THE PRESIDENT
OF THE
GENERAL ASSEMBLY

21 May 2009

Excellency,

I have the honor to provide herewith a preliminary draft of the full Report of the Commission of Experts of the President of the U.N. General Assembly on Reforms of the International Monetary and Financial System.

Although the document remains a work in progress, it contains the full background and explanations of the recommendations that were prepared for the March 25-27 interactive thematic dialogue. It also includes some additional recommendations, as well as amendments to earlier formulations of key issues and proposals.

I am confident that the draft report will serve as a valuable input to Member States as they prepare for the Conference. Likewise, I have instructed that the text be made available to Observers, as well as key stakeholders and civil society and the business community. Comments on the report should be sent to Mr. Eduardo Mangas, Deputy Chef de Cabinet, via e-mail at mangas@un.org

The Report will also be made available on the website for the Conference on the World Financial and Economic Crisis and Its Impact on Development: http://www.un.org/ga/econcrisissummit/

Please accept, Excellency, the assurances of my highest consideration.

Miguel d'Escoto Brockmann

All Permanent Representatives
and Permanent Observers
to the United Nations
New York

Report of the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System

(This is an unauthorized and unedited interim draft which is being circulated as a reference for the preparations for the UN Conference on the World Financial and Economic Crisis and its Impact on Development (1-3 June 2009). The intention is to solicit feedback and comments before the preparation and issuance of the final report.)

Chapter 1: Introduction

The Crisis: Its Origins, Impacts, and the Need for a Global Response

1. The current financial crisis, which began in the United States, then spread to Europe, has now become global. The rapid spread of the financial crisis from a small number of developed countries to engulf the global economy provides tangible evidence that the international trade and financial system needs to be profoundly reformed to meet the needs and changed conditions of the 21st century. The crisis has exposed fundamental problems, not only in national regulatory systems affecting finance, competition, and corporate governance, but also in the international institutions and arrangements created to ensure financial and economic stability. These institutions have proven unable to prevent the crisis and been slow to design and implement adequate responses. Indeed, some policies pushed by these institutions have facilitated the contagion of the crisis around the world.

2. This is a crisis emanating from the centre, which has now reached the furthest limits of the periphery. Developing countries, and especially the poor in these countries, are among the hardest hit victims of a crisis they had no role in making. Even emerging markets and less developed countries that have improved the management of their economies suffer declining output and employment. Indeed, those countries that have had the best performance in the recent past, and that have been most successful in integrating into the global economy; have been among the most badly affected.

3. Past economic crises have had a disproportionate impact on the poor, who are least able to bear these costs and who will bear consequences long after the crisis is over. Infants who suffer from malnutrition will be stunted for life. Children who drop out of school are not likely to return, and they will never live up to their potential. Future growth and employment prospects may be impaired if small firms are forced into bankruptcy. Economic policies must be particularly sensitive to these hysteresis effects.

4. It is important to recognize that what began as a crisis in the financial sector has now become an economic crisis; and that it is not only an economic crisis, but also a social crisis. According to the International Labour Organization, some 200 million workers, mostly in developing economies, could be pushed into poverty if rapid action is not taken to counter the impact of the crisis. Even in some advanced industrial countries, millions of households are faced with the threat of losing their homes and access to health care, while economic insecurity and anxiety is increasing among the elderly as they lose their life savings with the collapse of asset prices. The ILO estimates that unemployment in 2009 could increase by some 30 million compared to 2007, and could reach more than 50 million if conditions continue to deteriorate.

5. While the crisis began in the financial systems of advanced industrial countries, and then spread to the real economy, in many developing countries the initial impact of the crisis has been felt in the real sector, but is now spreading through the financial system. Developing countries are being affected through falling export demand and prices, accompanied by reversals of capital flows and reductions in remittances. While developed countries have the fiscal flexibility to respond—to stimulate their economies, to shore up failing financial

institutions, to provide credit, and to strengthen social protections, most developing countries have tighter budget constraints, and resources directed towards offsetting the impact of the crisis must be diverted from development purposes. Money spent to extend social protection may be at the expense of future growth.

6. While it is important to introduce structural changes to adapt the international system to prevent future crises, this cannot be achieved without significant immediate measures to promote recovery from the current crisis, but to the extent possible, these measures should promote, or at least be consonant with, the needed long run structural changes.

7. The welfare of developed and developing countries is mutually interdependent in an increasingly integrated world economy. Short term measures to stabilize the current situation must ensure the protection of the poorest in the least developed countries, many of whom are in sub-Saharan Africa and will bear a heavy burden of adjustment while long term measures to make another recurrence less likely must ensure sustainable financing to strengthen the policy response of developing countries. Without a truly inclusive response, recognizing the importance of all countries in the reform process, global economic stability cannot be restored, and economic growth, as well as poverty reduction worldwide will be threatened.

8. At the same time, the international community cannot focus exclusively on immediate measures to stimulate the economy if it wishes to achieve a quick robust recovery. This crisis is, in part, a crisis in confidence, and confidence cannot be restored unless steps are taken to begin the more fundamental reforms required, for instance through improved regulation of the financial system.

9. Any solution—short term measures to stabilize the current situation and long term measures to make another recurrence less likely—must be global, and must pay due attention to impacts on all countries and all groups within society.

10. Any inclusive global response will require the participation of the entire international community. To respond to this need, the President of the General Assembly created the present Commission of Experts to identify measures needed to meet the crisis and to recommend longer term reforms, giving explicit attention to the needs of developing countries. Recognizing work undertaken by the G-7/8 and G-20, and others, the Commission sees its own work as complementary, seeking to focus on impacts and responses to the crisis on poverty and development.

11. Reform of the International system must have as its goal the better functioning of the world economic system for the global good. This entails simultaneously pursuing long-term objectives, such as sustainable and equitable growth, the creation of employment in accordance with the "decent work" concept, the responsible use of natural resources, reduction of greenhouse gas emissions, and more immediate concerns, including addressing the challenges posed by the food and financial crises. As the world focuses on the exigencies of the moment, long standing commitments to the achievement of the Millennium Development Goals and protecting the world against the threat of climate change must remain overarching priorities; indeed, both the immediate steps taken in response to the crisis and the longer term global reforms should provide an opportunity to accelerate

progress toward meeting these goals. While the world will eventually recover from the global economic crisis, the resolution of other challenges, including that posed by global warming, and those posed by the potential shortage of food and water, will require additional measures. The conjunction of huge unmet global needs, including responding to the challenges of global warming and the eradication of poverty, in a world with excess capacity and mass unemployment is unacceptable.

12. Ten years ago, at the time of the Asian financial crisis, there was much discussion of the necessity for rapid reform to the global financial architecture if the world were to avoid the occurrence of another major crisis. Little—too little, it is now evident—was done. It is imperative that we provide an adequate immediate response to the current crisis, but also that we begin the long run reforms that will be necessary if we are to have a more stable, prosperous and balanced global economy. We must try to avoid future global crises.

13. Both developed and less developed countries must recognize that globalization must meet the needs of all citizens of the world. While it promised to help stabilize global financial markets and reduce the scale of domestic economic fluctuations, it failed to do so. Rather it served to facilitate contagion from one country to another. A failure in one economy is now leading to a global recession or depression. And unless something is done, and is done quickly, those in developing countries are likely to be among those who suffer most.

14. This report presents an analytical framework for understanding what has gone wrong and possible remedies. It presents both broad perspectives on policies and specific recommendations. This chapter provides an overview of some of the key issues and policy frameworks and perspectives. As noted, the crisis is both a financial crisis and an economic crisis. It has both macro- and micro- aspects. It began as a failure in the financial sector, but the problems in that sector were in part a result of underlying macro-economic problems, such as growing global imbalances and growing income inequalities within and between countries. The fact that existing global institutions did little to prevent the crisis, and the delays in developing adequate responses to the crisis, suggest that there are important institutional problems that the international community needs to address. The frequent crises that have accompanied globalization, with problems in one country quickly spilling over creating problems in others, suggests the need for reform of the international financial system to meet the needs of an increasingly interdependent world economy. The fact that a major impact of these crises has been in the poor and the developing countries makes it clear that there are inadequacies in global market and non-market mechanisms for managing financial risks.

15. The current economic crisis should provide an opportunity to reassess global economic arrangements and prevalent economic doctrines. Large changes have occurred in the global economy in recent years, e.g. in the sources of global savings, reserves and GDP, and these are not fully reflected in our global economic institutions and arrangements. As we address the short run crisis, we should seize the opportunity for making deeper reforms that enable the world to enter the twenty-first century with a more equitable and stable global financial system, one which could usher in an era of enhanced prosperity for all countries.

The Institutional Response to the Crisis

16. There have been unprecedented efforts to address the crisis. The stimulus measures introduced by many countries around the world will dampen the impact of the crisis. However, it must be recognised that there can be no return to the *status quo ante*. It is essential that governments undertake reforms that address the underlying factors that contributed to the current economic crisis if the world is to emerge from the crisis into sustainable, balanced growth. In this respect failure to act quickly to address the global economic downturn and more fundamental problems would increase the depth and duration of the crisis, making it more difficult and more costly to create a more balanced robust recovery.

17. Most of these longer-term reforms are not just luxuries, to be undertaken at leisure once the recovery is assured; they are essential to the recovery itself. Moreover, there is substantial risk that unless work on these more fundamental reforms is undertaken now, momentum for reform will be lost with the recovery. There are strong political forces at play: those who have benefited from existing arrangements will resist fundamental reforms. But allowing these interests to prevail would ensure the recurrence of crisis. This is one of the lessons to be learned from the Asian financial crisis of 1997-1998.

18. The urgent need to respond to the crisis has been highlighted by the meetings of the Heads of Government of the Group of Twenty in November in Washington and in April in London. These have led to commitments to undertake large fiscal expenditure packages, to introduce significant regulatory reforms, and to provide some increased assistance to developing countries. These are important initiatives, but more important is the recognition that the global nature of the crisis means that it cannot be solved by a small group of advanced industrialized countries, but must be addressed in a more inclusive framework. Nonetheless, the actions proposed and the processes by which decisions are made and implemented are not ideal.

19. First, and most importantly, the decisions concerning the necessary reforms in global institutional arrangements must be made not by a self-selected group (whether the G-7, G-8, G-10, G-20, or G-24), but should be taken by all the countries of the world, working in concert. This inclusive global response will require the participation of the entire international community; it must encompass representatives of the entire planet, from the G-192.

20. While discussions and proposals among smaller groups will necessarily play an important role in developing a global consensus on key and complex issues, decision making must reside within international institutions with broad political legitimacy, and with adequate representation of both middle income countries and the least developed countries. The only institution that has that broad legitimacy today is the United Nations. This suggests that appropriate framework for the proposed Global Economic Coordination Council is in relation to the UN system as a whole, rather than exclusively in relation to the United Nations Organization. For more discussion of this, see chapter 4.

21. Better representation and democratic legitimacy would not require the presence of all countries in all deliberations. Working committees, selected by mechanisms that ensure democratic selection, could be limited to a size that would ensure effective decision making.

The fact that all existing democracies have been able to achieve satisfactory solutions to these problems suggests that they are not irresolvable.

Policy Responses to the Crisis

22. Sustainable responses to the crisis require identifying the factors underlying the crisis and its rapid spread around the world. There have been policy failures at both micro- and macro-economic levels. Loose monetary policy, inadequate regulation and lax supervision interacted to create financial instability. "Reforms" over the past quarter century have exposed countries to greater instability and reduced the impact of "automatic" stabilizers. In some countries, social protection has been weakened, with the result that the adverse consequences of major crises such as the one the world is now facing have been especially hard on the poor.

23. At the global level, some international institutions continue to recommend policies, such as financial sector deregulation and capital market liberalization that are now recognized as having contributed to the creation and rapid diffusion of the crisis. The inadequate responses to the last global crisis in 1997-1998 led to a change in policy frameworks that brought increasing levels of reserves, and contributed to the large global imbalances whose disorderly unwinding was widely feared.

24. Part of the reason financial regulation was so ineffective lies in inadequate appreciation of the limits of markets—the prevalence of what economists call "market failures." While such failures arise in many markets, they are particularly important in financial markets and can have disproportionately large consequences as they spill over into "real" economic activity.

25. The conduct of monetary policy in the United States both prior to and after the crisis can be viewed in part as an attempt to offset an insufficiency of global aggregate demand, aggravated by increasing income inequality in most countries.

26. In many countries, the focus of monetary policy was on price stability, rather than other factors that might contribute to long-term growth and stability, because it was believed that low inflation was a necessary and (an almost) sufficient condition for economic prosperity. It should now be clear that monetary authorities should recognize the consequences of their policy decisions on financial stability.

27. The current crisis reflects problems that go beyond the conduct of monetary policy and regulation of the financial sector; it has exposed a flawed understanding of the functioning of markets. The belief that unfettered markets are, on their own, quickly self-correcting and efficient led national authorities and international institutions to support measures to deregulate financial markets.

28. This suggests that it is necessary to review the policies currently advocated by international institutions, such as the International Monetary Fund, the World Bank, the Regional Development Banks, and the WTO, and in their support of developing countries' response to the crisis.

A Global Crisis Needs a Global Response

29. The current crisis may be considered a manifestation of economic externalities at two levels. First, the failure of financial markets affected an externality on the real sector. Secondly, in a globally integrated world, the actions of any one country have effects on others. Too often these externalities are not taken into account in national policy decisions. Developed countries in particular need to be aware of the consequences of these externalities, and developing countries need frameworks to help protect them from regulatory and macro-economic failures in the major industrialised countries. Ironically, much of the effort to coordinate international economic policy has focused on putting constraints on countries whose behaviour is not systemically significant, while doing little about countries whose policies can have systemically significant consequences.

30. Similarly, the importance of externalities is often ignored in the design of countries' policies in response to crisis. Presently, there is a risk that countries may undertake insufficient expansionary measures because some of the benefits of their policies (such as deficit financed expenditures) accrue to those outside the country. As a result, without global cooperation, countries may spend less than the optimal amount on stimulus packages, as they balance the benefits of the stimulus with the cost of extra debt burdens, and/or try to distort their stimulus packages so that more of the benefits accrue domestically. The net result is that the overall global stimulus impact will be sub-optimal: all may suffer.

31. The introduction of protectionist policies to improve conditions at the expense of trading partners is an example of the negative impact of externalities on recovery from the crisis. Such beggar-thy-neighbour policies contributed to the depth of the Great Depression. Countries attempted to augment the domestic impact of expenditure policies through competitive devaluations or restraints on trade such as quotas and tariffs. Such moves proved to be counterproductive. In the current situation, explicit moves in this direction, at least of the magnitude and transparency of those that occurred in the Great Depression may be unlikely, but more subtle versions of such protectionism are already occurring. It is a matter of concern that although the G-20 resolved not to engage in protection measures in their meeting in November, by April, nearly all had broken that pledge. Particularly disturbing are protectionist measures directed against developing countries.

32. It has long been recognized that subsidies can be just as disturbing to a free and fair trading system as tariffs—and in some ways they are far more inequitable, because rich countries have greater resources to support them. Measures designed to offset the impact of subsidies in developed countries reduce the availability of already scarce development funds. In the current crisis, developed countries have provided unprecedented subsidies, primarily in the form of financial support for domestic financial and non-financial enterprises. Developing countries cannot match in breadth and scale these subsidies. Even the knowledge that there may be a rescue if things go badly gives firms in advanced industrial countries a distinct advantage; they can undertake risks that those in poorer countries cannot. This highlights the lack of coherence between existing global macro and financial arrangements, policies, and frameworks and those governing trade. Whether there ever was a level playing field may be debated; that there is no longer one cannot be.

33. Other measures taken in response to the crisis are implicitly protectionist. International banks that have received government support from their home governments may be encouraged to reduce their lending in developing countries to ensure that domestic lending increases. Or banks which have received large amounts of public money may do so even without explicit governmental oversight, because of worries about adverse political reactions. Such financial market protectionism exacerbates long standing asymmetries in the functioning of global financial markets.

34. Unless actions are taken to curb financial market and other forms of implicit and explicit protectionism, and to provide developing countries with compensatory payments to offset the distorting effects of bail-outs and guarantees and funds with which to engage in expansionary fiscal policies, there is a risk that the global imbalances which contributed to the crisis will increase.

35. A lack of resources is a major impediment to the introduction of strong stimulus packages in developing countries. The Report thus calls for a substantial increase in resources available to developing countries, not just to undertake stimulus measures, but to cope with the negative impact of the crisis. Funding will be needed to shore up their banking systems, provide credit, including trade credit, and strengthen social protection. Developing countries should have expanded scope to implement policies that will allow appropriate counter-cyclical policies and to design other structural policies consonant with their needs, objectives, and situation.

Reforming the international institutions

36. It is apparent that the conditionalities that were often imposed by international institutions in their support of developing countries were counterproductive. The demand that countries implement short run pro-cyclical policies exacerbated downturns, while long run structural policies exposed countries to greater risk and undermined social protection. It is important to design reforms that prevent, or at least reduce the likelihood, of such counterproductive policies in the future. Part of the answer is to be found in the reform of the governance structures of the international institutions.

Some Basic Principles

37. In addressing the crisis, several other basic principles—besides, for instance, acting with all due speed, paying attention to externalities, and avoiding protectionism, should guide the responses of the international community.

Restoring balance between the market and government

38. The crisis is, in part, a result of excessive deregulation of financial markets. Restoring the global economy to health will require restoring a balance between the role of the market and the role of the state. Both the global economic crisis and the global climate crisis are associated with massive externalities which can only be addressed by appropriate collective action at the national and the global level.

Greater transparency and accountability

39. Greater transparency on the part of all parties in responding to the crisis is necessary. More generally, democratic principles, including inclusive participation in decision making, should be strengthened and respected. Regrettably, in responding to the crisis, many governments, have undertaken non-transparent actions, and relied heavily on Central Banks, with only limited direct democratic accountability. Some Central Banks, with only limited direct accountability, have introduced without parliamentary/Congressional approval measures in support of financial institutions that have exposed taxpayers to massive risks.

Short run actions consistent with long run visions

40. In taking policy actions it is imperative that they do not exacerbate the current crisis through their impact on other countries or result in structural changes which increase future instability or reduce future growth. For example, in some countries the response to the crisis created by excessive risk undertaken by financial institutions that were too big to fail has resulted in bank consolidation which increases such risks in the future.

Assessing distributive impacts

41. Any economic policy, including those responding to crises, has large distributive consequences, both within and between countries, and policy makers need to be attentive to those consequences. As noted, previous financial and economic crises have had particularly adverse effects on poverty, but the strategies employed to address the crisis have sometimes resulted in exacerbating income and wealth inequalities. Bank bail-outs and restructurings have played a particularly important role in these adverse redistributions. For example the unprecedented lowering of interest rates may have been the correct macro-economic response to the crisis, but it has produced a sharp reduction in the income of retirees who did not gamble and invested prudently in government securities. In the East Asia crisis, high interest rates were imposed as a condition for international assistance. Small businesses, which found themselves unable to bear the burden of debt, were forced into bankruptcy.

Avoiding an increase in global imbalances and asymmetries

42. There are large inequalities in the global economy and large asymmetries in the global economic framework. It is important that the measures introduced to respond to this crisis seek to reduce, not exacerbate, these inequalities and asymmetries. For instance, countercyclical policies are pursued by developed countries, while most developing countries pursue pro-cyclical policies. As noted, this is a result of both the availability of resources to engage in countercyclical policies, and restrictions on “policy space,” resulting from conditions imposed on countries seeking assistance from international institutions. But even symmetric policies can have asymmetric effects: guarantees provided to financial institutions in developed countries cannot be effectively matched by developing countries.

Distribution and Incidence of Risk

43. All economic policies involve risks and uncertainties, but under different economic policies, different groups may bear the brunt of this risk. An aggressive stimulus policy may, for instance, increase the risk of inflation from over-stimulation, and those with long-term

investments with fixed nominal returns (such as bondholders) may suffer. A weak stimulus may lead to the risk of prolonged unemployment, with workers suffering.

Irreversibilities (hysteresis effects)

44. Policies need to be sensitive to non-linearities and problems of irreversibilities. Some policy mistakes are easy to correct, others are not. It may be easier to damp down demand in an economy which looks like it faces a risk of overheating, than to resuscitate a dying economy. Reversing policies that have lead to the bankruptcy of a firm cannot bring it back to life. These simple maxims of risk management need to be borne in mind in designing responses to the crisis.

Intellectual diversity

45. While much of the support for globalization and the changes in economic policy (e.g. in deregulation) over the past quarter century may have been driven by particular interests, it was also premised on economic doctrines whose theoretical foundations and empirical bases were, at best, questionable. Modern economic theory has brought into question many of the ideas underlying market fundamentalism, including the notion that unregulated markets would lead to efficient outcomes, or that markets were self-regulating and stable. The current economic crisis has raised further questions concerning these doctrines, and has highlighted the relevance of alternative theories and ideas. Any approach to addressing the current economic crisis and preventing future episodes must be robust, in the sense that the conclusions and policy prescriptions cannot rely on economic doctrines in which there is or should be limited confidence. Some international institutions have advocated notions of competitive pluralism, encouraging the creation of a market place of ideas, while others have tried to enforce a single-minded adherence to a particular ideology that the crisis has been shown to be inadequate. Strengthening diversity of ideas may contribute both to global stability, and to a strengthening of democracy.

46. The crisis also highlights that the standard nostrums, that countries should have sound macro-policies, strong governance, including transparency, and good institutions, may be less than helpful: countries that held they to be models of best practice have been shown to have had deeply flawed macro-policies and institutions, and suffer from major shortfalls in transparency.

Impact on developing countries

47. The crisis is likely to extract a particularly high toll on developing countries for four reasons.

48. First, the citizens of these countries have fewer resources with which to cope with a crisis of this magnitude.

49. Secondly, they already suffer from a lack of automatic stabilizers due to the embryonic nature of their fiscal and social protection systems.

50. Third, “markets” impose constraints on their ability to pursue countercyclical fiscal and monetary policies. Many are forced, for instance, to pursue pro-cyclical fiscal policies because in a downturn, tax revenues decline, and they cannot find adequate financing for existing, let alone, expanded, government expenditures. In this crisis especially, many firms and countries will face credit constraints and higher borrowing costs because capital flows to developing countries are likely to be markedly lower this year and risk premia have increased substantially. To retain foreign investors, countries may be tempted to raise interest rates, with the obvious adverse effects on the real economy. But as in the East Asian and global financial crises, such interest rate increases may not have the desired consequences and reduce economic growth as the economy slows, confidence erodes and capital is repatriated. Thus, the risk adjusted interest rate may even fall as the nominal interest rate is increased.

51. Fourth, these ever-present threats have been exacerbated by financial market integration. Countries that have fully opened their capital accounts, have engaged in financial market liberalization, and relied on private finance from international capital markets are among those most likely to be most adversely affected. Many countries have come to rely on foreign banks, some from countries that were poorly regulated and that followed inappropriate macro-economic policies and now find their capital badly impaired. These institutions are now repatriating capital, with obvious adverse effects on developing countries. The difficulty is compounded by the fact that many developing countries have entered into free trade agreements (FTA), bilateral investment treaties (BIT) and World Trade Organization (WTO) commitments which enshrine the policies of market fundamentalism noted above and limit their ability to regulate financial institutions and instruments or manage capital flows.

52. In the past, those developing countries that have accessed IMF financing have been constrained by international financial institutions to adopt restrictive policies in times of slow growth or even recession. Such pro-cyclical policies are counterproductive, since one of the purposes of assistance should be to enable developing and emerging markets to stabilize their economies. But in the current global crisis, it is not just the developing countries which are forced to adopt such policies that suffer; the entire global economy suffers. Effective international response requires all countries to engage in expansionary policies—*including developing countries.* The purpose of IMF assistance is, in part, to enable the developing countries to participate in this global effort. Even without these artificially imposed constraints, the natural market constraints referred to earlier may impede developing countries, even those receiving assistance, from having as strong countercyclical policies as would be desirable.

53. The legacy of past imposition of pro-cyclical policies may itself exert a depressing effect on developing countries today unless there are strong and clear signals of a marked change in the policy regime. These countries may have to pay higher risk premia in the current crisis as market participants know that they are likely to face a deeper and longer downturn than they would have had if they had been allowed to pursue more countercyclical policies. Unfortunately, the signals are mixed: Constraints on implementing countercyclical policies have become apparent in the current crisis in the conditions attached to IMF programmes in several countries.

54. More broadly, developing country dependence on IMF financing has not only constricted policy space for countercyclical policy, concern about future imposition of these

constraints has contributed to the building of reserves and global imbalances. Unless the policy regime is changed, incentives for further build-up of reserves could increase, impairing the ability of the global economy to emerge quickly from the global economic crisis.

55. If appropriate measures from the international community are not taken quickly, developing countries may in fact be hurt rather than helped by the responses of developed countries to the crisis. Global imbalances may be increased. In the short and medium term, it is necessary that developing countries undertake a variety of countercyclical policies, including social protection measures, infrastructure development, and credit guarantees, and it is imperative that developed countries provide them with appropriate assistance and policy space to do this. Such measures may also ensure fair global competition.

56. The major focus of this Report is on short term measures and the longer term reforms of the international financial and system that support the developing countries and their aspirations for development. As noted above, developing countries will bear the greatest costs of the crisis, but do not have the resources necessary to deal with its negative impacts. Measures are very quickly needed to avoid further deepening of the crisis in emerging and developing countries, including for restoring and expanding social protection, and reducing the pro-cyclical features of the economic policy. Delay will mean that the eventual cost of dealing with the problem will be higher and the length and depth of the downturn will be greater, with more innocent victims losing their jobs, with more small—and even large—businesses forced into bankruptcy, with public finances increasingly put into jeopardy. The consequences of our failures now may be felt for decades to come.

Chapter 2: Macro-Issues and Perspectives

1. While the current economic crisis is global in its causes and ramifications, the responses to the crisis have been decided and implemented at the national level. Little attention has been given to the global externalities and the spillovers that arise out of uncoordinated decisions at the national level. The challenge raised by the crisis is to design a framework and roadmap for a coordinated, global response that recognizes the differing constraints facing individual countries and in particular the most vulnerable developing countries.

2. Coordination is essential to the success of the different actions currently being implemented by governments in response to the crisis because the impact of individual policies will depend on actions undertaken by other countries. It is important that national governments recognize that their policies will be more effective in protecting their citizens from the crisis if they are internationally coordinated.

3. Coordination failure can lead to growing global imbalances and an increase in exchange rate and asset price volatility, and these will impair a return to robust growth. The protectionist measures introduced in response to the crisis will impede the speed of global recovery

4. National policies may have unintended and unforeseen protectionist effects. While some measures designed to protect the well being of domestic populations, such as guarantees and bail-outs, may not be intended to provide trade protection, they may nonetheless create preferential treatment for domestic firms. It is thus important to design measures that protect domestic residents without increasing trade protection. It is necessary o find ways of providing social protection without protectionism. One of the major lessons of the Great Depression was that protection may be counterproductive. In current conditions the effects of protectionism may be even worse because of the increased global integration of trade and production.

5. Developing and emerging countries are especially exposed to these kinds of adverse effects. A globally "balanced" response to the crisis will thus require coordination of the national recovery programmes and a substantial increase of assistance for developing countries through increased official assistance and the creation of new credit facilities.

6. The objectives of national and international policy should be a quick recovery and protecting the vulnerable that are likely to be most adversely affected, and doing so in ways that promote equitable, democratic, environmentally and socially sustainable development. It should, at the same time, facilitate the necessary restructuring of national economies and the global economic system.

The Sources of the Crisis

7. There are many "failures" behind the current financial crisis. Other parts of this Report discuss failures in the regulation of developed country financial systems and management of risk. But "macro-economic" failures were part of all other failures. It is important to understand these interrelationships in order to design policies that will allow the global

economy to emerge from the crisis with robust growth and to make a recurrence of the crisis less likely.

8. Clearly, the sub-prime crisis which led to a wider crisis in credit markets was partly engendered by an "excess" supply of liquidity and the failure of the central bank in the United States and some other advanced industrial countries to act to restrain liquidity and dampen the speculative increases in housing prices. While lax financial regulation may have contributed to the particular *form* taken by the crisis, the magnitude of the excess liquidity, and other associated factors, made further difficulties inevitable.

9. While problems initially appeared in the financial sector, the origins of the problem are deeper, and cannot be addressed *simply* by repairing the "plumbing" of the financial sector. For example, inadequacies in competition policy and corporate governance discussed in Chapter 3 were of major significance.

10. Focusing attention on the failures of public policy should not, however, detract attention from the underlying market failures. Financial markets mismanaged risk and misallocated capital. Had markets done what they should have the availability of capital at low cost could have led to large increases in productivity—rather than the further impoverishing lower income Americans.

11. This crisis has much in common with several other financial and economic crises, including the Great Depression. It is clear that economic policies have not fully taken account of the lessons of those crises. Part of the reason for this lies in economic doctrines that became fashionable in some quarters during the last three decades.

12. As the international community frames an immediate response to the crisis, it would be a mistake to forget the broader context. The present chapter thus focuses on macro-economics—both the underlying macro-economic problems and the necessary macro-economic responses, trying to identify policy responses that may even make recurrence of the crisis more likely.

Role of economic doctrines

13. Part of the explanation of the current crisis may be found in the underlying economic fundamentals. Another is in the economic theories that motivated the financial and economic policies which produced the crisis. A more detailed discussion of the impact of these economic doctrines on regulatory policy is found in Chapter 3. These same economic doctrines--the belief that economic agents are rational, that governments are inherently less informed and less motivated by sound economic principles, and therefore their interventions are likely to distort market allocations, and that markets are efficient and stable, with a strong ability to absorb shocks--also affected macro-economic policies.

14. One of the most important lessons of the Great Depression was that markets are not self-correcting and that government intervention is required at the macroeconomic level to ensure recovery and a return to full employment. In the aftermath of the Great Depression, governments introduced policies that provided automatic stabilizers for aggregate demand and implemented discretionary policy frameworks to reduce economic instability. But as the

Great Depression and earlier panics and crises faded from memory, confidence in the self-stabilising nature of the market returned.

15. The fact that the world recovered so quickly from financial crises such as the East Asian crisis of 1997 and the global liquidity crisis of 1998 induced false confidence in the self-correcting nature of market processes. The historical role of government intervention in recovery and stability was forgotten.

Changes in the global economy

16. The level of international economic interdependence may also have contributed both to an increase in economic vulnerability of the global economic system to external shock or to insufficiency in aggregate demand.

17. In some countries, the weakening of social protection and the reduction in the progressivity of income tax systems weakened the automatic stabilizers. In others it led to a structural decline in domestic consumption levels, and thus to a decline in the multiplier. Too often in national policy discourse, and even in some theoretical discussion, globalization was used as a pretext for competitive reductions in social protection, creating a global race to the bottom.

18. Constraints imposed in the European Union by the Stability and Growth Pact, and concerns in other countries about the size of fiscal deficits and national indebtedness may impair the use of countercyclical fiscal policies to respond effectively to shocks, including the extra-ordinary shock that the world faces today.

19. However, in the absence of loose monetary policy and lax regulation that characterised the period before the crisis it is likely that there would have been an insufficiency of aggregate demand in the United States caused by growing inequality in income and wealth distribution. The expansion in lending associated with new risk management practices, deregulation, and accommodating monetary policy offset this tendency by allowing consumption to grow more rapidly than incomes through increasing household indebtedness. In the presence of policies in many developing countries to encourage external trade surpluses as a defence against international financial volatility this led to ever increasing global imbalances.

Growing inequality as a source of the crisis

20. Although economic globalization has supported rapid growth, it has also produced increased volatility in incomes and increasing income inequality. It has not only been associated with increasing inequality of income within developing countries, but also between developing countries and between developed and developing countries. Inequality has also increased within developed countries. When combined with changes in financial markets, this growth in inequality has had important consequences for the evolution and resolution of the crisis.

21. It is now recognized that in most advanced industrial countries, median wages stagnated during the last quarter century, while income inequalities surged in favour of the upper

quintiles of the income distribution. In effect, money was transferred from those who would have spent to meet basic needs to those who had far more than they could easily spend. This created a downward tendency in aggregate effective demand.

22. There were many forces contributing to this growth in inequality, including asymmetric globalization—especially the greater liberalization of capital than of labour movements--weakening of labour unions, deficiencies in corporate governance, and a breakdown of social conventions, which resulted in greater disparity in compensation between top executives and average workers. Finally, it was believed that increased incentives would increase saving, labour supply, and investment and thus growth. These problems were exacerbated by the reduction of progressivity in tax structures in some countries. In most OECD countries the highest tax bracket rate has been reduced by more than 10 percentage points on average.

23. The negative impact on rising income inequality on aggregate demand was largely offset by increased indebtedness of households, especially in the United States and some other developed countries such as the United Kingdom. But the high level of indebtedness was not sustainable.

24. It is possible to argue that the increase in public debt in some OECD countries was partly the consequence of the evolution of the distribution of income. In advanced countries such as in the European Union the social protection system compensated for stagnating income in a context of high unemployment, but was accompanied by increasing public deficits and public debt.

25. In countries where the social protection system is much weaker (e.g. the US), increased household borrowing may have enabled a postponement of a decline in living standards and consumption in tandem with the decline in real wages .

26. The 2001 and 2003 tax cuts in the United States provided little stimulus to the economy but had a negative impact on the deficits and government debt, placing a greater burden on monetary policy to sustain the economy at full employment.

27. The Iraq War and other events which helped set off an increase in the price of oil had a further depressing effect on countries which import energy, including the U.S. The magnitude of the increase in energy prices may have been exacerbated by speculation. This change in the price of energy contributed to higher food prices as a result governments' attempts to develop alternative bio energy sources. The sharp increase in energy prices thus directly and indirectly brought further reductions in purchasing power within many countries. The transfer of income from those who suffered from these price increases to those who benefited weakened global aggregate demand and contributed to the global imbalances which played an important role in the crisis.

28. While the negative impact of income inequality and energy, commodity and food inflation was thus temporarily offset by mounting private and public debt, it should have been clear that this was not sustainable. But those responsible for macro-economic management, including monetary authorities, in part blinded by certain economic doctrines, failed to recognize this and take appropriate actions.

29. Policy responses designed to ensure a robust recovery from this crisis must also address the problem of how growing income and wealth inequality might be reversed. Should the trend towards reducing the progressivity of the fiscal system be reversed? Should some harmonization of businesses taxation throughout the world be advocated? Should changes in inequality inside each country become public knowledge through a yearly parliamentary debate?

30. One thing seems to be certain: fiscal competition of the type which dominated the golden years of globalization is not sustainable. This is for at least two reasons. The first is its contribution to the rise in inequality through regressive redistribution of income; the second is the brake it puts on the capacity of the state to provide public goods to the population (which also contribute to the rise of inequality).

Global imbalances and imbalances in global aggregate demand

31. Part of the reason that the United States was able to sustain an expanding external deficit was the decision of many emerging countries to respond to the financial crises in the 1990s by adopting policies to strengthen their external balances. The resulting increase in foreign exchange reserves, along with the increasing reserves accruing to oil producing countries from the rise in oil prices, were invested in official dollar assets, provided the financial counterpart to the rising US external deficits.

32. What appeared to be an unending increase in what came to be known as global imbalances raised concerns that they were unsustainable. A disorderly unwinding of the imbalances could generate a global financial disruption or exchange rate crisis. But those responsible for global macro-management did not take appropriate action, highlighting deficiencies both in the arrangements for macro-economic management and in the economic doctrines that govern economic policy.

33. There were several reasons why many emerging markets chose to adopt policies to strengthen their external accounts that led to an accumulation of foreign reserves amounting to $4.5 trillion in October 2008. The first was to ensure a defence against external instability due to volatile external financial flows. Countries with insufficient reserves had paid high economic and political costs in the East Asia and global liquidity crises of the end of the previous decade. The loss of economic sovereignty associated with the imposition of pro-cyclical macroeconomic conditionality as part of IMF support programmes has been a source of particular concern to many countries. In addition, some countries had adopted exchange rate stabilisation as part of their policies to ensure external balance and stability, and built up substantial reserves as a result of attempts to prevent exchange rate appreciation, with its adverse effects on economic development (as discussed further in chapter 5).

34. Moreover, many emerging markets, especially those deriving export incomes from the sale of primary commodities, had been made aware of the high commodity price volatility. Speculative activity in recent years may have increased this volatility. Prudential behaviour in response to this volatility required building up of substantial reserves, for when these prices might fall. Those that built up these reserves are now glad that they did so.

35. The collapse of the US mortgage market produced a sharp increase in household saving and a decline in investment in the US. Other countries also had real estate bubbles, and these bubbles too burst, with similar consequences. These problems precipitated problems in financial markets, discussed more extensively in the next chapter. The problems of bad lending were aggravated by high leverage and other risky behaviour, as well as by a lack of transparency. The resulting collapse of credit reinforced the underlying weakening of aggregate consumption, leading to a rapid decline in global aggregate demand. Declines in final demand and increasing cost and decreasing availability of credit led to inventory adjustments which accelerated the downward movement in global GDP. But it is important to note that while the inventory adjustments may have aggravated the crisis, they are not part of the underlying cause; and thus, even when these inventory adjustments are completed, there will not be an end to the downturn.

36. Indeed, unless the response to this crisis provides a coordinated policy to support global demand it is possible that the problem of global imbalances may be exacerbated. With countries facing the threat of high volatility in export earnings and global financial flows, it is rational for countries to have precautionary savings to act as insurance against future potential calamities. While it is rational for individual countries to "insure" against another crisis through the build-up of external surpluses and foreign reserves, doing so weakens aggregate demand. The absence of alternative ways of obtaining "insurance" may not only impair the ability of the world to return to a robust recovery, but also lead, in the long run, to further instability. The implication is that a reform of the Global Reserve Currency System and other forms of risk mitigation is imperative. Proposals for how this may be done are taken up in Chapter 5.

37. It is possible that when many countries simultaneously attempt to build up reserves the global economy will suffer from generalised insufficiency of aggregate demand—a global version of the well-known paradox of thrift.

38. It is important that the international community not only address the issue of risk mitigation but also the underlying sources of volatility. Commodity price speculation, as we have noted, probably contributed to the magnitude of price volatility. Reforms in the global financial system, in particular capital market liberalization have facilitated international contagion and thereby increased the risk of volatility originating from abroad.

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Instability and *built in de-stabilizers*

39. Another major source of concern is the instability of the economic system—the extent to which it responds to any shock which it faces. As noted above, economic systems may have become more unstable as a result of weakening of both public and private automatic stabilizers through the reductions in the progressivity of tax structures, weakening of safety nets, greater wage flexibility, and the movement from defined benefit to defined contribution schemes[1]. New bank regulations, including mark to market accounting, may actually have resulted in built-in de-stabilizers.

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1 Under present abnormal circumstances, with companies unable to access credit markets to smooth shocks, the relative shocks could even reverse.

40. An important part of the response to the crisis should therefore be the strengthening of the automatic stabilizers, and more broadly the adoption of policies that not only reduce the shocks to which economies are exposed, but dampen the responses. Chapter 3 discusses one important reform instituting countercyclical capital adequacy and provisioning standards.

41. Flexible unmanaged exchange rate regimes may, in particular, expose developing countries to high levels of volatility, especially when combined with certain monetary policies. Countries that raised their interest rate in response to high food and energy prices saw large appreciations of their currency; and this has now been followed by large depreciations. Such volatility exacts a heavy toll on developing countries.

International Responses: Fiscal Policy

The need for and the nature of a globally coordinated response

42. This crisis is different from the financial crisis of 1997-1998. Then the affected countries used exchange rate adjustments and other policies to export their way out of the crisis. In a global crisis affecting all countries this solution is not possible. It is thus imperative that all countries take strong, coordinated, actions to stimulate their economies.

43. There will be some temptation for countries,-especially those with small, open economies, to avoid taking action and benefiting from the expansion that will result from stimulus policies introduced in other countries. As countries balance the trade-off of the benefits of expansion against the costs of increased debt financed government spending, the risk is that they will undertake insufficient action (when viewed from a global perspective) and, as result, that the global stimulus will be deficient. If all countries think in this way, the global downturn will be more prolonged. Rapid recovery depends on there being no free riders.

44. Moreover, countries will look for those forms of expenditure which have the largest domestic multipliers. What is at stake is illustrated by the fact that national expenditure multipliers are generally believed to be around 1.5, due to leakages of demand abroad through increased imports. But from a global perspective there can be no such leakages (though multipliers will still be limited by savings), so that multipliers for a coordinated global expansion are in reality much larger.

45. The implication is that a global crisis requires a global stimulus—it is much like a global public good. The level of the global stimulus that is desirable is greater than the level that would be implemented by each country thinking only of itself. Moreover, if every country attempts to maximise the domestic impact of its stimulus policies the domestic and the global effectiveness of the policies measured in the expansionary impact per dollar spent will be reduced.

46. Similarly, there will be a temptation in many countries to maximise the domestic impact of their stimulus policy expenditures by introducing protectionist measures that limit leakages of demand into imports from foreign countries. Such measures are more likely to be introduced if countries perceive that others are free riding on their efforts. While these

measures may be introduced with the best of intentions, to maximise social protection, they may not respect equal treatment trade principles, and when imitated by others, are likely to be counterproductive. The fact that so many countries have already introduced such protectionist measures should be viewed as a cause of concern. But even measures that are not designed to have protectionist effects may do so, as we note below. These protectionist measures—both the intentional and the unintentional—can be particularly harmful to developing countries.

47. There would be additional benefits from a globally coordinated fiscal response if significant proportions of those expenditures are directed at addressing global problems.

The need for stronger social protection

48. Social protection is not only an instrument of social justice, but also a major tool of economic stabilization. Well designed social protection systems make the economy more resilient to shocks by increasing the size of automatic stabilizers. Social protection systems have two components: the first is insurance against risks; this insurance enables smoothing of disposable income and the enhanced security is of value in its own right; the second component is progressive redistribution, to avoid exclusion and to prevent individuals from being trapped in poverty. Social mobility, ("giving to my children better opportunities than I had") is one of the engines of growth and prosperity. But social mobility is all the more likely when "counters are reset", at least partially, at each generation. One of the roles of social systems is a transfer of resources that helps reduce inequalities of initial conditions for the new generations.

49. Besides its role as an "insurance" against income and consumption fluctuations, especially for poorer households, social spending has a more direct effect. Increasing the collective supply of public goods would free part of the income that is now saved for precautionary purposes, and make it available for spending, including investment in both physical and human capital. In other words, social spending could "crowd in" private expenditure and raise the economy's current and future growth rate alike while decreasing its volatility.

Monetary Policy and Restructuring Financial Markets

50. It is equally important that monetary policy be coordinated across countries. Otherwise, there may be large, costly, and destabilizing exchange rate movements. But it may be difficult to achieve the necessary level of coordination, given different circumstances and different views of the role and objectives of monetary policy. Conventional monetary policy measures to combat the crisis appear to have been exhausted in several major countries. Interest rates in the U.S. and some other countries cannot go much lower. This is one of the reasons why most of the burden of the economic policy response to the crisis must now fall on the shoulders of fiscal policy.

51. Monetary policy operates by increasing the availability of money and credit and easing the terms at which credit is available. Much of credit availability is mediated through the banking and financial system. Providing more liquidity to financial institutions may not, however, lead to more lending. A kind of liquidity trap can arise in circumstances such as those the world is facing today. Banks with large risks to their balance sheets, which have

seen large erosions in their net worth, and facing prospects of high default rates on existing risky loans, are not disposed to increase lending. There may, of course, be overreaction: an episode of excess risk taking may be followed by an episode of excessive precaution. If that is the case, governments may take a more active role, in absorbing some of the risk of lending. Chapter 5 discusses some of the ways in which this may be done.

52. It is thus probable that traditional monetary policy by itself will have only limited effects in resuscitating the global economy; a reduction in interest rates will have an insufficient impact on aggregate demand unless there is an expectation of increased levels of activity and profits.

53. Monetary policy has traditionally focused on the overnight interest rate at which banks borrow from each other or from the Central Bank at the discount window. The spread between the policy interest rate and the interest rate at which firms or households can borrow in the medium and long term is an endogenous variable, which may actually increase as the policy rate falls. This may be because of changed inflationary expectations, or because other changes in the economy result in heightened risk perceptions for lenders. It is possible for monetary authorities to influence longer term interest rates for government securities and for private sector liabilities by opening the discount window to them or by buying them outright through open market purchases. However, this would require the Central Bank to assume risks that are beyond those that Central Banks have assumed in normal times through its lender of last resort function. It is important that when Central Banks assume such risks, that they estimate the future actuarial cost carefully and to the extent possible be reflected in the public domain.

54. When policy intervention involves the purchase of the liabilities of particular private sector issuers this may be equivalent to an implicit subsidy on the financing costs for that sector. If it is restricted to very large firms it may place small and medium sized firms at a disadvantage.

55. In the interests of transparency and accountability, since the costs of these actions may have an impact on resource allocation as well as on the balance sheet and the receipts of the national treasury, it is desirable for these decisions be ratified by parliament.

56. At the same time, it needs to be recognized that traditional prudential policies may also have significant impacts on credit availability and the terms at which it is available. There is a fundamental difference between prudential policies affecting a single bank and those that affect an entire banking system. The introduction of prudential regulations in response to financial difficulties has in the past produced excessive credit contraction. While getting the balance right is extraordinarily difficult, Central Bankers need to be attentive to the macro-economic consequences of prudential policies. If a policy of forbearance is adopted, it must be accompanied by increased supervision in order to offset the possibility of moral hazard leading to excessive risk taking and fraudulent behaviour.

57. In some economies, monetary policies, both conventional and unconventional are actively being used in order to prevent a deepening of the financial crisis and its harmful impacts on the employment and income. Part of this is a response to the fact that capital markets have proved inefficient and these policies are a direct response to such

inefficiencies. Nevertheless, as a result of the actions of central banks, there is a concern among some observers about high rates of inflation in the short to medium term. While trade-offs between preventing downturns and causing inflation will differ from country to country, at the current juncture there is a need for a global coordination of expansionary policy. In the future, if and when the immediate and severe crisis appears mitigated, governments and central banks will have to make the difficult decision on whether and how to retract liquidity. This will certainly depend on the particular context of the country, and will require a careful balancing of the risks of a return to recession versus accelerating inflation.

Bail-outs

58. Bail-outs of financial and non-financial institutions have become a distinguishing feature of the macroeconomic policy responses to this crisis. They have changed the expectations of the future development of global financial markets. The efficiency of the bail-outs will affect the pace of recovery, the level of the national debt, and the ability of a country to pursue a broader range of objectives. One of the important goals of the bail-outs should be to facilitate a restructuring of the financial sector in ways which enhance economic stability and growth. Bailout decisions must be made with future design of financial structure in mind. We should strive to create a financial system in the future that does not embody the structural flaws revealed in the recent crisis. In many countries, the financial system had grown too large; it had ceased to be a means to an end but an end in itself.
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59. The primary concern in this report is the impact of these policies on developing countries and the impact of badly structured bail-outs in diverting capital resources from developing countries, impeding their long term growth prospects. For developing countries especially the new global financial system should manage risk better than in the past, and provide a more stable source of funding, including funding for small and medium sized enterprises. In the past, the global financial system has exacerbated economic fluctuations in many developing countries by providing funds in a pro-cyclical manner; diverted funds away from lending to small and medium sized enterprises; and forced developing countries to bear a large fraction of the risks they face, including those associated with exchange rate and interest rate fluctuations.

60. In assessing the policies introduced in response to the crisis a distinction needs to be made among the various impacts on the economy. The primary focus of any bail-out is to restore credit flows to the real economy and contribute to macroeconomic recovery. However, there are distributional impacts of a bail-outs and its design will affect all stakeholders—shareholders, bondholders, workers, firms and households seeking credit-and particularly other claimants to a bank's resources in different ways. There is a concern that in some countries there has been excessive focus on saving bankers and bank shareholders; and greater focus on saving financial institutions than on the re-establishment of credit flows.

61. One result is that the bail-outs have been more costly than they might otherwise have been, another that the bail-outs have been viewed to be very unfair; a third that there has been a massive redistribution of wealth from ordinary taxpayers to those bailed out. A bailout can be accomplished by forcing unsecured debt holders to restructure their assets, diminishing debt and converting the residual into equity. Alternatively, taxpayers can finance

a bailout. The latter approach, by subsidizing bondholders who did not have explicit guarantees, may serve to reinvigorate moral hazard in the future. In addition, the distributional impact of a taxpayer bailout may reduce growth in the future in order preserve wealth that was created in the past. Also, because resources are scarce, and the national debt is larger than it otherwise would have been, there will be less to spend, e.g. on a stimulus package or social protection. The perception that the bail-outs have been unfair may impede future actions to resuscitate the financial system or to undertake other actions necessary to address the crisis. The fact that the bail-outs have, in many cases, been slow to restart lending is of particular concern because if this continues, prospects of a robust recovery are diminished.

62. Finally, the perception that the bail-outs have been unfair may be corrosive to the reputation of the government and impede its capacity to inspire future actions to resuscitate the financial system or to undertake other actions necessary to address the crisis. A demoralized body politic that does not believe that government representatives can implement desired change equitably may choose in the future to elect officials who reflect their pessimistic views of the capacity of the public sector to play a constructive role. This would diminish society's capacity to achieve collective responses to many challenges that are not well handled by private markets alone.

63. Given that the focus should be on restarting lending, governments should expand their strategies to include additional options such as the establishment of a new bank or banks operating without the bad debts of the failed institutions and to provide (partial) guarantees for new lending. The terms at which any newly established institution should be provided funds should be such as not to give the new bank a competitive advantage over existing banks that have not required additional support.

64. In transferring assets and liabilities between the public and private sector, particular attention needs to be paid to the prices paid; overpaying the private sector for a particular asset or a bundle of assets represents an unwarranted transfer to the firm at the expense of the taxpayers. In addition, some schemes for asset sales will utilize public money to buy impaired assets from solvent financial institutions at subsidized prices. This is an inefficient use of public funds. Preventing such transfers is, however, difficult, given that one of the features of this (and similar) crisis is the failure of markets to function properly. In such a situation, minimizing the scope for unwarranted transfers from the public to the private sector should be one of the objectives of public policy. Similarly, in providing equity injections into banks, it is important that the value of the shares obtained be commensurate with the funds provided. This has not been the case in some countries.

65. There is a strong presumption that government should set rules to protect the taxpayers and to ensure that financial firms play by the rules. These rules entail reorganization when bank capital falls below certain levels. Banks that are too big to fail are not too big to be financially reorganized. Financial reorganizations that do not impose costs on shareholders and bondholders lead to future moral hazard problems. Moreover, public subsidies to the financial sector lead to distorted resource allocations. The fact that there have been repeated, ad hoc bail-outs of the financial sector suggests failures in their ability to assess creditworthiness and suggest systemic problems that must be addressed both as part

of the bail-out and the long term strategies for preventing another crisis. More discussion of these issues is made in chapter 3.

66. Five principles should guide bail-outs: they should (a) be designed to restore capital adequacy; (b) impose the minimal burden on the public sector budget; (c) establish proper governance/incentive structures; (d) reduce—and certainly not exacerbate—existing problems in the financial system; and (e) be viewed to be fair. In some bail out plans most of the capital has been supplied by the government, while the government has little or no governance role. A failure to align ownership and control almost inevitably gives rise to incentive problems, some of which have been manifest in recent bail-outs, where attempts at recapitalization have been partially undone as the banks have paid out large amounts in bonuses and dividends.

67. Moreover some of the bail-outs of financial firms in the wealthiest economies have exacerbated the problems arising from institutions that are "too big to fail". The bail-outs have provided money to weak large institutions failing thereby penalizing them for their misallocation of resources. Moreover this encourages further consolidation and thereby increasing systemic risk in the future.

68. Such consolidation fortifies a market structure that is deeply infused with moral hazard and prone to repeated bouts of excessive risk taking. The mere fact of the vulnerability of the real economy to spill-overs from the experience of financial crisis informs the expectations of risk takers. The foreknowledge of their ability to induce bailouts is most profound in these large highly leveraged institutions whose executives are politically very powerful. The G-20, Financial Stability Board and BIS Committees must give substantially more consideration to the long term consequences of too big to fail institutions if they are to design sound public policies for the world economy using the lessons of the crisis. Excessive deference to the wishes of large institutions for a particular form of regulatory design has been-- and will continue to be-- part of the problem rather than part of the solution to this very damaging experience.

69. The role of open bank assistance and the use of guarantees on a contingent basis are costly methods even if in some instances they deter instability in funding. These methods need to be scored on budgets rather than hidden, and the implication of these policies for exacerbating moral hazard must be addressed explicitly.

70. The Use of Guarantees for wholesale liabilities may also serve to impair the credit quality of the sovereign debt of the country providing the guarantee when the balance sheets of impaired financial institutions are very large in relation to the size of the economy. The credibility and effectiveness of these guarantees may also be called into question in such cases.

71. A policy of forbearance by large countries is much more dangerous to the soundness of the national debt in the long term than is the case for small countries that can devalue their exchange rate and rely upon the core countries to tow them out of the crisis that led to financial fragility. In addition, large core countries practicing forbearance can have medium term negative external impact on smaller countries who also suffer from the substandard growth resulting from an impaired credit allocation system in the large country in question.

72. Providing more money to financial institutions supplying credit to small and medium sized enterprises may be viewed as fairer and more effective in rekindling lending. In any case, any strategy for restructuring the financial system needs to focus on the functions which the financial system should be providing, and take due account of the repeated failures in recent decades. Chapter 3 discusses the potential relevance of a 'nationalized core' of banking.

The Role of Central Banks

73. Several aspects of the conduct of monetary and credit policies contributed directly to the crisis. The deregulatory pressures of the last two decades, as well as the successful management of recent financial crises led to a larger appetite for risk, were central to the breakdown of the financial system. Regulators leaning against these currents faced substantial pressure. These issues are discussed more extensively in Chapter 3. This chapter focuses on Central Bank monetary policies, and the governance of central banks, which may affect their conduct of monetary policy. Certain widely held Central Bank beliefs may have contributed to these problems.

74. There was a widespread belief that price stability was necessary and (nearly) sufficient for growth and stability. However, success in stabilising goods prices was often accompanied by inflation in asset prices causing unsustainable speculation and created a policy dilemma. Decisions to focus on price behaviour in the real sector led Central Banks to ignore the broader impact of financial innovations on risk and liquidity management in financial markets. Thus, while price stability was achieved, central banks did not prevent, and may even have contributed to the gravest financial turmoil since the great depression. In particular, it is clear that the economic cost of financial fragility was much greater than the economic costs that might have resulted from the slight distortions in resource allocation as a result of relative price misalignments which can arise with uncoordinated price changes in the presence of low to moderate inflation.

75. Underlying these failures was perhaps an excessive reliance on a particular set of models making unrealistic assumptions concerning rational behaviour, and which ignored key aspects of the economy, including the importance of information asymmetries, diversity of economic agents, and the behaviour of banking institutions. It focused, for instance, on the efficiencies arising from the diversification of risk associated with securitization, but ignored the problems of information asymmetry to which securitization gave rise.

76. In the period before the outbreak of the crisis, inflation spread from financial asset prices to petroleum, other commodities and food, as they became financial assets subject to speculative pressures. While it became impossible for Central Banks to ignore the impact of asset inflation on goods inflation, the appropriate policy response was not clear. This was the case in particular for Central Banks following (goods) inflation targeting.

77. Since food and energy prices represent a larger fraction of the consumer price index in developing countries, attempting to control inflation may require especially high interest rates. But since this inflation is imported, it is relatively unaffected by changes in the interest rates; there is typically little effect on the rate of inflation, except through the appreciation of the exchange rate with devastating effects on the real economy. Those economies that

allowed exchange rate appreciation soon faced conditions in which the advanced industrial countries (followed by the emerging markets) were responding to the threat of deflation with lower interest rates. The interest rate differentials in favour of these developing countries then reinforced the exchange rate appreciation, with its adverse macro-economic effects, until the impending global crisis reversed the rise in oil and food prices, and interest rates could be reduced. The fall in interest rates, combined with the sudden change in market appetite for risk and capital repatriation then led to rapid depreciation in exchange rates. All of this exerted a high toll on developing countries that followed these policies.

78. Countries that judiciously intervened in their foreign exchange markets and capital markets have fared better than those that did not. Risk absorption mechanisms, especially in developing countries, both in the public and in the private sector, are not as developed, and the capacity of firms and households with limited wealth to absorb shocks of these magnitudes is limited. Those Central Banks that used the flexibility implicit in an inflation targeting approach also may have fared better.

79. The lesson of this experience is that monetary policy decisions should be sensitive to the source of inflation. Increasing interest rates to counter increasing prices of tradable goods in an open economy or increases in administered prices is unlikely to have any direct impact on inflation. In some developing countries, these sources of inflation can constitute three fourths or more of GDP. Hence, attempting to rein in inflation by raising interest rates imposes a high cost on the economy, and especially on interest sensitive non-traded sectors.

80. The recent food and energy crisis also highlighted the problem of the choice of the appropriate target for monetary policy dedicated to price stability. Some Central Banks have focused on "core inflation"—excluding the volatile energy and food sectors—but in developing countries, this excludes the prices that have the highest impact on household purchasing power and are thus most important in influencing inflationary expectations.

81. Monetary authorities should, at the same time, be sensitive to the consequences of asset price bubbles and other factors that might affect financial stability, and thus economic stability and growth.

82. Another lesson to emerge from this crisis is that the definition of national and global macroeconomic stability needs to be broadened. It is clear that central banks need to assess the impact of their policy on other aspects of stability than just price stability. In particular the stability of the real economy and the financial system should also be taken into account.

83. But because these objectives will also be influenced by the behaviour of the real economy including incomes and employment, better coordination of fiscal and monetary policy as well as social policy is required.

84. While high levels of inflation do present a problem, there is little evidence that moderate, non-accelerating levels of inflation lead to reduced growth. Moreover, history suggests that deflation represents just as great a threat to economic prosperity as hyperinflation. A gently rising price level as the late Sir Austin Robinson put it has the merit of speeding up the market process of resource reallocation.

Risks and policy trade-offs

85. Monetary policy has tended to focus exclusively on the stability of prices of real goods and services. Many central bankers claim that asset price stability is either not their responsibility or that they do not have the capacity or instruments to control asset prices. Certain central bank governors, for instance, claimed that they could not ascertain whether there was a speculative element present in market prices, or that there was a bubble, but that even had they been able to do so they only had one instrument, the interest rate, to deal with two objectives. Using tight interest rates to dampen asset price inflation would have caused an unnecessary sacrifice of real output.

86. While one cannot ascertain the presence of a speculative bubble with certainty, there are indicators that suggest the likelihood of its presence. But, nothing in economics is certain; if one were only to take actions when the consequences were certain, no decision would ever be taken. Economic policy is always conducted under uncertainty, and part of the art and science of policy making is to assess and balance the risks. It is clear that many Central Banks failed to do so.

Multiple instruments

87. It is also important to note that Central Bank do have a number of additional policy instruments at their disposal, such as margin requirements which (together with other regulatory restrictions discussed in chapter 3) could have been used to dampen speculative activity in asset markets.

88. It is also not the case that each institution in an economy should use only one instrument and be responsible for only one objective. Only in the context of highly simplified models can such assignments be optimal.

Changing structure of the financial sector

89. The large interventions in financial markets by Central Banks raise a number of other difficult issues, some of which we discuss below. One overriding issue is that there have been large changes in the structure of financial markets in recent decades, e.g. the growth of securitization and the decline in the role of relationship banking. Some of the failings of the financial system may be related to these changes. Government intervention will have an effect on the future evolution of the structure of the financial sector. Governments and Central Banks need to take decisions that they believe will be most effective in generating the benefits that can be derived from a well performing financial sector—and which will insulate the real economy from the risks to which it has been exposed as a result of the malfunctioning of the financial sector.

Governance

90. The large role that some Central Banks have been taking in direct lending raises further questions about the governance of Central Banks: when they are engaged in a quasi-fiscal role is the independence from political interference required by the need to gain "policy credibility"? As already noted, many interventions by central banks have a fiscal character:

implicit subsidies and taxes, unfunded or contingent liabilities etc. With the present crisis these operations have greatly increased in number and in magnitude. While in the past these quasi-fiscal operations were limited and their effect on public finance was more or less regular, we are confronted now with a strong discontinuity. The problem is that when central banks engage in quasi fiscal activity conventional measures of fiscal activity such as the Non Financial Public Sector borrowing requirement or the deficit of the central government becomes misleading indicators of the size or impact of fiscal policy. . Therefore, these activities with fiscal implications must be closely coordinated with the governments.

Multiple and New Objectives

91. Beyond the immediate issues currently being addressed by most countries—stimulating their economies and restarting the flow of credit—there are some basic problems which have to be addressed, in particular: redressing national inequalities and global imbalances. The policies that are currently being introduced to deal with the economic crisis may exacerbate national inequalities and global imbalances.

The Need for Economic Restructuring

92. In addition to the problems confronting the global economy just described, many countries face problems in economic restructuring. Rapid increases in productivity in manufacturing combined with globalization has translated into rapid improvements in competitiveness in developing countries and has resulted in rapid changes in comparative advantage across developed and developing countries, This has led to changes in the international division of labour. Such adjustments are always very costly and painful, especially when there is high unemployment, and in countries which provide insufficient adjustment assistance to their citizens, and in circumstances in which many citizens have seen large fractions of their wealth—which might have provided a buffer against such changes—disappear. High interest rates and lack of availability of credit—a problem facing many developing countries hinders structural adjustments and increases the difficulties of economic restructuring, while excessively low interest rates may impede restructuring by leading to overinvestment and excess capacity, if financial markets are dysfunctional and especially if they are under-regulated, and fail to allocate capital to high productivity uses.

93. There is also a need to restructure the global economy to meet the challenges of global warming. Providing a clear price signal concerning the economic costs associated with global warming would provide strong incentives to the private sector, both for households to change consumption and living patterns and firms to change modes of production. Restructuring the capital stock would provide large demands for investment that could be a major stimulus for the economy. There may be a need for government also to assist in the financing of these green investments.

Impacts on Developing Countries

94. Measures are needed very quickly to avoid a further deepening of the crisis in emerging and developing countries. These, include restoring and expanding social protection, and reducing the pro-cyclical features of the economic system. Delay will mean that the eventual cost of dealing with the problem will be higher and the length and depth of the downturn

will be greater, with more innocent victims losing their jobs, with more business (small and even large) forced into bankruptcy. The crisis is likely to extract a particularly high toll on developing countries for four reasons.

Why developing countries are being hurt so badly

95. First, the citizens of developing countries have fewer resources with which to cope with a crisis of this magnitude. Secondly, they already suffer from a lack of automatic stabilizers due to the embryonic nature of their fiscal and social protection systems. Third, "markets" impose constraints on their ability to pursue countercyclical fiscal and monetary policies. Many are forced to pursue pro-cyclical policies. This is especially true of those countries that have fully opened their capital accounts and have engaged in financial market liberalization, and have turned in boom years to international capital markets. Those markets are now greatly impaired. Fourth, the size of capital flows to developing countries is likely to be markedly lower this year than in earlier years. Risk premia have suddenly increased, so that emerging markets often face higher borrowing costs. Many firms and countries will face credit constraints. Some countries, faced with large capital outflows may be tempted to raise interest rates, with adverse effects on the real economy. As the economy slows, confidence erodes, and capital flees even faster.

96. These ever-present threats have been exacerbated by financial market integration. Many countries have come to rely on foreign banks, and some foreign banks from countries that practiced inadequate regulation and that followed inappropriate macro-economic policies find their capital badly impaired. They are now repatriating capital with adverse effects on developing countries. The difficulty is compounded by the fact that many developing countries have entered in North-South free trade agreements (FTA), bilateral investment treaties (BIT) and World Trade Organization (WTO) commitments, which prevent them from regulating the operation of financial institutions and instruments or regulating capital flows.

97. For example if a developing country decides to nationalize some services such as banking, this can require compensation if the sector has been liberalized under the WTO GATS agreements on trade in financial services or under an FTA/BIT. When these agreements and commitments are enforced, developing countries have to pay compensation or suffer from the imposition of tariffs on their exports to the complainant if they do not comply.

The Role of Protectionism

98. These adverse effects of financial globalization have been further exacerbated by a wave of financial protectionism. Governments that have provided large amounts of capital to their banks, either under recapitalization programs or through the central banks providing liquidity in unusual amounts and in unusual ways, with attendant risks to the public finances, understandably expect an increase in domestic lending. The irony is that this kind of financial protectionism does not seem to be subject to sanction.

99. Certain policy measures taken by developed countries have exacerbated these problems further. Credit guarantees have contributed to the reversal of capital flows. Even if

developing countries believed it was desirable and appropriate for government to provide guarantees of the depth and breadth provided by some advanced industrial countries, their guarantees would be less credible. Symmetric policies can have asymmetric effects. Credit guarantees not paid for are clearly a violation of the spirit of the "level playing field" in international trade that the international community has attempted to construct over the past half century. Most countries providing such extended guarantees have made no attempt to ensure that those receiving these guarantees pay for them on an actuarially fair basis. In the absence of such full payment, such guarantees represent a major subsidy.

100. Market forces and resource constraints may also limit the ability of developing countries to pursue countercyclical fiscal policies. They may not have sufficient domestic resources, but when they turn to global markets to finance the deficits required to manage countercyclical fiscal policies, they may find international markets either unwilling to lend, or willing to lend only at very high interest rates. This is one of the reasons that some developing countries have resorted to policies to reduce external constraints and build up large reserves (see chapter 5 for a more substantial discussion of these issues).

101. Market inequities have been exacerbated by government distortions in another way. There have been massive bail-outs, especially of financial institutions, but increasingly of firms in other sectors of the economy. Most developing countries do not have the resources to match these support measures. Again this problem may be aggravated if the developing country is part of an international agreement (FTA or BIT). In that case in effect the agreement would require that if a country wants to support domestic companies facing difficulty it should provide equal treatment to foreign companies. Here too the apparent symmetrical treatment which appears in the agreement has deep asymmetrical effects. In rich countries, the big firms are usually national, and the foreign firms, especially those originating from developing countries are much smaller in size. It would be very difficult for a developing country to bail out a large foreign company, in view of its limited resources, and this represents a de facto impediment to providing assistance to local companies. The same de facto asymmetry applies to stimulus packages which require equal treatment to firms whatever their country of origin.

102. The same consideration applies to public procurement policy. But here again there is an asymmetry. There are multilateral procurement agreements among developed countries, but relatively few between developed and less developed countries. Hence, if a developed country adopts a "buy national" policy with an exception for WTO commitments, the effect is to discriminate against purchases from developing countries.

103. In addition many developing countries have been constrained by international financial institutions to adopt restrictive policies in times of slow growth or even recession. These policies are markedly different from the countercyclical policies being adopted by the advanced industrial countries, and increase the risks faced by investors in developing countries relative to those in developed. The asymmetry in IMF policy stances has become apparent in the current crisis in several countries. And with some contagion: even the EU is imposing procyclical policies on the enlargement countries, including wage reductions in the public sector.

104. More broadly, developing country dependence on IMF financing has constricted their ability to adopt countercyclical policy and other counter cyclical measures and may impede their willingness to turn to international institutions in a timely way, resulting in costly delays.

105. If strict measures are not taken quickly by the international community, developing countries will suffer from the attempts by developed countries to protect themselves from the crisis. In the short and medium term, countercyclical policies, social protection measures, infrastructure development, and credit guarantees are indispensable for developing countries and may enhance global fairness.

Developing countries need additional funding

106. Developing countries will need substantial additional funding (additional to that provided by traditional assistance) to participate effectively in a global stimulus. They will also need funds for other important responses: to protect their most vulnerable individuals by strengthening social protection, to provide trade finance and finance to corporations whose sources of international credit may have dried up, and to bolster domestic financial institutions weakened both by the withdrawal of funds and by the precipitous collapse of export earnings. Developing countries need low-conditionality financing to tackle volatility in commodity prices and other external vulnerabilities which are not dependent on their domestic policies and to compensate them for the adverse effects of the intentional and unintentional protectionist measures of the developed countries.

107. Sources of funding for developing countries that could be activated quickly and are not subject to inappropriate conditionality are necessary. Indeed, additional funding would be required just to offset the imbalances and inequities created by the massive stimulus and bail-out measures introduced in advanced industrialised countries. As in developed countries, substantial portions of this stimulus spending could be directed to environmental measures, fulfilling in part developed country commitments under the United Nations Framework Convention on Climate Change.

108. Failure to maintain the levels of official assistance and provide this additional assistance will have long-term effects. There will be an increase in poverty and malnutrition and the education of many young people will be interrupted, with life-long effects. The sense of global social solidarity will be impaired, making agreement on key global issues, such as responding to the challenges of climate change, more difficult. Failure to provide such assistance can be counterproductive even in a more narrow sense: it can impair the global recovery.

109. Such funding could be provided immediately by completion of the issuance of Special Drawing Rights approved by the IMF Board in September 1997 through the proposed Fourth Amendment of the Articles of Agreement to double cumulative SDR allocations to SDR 42.8 billion. In addition, rapid action should be taken to provide for the issuance of additional SDRs through standard procedures in the amount of at least $250 billion per year for the duration of the crisis (see chapter 5 for more discussion of this issue).

110. To make these allocations fully effective, it will be important that the advanced industrial countries receiving SDR allocations transfer them to less developed countries. The

priority should be given to transfers to the lowest income countries and countries which might otherwise pose a systemic risk to the global economy. It will be important to develop better mechanisms for facilitating this transfer. Ad hoc measures may have to suffice in this crisis, but the international community should consider changes in the Articles of Agreement that would provide for alternative systems of allocating SDRs (see Chapter 5) and facilitate the transfer of SDRs.

111. In addition regional efforts to augment liquidity should be supported. For instance, extension of liquidity support under the Chiang Mai initiative without an IMF program requirement should be given immediate consideration. Regional cooperation arrangements can be particularly effective because of a greater recognition of cross-border externalities and greater sensitivities to the distinctive conditions in neighbouring countries.

112. These additional sources of funding should be in addition to traditional official development assistance. More broadly, developed countries must make a renewed effort to meet the commitments made in the 2000 Millennium Declaration, the 2002 Monterrey Consensus, the 2005 Global Summit, and the 2008 Doha Declaration by 2015.

113. In thinking about additional funding, it is important to distinguish between support for countercyclical macro-economic policies and longer term development programming, though increases in the latter can have important countercyclical effects. Traditionally, the World Bank and the regional and sub regional development banks have played the central role in development assistance, while the IMF has played a more important role in managing crises. Some studies have emphasized that it should not play a central role in development assistance. The question is what role it should play in the provision of credit in the current crisis, and what role should credit itself play.

114. At the beginning of the decade, there was considerable concern about excess debt burdens of developing countries. In addressing this crisis, it is important to avoid a build-up of unsustainable debt, or debt that would crowd out developmental efforts. Thus, the bulk of assistance to the least developed countries should take the form of transfers, rather than loans. There is concern that the initiatives announced by the G-20 rely largely on the provision of credit.

115. A potential source of funding for such assistance would be a commitment by the developed countries to devote 1% of any stimulus package to developing countries.

116. Over the longer run, the international community should consider establishing a special facility to provide support for those countries creating strong systems of social protection. While such systems may be largely self-funded, it will take time to build up the required reserves, and the international community should consider back-stopping these efforts. Such commitments might have important incentive effects in inducing the creation of such systems, which, through their automatic stabilizers, would also serve to help stabilize the global economic system.

117. The magnitude of the necessary support requires the utilization of multiple systems of disbursement of funds for effective implementation, including regional development

banks, the IMF, the World Bank, and possibly a newly created credit facility to be described below.

118. While it is essential to continue the important work of harmonization of official development assistance, it is also important that harmonization, and especially of counter-cyclical lending, does not lead to concerted imposition of pro-cyclical conditionality. This is especially urgent given the need for countries quickly undertaking measures to stimulate their economy, protect the vulnerable, and maintain the flow of credit.

119. The reluctance of many countries to accept assistance from certain institutions and the reluctance of some potential lenders to provide funds to certain institutions constitutes an impediment that may not be fully addressed by the reforms that are likely to be made in the short run. The availability of alternative mechanisms of disbursement might not only accelerate the flow of funds, but also make it less likely that they be accompanied by pro-cyclical conditionality either de jure or de facto.

New Credit Facility

120. It is thus imperative that, during the recovery phase developing countries should have access to additional sources of external funding, including credit and liquidity facilities for social protection, infrastructure investment and environmental interventions, for government support, for support of developing country financial systems, and for corporate borrowing. Without such support the global crisis may grow worse and long term global cooperation may be impeded.

121. Alternative financing could be provided through the creation of special funds in existing institutions administered under more accountable governance arrangements, or through the creation of new international economic institutions or facilities.

122. Existing facilities presently do not meet these needs for several reasons. First, the current system does not provide an efficient mechanism for mobilizing the funds available in countries that have accumulated large reserves. It would be beneficial for all participants in the global economy if savings from emerging markets could be utilized in support of developing countries. Government agencies in some emerging market countries that have reserves are reluctant to provide development funds to existing multilateral institutions, because these countries are often under-represented in their governance structure and because they perceive the policy advice and conditionalities provided by these institutions as inappropriate to the needs of developing countries.

123. In addition, there is a lack of appropriate funding facilities to respond to the interests of some developing countries with high reserves, such as sovereign wealth funds that seek investment possibilities with acceptable return and limited risk. The current financial system does not provide this intermediation facility. Moreover, as we have noted, there may be a reluctance by some developing countries to turn to certain international institutions

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124. In assessing the alternative options, concern should focus both on the speed with which new a new facility can be established as well as the role that it might play in helping construct better long run architecture. Some worry that creating a new facility will take too

long, though personnel could be seconded from existing institutions, and if there is no scope for macro- or micro-conditionality, implementation problems are greatly reduced. Others worry that necessary or desirable reforms within existing institutions may occur too slowly. These concerns have been increased as a result of the appearance of large discrepancies between official discourse on changes in IMF operating policies and their official implementation in lending agreements that appear to require fiscal tightening, inflation targeting and even tight constraint on nominal wage growth in the public sector. The World Bank seems to have made more progress in revamping its approach to developing countries, but also requires substantial progress which will take time to achieve.

125. Thus is appears preferable to create a New credit facility, perhaps administered by an existing multilateral institution or a consortium of multilateral institutions, but with its own governance structure. Such a New credit facility could draw upon the administrative expertise of existing institutions, and could be created rapidly. Its governance would reflect more recent thinking concerning appropriate governance structures, ensuring not only greater say for those countries providing the funds, but also for recipient countries. Given the limited remit of IMFs new flexible credit line, and the relatively minimal conditionality related to the usage of the funds, it may be easier to achieve agreement on details of governance. Various alternative voting arrangements, including double majority voting, should be given serious consideration.

126. Special consideration would be given to timely environmental investments addressing problems of climate change. The facility could adopt climate change principles to ensure that the short run focus of this spending is consistent with longer term development strategies.

127. The governance structure of this facility could be more modular with regional groupings (for example by the Inter American Development Bank, the Asian Development Bank , the African Development Bank and so on) charged with its operation.

128. The other question to be resolved in the creation of a new credit facility is the origin of the new resources. There are different possibilities, which are not mutually exclusive. It might be provided by a new allocation of Special Drawing Rights, by increased contributions from developed countries, in addition to existing commitments of official development assistance, by contributions from countries with large international non-borrowed reserves, or by regional arrangements such as Bank of the South or the swap arrangements under the Chiang Mai initiative.

129. There are other options which should be simultaneously pursued. In particular, the reforms in the international financial architecture and the provision of global reserves should include further expansion of already existing regional arrangements. Whatever the financing arrangement, the inherent asymmetrical treatment of countries by private markets does not justify imposing symmetrical policy responses on developing countries.

130. The advanced industrial countries should maintain their existing commitments for official development assistance. To offset potential imbalances arising from the disparity in resources with which to address the crisis, there should be an increase in official development assistance. The initiative of the World Bank to induce developed countries to increase such aid in tandem with the assistance they provide to their own economies is

therefore an appropriate one. It needs to be ensured however that such funding is additional to existing aid commitments.

Concluding Remarks

131. As the world addresses the exigencies posed by this crisis, through stimulus packages, monetary and credit policies, and bail-outs and guarantees, the international community should not to lose sight of remedies for the underlying causes of the crisis. National economic systems which give rise to high levels of inequality pose problems not only for social and political sustainability, but also for economic sustainability, i.e. excessive increases of household and public debt. .

132. It is also of crucial importance that the crisis response fully takes into account the need for transforming the present mode of growth by trying to slow down the overexploitation of natural resources, in particular of oil reserves, which may imply a change in consumer habits (environmental sustainability). In this respect, investment in new environment and energy technologies to address adaptation and mitigation of climate change is a formidable opportunity for countercyclical stimulus. "New environment and energy technologies" (NE^2T) include all technologies able to lower the energy and emissions content of our standard of living, technologies leading to the production of energy from renewable resources, and technologies helping to preserve, repair and improve ecosystems. For developing countries, the full incremental costs of these investments, justified by their global benefit should be financed by industrialized countries and transferred to developing countries in exchange for commitments on climate change and biodiversity. Such commitments of resources have already been made as part of earlier international environmental conventions, but substantial additional resources to fulfil those commitments have yet to be provided. The imperative to address this question is enhanced by the fact that while developed countries are by far the biggest global polluters up to now, emerging and some developing countries could become the biggest global polluters tomorrow. It thus makes good sense to invest massively today to develop those technologies and, through technological transfer, make them available freely to developing and emerging countries. Climate change and biodiversity are quintessential global public goods. Supporting developing countries in their own efforts to address climate change and preserve biodiversity should be seen as part of the solution, part of the way that the international community can ensure that these global objectives are effectively addressed.

133. Hence, the political feasibility of additional mechanisms and innovative sources of financing such as emission rights trading and financial transactions taxes should be enhanced. For further details on innovative sources of finance see chapter 5.

134. Policy makers need to be particularly attentive that, in addressing the crisis, these and other underlying problems are not exacerbated. As noted elsewhere, bank consolidation increases the risk of creating more institutions that are too big to fail, one of the problems giving rise to this crisis. Similarly, poorly designed bail-outs may lead to increased inequality, exacerbating one of the fundamental problems giving rise to this crisis; and without appropriate action directed at developing countries, global imbalances, another of the fundamental problems, may be exacerbated. Moreover, unless policies are well designed

there is a risk there national and government debts are increased unnecessarily, constraining policy spaces for the future.

135. To date, there has been little effort to coordinate international responses to the crisis. Reactions in almost all countries have been simply to launch a recovery programme. These programmes have been nationally designed with almost no coordination between countries, even in the Euro area. Traditional thinking, derived from crises arising in a single country, entails identifying areas in which domestic multipliers are high. But since approaches may lead to recovery programs that are far from optimal, delivering less global stimulus relative to the size of the increase in total spending or indebtedness. Underlying problems like global imbalances may only not be addressed, but may be exacerbated. There is an especial need for surplus countries to take strong actions. Moreover, macroeconomic coordination would avoid the risk of self-defeating beggar-thy-neighbour strategies aimed at increasing exports while attempting to decrease imports, or increasing credit available to home country firms at the expense of credit available elsewhere. We should be aware that these new forms of protectionism can by even more invidious to the global economic system, and unfair to developing countries. Protectionism through subsidies and guarantees are particularly disturbing, since while developing countries can match such actions taken by developed countries, they cannot match the subsidies and guarantees.

136. A cross cutting issue is therefore the need for significant improvements in regulatory cooperation. This includes the need for cooperation on tax regulation and on capital controls, in addition to the proposals for coordination above. It is critical, for example to have a reliable metric to differentiate illegal tax evasions and the establishment of international financial centres. Bilateral tax treaties often have the perverse effect of discriminating against residents which encourages ‘round-tripping’ of capital and undermines the workings of the world economy. To that extent, there is an urgent requirement for preventing regulatory arbitrage which can work to distort capital allocation and undermine state efforts at reinvigorating their economies.

137. Because countries are at different phases of the business cycle, and different countries have different automatic stabilizers and de-stabilizers, mechanisms for coordinating macroeconomic policy and evaluating relative contributions will be difficult. Developing countries have a stronger external dependence and vulnerability to external cycles and have a much weaker capacity to undertake countercyclical policies.

138. This is the most significant global crisis in seventy five years; it may be the most significant global crisis in history. It is clear that the global arrangements that have facilitated rapid growth in many parts of the world have not come without a cost: growing inequality in many countries, sometimes a loss of national sovereignty in matters that are of vital importance to citizens, in some cases excessively rapid depletion of natural resources and degradation of the environment. This crisis has shown another manifestation: while globalization offered the promise of greater economic stability it has led to a global recession. Toxic products, flawed regulatory philosophies, and deficient institutional practices were exported from countries claiming to be exemplars for others to follow. The debate about appropriate institutional practices and arrangements, and the economic, political, psychological and social theories on which they rest will continue for years. However, it is clear that current institutions and arrangements governing globalization and

many national government policies have been based on a certain set of ideas and ideologies, while other ideas which might have been more helpful in avoiding the crisis and mitigating its size were overlooked. The ideas and ideologies underlying key aspects of what has variously been called neo-liberalism, market fundamentalism, or the Washington consensus doctrines have been found wanting. As the International Community approaches the challenge of working towards a quick return to robust and sustainable growth and a reform of international institutions and arrangements that ensure long term democratic, equitable, stable, and sustainable growth, it does so with a broader respect for a wider range of ideas and perspectives.

Chapter 3:
Reforming Global Regulation To Enhance Global Economic Stability

The Purpose of Financial Regulation

1. We regulate firms operating in the financial sector, over and above the way we regulate other firms for two principal reasons. The first is that consumers require additional protection in financial products than other products because while the failure of financial products can have life-changing ramifications, the market is not good at differentiating good and bad products because the performance of a financial product cannot easily be tested before, at, or shortly after the point of purchase.

2. The second reason why we regulate financial firms over and above other firms is that the nature of the credit economy is that the lending by one bank, often acts as a deposit at another and this deposit may be used to provide collateral for borrowing at a third. An essential part of banking is that banks lend to banks in a way that shoe shops and car companies do not. This makes banking highly systemic. The failure of a single bank can bring down the entire financial system, either directly, or as a result of a loss of confidence in banks more generally which leads to a freezing in the inter-bank markets. At another time this discussion would appear a little academic, but the Credit Crunch has underscored the systemic nature of bank failures and the role of confidence.

3. The financial sector is the interface between households' savings and the financing of business investment. In the language of economics, there may be large negative externalities associated with the operation of banks and financial markets. Failures in financial markets have large repercussions for the rest of the economy. Financial markets have a tendency to produce financial crises. Recessions that follow banking crises are often more severe and long-lasting than recessions that have their origins elsewhere. Regulation should be especially directed at reducing the scope for these market failures.

4. The role that banks (institutions licensed and regulated for banking operations and having access to liquidity from the central bank) play in a credit economy is unique and quite different from the role played by non-banks such as traditional investment funds, insurance companies, hedge funds. While this distinction was smudged in the run up to this crisis with some insurance companies and hedge funds behaving like banks and some banks owning investment funds, the crisis has also highlighted that bank access to central bank liquidity and provision of liquidity to the rest of the economy played a critical role in the transmission of at first boom and later bust. We discuss this distinction later and it provides a basis for recommendations to regulate the activities of core banking activities (deposits form individuals and loans to companies) more heavily than non-bank institutions, while making regulation more comprehensive across the local and international financial system.

5. The purposes of banking regulation set out above will appear narrow from some perspectives and we recognise the broader role that banks and financial markets can play in

society by considering financial regulation as a subset of overall financial policy.

Financial policy and regulatory policy

Failure of the Prevailing Regulatory Philosophy

6. Although the current crisis had many causes, there was one feature that underlay several of the most important: a flawed philosophy. The reason why we regulate as suggested above is because of a number of market failures regarding the internalising of individual and social risks. Yet the prevailing view was that market prices were the best available signals and so market prices were our defence against market failure. Such a view ignores the fundamentally and uniquely systemic nature of finance, the theoretical arguments explaining why financial markets often fail to produce efficient or stable outcomes, and the long historical experience. The current crisis is a direct consequence of these ideas, which resulted in the stripping away of many regulations. The failure to adopt new regulations reflecting the changing economy, and the weakening supervision of banks, and suggests the imperative for effective government regulation and oversight of financial participants and markets.

7. Before the crisis there was a heated debate between a principle-based approach to financial regulation and a rule-based approach. Those concerned with banks using rules as goal posts to get around favoured principles and those concerned that the application of principles may be subject to regulatory capture favoured rules. But the crisis overwhelmed both rule-based and principle-based regulatory systems, suggesting that this dichotomy was not as important as it may have appeared. It seems to us that we need both: principles that set out the objective of regulation and rules that try to apply these principles.

8. The failure of financial markets to provide the appropriate allocation of financial resources to support the productive economy and to manage risk has been one of the contributing factors in the present crisis. Financial policy is thus necessary to ensure that finance is available to meet the needs of the real economy as well as social goals attuned to local conditions such as banking the un-banked, insuring the uninsured, better allocation of savings and investment, supporting sustainable growth, trade etc. The measure of success of financial policy is not the rate of growth or the size of the financial sector as a share of GDP. Indeed, an excessively large financial sector relative to the GDP of a medium to large economy should be a cause of concern to those interested in long-term economic growth because financial crises are associated with unsustainable growth of the financial sector.

9. Unregulated market forces have provided incentives for the creation of an abundance of financial products with passing relevance to these social goals and under-production of financial products that support social goals. At the same time incentives have been created for financial behaviour which are socially suboptimal. Such behaviour is supported by incentive structures in which there are higher fees and commissions for activities such as "churning," while seemingly products which might help manage important risks, like GDP-linked or commodity-price linked bonds, do not generate sufficient fees to attract the interest

of financial markets. One of the roles of financial policy is to address these market failures in financial product development.

10. The financial sector is the interface between households' savings and the financing of business investment. In the language of economics, there may be large negative externalities associated with the operation of financial markets. Failures in financial markets have large repercussions for the rest of the economy. Financial markets have a tendency to produce financial crises. . Recessions that follow banking crises are often more severe and long-lasting than recessions that have their origins elsewhere. Regulation should be especially directed at reducing the scope for these market failures.

11. Ensuring global financial stability to support economic stability is, in this sense, a global public good. This chapter sets forth some of the general principles of financial sector regulation, and some of the reforms that are needed to bring existing national and international regulatory practices in line with these principles.

12. Although the current crisis had many causes, there was one feature that underlay several of the most important: a flawed philosophy that markets themselves were efficient and self-correcting. They were, in a sense, self-regulating; there was no need for an outside (government) regulator. Such a view ignores the fundamentally and uniquely systemic nature of finance, the theoretical arguments explaining why financial markets often fail to produce efficient or stable outcomes, and the long historical experience. The current crisis is a direct consequence of these ideas, which resulted in the stripping away of many regulations. The failure to adopt new regulations reflecting the changing economy, and the weakening supervision of banks, underscores the imperative for effective government regulation and oversight of financial participants and markets.

13. Regulatory policy fits within the broad ambit of financial policy, but is more narrowly focused on facilitating the attainment of social and economic objectives through consumer and investor protection (deposit insurance, rules against fraud, market manipulation, misrepresentation of products, and laws promoting competition), ensuring the safety and soundness of individual institutions, ensuring that there is access to finance, and other interventions designed to promote the maintenance of orderly markets. Ensuring systemic stability, however, goes beyond ensuring the safety and soundness of individual institutions. Such regulations can support and safeguard confidence in the financial system as a whole, and enhance financial and economic stability. While they may not be able to prevent crises such as the current one, they can make them less frequent and less severe.

14. Regulations are not costless. As always, one must balance the costs and the benefits. Today, the global economy is paying a very high price for inadequate regulations as well as a failure to effectively enforce those that did exist. Clearly, regulators in the main financial centres of the world failed to get the balance right, and their failures have imposed heavy costs on the entire global economy. While the general principles of regulation and the purpose and functions of particular aspects of regulation need to be specified, the particular institutional framework and implementation of these regulations can be flexible and tailored

to the circumstances of each country.

Regulation and innovation

15. One of the potential costs of regulation is to reduce the scope for innovation. But much of the recent innovations in the financial system have had as their objective to increase the short run profitability of the financial sector, but not the ability of the financial markets to perform its essential features of managing risk or allocating capital; they have served to engender financial instability rather than increasing the productivity of the economy and the well being of citizens. From the point of view of the economy as a whole, some of the innovations were clearly negative. It is important to design regulatory structures that encourage economic and socially productive innovations and place adequate constraints on socially dubious innovations; good regulation may actual enhance the scope for positive innovations.

Regulatory Capture

16. Regulatory design needs to be robust to attempts by the industry to influence regulators and divert them from their core responsibilities for consumer and investor protection and systemic stability. Much can be done to design regulatory systems that have built-in resistance to capture, such as a reliance on simple and transparent rules, clear rules on the regulation of instruments sold to unsophisticated, retail consumers or sold to wholesale consumers that are potentially of systemic significance." The design of regulatory governance can also reduce the scope for capture.

Boundaries of financial regulation

17. Traditionally regulation has been differentiated by institutional forms: banks are regulated and non-banks are not. Insurance products are regulated by insurance regulators, but derivatives that act essentially like insurance are unregulated. This represents the legacy of the past, rather than an analytical approach to regulation, is vulnerable to regulatory arbitrage and is in need adjustment. Regulation needs to be comprehensive with boundaries determined by the economic functions of financial institutions, not by what they are called or where they may be located.

18. Coverage should extend to all relevant institutions and instruments. The coherence of different regulatory frameworks needs to be considered when attempting to delineate the boundaries of regulation. Regulatory authorities need to coordinate seamless coverage across national and international capital markets, securities markets and deposit-takers. If there is not comprehensive and coherent regulation, there is likely to be regulatory arbitrage.

19. However, there is no guarantee that all the practices which expose the financial sector and the economy to excessive risk can be properly monitored and regulated. In these cases, regulation will have to put special emphasis on setting the right incentives and strengthen financial responsibility in order to restrain excessively risky activities and to reduce the scope

for adverse consequences.

20. At the International level, comprehensive coverage should eliminate exposure of national financial systems to the possibility that “rogue” states or institutions should fail to implement regulation. At the same time, care should be taken that regulatory standards should not be an anti-competitive ploy by developed financial centres to maintain their positions, in part attained through previous periods of regulatory and tax competition.

21. Comprehensive regulatory systems need to focus on both micro-prudential regulation and macro-prudential regulation. While regulators will need to give priority to systemically important activities, institutions and instruments, all market participants, institutions and instruments should be subject to some oversight, even if the intensity of regulation differs among them on the basis of their systemic importance. There should be clear principles to determine what is considered systemically important, such as leverage, size, exposure to retail investors, and/or degree of correlation with other activities. Regulators must have comprehensive authority. Regulation must occur continuously, on a day to day basis while at the same time ensuring long term consistency.

Micro-prudential regulation

22. Micro-prudential regulation, geared towards consumer protection, should apply to all financial institutions, with particular attention given to protection of unsophisticated, “vulnerable” consumers. Macro-prudential regulation should be focused on key components of systemic risk: leverage, the failure of large, inter-connected institutions, and systemically important behaviour and instruments and their interactions with the economic cycle.

23. Macro-prudential regulation, geared towards the containment of systemic risks, should be focused on those institutions most likely to have systemic consequences, which means those with the greatest leverage and size. But the experiences of this and previous crises suggest that it is difficult to tell which financial institutions have systemic consequences, so that it is imperative to maintain some oversight over all activities, institutions and instruments. Macro-prudential regulation thus must go beyond banking institutions. This is particularly important given the tendency, and incentives, for financial market participants to engage in regulatory arbitrage through activities that have led to the creation of what has come to be called the “shadow banking system”. (Similarly, a “shadow insurance system” has also been created.) There should also be a special focus on aspects of the financial sector that are most likely to have significant consequences for the “real economy.” This entails protecting the payments system and ensuring the flow of credit.

24. Instruments should be regulated where their use might be harmful to vulnerable consumers or pose systemic risks to the economy. This could be achieved through the creation of a *Financial Products Safety Commission* to ascertain the safety and appropriate use of various financial instruments and practices for retail consumers; alternatively, governments could create within their regulatory structure a corresponding body that focuses on these issues. It will be important to recognize that seemingly safe instruments can have damaging

consequences when their use alters, and that instruments used for hedging and insurance can also be used for speculation. Safety of financial products should thus be assessed not only in terms of their appropriateness in meeting the needs and objectives of retail consumers, but also terms of their impact on systemic behaviour. Safety should be continuously reviewed with respect to prevailing practice and the consequences for product safety. While great care should be taken in approving products for use by vulnerable consumers, all consumers need some protection.

25. Regulation is necessarily dynamic, with some instruments appearing safe initially, but becoming “dangerous” with changing or growing use. Other instruments might appear initially to be excessively risky for some uses, but as their risk or complexity becomes understood, and appropriate offsetting measures are devised, or as their safety is demonstrated in less highly regulated markets, they might be approved for specific uses in more regulated markets.

26. A key part of supervision is the continuous monitoring and consideration of instruments, institutions, markets and behaviour of more systemic importance and requiring greater oversight.

Ring-fencing

27. While there may be a case for differential regulation of financial market participants based on their ability to bear risk and sophistication, it should also be recognized that in financial markets it is difficult to erect hermetically sealed barriers between the highly regulated actors posing systemic risks and the less regulated actors who do not; for instance, credit inter-linkages are likely to remain. As a result, depending on the depth of a financial crisis, regulators may feel forced to bail-out risky players who are interlinked in order to protect the interest of vulnerable participants and to avoid adverse systemic consequences, though typically, it is more “fiscally efficient” to bailout directly those that must be bailed out because of their direct systemic importance. To the extent that the government does not regulate tightly all financial institutions, to prevent problems in the unregulated sector spreading to the regulated, the less regulated must be, at least to some extent, ring fenced, with sensible controls on the extent of interaction with the more regulated sector. Governments need to be aware of the danger of contagion from one part of the financial system to others. Thus, the better and more comprehensive financial systems are regulated, the more integrated (less segmented) can the financial system be. The advantages of diversification provided by a large integrated market may be more than offset by the risks of contagion, as a problem in one part of the economy spreads throughout the whole. This appears to be the case especially in real estate: had mortgages been centred in a specialized set of institutions, the problem may have been contained, as it was in the Savings and Loan crisis. Regulators have to be especially attentive to the ever-present attempts at circumvention, including through the creation of special purpose vehicles.

Some Common Principles of Macro- and Micro-Prudential Regulation

Incentives

28. Incentives are the key to an efficient and effective financial system. Regulators need to make sure that the incentives of financial institutions and those running them are compatible with the objectives of a good financial system. It will never be possible to monitor and regulate all the practices which expose banks and the economy to excessive risk; it is therefore imperative to get incentives right. It is clear that private rewards have not been linked to social returns. This means that there are perverse incentives that produce adverse outcomes.

29. Flawed incentive structures are in part the result of flawed corporate governance structures. The fact that so many firms have adopted incentive structures that served shareholders and other stakeholders well in the short run, but so poorly in the long run, is suggestive of serious and pervasive failures in corporate governance. Weaknesses in corporate governance in both developed and less developed countries have long been recognized, but not enough has been done. This crisis should provide an opportunity to revisit these issues. The payment of large bonuses to top executives of banks making record losses shows that " incentive pay" was not closely related to performance—something that some statistical studies also suggest to be the case.

30. One of the long recognized problems is that current incentive structures encourage excessive risk taking and short-sighted behaviour. Possible methods of remedying these problems include suspension of the practice of cancelling long-term and non-transferable stock options when an employee leaves, requiring incentive compensation schemes to be based on long-term performance, and implementation of a requirement that firms pay higher capital charges if their remuneration schemes are not designed to limit excessive risk-taking. Taking into account other indicators than economic success could be another option to create incentive schemes that are more commensurate with social objectives, e.g. by rewarding achievements in corporate social responsibility. Payment through stock options can provide particularly perverse incentives, because it encourages deceptive accounting practices that contribute to (temporarily) high stock prices. Firms must take a conservative approach to accounting for stock options. Stock options should be reported as a form of remuneration--expensed and valued at the time of issue or the re-setting of stock option prices. The financial sector should not be paying their top executives in forms that are not transparent, and in ways that shareholders cannot easily value.

31. When banks become too big to fail, they have perverse incentives for excessive risk taking. It is imperative that governments impose strong anti-trust policies, with criteria that are stronger than just market power. Under current arrangements, large banks, knowing that they are too big to fail, have an unwarranted competitive advantage over smaller banks because of the implicit insurance. Accordingly, any large bank that is not broken up should face have capital adequacy requirements.

32. Regulators should be particularly attentive to conflicts of interest. The scandals in the United States' financial markets earlier in the decade exposed the conflicts of interests

between investment banks, their analysts, the companies issuing IPO's, and customers. Some actions were taken with respect to analysts, but many of the other problems remain. For instance, investment banks' views affect markets—and those views may be tainted by the positions that they hold. These scandals highlighted conflicts of interest between the role of financial institutions as commercial banks and investment banks. Disclosure is an important first step. Disclosure is necessary, but almost surely not sufficient. For example, mortgage originating companies should not be allowed to own their own appraisal companies.

33. Guarantees and insurance. Guarantees and insurance distort incentives since there is no risk of loss. The higher potential gain from more risky behaviour accrues to the individual while loss is absorbed by the government. Such behaviour was common in the Savings and Loan crisis of the later 1980s, with significant social consequences. However, in times of economic crisis guarantees and insurance may be part of a government's crisis response in order to stimulate countercyclical economic activity and to prevent runs on banks. In some cases, issuing government guarantees may even be a strategy to attract individuals to investments with relatively high risk, but with a perspective of high long-term positive social or ecological effects. Adverse incentive effects can be mitigated by providing only partial insurance / guarantees.

Securitization

34. Securitization held open the promise of risk-diversification and access to new sources of funding. But it also opened up new information asymmetries and avenues of inappropriate behaviour by investors who did not possess the ability to bear the risks or could not evaluate them appropriately since they did not have the relevant knowledge of the underlying assets available to the originators. Markets, regulators and the models used by bankers, credit rating agencies, and investors to assess risks overestimated the benefits of risk diversification and underestimated the costs of the information asymmetries and concentration of investor behaviour.

35. Securitization has also presented new problems in debt restructuring (problems that arose earlier in the debt crises of the latter part of the last century). Governments will need to address the legal issues *raised* by debt renegotiation in ways which balance the rights and interests of creditors and debtors, with due account of systemic consequences of a failure to renegotiate. Originators of securities should be required to hold a stake of at least 10 per cent in each issue of securities they underwrite. While this would significantly reduce the capacity for future securitization, it would also substantially reduce the potential for systemic risks associated with structured products and would encourage higher underwriting and lending standards.

36. The perverse incentives and distorted market signals that are produced from the behaviour of the economy may be offset by counter-cyclical regulation. The introduction of time-varying capital adequacy requirements that rise and fall with the business cycle provides an example. To better combine macro-prudential and micro-prudential regulation regulators and central banks might jointly agree an annual rate of expansion in bank lending and the

bands around that rate, above which a bank would be required to increase its capital adequacy requirements, or below which it would be able to reduce its requirements. If time-varying capital adequacy requirements would have been in place, the magnitude of the previous boom and its inevitable crash would have been moderated. Relating macro-prudential regulation to the rate of growth of bank lending would further enhance the temptation for banks to hide their own lending in associated off-balance sheet vehicles, like conduits and SIVs. Regulators must prevent this happening by treating all such associated vehicles as effectively remaining on the balance sheets of the banks.

37. The privatized GSE (government sponsored enterprise) model, in which government provides funding or what is interpreted as effective government guarantees may be a particularly hard model to design to work well. The potential conflicts between managerial interests in maximizing their own returns or returns to shareholders may conflict with public interests.

38. Recent government bailouts and government guarantees have raised issues of conflicts of interest and divergences between the interests of firm managers and those of the government providing capital. It exacerbates the usual incentive problems that arise when there is a separation between ownership and control. The much criticized behaviour of banks taking money that was intended to recapitalize them and paying it out in bonuses and dividends instead is fully explicable in terms of the differences in interests between those making the decisions (the bank officers) and that of the public providing the money. The risks should have been apparent. (See the discussion in Chapter 2).

39. Perverse incentives can become most acute as financial institutions face the possibility of bankruptcy or falling below capital requirements.

40. While mark-to-market value accounting may not be appropriate for the risk management of some long-term institutions, it is important to recognize that failure to apply mark to market accounting may induce other forms of perverse incentives. Banks may have an incentive to undertake excessive risk taking; assets that go down in price can be kept, and those that go up in price can be sold. The result is to increase the divergence between mark to market values and "book" value. This incentive has been compounded by recent actions to suspend mark-to-market accounting in the crash, having promoted it in the boom. At the same time, there needs to be recognition of the different uses to which accounting information is put. Much of the accounting framework is designed to assist in the evaluation of shares. From this perspective, increasing market value when there is a decrease in the value of outstanding bonds because of market perceptions of an increased probability of default makes sense. But bank regulators are concerned with the risk that the bank will not have sufficient assets to pay off its depositors (and possibly other creditors). In this context, it makes little sense to suggest that the bank is in a better position because the market thinks it is going to default.

41. In economies where banks are publicly listed and are subject to takeover, supervision needs to be particularly intense in circumstances where incentive structures are such as to

increase the likelihood of excessively risky, short sighted and fraudulent behaviour and when managerial incentives may not be well aligned with other stakeholders. Financial institutions where the government has provided much of the capital, but government's financial stake is not fully reflected in voting shares are also prone to incentive misalignments and need to be especially tightly supervised.

42. Whenever banks are too big to fail because failure might create systemic instability there are incentives to engage in excessive risk taking. Such institutions need to be closely supervised.

Transparency

43. Much of the discussion on regulatory reform has focused on transparency. It is sometimes suggested that lack of transparency is the major market failure, and the introduction of full transparency would resolve the problems of market failure. It is unlikely that in aggregate, the excessive lending and borrowing would have been substantially less if there was greater transparency, but transparency plays an important role in the distribution of losses and is critical for consumer and investor protection. In this crisis, a lack of transparency was evident not only in off-balance sheet activity, but also in the extensive utilization of the hard-to-evaluate over the counter derivatives. The lack of transparency is often a symptom of deeper market failures that produces incentives to limit information, and these deeper market failures may have other manifestations. Moreover, lack of transparency is only one of several market failures.

44. There is now widespread agreement that private markets do not necessarily provide optimal incentives for transparency. There may even be incentives for providing distorted information, e.g. associated with executive compensation schemes based on stock options. Regulatory arbitrage provides another set of incentives for a lack of transparency. Lack of transparency may also be a management defence mechanism against takeovers, for it creates additional uncertainties for any would-be firm contemplating such a move. Lack of transparency may also enable banks to price discriminate and enhance profitability in other socially destructive ways.

45. Banks should be restricted in creating off-balance sheet vehicles/instruments. Overall, there needs to be more transparency in accounts. Mark to market accounting was introduced to increase transparency. But some have argued that its inappropriate application to all assets contributes to market volatility. The problem is not with mark to market accounting, but with how the information provided is used by firms, markets and regulators. The adverse effects of mark to market accounting could be offset by countercyclical capital adequacy and provisioning described above. It would be a major retreat from transparency to move away from mark to market accounting, however, where institutions have long-term funding or liabilities, it may be important to supplement mark-to-market accounting with a mark-to-funding accounting when it is more appropriate in the risk management of the financial firm.

46. Accounting standards should make information as transparent as possible for

shareholders and bondholders. This might require thinking about changing other existing standards. For example, while dynamic, counter-cyclical provisioning is a desirable feature, accounting boards are not currently well disposed to such proposals since they prefer event based to statistical accounting. Statistical techniques may be the best means of providing reliable estimates of future losses.

47. Anomalies in accounting systems, such as failure to expense stock options, need to be addressed. These can not only make it difficult for investors to appraise the firm's economic position, but distort behaviour as well as the provision of information.

48. No single information system can provide all the relevant information. For institutions with long-term funding or liabilities–something which the regulatory system should reward—mark-to-funding accounting could be useful (and in some cases even more relevant). Life insurance firms, for instance, with long term liabilities but with assets matching those liabilities should not be "punished." But this is what would happen with mark to market accounting if liquidity risk spreads rose and the long term assets in which they had invested fell in value. It would be inefficient to match each asset with its funding, but pools of assets could be matched with pools of funding. One issue in a mark-to-funding or mark-to-liability approach would be determining the maturity of funding. Life insurance policies might normally be held to maturity, but the contract provides a liquidity option—owners can borrow against them. They also have a cash value. Demand deposits are normally held for a long time; but in a panic, they can be withdrawn overnight.

49. Transparency is important, but stronger transparency and disclosure standards are not enough. Even if there had been full disclosure of financial products, many are complex and the level of financial understanding insufficient. The nature of over-the-counter products can be highly complex, making it difficult to assess risks and to net out positions for hedging purposes or in the case of bankruptcy. Over the counter trading should be restricted and those engaging in such trades should be required to set aside appropriate margins reflecting the systemic risk those trades might pose. (Below it is argued that even trading over the counter for Highly Regulated Financial Institutions such as commercial banks should be limited to covering "insurable risks.")

50. Economic theory suggests that transparency may actually lead to more volatility. But even if this proves to be the case, most of the time, the benefits of transparency outweigh the costs, and so there should be a strong presumption for greater transparency. Without good information, resources cannot be efficiently allocated, and lack of transparency can too easily contribute to exploitation and corruption.

51. Just as much as accounting standards should allow for as much information and transparency as possible, one should strive to ensure as much transparency in the dealings of the regulator. While regulators should in principle be free to ask for information from private actors, the dissemination of any findings publicly needs to be carefully handled. The regulator should have an obligation to put transactions involving public monies in the public domain but perhaps with a lag if there are concerns about market sensitivity. If proprietary

information issues restrict full disclosure of firm level data, there should be full disclosure of aggregative data. Parties not willing to transact with the government on the basis of transparency should be prohibited from receiving public funds or entering into contracts with the government.

52. Transparency should be encouraged when a financial rescue plan is being undertaken. In the current scenario the manner in which financial rescues/bailouts are being conducted are often opaque and uncertain. As a result, a great deal of confusion has been sown about the principles underlying the financial restructuring that is occurring and about the process by which the terms of the deals are determined. This has contributed to market uncertainty. While in the past, a simple adage 'save the banks, not the bankers' has been followed, in the current crisis, in some countries this important distinction has been blurred In such a scenario clear principles need to be agreed upon beforehand which recognize that while banks may be systematically important, not all elements of their capital structures are. An expedient resolution through recapitalization, (temporary) nationalization, and/or super (or expedited) "chapter 11" bankruptcy (conservatorship) could restore the credit intermediation process in the most rapid and most transparent manner possible.

Macro-prudential regulation

53. Regulation should be more focused on the capacity of the financial system as a whole to bear and allocate risks and where this is best done, rather than solely on measures of individual firm risks. Risk is not just about assets. It is about how the assets are funded and how the assets are used. Regulation of systemic risks needs to include an assessment of funding liquidity.

54. Financial liquidity and stability requires diversity of action and opinion. If all firms respond in the same way (e.g. trying to sell some asset at the same time), markets may exhibit extreme volatility. It is important that regulators do what they can to preserve natural diversity, especially in the face of enhanced transparency, common accounting standards and the increasing comprehensiveness of regulation.

55. The benefit of diversity is another argument in favour of a return to more specialized, simpler institutions and the segmentation of markets, perhaps with a return to the "public utility" aspect of banking for core deposit taking institutions and regulatory segmentation of institutions into areas such as retail banking, long-term savings institutions and wholesale investment banking. Each function could then be regulated to discourage it from holding risks it does not have a natural capacity to hold.[1].

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[1] In the United States, the regulatory segmentation was largely eliminated in the era of free market philosophy from 1980 to 2000. The Gramm-Leach-Bliley (GLB) Act of 1999 was the key legislation repealing the Glass Steagall Act of 1933 that segmented banks from other financial activities. Under GLB, banks and other financial institutions were permitted to commingle banking, insurance, and securities activities within one institution. At the time the promoters of such legislation emphasized the benefits of diversification and ability to compete with foreign institutions that were permitted to combine these activities in one institution. Little concern about conflicts of interest between the various dimensions of the business or about the commingling of risky activities

56. The virtue of differentiated regulatory structures and standards for different kinds of financial institutions has to be offset against the risks of regulatory arbitrage.

Countercyclical regulations

57. There should be countercyclical capital adequacy and provisioning requirements, based on simple rules, which call, for instance, for an increase in capital requirements as the rate of growth of the assets of a bank increases or the rate of growth of a particular class of assets within the bank increases. This, and other ways of providing "speed bumps" would have dampened most earlier boom and bust cycles. Provisioning requirements automatically ensure that the bank set aside more funds as it lends more. But since the riskiness of lending is likely to increase as the pace of lending accelerates, the likelihood of problems increases, implying that the requisite provisioning should go up. By the same token, as the ratio of the value of housing to income increases, the probability of a problem increases, and so the magnitude of the provisioning (or the capital adequacy required) needs to be adjusted. (It may be necessary to develop accounting frameworks based on statistical loss estimates to deal appropriately with these issues.) Regulators need to be aware of distortions in capital allocation when provisioning and capital adequacy requirements do not accord well with actuarial risks.

Capital market liberalization

58. Regulations which affect the flow of capital into and out of a country, especially of small or medium-size, may be among the most important in determining macro-economic stability and the scope for policy responses, in the event of a crisis. There is growing consensus that capital market liberalization may contribute to economic volatility, especially in developing countries. More broadly, a fully integrated global financial system may be subject to more volatility than one with "circuit breakers" and "surge protectors" (to use an analogy to electricity networks). Part of the reason for this is that capital flows tend to be pro-cyclical. And yet there is little conclusive evidence that, especially for less developed countries, capital market liberalization contributes significantly to economic growth. Part of the reason for this is that much of the cyclical lending finances consumption, rather than investment; and part of the reason is that the increased volatility associated with liberalization imposes a high costs on an economy, raising risk premia, and forcing governments to set aside larger reserves. The opportunity costs of these funds may be large, and the building of these reserves contributes to global imbalances, and in an international system with a single reserve currency may add to global financial fragility.

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with the core activities of the payment system and deposit protection was voiced. It was only in the aftermath of the events illuminated by the crisis where the political power and moral hazard implications of too big to fail institutions have been shown to be of critical importance. The Group of 30, under the leadership of Paul A. Volcker, has raised concerns about these issues in their report entitled *Financial Reform: A Framework for Financial Stability*. Their report states that: "The clear implication is that at least the very large and complex banking organizations that now account for so much of the extensions of credit and carry the major responsibility for maintaining the financial infrastructure will need to be held to more rigorous standards of prudential regulation and supervision, with new constraints on the type and scope of their risk-taking activities.

Capital Account Management for Development

59. Developing countries often need to stabilize international financial flows for a variety of reasons. These include the need to promote financial stability; to encourage desirable investment and financing arrangements; to enhance policy autonomy, including the maintenance of stable and competitive exchange rates; and to enhance national sovereignty and democracy. Full capital account convertibility as well as implicit and explicit agreements to forego intervention in international capital markets can serve to prevent such desirable outcomes, and should therefore not be seen as ends in themselves.

60. To achieve these objectives, Governments should be given space to undertake capital management techniques as part of their development and risk management strategies. Such techniques--which have been used successfully in the past--have included, but are not limited to, prudential management of foreign borrowing, the imposition of unremunerated reserve requirements, the placing of limits on equity ownership of certain financial and other activities, and so on. It is imperative for the success of development strategies that countries be allowed to undertake dynamic capital management by having the flexibility to both tighten and loosen controls as and when necessary.

Capital market interventions during crises

61. Governments have, as part of their arsenal of policy tools, a variety of interventions to help stabilize financial flows. In a crisis, when traditional tools such as interest rates are less effective, they may consider temporary restrictions or longer-term taxes on inflows and on outflows, as well as both price and quantity interventions. Particularly in the context of a financial and economic crisis, countries may find it necessary to impose restrictions on capital outflows, in order to give them more scope for monetary policy discretion.

62. To a limited extent, recommendations for "host versus "home" country regulation and proposals for counter-cyclical capital charges can also act as "speed limits" on international capital that flows in and out of the domestic banking system. In similar vein, greater prudential regulation of banks—to avoid currency mismatches—can simultaneously be used as an important instrument in capital account management.

Financial market liberalization

63. The framework of financial market liberalization under the Financial Services Agreement of the WTO may serve to restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors. At the same time, existing agreements do not seem to be designed in ways to prevent financial market protectionism and arbitrary "black listing" on the part of developed countries or to prevent major adverse effects on developing countries.

64. There is some evidence that, at least in some countries, the entry of foreign banks has led to reduced lending (in general, or to SMEs in particular) and/or speedier unwinding of

lending. Restrictions of the kind proposed in the following paragraphs may be helpful in addressing this concern. Such restrictions should be imposed broadly, on both domestic and foreign banks, even if such uniform restrictions indirectly have a differential effect on foreign banks.

65. Problems in the home country banking system can spread to other countries in which that bank has branches or subsidiaries. They may, for instance, reduce lending. Such problems are exacerbated when governments put pressure on their banks to use what limited capital resources they have for lending to the home country. Such pressure is not surprising when home governments have provided large amounts of funding for the survival of domestic banks. Earlier discussions emphasized the importance of “national treatment,” that foreign banks should not be treated in a disadvantageous way. The current crisis has shown the need for a new dimension of “national treatment”: foreign borrowers (branches, subsidiaries) should be treated as well as those at home. Since such discrimination may be tacit and/or difficult to detect, it may be difficult to enforce these aspects of national treatment that can be of great importance to the well being of developing countries.

66. Developing countries may find it desirable, in order to ensure that there is adequate funding for domestic lending of foreign banks and that the effective capital underlying such lending is not withdrawn back to the home country (as seems to have happened in some instances) to require foreign banks operating within their countries to operate as subsidiaries rather than as branches.

Further issues in Micro-regulation

Restricting excessively risky practices

67. It is clear that the banks engaged in excessively risky practices. The discussion of countercyclical capital adequacy and/or provisioning requirements provides one approach to discourage such excessively risk activities. Governments, especially in developing countries, may want to consider others. For instance, quantitative restrictions on the fraction of bank portfolios that can be allocated to certain sectors prone to speculative activity such as real estate, may not only lead to greater stability, but ensure greater financing for infrastructure or employment related investments on a longer term basis.

68. Countries that allowed banks to own equity shares in non-financial companies may experience greater volatility, because even when their lending practices are sound, a sudden decrease in stock prices can force a credit contraction. Banks' comparative advantage and institutional role in our society is providing credit, and accordingly, an argument can be made that they should be subject to appropriate regulation if equity shares are part of their investment book.

69. Some of the problems in earlier crises were a result of foreign exchange mismatches. Regulations should place strict limits on uncovered foreign exchange exposures. Similarly, there should be restrictions on engaging in swaps and other insurance and derivative products

other than to hedge or mitigate existing risks. Banks, with their implicit or explicit government guarantees, should be restricted from being engaged in activities that may significantly increase their individual and systemic risks.

70. Countries that allowed their banks to grow beyond the size of their economy are not in a position to provide guarantees should the bank fail, or can do so only at great costs to the rest of society. It is thus necessary that either (i) a global deposit insurance fund be created, funded through contributions of the banks with fees depending on their individual capital adequacy ratio or through a tax on all cross border deposits and set at a rate that is deemed to be actuarial fair, and backed by the government of the depositors be created; or (ii) depositors in foreign banks not explicitly insured by the host country recognize that those deposits are not insured. The second approach is likely to limit the extent of cross border financial flows. The provision by the host country of deposit insurance should only extend to separately capitalized subsidiaries of foreign banks, with strong restrictions on the pay-out of capital to the holding company, and close oversight by host country regulators.

71. This approach will not be welcomed by international banks who will claim that it will reduce the efficient allocation of capital and restrict international capital flows. It is likely to prove a price worth paying.

Restricting securities markets

72. Banks are only one part of modern financial system, and many non-bank operations in the securities market contributed to the current crisis. Excessive volatility in securities markets can have adverse effects throughout the financial system. Core financial institutions should not be allowed to undertake excessively risky market positions such as “naked” short sales, and governments should consider broadening such restrictions to all participants in financial markets.

73. Comprehensive regulation entails ensuring that equivalent instruments be treated the same, i.e. if there are restrictions on naked short sales, there should be analogous restrictions on the use of derivatives and credit default swaps.

Regulation of Credit Derivatives, Swaps

74. Since the default of a large corporation can have far greater monetary implications than the size of any of its outstanding liabilities it may be prudent for lenders to also hedge the risk of a default of the company affecting its suppliers, dealers, pensioners, stores local to the employees etc., so the outstanding value of credit default swaps may be larger than any single liability. However, there are systemic implications of a large CDS market where there is no centralized clearing house or regulated exchange trading. Hence, centralized clearing should be the preferred route and OTC should be subject to enhanced monitoring, margin set aside above and beyond that required on an exchange and disciplined pricing that does not rely upon mark to model methods. The regulator should further have access and information both for OTC and centralized clearing through a system of ex-post reporting to a centralized

agency.

75. The regulatory agencies should also be authorized to declare any CDS transactions that it considers to have become of systemic importance to comply with a range of requirements, including, a registration process, centralized clearing and where appropriate to the risks being taken, margin and capital requirements. While the regulator should have a preference for exchange traded instruments relative to over the counter instruments, if OTC instruments are approved, there should be adequate transparency in the form of mandated and regular reporting to the regulator and aggregative information should be put in the public domain as determined by the regulator.

Predatory lending and usury

76. Regulating predatory lending is mostly a matter of consumer/investor protection, but, as this crisis has shown, it is also a matter of risk management. The subprime mortgage market provided examples of predatory lending, but there have been other abusive practices as well (rent a centre, pay day loans).

77. The elimination of usury restrictions has been advocated on the grounds that it encourages risk taking. But it may have resulted in excessive risk taking and abuse of ill-informed borrowers. Regulators need to be attentive to the variety of forms that circumvention can take, e.g. through rent-a-centre and other commercial activities.

78. Recent years have seen particular abuses with credit cards. Such practices have flourished in part because of anti-competitive behaviour, which has helped generate above market returns. In some countries, such anti-competitive behaviour have been restricted, while in others proposals for restricting abusive and anti-competitive behaviour have, not surprisingly, met resistance from the industry. Governments are strongly encouraged to consider such actions, which would contribute to a more efficient and more equitable financial markets. Moreover, abusive lending practices lead to high returns to lending, and have contributed to the build-up of excessive household debt. The misery of the ill-informed borrower is compounded by the recourse by lenders to recovery agents who use unregulated and uncivilized means of loan recovery.

Lending and public banking to promote development

79. The objective of financial policy is not only to regulate institutions and the system in a prudential manner, but also to ensure that the financial sector can live up to its positive potential contribution to society, including ensuring access to credit for all and the provision of credit for long term development. In the past, many financial institutions engaged in red-lining, excluding lending to certain discriminated against groups. Certain key sectors of the economy did not have sufficient access to credit. Government created institutions, including the establishing and support of public banks, as well as supporting development banks, may need to play an important role in the provision of credit to underserved sectors and segments of society, financial sector policy in general and on occasion regulatory policy can play an

important role

80. While there has been a presumption that a fully private banking sector is the best system to ensure the most productive and efficient management of liquidity, risk and development, the current crisis and other experiences in various developing countries suggest reasons to support a much more substantial role for publicly owned banks. A public bank can substantially realign incentives driving bank managers and can harmonize the role of bank operations and supervision. Further, by making the inherent and incessant profit motive subordinate to social objectives, it allows the financial system to exploit the potential for cross subsidization and to direct credit—even if the bank incurs higher costs to targeted sectors and disadvantaged sections of society. Given that a significant determinant of poverty is limited access to finance, public banking can thereby permit financial inclusion. In the experience of several successful development strategies, public banking has allowed for the mobilization of technical and scientific talent to deliver both credit and technical support to agriculture and the small-scale industrial sector which have the most direct effect on job creation and poverty reduction. Moreover, public lending is less likely to engage in the abusive practices that marked America's financial sector in this decade. Development banks have played an important role in the development of several successful countries. Recent crises have shown another problem with private sector lending—it can be highly cyclical, exacerbating economic fluctuations. Nevertheless there is always a danger that public banks may have their portfolios manipulated for political rather than social reasons, and the record of publicly owned banks has been spotty. Some recent experiences, however, of public development banks with better and more transparent governance structures is encouraging. Public and private banks have to be coexisting elements of a sustainable financial system. The concept of subsidiarity, where government takes on especially those tasks that the private sector is not able to carry out more efficiently or risks of market failure are too high (e.g. full financial inclusion, direct credit to targeted sectors), may be one of the principles in establishing sustainable banking sectors.

81. In some countries, mandates for lending to underserved segments have played an important role, and have, in the long term, even proven profitable. Apart from implementing direct public banking, countries should encourage the availability of banking services to the un-banked and insurance to the uninsured. This could include a direct subsidy to offset the credit monitoring costs of dealing with small loans, or through mandating lending to certain groups such as the US Community Reinvestment Act (CRA) requirements. Because information is at the heart of banking, requirements that banks open up branches in underserved parts of a country can also be an important instrument of development.

82. We recognize that lending to the real estate sector can have a number of social benefits, but it is also a common source of excessive lending and asset market bubbles. Consequently, we recommend limits to real-estate-related lending such as loan-to-value limits on mortgage lending. We believe there is an argument for these limits being time-varying rising in a boom and falling in a crash. Restricting lending, e.g. to the real estate sector, may also be an important instrument in encouraging lending to other sectors. Such restrictions may both enhance stability and development.

83. Negative and positive "priority" lending may be most effective when broad based, leaving the private sector with the strongest incentives to find the best commercial opportunities within those constraints.

84. Incentives may be an important part of helping direct lending to areas where social returns might exceed private returns, such as micro-credit, SME and rural-sector lending. Similarly, there should be measures to restrain socially damaging activity.

85. In some banking systems, banks appear to solely or mostly invest in government paper. A number of reasons may be behind this, including the regulation of deposit and lending rates or crowding out of private enterprise by large government deficits rates. Governments should be encouraged to explore various mechanisms by which the banking system could be used to facilitate productive activity. One arrangement, for example, may be to accept savings directly by the government through a network of post offices to reduce the spread between the bank deposit rate and interest charged by banks to government paper.

Regulating other players

86. Financial markets have become more complex over time. Finance is provided by banks and through security markets. There are a host of other actors, some of which may have played an important role in the current crisis, some of which have become the subject of extensive controversy. Comprehensive and fair regulation must ignore past distinctions and be based on economic function.

87. In particular, there are two non-traditional financial firms that require additional attention: rating agencies and sovereign wealth funds.

Rating agencies

88. There is a consensus that the rating agencies did not perform their job well, mainly in respect of the rating of structured credit products Whether it was a result of a conflict of interest or incompetence—they are paid by those that they were asked to regulate—and the presence of this clear conflict of interest has undermined confidence. Moreover, some generated revenues by advising financial firms on how to improve their grading. Some reforms, such as increased transparency through requiring disclosure of the details of the ratings process may help; but even such mild reforms are not without their controversy. Financial firms may be reluctant to disclose information which they believe might be disclosed more publicly and disclosure of rating methodologies contributed to banks building structured products to rating. But greater transparency in the way that rating agencies discuss and present their analyses, clarifying assumptions made and sensitivities of results to these assumptions, should contribute to the functioning of financial markets. In addition, rating agencies should be required to provide information concerning their overall performance and/or an independent government agency should provide such information, which would enhance "positive" competition among rating agencies.

89. Part of the problem is caused by the market structure–a small oligopoly–which means that rating failures do not lead to significant market discipline. Many investors and hence borrowers are required by their investment by-laws to obtain a rating from each of the main agencies. It may be necessary therefore for the government to impose discipline by penalizing rating failures.

90. Given the difficulties of resolving the problems posed by credit rating agencies, it is important that regulators—and others charged with risk management—rely less on them. Rating agencies proved to be no less pro-cyclical than market prices and their use by regulators added to the pro-cyclicality of bank lending. Problems with individual ratings need to be viewed in the broader context of the provision of information. In the Enron/WorldCom scandals, conflicts of interest in the ratings provided by analysts paid by investment banks drew extensive criticism. In the recent food and energy crisis, information provided by some investment banks may have simultaneously enriched those providing the information and contributed to those crises. While the reforms concerning analysts pay were a move in the right direction, they do not go far enough. There should be disclosure, to the regulator, of positions of investment banks and others capable of "moving" markets, to at least identify potential conflicts of interest.

91. Credit rating agencies (CRAs) play a key role in financial markets by reducing information asymmetries between issuers and investors. Their role has expanded with financial globalization and received an additional boost with Basel II, which incorporates the CRAs' ratings into the rules for assessing credit risk. However, rating agencies have been subject to serious criticism, recently, for generous ratings to complex financial instruments backed by "sub-prime" mortgages. The risk assessments of rating agencies have been highly pro-cyclical, and tend to react to the realization of risks, rather than to risk build-up, in relation to both sovereign and corporate risk. The risk models of CRAs rely, to a large extent, on market-determined variables like equity prices and credit spreads, thus exacerbating pro-cyclicality. Additionally, the independence of the rating is compromised because a dual role of rater and advisor is often assumed by the same CRA.

92. As assessments of creditworthiness by CRAs came to be viewed as authoritative in financial markets, such ratings adversely affected financing for developing countries. Because CRAs operate as unregulated private institutions, the existing regulatory framework and surveillance mechanisms are minimal and inappropriate. To ensure CRAs' accountability, both to issuers and investors, a collective institution should be established to be responsible for assigning agencies for rating particular security issues and for paying them.

Sovereign wealth funds

93. Earlier conventional wisdom argued that ownership did not matter, so long as it was not the government of the country. Developing countries were urged to privatize state owned assets, paying little attention to the identity of the buyer who in some cases, the buyer was even a foreign government. It seemed permissible for a foreign government to own a country's assets, but not the country's own government. As entities owned and controlled by

foreign governments have taken a more active role in purchasing assets in developed countries, these views have evolved creating investor uncertainty over the rules of the game. Whatever rules are devised and agreed upon should be universally and fairly applied.

94. There may be particular industries or sectors where ownership matters. Governments should agree on those sectors. If national security provides a rationale for ownership restrictions in one country, there should be a presumption that it provides a rationale for similar limitations on ownership in other countries. If ownership matters, one should be as concerned by aberrant private sector behaviour as by that of a government owned enterprise. Indeed, some have suggested that governments may be a more responsible investor than private sectors, precisely because of the greater degree of accountability.

95. Some have suggested that a special code of conduct be imposed on sovereign wealth funds, including provisions relating to transparency and disclosure, including disclosure of the sovereign wealth fund's business model, and that such a code of conduct will suffice. Others have argued that that is just window dressing (on the part of countries that want the funds, but realize the political sensitivities): almost any action can be cloaked within a business rationale. While transparency and disclosure may be helpful, it is unconvincing that it would "solve" the problem. So too with a broader voluntary code of conduct. But any requirements imposed on sovereign wealth funds should be symmetrically imposed on private sector investors. The point is reinforced by the growing blurring of the line between private and public investors, with the bulk of the capital of many Western banks being provided by governments. Moreover, restrictions on sovereign wealth funds may be relatively meaningless, so long as there is no comprehensive disclosure of ownership. Ownership stakes could be mediated through third parties, without disclosure. If governments are concerned about ownership, there has to be accordingly comprehensive disclosure.

96. If there are certain behaviours of the foreign owner that are a source of concern, those behaviours should be restricted, whether on the part of private or government entities. Worries about their behaviour are thus symptomatic of a lack of confidence in the overall regulatory regime. Countries should identify the inadequacies in their regulatory structures and seek to remedy them.

Regulatory institutions

97. Regulatory failure. It is not enough to have good regulations; they have to be enforced. The failures in this crisis are not just a failure of regulation, but of regulatory institutions. Those assigned responsibility for regulation did not always effectively implement the regulations. All human institutions are fallible, and it may happen again, especially if those who are appointed to oversee the regulatory system do not believe that regulation has a role.

98. At the same time, it is clear that regulatory structures can be designed in ways that reduce the scope for the failure of regulatory institutions. Regulators may be under pressure during a boom. While the regulator is supposed "to take away the punch bowl just before the party gets going," pressures are often brought to bear to continue the party, since so many are

making so much money doing so. Specious arguments are brought forward—like you can't tell a bubble until it breaks: it is true that you can't be sure, but you can ascertain that there is an increasing probability of a bubble, as prices relative to incomes attain historically high or even unprecedented levels.

99. In light of this pressure, it may be necessary to "hard wire" much of the regulatory structure, leaving less discretion to regulators and supervisors. Provisioning requirements and countercyclical capital adequacy requirements of the kind discussed in previous sections should be rule based.

Capture and voice

100. Regulatory institutions have to be created with recognition of the risks of capture by interests and perspectives of those being regulated, and ensuring that users of finance such as small and medium-sized businesses, pensioners, consumers and perhaps other stakeholders are given voice. Pensioners who are likely to see the hard earned pension funds disappear as a result of poor regulation should, for instance, have a strong voice in regulatory structures, as should other groups representing retirees. Those who benefited from the continuation of the bubble often have excessive influence on the regulatory institutions as presently constituted.

101. The creation of a specific financial regulator (with appropriate governance structures) whose mandate is to ascertain the safety and appropriate use of various financial products may reduce the likelihood of regulatory capture. Moreover, the benefits and costs of regulatory duplication and segmentation may be worth reconsidering. All institutions are fallible, and the costs of regulatory mistakes are enormous, and overwhelm any costs of duplication. Sectoral regulators with simple objectives and rules may also be harder to capture.

Regulation and political processes

102. Regulation is part of the political process; failures in public governance contribute to failures in regulatory design. When the political process is unduly influenced by campaign contributions from and other forms of lobbying by the financial sector, failures in the design of financial regulations become more likely. In some countries, "revolving doors" and other pecuniary and non-pecuniary considerations present problems compromising the integrity, adequacy and appropriateness of financial regulation, supervision and enforcement.

Incentive structures

103. To the extent possible, regulatory institutions should be designed to have incentives to encourage good regulation. In this regard there is a consensus that credit rating agencies, paid for by those whom they regulate, should be taken out of regulation

Personnel

104. Many regulatory bodies face difficulties in attracting qualified personnel: the battle between the regulator and the regulated might seem to be an unfair one from the start, given the high salaries paid in the financial sector. But the skills and talents necessary for creating new products and circumventing existing regulations and accounting standards are different from those required for assessing the safety and soundness of financial institutions or the safety and efficacy of particular financial products. Nonetheless, it may be desirable, or even necessary, to link the salaries, financed by a financial sector tax linked to the salaries of those in the financial sector.

Regulatory Structure

105. Much of the discussion over regulatory design has focused on the problem of assignments of responsibilities, e.g. should there be a single regulatory authority for the entire financial sector? Old models of regulatory structure have been failing because different institutions have been providing services formerly associated with other institutions. Securities markets and insurance firms and futures exchanges all provide opportunities for market participants to speculate on the outcomes of particular events (securities, defaults). Should responsibility be assumed by the Central Bank? While there appears to be no single model, appropriate for all countries, there are certain principles which should guide the design of the regulatory structure.

106. While different countries, at different stages of development, may find different structures better in meeting their overall needs, one possible structure entails two Apex regulatory institutions, working closely together: A New Central Bank focusing on macro-economic issues, the other, a Financial Regulatory Authority, focusing on micro-issues, closely coordinated with each other so that, for instance, the CB would be aware of the macro-economic consequences of the actions taken by the FRA. This is especially important because micro-prudential regulations have macro-economic consequences. The FRA would have under it several sub-commissions, a Securities and Exchanges Commission, an Insurance Commission, a Financial Products Safety Commission, an Accounting Oversight Commission, and a Financial Systems Stability Commission. It would have cross cutting committees to ensure that similar functions performed by different institutions were treated similarly. The Financial Systems Stability Commission could impose high margin requirements or large down payments for products sold to retail customers, if it felt that there was growing excess leverage in the economy or in the market. The Accounting Oversight Commission would ensure that the information provided by firms was not misleading, and represented the best estimate of the overall state of the firm, including its vulnerability. It might overtime develop broader set of metrics that might be of use to investors and other regulators.

Global Regulation

107. This crisis in global financial markets differs from all previous crises in its global reach. The magnitude of the scale of flawed products (toxic mortgages) that were exported from the US is large, with severe consequences for importing countries. While it may not be

the only source of the problems facing some European countries, it is a major contributor. As the crisis has evolved, there has been a break-down of trust: investors no longer trust banks. Citizens no longer trust the regulators who were supposed to regulate them, and regulators in one country no long trust that the regulators in other countries—even those with seemingly good institutions—are doing their jobs properly.

Comprehensiveness

108. As financial markets become global, it is imperative to have global co-ordination of regulation. This is especially so as responsibilities for bail-outs remain at the national level.

109. Circumstances in different countries differ, which would suggest that the optimal regulation and regulatory structures might differ. Thus there are items of regulation which should be focused locally, with international co-ordination, and others where the focus of regulation is international. The dividing line relates to those issues which require a high degree of reciprocity, such as regulation aimed against money laundering and tax secrecy; and/or on those issues where inadequate regulation in one country has large effects on other countries (either because of network effects or because of an induced race to the bottom.)

110. The placement of this dividing line also depends on the representativeness of regulatory bodies. In existing global regulatory bodies, concerns of developing countries are often given short shrift. For instance, the Basle I standards encouraged short term lending (relative to long term lending) by developed to developing countries, exacerbating their volatility. Many have been concerned that Basle II would have had the effect of discriminating against developing countries whose institutions do not have the ability to develop the complicated—and we now realize, totally inadequate—risk management systems.

111. Part of the concern about these regulatory systems is that they were arrived at by international institutions with flawed governance structures—under representation of developing countries and emerging markets, and over-influence of those banks being regulated. Basle II is seen by many developing countries as an example of that.

International Banking Centres and International Tax Cooperation

112. Well regulated economies have to be protected from those that are under- or unregulated. The problems of tax competition and regulatory arbitrage are often linked. The lack of transparency and regulatory standards is some countries is harmful to the functioning of national tax systems as well as to financial stability. Tax evasion and inappropriate tax practices are major problems for developed as well as developing countries. Each year, developing and developed countries lose enormous amounts that could be used for the financing of development. We must strive for a universal no-tolerance policy towards financial centres that continue to harbour generalized tax and bank secrecy.

113. While particular attention on this issue is drawn to off-shore financial centres in developing countries, we note that so far, the principal sources of tax evasion, tax secrecy,

money laundering, and regulatory arbitrage have been connected to developed country, on-shore banking systems. Delaware and Nevada for instance are two US states that make the establishment of anonymous accounts far easier than almost all international banking centres. Bank secrecy remains an issue in several developed centres. London's light touch regulatory regime was a source of much regulatory arbitrage. The biggest money laundering cases involved banks in London, New York and Zurich. The European Commission has decided to refer four smaller member states to the European Court of Justice over non-implementation of the 2005 anti-money laundering directive and two large member states have been given a final warning.

114. The matter is best handled through multilateral agreements on issues of tax secrecy, which have reciprocity and are enforceable by international courts. The major financial centres should sign up to these agreements first and then welcome others to follow, with the threat that those who do not chose to do so, would not be allowed to have linkages with those financial centres that have signed up to the agreement.

115. Ad-hoc and discriminatory targeting of small international financial centres in developing countries while a blind eye is turned to lax rules in developed economies are neither fair nor effective. For instance while many developing country financial centres have several bilateral tax information agreements, the advanced economies do not reciprocate. We need to move away from bilateral to multilateral agreements. Under these multilateral agreements "rogue centres" should be ring-fenced from the rest of the international financial system, but this must be done in an objective manner that could include rich as well as poor countries. We note for instance that for foreign investors the US is effectively a tax haven and developed countries engage in greater tax incentives, subsidies and tax competition to attract foreign investment than developing countries can afford. Moreover, the development of developed country financial centres such as London, Luxembourg and Dublin, has been based on tax competition.

116. We do not sanction one rule for the rich and a tougher rule for the poor and the preservation of centres and practices in developed countries that are not permitted in developing countries. This is why our focus is on the removal of tax secrecy that facilitates tax evasion and shining a light on tax avoidance practices. We accept that for responsible small states that sign up to the multilateral agreements, which we suggest above on tax secrecy, exporting high-value services that are found around international financial centres is a viable development strategy that has in fact been promoted as such by the International Financial Institutions over the past two decades.

117. It is important to promote common standards in the tax field and to develop criteria for those countries that do not comply with acknowledged international standards. Common standards have to be enforced effectively, e.g. by restricting dealings with the respective jurisdictions (e.g. by requiring companies to close their branches or to prohibit their outsourcing to those financial centres; or by prohibiting transactions between financial institutions in those jurisdictions and those in more highly regulated countries). It is also important that multilateral development banks and governments adopt coherent policies in

order to contribute to efforts to combat tax havens.

118. Institutional arrangements for improving harmonization and cooperation on tax matters need to be strengthened. A new inter-governmental commission to strengthen international tax cooperation should be created under the auspices of the Economic and Social Council (ECOSOC) of the United Nations. The existing UN Committee of Experts on International Cooperation under ECOSOC will serve this commission in identifying, analyzing and proposing solutions for the commission's consideration. The IMF and other bodies could also have consultative status with the new commission. In order to effectively mobilize public resources, many developing countries need to urgently undertake measures to enhance their tax revenues and fiscal capacity by rationalizing their tax systems, improving collection, limiting tax evasion and widening their tax base. National efforts to enhance tax revenues must be complemented at the global level by strengthening international cooperation and technical coordination and assistance on tax matters. While the United Nations Committee of Experts on International Cooperation on Tax Matters has helped developing countries mobilize public revenues by enhancing international cooperation in areas such as limiting tax evasion, and strengthening tax administration and taxation of services and natural resource use, the Committee's ability to further international cooperation in such areas could be significantly enhanced. We support the idea of an International Tax Compact, which should complement existing initiatives and programmes, strengthen voice and participation of developing countries in ongoing processes and provide coordinated approach to support national tax systems in developing countries.

119. But tax cooperation has also its important national component. There is a need not only for more, but in particular for more stable domestic sources of finance for development. Combating tax evasion and improve tax collection is one priority here. Development cooperation needs to support domestic resource mobilization of developing countries which is challenged by tax evasion and avoidance. This is due to weak domestic tax systems, but also the existence of onshore and offshore financial centres. The international community is encouraged to start dialogue on how to tackle these problems within the proposed framework of an International Tax Compact.

International cooperation on taxation

Home versus host country regulation

120. Equality of treatment has been a mantra of regulation that demands greater circumspection. Not all consumers should use all products. The developmental priorities of financial policy will differ among countries. Macro-prudential regulation will differ between countries at different stages in the credit cycle. The trend in supervision has been away from host countries towards home countries and this will need to reverse. Indeed, since host countries still are responsible for the functioning of their real and financial sectors, they can fulfil that responsibility only with tight oversight of all financial institutions operating within their country. This entails host country supervision, and, as suggested elsewhere in the report, almost surely a requirement that banks operating in a country operate through subsidiaries

rather than branches.

121. Strengthening host country regulation, introducing counter-cyclical capital charges, redefining the boundary of regulation to be more comprehensive while promoting diversity, is all under the remit of domestic regulation (and permitted within the supervisory discretion in Basle II.) Of course, ideally, while these initiatives could be executed locally, the principles behind these domestic initiatives would be agreed and harmonized internationally by our global financial authority.

Beyond *financial* regulation

122. Ensuring a well functioning financial market requires, as we have noted, more than just financial sector regulation. Inadequate corporate governance contributed to incentive structures that served neither shareholders nor borrowers well. Failure to enforce anti-trust policies led to excessive concentration in the financial sector, and banks that were too big to fail (though not to be financially restructured). Given that there has been considerable consolidation in response to the crisis, some banks may have large market power in some markets, and the abuse of that market power is likely to lead to higher lending rates and a consequent slower recovery.

123. Recent experience in the developed countries has revealed a very disturbing process where some institutions have been revealed to be too big to resolve (TBTR). When faced with the challenge of restructuring such large and multifaceted institutions on the doorstep of failure, public officials have chosen deliberate forbearance on the grounds that it would disrupt the financial markets, and quickly thereafter the real economy, to put these institutions into a conservatorship. The avoidance of resolution on grounds that it would do tremendous harm to the economy rests on the argument that governments do not have the resolution powers for financial services holding companies and insurance companies that they have in the case of banks. In additions some have suggested that the sheer size and complexity of these institutions changing organizational form would start a run on other institutions that are heavily intertwined with the behemoth institutions on the threshold of insolvency. Still others have suggested that governments are incapable of taking over and running such institutions and that substantial "going concern " value would be lost irreversibly in the process. In essence, society is faced with a policy regime where officials claim they cannot protect government finances and the taxpayers from the excesses of the TBTR firm.

124. This TBTR regime goes beyond Too Big to Fail, whereby critical functions of restructured institutions have to be preserved. A TBTR regime implies that managements, creditors are immune from consequence. A policy regime such as this is not consistent with a market economy that performs its social function well in the longer term. A strategy of entangling a financial institution so deeply and largely into the fabric of the economy that it could not be permitted to be resolved puts society in a position of great fiscal danger. It no longer has control of the scale of fiscal losses than can be imposed upon it by the financial institutions managers. This puts the management of TBTR institutions in a very powerful

position that is incompatible with social goals. The incentives they experience are not aligned with social incentives to an extreme degree. Some activities undertaken, rationally by management, though reckless from a social perspective, can induce bailouts of unlimited magnitude with no consequences for managers (firing) or creditors in the event of loss. While gains accrue to the managers if risky activities pay off. In some countries, even at present, the scale of these institutions has reached a magnitude that the quality of guarantees on liabilities is drawn into question. This entire process is amplified by the fact that knowledge of TBTR status removes risk from the creditors of the institution and the funding cost advantage contained within the creditors' expectations give an advantage to TBTF enabling them to further increase their size.

125. It is imperative for policy officials around the world to come to grips with this challenge. The aforementioned enhanced resolution powers must be promptly enacted and strategies to limit the absolute size of financial institutions must be created to mitigate the costs for officials of choosing to restructure them. In addition extensive examination of large institutions on an ongoing basis can prepare officials for controlled restructuring. There is not basis for allowing these large institutions any degree of opacity vis a vis regulators who must always be prepared for the contingency of a resolution. While antitrust laws have often been invoked for anti competitive practices, a new consideration of the role of anti trust, akin to the spirit of Theodore Roosevelt in the early 20th century may be necessary to put the structure of capital markets back on a footing that is sound and manageable.

Beyond financial *regulation*

126. As we have noted, financial sector regulation is a key instrument of financial policy. But there are other instruments, which countries, especially developing countries, should consider to ensure that the objectives of a good financial system are attained:

Direct Lending

127. Even in more advanced industrial countries, there are certain areas where governments have traditionally taken an active role in lending. Public student lending programs have been far more efficient than private lending, and have avoided the corruption and abuses that have marked private lending. In many countries, including the U.S., the government has to introduce special programs to ensure adequate access for small and medium sized enterprises (e.g. partial guarantees, as under the Small Business Administration.) In many successful developing countries, development banks have played an important role at particular stages of their development. Given the record of abusive lending to poor individuals, governments may need to consider whether regulatory mechanisms suffice, or whether direct lending programs should be established.

Innovation

128. Government (financial policy) can also play an important catalytic role in the development of financial markets (as it has done in mortgage markets in many countries) and in the creation of new products (like inflation or GDP indexed bonds, or Danish mortgage bonds). Private financial markets have failed to make innovations that address many of the

critical needs associated with creating products that meet the needs of ordinary citizens. In some cases, after the potential of those markets has been established, the private sector can take over.

129. These innovations are important both domestically and internationally, e.g. in improving the distribution of risk bearing between developed and less developed countries. Examples of the kinds of innovations that might be helpful are discussed in Chapter 5.

Electronic payments mechanism

130. One important area of innovation is in the payments mechanism itself. Changes in technology enable the creation of a low cost electronic payments mechanism. Introducing this requires some cooperation among financial institutions. Unfortunately, in some countries financial institutions have colluded—to maintain a high cost payments mechanism. Therefore, regulators need to pursue a policy of incentivizing the use of electronic payments both for efficiency and financial inclusion.

Chapter 3:
Reforming Global Regulation To Enhance Global Economic Stability

The Purpose of Financial Regulation

1. We regulate firms operating in the financial sector, over and above the way we regulate other firms for two principal reasons. The first is that consumers require additional protection in financial products than other products because while the failure of financial products can have life-changing ramifications, the market is not good at differentiating good and bad products because the performance of a financial product cannot easily be tested before, at, or shortly after the point of purchase.

2. The second reason why we regulate financial firms over and above other firms is that the nature of the credit economy is that the lending by one bank, often acts as a deposit at another and this deposit may be used to provide collateral for borrowing at a third. An essential part of banking is that banks lend to banks in a way that shoe shops and car companies do not. This makes banking highly systemic. The failure of a single bank can bring down the entire financial system, either directly, or as a result of a loss of confidence in banks more generally which leads to a freezing in the inter-bank markets. At another time this discussion would appear a little academic, but the Credit Crunch has underscored the systemic nature of bank failures and the role of confidence.

3. The financial sector is the interface between households' savings and the financing of business investment. In the language of economics, there may be large negative externalities associated with the operation of banks and financial markets. Failures in financial markets have large repercussions for the rest of the economy. Financial markets have a tendency to produce financial crises. Recessions that follow banking crises are often more severe and long-lasting than recessions that have their origins elsewhere. Regulation should be especially directed at reducing the scope for these market failures.

4. The role that banks (institutions licensed and regulated for banking operations and having access to liquidity from the central bank) play in a credit economy is unique and quite different from the role played by non-banks such as traditional investment funds, insurance companies, hedge funds. While this distinction was smudged in the run up to this crisis with some insurance companies and hedge funds behaving like banks and some banks owning investment funds, the crisis has also highlighted that bank access to central bank liquidity and provision of liquidity to the rest of the economy played a critical role in the transmission of at first boom and later bust. We discuss this distinction later and it provides a basis for recommendations to regulate the activities of core banking activities (deposits form individuals and loans to companies) more heavily than non-bank institutions, while making regulation more comprehensive across the local and international financial system.

5. The purposes of banking regulation set out above will appear narrow from some perspectives and we recognise the broader role that banks and financial markets can play in

society by considering financial regulation as a subset of overall financial policy.

Financial policy and regulatory policy

Failure of the Prevailing Regulatory Philosophy

6. Although the current crisis had many causes, there was one feature that underlay several of the most important: a flawed philosophy. The reason why we regulate as suggested above is because of a number of market failures regarding the internalising of individual and social risks. Yet the prevailing view was that market prices were the best available signals and so market prices were our defence against market failure. Such a view ignores the fundamentally and uniquely systemic nature of finance, the theoretical arguments explaining why financial markets often fail to produce efficient or stable outcomes, and the long historical experience. The current crisis is a direct consequence of these ideas, which resulted in the stripping away of many regulations. The failure to adopt new regulations reflecting the changing economy, and the weakening supervision of banks, and suggests the imperative for effective government regulation and oversight of financial participants and markets.

7. Before the crisis there was a heated debate between a principle-based approach to financial regulation and a rule-based approach. Those concerned with banks using rules as goal posts to get around favoured principles and those concerned that the application of principles may be subject to regulatory capture favoured rules. But the crisis overwhelmed both rule-based and principle-based regulatory systems, suggesting that this dichotomy was not as important as it may have appeared. It seems to us that we need both: principles that set out the objective of regulation and rules that try to apply these principles.

8. The failure of financial markets to provide the appropriate allocation of financial resources to support the productive economy and to manage risk has been one of the contributing factors in the present crisis. Financial policy is thus necessary to ensure that finance is available to meet the needs of the real economy as well as social goals attuned to local conditions such as banking the un-banked, insuring the uninsured, better allocation of savings and investment, supporting sustainable growth, trade etc. The measure of success of financial policy is not the rate of growth or the size of the financial sector as a share of GDP. Indeed, an excessively large financial sector relative to the GDP of a medium to large economy should be a cause of concern to those interested in long-term economic growth because financial crises are associated with unsustainable growth of the financial sector.

9. Unregulated market forces have provided incentives for the creation of an abundance of financial products with passing relevance to these social goals and under-production of financial products that support social goals. At the same time incentives have been created for financial behaviour which are socially suboptimal. Such behaviour is supported by incentive structures in which there are higher fees and commissions for activities such as “churning,” while seemingly products which might help manage important risks, like GDP-linked or commodity-price linked bonds, do not generate sufficient fees to attract the interest

of financial markets. One of the roles of financial policy is to address these market failures in financial product development.

10. The financial sector is the interface between households' savings and the financing of business investment. In the language of economics, there may be large negative externalities associated with the operation of financial markets. Failures in financial markets have large repercussions for the rest of the economy. Financial markets have a tendency to produce financial crises. . Recessions that follow banking crises are often more severe and long-lasting than recessions that have their origins elsewhere. Regulation should be especially directed at reducing the scope for these market failures.

11. Ensuring global financial stability to support economic stability is, in this sense, a global public good. This chapter sets forth some of the general principles of financial sector regulation, and some of the reforms that are needed to bring existing national and international regulatory practices in line with these principles.

12. Although the current crisis had many causes, there was one feature that underlay several of the most important: a flawed philosophy that markets themselves were efficient and self-correcting. They were, in a sense, self-regulating; there was no need for an outside (government) regulator. Such a view ignores the fundamentally and uniquely systemic nature of finance, the theoretical arguments explaining why financial markets often fail to produce efficient or stable outcomes, and the long historical experience. The current crisis is a direct consequence of these ideas, which resulted in the stripping away of many regulations. The failure to adopt new regulations reflecting the changing economy, and the weakening supervision of banks, underscores the imperative for effective government regulation and oversight of financial participants and markets.

13. Regulatory policy fits within the broad ambit of financial policy, but is more narrowly focused on facilitating the attainment of social and economic objectives through consumer and investor protection (deposit insurance, rules against fraud, market manipulation, misrepresentation of products, and laws promoting competition), ensuring the safety and soundness of individual institutions, ensuring that there is access to finance, and other interventions designed to promote the maintenance of orderly markets. Ensuring systemic stability, however, goes beyond ensuring the safety and soundness of individual institutions. Such regulations can support and safeguard confidence in the financial system as a whole, and enhance financial and economic stability. While they may not be able to prevent crises such as the current one, they can make them less frequent and less severe.

14. Regulations are not costless. As always, one must balance the costs and the benefits. Today, the global economy is paying a very high price for inadequate regulations as well as a failure to effectively enforce those that did exist. Clearly, regulators in the main financial centres of the world failed to get the balance right, and their failures have imposed heavy costs on the entire global economy. While the general principles of regulation and the purpose and functions of particular aspects of regulation need to be specified, the particular institutional framework and implementation of these regulations can be flexible and tailored

to the circumstances of each country.

Regulation and innovation

15. One of the potential costs of regulation is to reduce the scope for innovation. But much of the recent innovations in the financial system have had as their objective to increase the short run profitability of the financial sector, but not the ability of the financial markets to perform its essential features of managing risk or allocating capital; they have served to engender financial instability rather than increasing the productivity of the economy and the well being of citizens. From the point of view of the economy as a whole, some of the innovations were clearly negative. It is important to design regulatory structures that encourage economic and socially productive innovations and place adequate constraints on socially dubious innovations; good regulation may actual enhance the scope for positive innovations.

Regulatory Capture

16. Regulatory design needs to be robust to attempts by the industry to influence regulators and divert them from their core responsibilities for consumer and investor protection and systemic stability. Much can be done to design regulatory systems that have built-in resistance to capture, such as a reliance on simple and transparent rules, clear rules on the regulation of instruments sold to unsophisticated, retail consumers or sold to wholesale consumers that are potentially of systemic significance." The design of regulatory governance can also reduce the scope for capture.

Boundaries of financial regulation

17. Traditionally regulation has been differentiated by institutional forms: banks are regulated and non-banks are not. Insurance products are regulated by insurance regulators, but derivatives that act essentially like insurance are unregulated. This represents the legacy of the past, rather than an analytical approach to regulation, is vulnerable to regulatory arbitrage and is in need adjustment. Regulation needs to be comprehensive with boundaries determined by the economic functions of financial institutions, not by what they are called or where they may be located.

18. Coverage should extend to all relevant institutions and instruments. The coherence of different regulatory frameworks needs to be considered when attempting to delineate the boundaries of regulation. Regulatory authorities need to coordinate seamless coverage across national and international capital markets, securities markets and deposit-takers. If there is not comprehensive and coherent regulation, there is likely to be regulatory arbitrage.

19. However, there is no guarantee that all the practices which expose the financial sector and the economy to excessive risk can be properly monitored and regulated. In these cases, regulation will have to put special emphasis on setting the right incentives and strengthen financial responsibility in order to restrain excessively risky activities and to reduce the scope

for adverse consequences.

20. At the International level, comprehensive coverage should eliminate exposure of national financial systems to the possibility that “rogue” states or institutions should fail to implement regulation. At the same time, care should be taken that regulatory standards should not be an anti-competitive ploy by developed financial centres to maintain their positions, in part attained through previous periods of regulatory and tax competition.

21. Comprehensive regulatory systems need to focus on both micro-prudential regulation and macro-prudential regulation. While regulators will need to give priority to systemically important activities, institutions and instruments, all market participants, institutions and instruments should be subject to some oversight, even if the intensity of regulation differs among them on the basis of their systemic importance. There should be clear principles to determine what is considered systemically important, such as leverage, size, exposure to retail investors, and/or degree of correlation with other activities. Regulators must have comprehensive authority. Regulation must occur continuously, on a day to day basis while at the same time ensuring long term consistency.

Micro-prudential regulation

22. Micro-prudential regulation, geared towards consumer protection, should apply to all financial institutions, with particular attention given to protection of unsophisticated, “vulnerable” consumers. Macro-prudential regulation should be focused on key components of systemic risk: leverage, the failure of large, inter-connected institutions, and systemically important behaviour and instruments and their interactions with the economic cycle.

23. Macro-prudential regulation, geared towards the containment of systemic risks, should be focused on those institutions most likely to have systemic consequences, which means those with the greatest leverage and size. But the experiences of this and previous crises suggest that it is difficult to tell which financial institutions have systemic consequences, so that it is imperative to maintain some oversight over all activities, institutions and instruments. Macro-prudential regulation thus must go beyond banking institutions. This is particularly important given the tendency, and incentives, for financial market participants to engage in regulatory arbitrage through activities that have led to the creation of what has come to be called the “shadow banking system”. (Similarly, a “shadow insurance system” has also been created.) There should also be a special focus on aspects of the financial sector that are most likely to have significant consequences for the “real economy.” This entails protecting the payments system and ensuring the flow of credit.

24. Instruments should be regulated where their use might be harmful to vulnerable consumers or pose systemic risks to the economy. This could be achieved through the creation of a *Financial Products Safety Commission* to ascertain the safety and appropriate use of various financial instruments and practices for retail consumers; alternatively, governments could create within their regulatory structure a corresponding body that focuses on these issues. It will be important to recognize that seemingly safe instruments can have damaging

consequences when their use alters, and that instruments used for hedging and insurance can also be used for speculation. Safety of financial products should thus be assessed not only in terms of their appropriateness in meeting the needs and objectives of retail consumers, but also terms of their impact on systemic behaviour. Safety should be continuously reviewed with respect to prevailing practice and the consequences for product safety. While great care should be taken in approving products for use by vulnerable consumers, all consumers need some protection.

25. Regulation is necessarily dynamic, with some instruments appearing safe initially, but becoming “dangerous” with changing or growing use. Other instruments might appear initially to be excessively risky for some uses, but as their risk or complexity becomes understood, and appropriate offsetting measures are devised, or as their safety is demonstrated in less highly regulated markets, they might be approved for specific uses in more regulated markets.

26. A key part of supervision is the continuous monitoring and consideration of instruments, institutions, markets and behaviour of more systemic importance and requiring greater oversight.

Ring-fencing

27. While there may be a case for differential regulation of financial market participants based on their ability to bear risk and sophistication, it should also be recognized that in financial markets it is difficult to erect hermetically sealed barriers between the highly regulated actors posing systemic risks and the less regulated actors who do not; for instance, credit inter-linkages are likely to remain. As a result, depending on the depth of a financial crisis, regulators may feel forced to bail-out risky players who are interlinked in order to protect the interest of vulnerable participants and to avoid adverse systemic consequences, though typically, it is more “fiscally efficient” to bailout directly those that must be bailed out because of their direct systemic importance. To the extent that the government does not regulate tightly all financial institutions, to prevent problems in the unregulated sector spreading to the regulated, the less regulated must be, at least to some extent, ring fenced, with sensible controls on the extent of interaction with the more regulated sector. Governments need to be aware of the danger of contagion from one part of the financial system to others. Thus, the better and more comprehensive financial systems are regulated, the more integrated (less segmented) can the financial system be. The advantages of diversification provided by a large integrated market may be more than offset by the risks of contagion, as a problem in one part of the economy spreads throughout the whole. This appears to be the case especially in real estate: had mortgages been centred in a specialized set of institutions, the problem may have been contained, as it was in the Savings and Loan crisis. Regulators have to be especially attentive to the ever-present attempts at circumvention, including through the creation of special purpose vehicles.

Some Common Principles of Macro- and Micro-Prudential Regulation

Incentives

28. Incentives are the key to an efficient and effective financial system. Regulators need to make sure that the incentives of financial institutions and those running them are compatible with the objectives of a good financial system. It will never be possible to monitor and regulate all the practices which expose banks and the economy to excessive risk; it is therefore imperative to get incentives right. It is clear that private rewards have not been linked to social returns. This means that there are perverse incentives that produce adverse outcomes.

29. Flawed incentive structures are in part the result of flawed corporate governance structures. The fact that so many firms have adopted incentive structures that served shareholders and other stakeholders well in the short run, but so poorly in the long run, is suggestive of serious and pervasive failures in corporate governance. Weaknesses in corporate governance in both developed and less developed countries have long been recognized, but not enough has been done. This crisis should provide an opportunity to revisit these issues. The payment of large bonuses to top executives of banks making record losses shows that " incentive pay" was not closely related to performance—something that some statistical studies also suggest to be the case.

30. One of the long recognized problems is that current incentive structures encourage excessive risk taking and short-sighted behaviour. Possible methods of remedying these problems include suspension of the practice of cancelling long-term and non-transferable stock options when an employee leaves, requiring incentive compensation schemes to be based on long-term performance, and implementation of a requirement that firms pay higher capital charges if their remuneration schemes are not designed to limit excessive risk-taking. Taking into account other indicators than economic success could be another option to create incentive schemes that are more commensurate with social objectives, e.g. by rewarding achievements in corporate social responsibility. Payment through stock options can provide particularly perverse incentives, because it encourages deceptive accounting practices that contribute to (temporarily) high stock prices. Firms must take a conservative approach to accounting for stock options. Stock options should be reported as a form of remuneration--expensed and valued at the time of issue or the re-setting of stock option prices. The financial sector should not be paying their top executives in forms that are not transparent, and in ways that shareholders cannot easily value.

31. When banks become too big to fail, they have perverse incentives for excessive risk taking. It is imperative that governments impose strong anti-trust policies, with criteria that are stronger than just market power. Under current arrangements, large banks, knowing that they are too big to fail, have an unwarranted competitive advantage over smaller banks because of the implicit insurance. Accordingly, any large bank that is not broken up should face have capital adequacy requirements.

32. Regulators should be particularly attentive to conflicts of interest. The scandals in the United States' financial markets earlier in the decade exposed the conflicts of interests

between investment banks, their analysts, the companies issuing IPO's, and customers. Some actions were taken with respect to analysts, but many of the other problems remain. For instance, investment banks' views affect markets—and those views may be tainted by the positions that they hold. These scandals highlighted conflicts of interest between the role of financial institutions as commercial banks and investment banks. Disclosure is an important first step. Disclosure is necessary, but almost surely not sufficient. For example, mortgage originating companies should not be allowed to own their own appraisal companies.

33. Guarantees and insurance. Guarantees and insurance distort incentives since there is no risk of loss. The higher potential gain from more risky behaviour accrues to the individual while loss is absorbed by the government. Such behaviour was common in the Savings and Loan crisis of the later 1980s, with significant social consequences. However, in times of economic crisis guarantees and insurance may be part of a government's crisis response in order to stimulate countercyclical economic activity and to prevent runs on banks. In some cases, issuing government guarantees may even be a strategy to attract individuals to investments with relatively high risk, but with a perspective of high long-term positive social or ecological effects. Adverse incentive effects can be mitigated by providing only partial insurance / guarantees.

Securitization

34. Securitization held open the promise of risk-diversification and access to new sources of funding. But it also opened up new information asymmetries and avenues of inappropriate behaviour by investors who did not possess the ability to bear the risks or could not evaluate them appropriately since they did not have the relevant knowledge of the underlying assets available to the originators. Markets, regulators and the models used by bankers, credit rating agencies, and investors to assess risks overestimated the benefits of risk diversification and underestimated the costs of the information asymmetries and concentration of investor behaviour.

35. Securitization has also presented new problems in debt restructuring (problems that arose earlier in the debt crises of the latter part of the last century). Governments will need to address the legal issues *raised* by debt renegotiation in ways which balance the rights and interests of creditors and debtors, with due account of systemic consequences of a failure to renegotiate. Originators of securities should be required to hold a stake of at least 10 per cent in each issue of securities they underwrite. While this would significantly reduce the capacity for future securitization, it would also substantially reduce the potential for systemic risks associated with structured products and would encourage higher underwriting and lending standards.

36. The perverse incentives and distorted market signals that are produced from the behaviour of the economy may be offset by counter-cyclical regulation. The introduction of time-varying capital adequacy requirements that rise and fall with the business cycle provides an example. To better combine macro-prudential and micro-prudential regulation regulators and central banks might jointly agree an annual rate of expansion in bank lending and the

bands around that rate, above which a bank would be required to increase its capital adequacy requirements, or below which it would be able to reduce its requirements. If time-varying capital adequacy requirements would have been in place, the magnitude of the previous boom and its inevitable crash would have been moderated. Relating macro-prudential regulation to the rate of growth of bank lending would further enhance the temptation for banks to hide their own lending in associated off-balance sheet vehicles, like conduits and SIVs. Regulators must prevent this happening by treating all such associated vehicles as effectively remaining on the balance sheets of the banks.

37. The privatized GSE (government sponsored enterprise) model, in which government provides funding or what is interpreted as effective government guarantees may be a particularly hard model to design to work well. The potential conflicts between managerial interests in maximizing their own returns or returns to shareholders may conflict with public interests.

38. Recent government bailouts and government guarantees have raised issues of conflicts of interest and divergences between the interests of firm managers and those of the government providing capital. It exacerbates the usual incentive problems that arise when there is a separation between ownership and control. The much criticized behaviour of banks taking money that was intended to recapitalize them and paying it out in bonuses and dividends instead is fully explicable in terms of the differences in interests between those making the decisions (the bank officers) and that of the public providing the money. The risks should have been apparent. (See the discussion in Chapter 2).

39. Perverse incentives can become most acute as financial institutions face the possibility of bankruptcy or falling below capital requirements.

40. While mark-to-market value accounting may not be appropriate for the risk management of some long-term institutions, it is important to recognize that failure to apply mark to market accounting may induce other forms of perverse incentives. Banks may have an incentive to undertake excessive risk taking; assets that go down in price can be kept, and those that go up in price can be sold. The result is to increase the divergence between mark to market values and "book" value. This incentive has been compounded by recent actions to suspend mark-to-market accounting in the crash, having promoted it in the boom. At the same time, there needs to be recognition of the different uses to which accounting information is put. Much of the accounting framework is designed to assist in the evaluation of shares. From this perspective, increasing market value when there is a decrease in the value of outstanding bonds because of market perceptions of an increased probability of default makes sense. But bank regulators are concerned with the risk that the bank will not have sufficient assets to pay off its depositors (and possibly other creditors). In this context, it makes little sense to suggest that the bank is in a better position because the market thinks it is going to default.

41. In economies where banks are publicly listed and are subject to takeover, supervision needs to be particularly intense in circumstances where incentive structures are such as to

increase the likelihood of excessively risky, short sighted and fraudulent behaviour and when managerial incentives may not be well aligned with other stakeholders. Financial institutions where the government has provided much of the capital, but government's financial stake is not fully reflected in voting shares are also prone to incentive misalignments and need to be especially tightly supervised.

42. Whenever banks are too big to fail because failure might create systemic instability there are incentives to engage in excessive risk taking. Such institutions need to be closely supervised.

Transparency

43. Much of the discussion on regulatory reform has focused on transparency. It is sometimes suggested that lack of transparency is the major market failure, and the introduction of full transparency would resolve the problems of market failure. It is unlikely that in aggregate, the excessive lending and borrowing would have been substantially less if there was greater transparency, but transparency plays an important role in the distribution of losses and is critical for consumer and investor protection. In this crisis, a lack of transparency was evident not only in off-balance sheet activity, but also in the extensive utilization of the hard-to-evaluate over the counter derivatives. The lack of transparency is often a symptom of deeper market failures that produces incentives to limit information, and these deeper market failures may have other manifestations. Moreover, lack of transparency is only one of several market failures.

44. There is now widespread agreement that private markets do not necessarily provide optimal incentives for transparency. There may even be incentives for providing distorted information, e.g. associated with executive compensation schemes based on stock options. Regulatory arbitrage provides another set of incentives for a lack of transparency. Lack of transparency may also be a management defence mechanism against takeovers, for it creates additional uncertainties for any would-be firm contemplating such a move. Lack of transparency may also enable banks to price discriminate and enhance profitability in other socially destructive ways.

45. Banks should be restricted in creating off-balance sheet vehicles/instruments. Overall, there needs to be more transparency in accounts. Mark to market accounting was introduced to increase transparency. But some have argued that its inappropriate application to all assets contributes to market volatility. The problem is not with mark to market accounting, but with how the information provided is used by firms, markets and regulators. The adverse effects of mark to market accounting could be offset by countercyclical capital adequacy and provisioning described above. It would be a major retreat from transparency to move away from mark to market accounting, however, where institutions have long-term funding or liabilities, it may be important to supplement mark-to-market accounting with a mark-to-funding accounting when it is more appropriate in the risk management of the financial firm.

46. Accounting standards should make information as transparent as possible for

shareholders and bondholders. This might require thinking about changing other existing standards. For example, while dynamic, counter-cyclical provisioning is a desirable feature, accounting boards are not currently well disposed to such proposals since they prefer event based to statistical accounting. Statistical techniques may be the best means of providing reliable estimates of future losses.

47. Anomalies in accounting systems, such as failure to expense stock options, need to be addressed. These can not only make it difficult for investors to appraise the firm's economic position, but distort behaviour as well as the provision of information.

48. No single information system can provide all the relevant information. For institutions with long-term funding or liabilities–something which the regulatory system should reward—mark-to-funding accounting could be useful (and in some cases even more relevant). Life insurance firms, for instance, with long term liabilities but with assets matching those liabilities should not be "punished." But this is what would happen with mark to market accounting if liquidity risk spreads rose and the long term assets in which they had invested fell in value. It would be inefficient to match each asset with its funding, but pools of assets could be matched with pools of funding. One issue in a mark-to-funding or mark-to-liability approach would be determining the maturity of funding. Life insurance policies might normally be held to maturity, but the contract provides a liquidity option—owners can borrow against them. They also have a cash value. Demand deposits are normally held for a long time; but in a panic, they can be withdrawn overnight.

49. Transparency is important, but stronger transparency and disclosure standards are not enough. Even if there had been full disclosure of financial products, many are complex and the level of financial understanding insufficient. The nature of over-the-counter products can be highly complex, making it difficult to assess risks and to net out positions for hedging purposes or in the case of bankruptcy. Over the counter trading should be restricted and those engaging in such trades should be required to set aside appropriate margins reflecting the systemic risk those trades might pose. (Below it is argued that even trading over the counter for Highly Regulated Financial Institutions such as commercial banks should be limited to covering "insurable risks.")

50. Economic theory suggests that transparency may actually lead to more volatility. But even if this proves to be the case, most of the time, the benefits of transparency outweigh the costs, and so there should be a strong presumption for greater transparency. Without good information, resources cannot be efficiently allocated, and lack of transparency can too easily contribute to exploitation and corruption.

51. Just as much as accounting standards should allow for as much information and transparency as possible, one should strive to ensure as much transparency in the dealings of the regulator. While regulators should in principle be free to ask for information from private actors, the dissemination of any findings publicly needs to be carefully handled. The regulator should have an obligation to put transactions involving public monies in the public domain but perhaps with a lag if there are concerns about market sensitivity. If proprietary

information issues restrict full disclosure of firm level data, there should be full disclosure of aggregative data. Parties not willing to transact with the government on the basis of transparency should be prohibited from receiving public funds or entering into contracts with the government.

52. Transparency should be encouraged when a financial rescue plan is being undertaken. In the current scenario the manner in which financial rescues/bailouts are being conducted are often opaque and uncertain. As a result, a great deal of confusion has been sown about the principles underlying the financial restructuring that is occurring and about the process by which the terms of the deals are determined. This has contributed to market uncertainty. While in the past, a simple adage 'save the banks, not the bankers' has been followed, in the current crisis, in some countries this important distinction has been blurred In such a scenario clear principles need to be agreed upon beforehand which recognize that while banks may be systematically important, not all elements of their capital structures are. An expedient resolution through recapitalization, (temporary) nationalization, and/or super (or expedited) "chapter 11" bankruptcy (conservatorship) could restore the credit intermediation process in the most rapid and most transparent manner possible.

Macro-prudential regulation

53. Regulation should be more focused on the capacity of the financial system as a whole to bear and allocate risks and where this is best done, rather than solely on measures of individual firm risks. Risk is not just about assets. It is about how the assets are funded and how the assets are used. Regulation of systemic risks needs to include an assessment of funding liquidity.

54. Financial liquidity and stability requires diversity of action and opinion. If all firms respond in the same way (e.g. trying to sell some asset at the same time), markets may exhibit extreme volatility. It is important that regulators do what they can to preserve natural diversity, especially in the face of enhanced transparency, common accounting standards and the increasing comprehensiveness of regulation.

55. The benefit of diversity is another argument in favour of a return to more specialized, simpler institutions and the segmentation of markets, perhaps with a return to the "public utility" aspect of banking for core deposit taking institutions and regulatory segmentation of institutions into areas such as retail banking, long-term savings institutions and wholesale investment banking. Each function could then be regulated to discourage it from holding risks it does not have a natural capacity to hold.[1].

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[1] In the United States, the regulatory segmentation was largely eliminated in the era of free market philosophy from 1980 to 2000. The Gramm-Leach-Bliley (GLB) Act of 1999 was the key legislation repealing the Glass Steagall Act of 1933 that segmented banks from other financial activities. Under GLB, banks and other financial institutions were permitted to commingle banking, insurance, and securities activities within one institution. At the time the promoters of such legislation emphasized the benefits of diversification and ability to compete with foreign institutions that were permitted to combine these activities in one institution. Little concern about conflicts of interest between the various dimensions of the business or about the commingling of risky activities

56. The virtue of differentiated regulatory structures and standards for different kinds of financial institutions has to be offset against the risks of regulatory arbitrage.

Countercyclical regulations

57. There should be countercyclical capital adequacy and provisioning requirements, based on simple rules, which call, for instance, for an increase in capital requirements as the rate of growth of the assets of a bank increases or the rate of growth of a particular class of assets within the bank increases. This, and other ways of providing “speed bumps” would have dampened most earlier boom and bust cycles. Provisioning requirements automatically ensure that the bank set aside more funds as it lends more. But since the riskiness of lending is likely to increase as the pace of lending accelerates, the likelihood of problems increases, implying that the requisite provisioning should go up. By the same token, as the ratio of the value of housing to income increases, the probability of a problem increases, and so the magnitude of the provisioning (or the capital adequacy required) needs to be adjusted. (It may be necessary to develop accounting frameworks based on statistical loss estimates to deal appropriately with these issues.) Regulators need to be aware of distortions in capital allocation when provisioning and capital adequacy requirements do not accord well with actuarial risks.

Capital market liberalization

58. Regulations which affect the flow of capital into and out of a country, especially of small or medium-size, may be among the most important in determining macro-economic stability and the scope for policy responses, in the event of a crisis. There is growing consensus that capital market liberalization may contribute to economic volatility, especially in developing countries. More broadly, a fully integrated global financial system may be subject to more volatility than one with “circuit breakers” and “surge protectors” (to use an analogy to electricity networks). Part of the reason for this is that capital flows tend to be pro-cyclical. And yet there is little conclusive evidence that, especially for less developed countries, capital market liberalization contributes significantly to economic growth. Part of the reason for this is that much of the cyclical lending finances consumption, rather than investment; and part of the reason is that the increased volatility associated with liberalization imposes a high costs on an economy, raising risk premia, and forcing governments to set aside larger reserves. The opportunity costs of these funds may be large, and the building of these reserves contributes to global imbalances, and in an international system with a single reserve currency may add to global financial fragility.

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with the core activities of the payment system and deposit protection was voiced. It was only in the aftermath of the events illuminated by the crisis where the political power and moral hazard implications of too big to fail institutions have been shown to be of critical importance. The Group of 30, under the leadership of Paul A. Volcker, has raised concerns about these issues in their report entitled *Financial Reform: A Framework for Financial Stability*. Their report states that: “The clear implication is that at least the very large and complex banking organizations that now account for so much of the extensions of credit and carry the major responsibility for maintaining the financial infrastructure will need to be held to more rigorous standards of prudential regulation and supervision, with new constraints on the type and scope of their risk-taking activities.

Capital Account Management for Development

59. Developing countries often need to stabilize international financial flows for a variety of reasons. These include the need to promote financial stability; to encourage desirable investment and financing arrangements; to enhance policy autonomy, including the maintenance of stable and competitive exchange rates; and to enhance national sovereignty and democracy. Full capital account convertibility as well as implicit and explicit agreements to forego intervention in international capital markets can serve to prevent such desirable outcomes, and should therefore not be seen as ends in themselves.

60. To achieve these objectives, Governments should be given space to undertake capital management techniques as part of their development and risk management strategies. Such techniques--which have been used successfully in the past--have included, but are not limited to, prudential management of foreign borrowing, the imposition of unremunerated reserve requirements, the placing of limits on equity ownership of certain financial and other activities, and so on. It is imperative for the success of development strategies that countries be allowed to undertake dynamic capital management by having the flexibility to both tighten and loosen controls as and when necessary.

Capital market interventions during crises

61. Governments have, as part of their arsenal of policy tools, a variety of interventions to help stabilize financial flows. In a crisis, when traditional tools such as interest rates are less effective, they may consider temporary restrictions or longer-term taxes on inflows and on outflows, as well as both price and quantity interventions. Particularly in the context of a financial and economic crisis, countries may find it necessary to impose restrictions on capital outflows, in order to give them more scope for monetary policy discretion.

62. To a limited extent, recommendations for "host versus "home" country regulation and proposals for counter-cyclical capital charges can also act as "speed limits" on international capital that flows in and out of the domestic banking system. In similar vein, greater prudential regulation of banks—to avoid currency mismatches—can simultaneously be used as an important instrument in capital account management.

Financial market liberalization

63. The framework of financial market liberalization under the Financial Services Agreement of the WTO may serve to restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors. At the same time, existing agreements do not seem to be designed in ways to prevent financial market protectionism and arbitrary "black listing" on the part of developed countries or to prevent major adverse effects on developing countries.

64. There is some evidence that, at least in some countries, the entry of foreign banks has led to reduced lending (in general, or to SMEs in particular) and/or speedier unwinding of

lending. Restrictions of the kind proposed in the following paragraphs may be helpful in addressing this concern. Such restrictions should be imposed broadly, on both domestic and foreign banks, even if such uniform restrictions indirectly have a differential effect on foreign banks.

65. Problems in the home country banking system can spread to other countries in which that bank has branches or subsidiaries. They may, for instance, reduce lending. Such problems are exacerbated when governments put pressure on their banks to use what limited capital resources they have for lending to the home country. Such pressure is not surprising when home governments have provided large amounts of funding for the survival of domestic banks. Earlier discussions emphasized the importance of "national treatment," that foreign banks should not be treated in a disadvantageous way. The current crisis has shown the need for a new dimension of "national treatment": foreign borrowers (branches, subsidiaries) should be treated as well as those at home. Since such discrimination may be tacit and/or difficult to detect, it may be difficult to enforce these aspects of national treatment that can be of great importance to the well being of developing countries.

66. Developing countries may find it desirable, in order to ensure that there is adequate funding for domestic lending of foreign banks and that the effective capital underlying such lending is not withdrawn back to the home country (as seems to have happened in some instances) to require foreign banks operating within their countries to operate as subsidiaries rather than as branches.

Further issues in Micro-regulation

Restricting excessively risky practices

67. It is clear that the banks engaged in excessively risky practices. The discussion of countercyclical capital adequacy and/or provisioning requirements provides one approach to discourage such excessively risk activities. Governments, especially in developing countries, may want to consider others. For instance, quantitative restrictions on the fraction of bank portfolios that can be allocated to certain sectors prone to speculative activity such as real estate, may not only lead to greater stability, but ensure greater financing for infrastructure or employment related investments on a longer term basis.

68. Countries that allowed banks to own equity shares in non-financial companies may experience greater volatility, because even when their lending practices are sound, a sudden decrease in stock prices can force a credit contraction. Banks' comparative advantage and institutional role in our society is providing credit, and accordingly, an argument can be made that they should be subject to appropriate regulation if equity shares are part of their investment book.

69. Some of the problems in earlier crises were a result of foreign exchange mismatches. Regulations should place strict limits on uncovered foreign exchange exposures. Similarly, there should be restrictions on engaging in swaps and other insurance and derivative products

other than to hedge or mitigate existing risks. Banks, with their implicit or explicit government guarantees, should be restricted from being engaged in activities that may significantly increase their individual and systemic risks.

70. Countries that allowed their banks to grow beyond the size of their economy are not in a position to provide guarantees should the bank fail, or can do so only at great costs to the rest of society. It is thus necessary that either (i) a global deposit insurance fund be created, funded through contributions of the banks with fees depending on their individual capital adequacy ratio or through a tax on all cross border deposits and set at a rate that is deemed to be actuarial fair, and backed by the government of the depositors be created; or (ii) depositors in foreign banks not explicitly insured by the host country recognize that those deposits are not insured. The second approach is likely to limit the extent of cross border financial flows. The provision by the host country of deposit insurance should only extend to separately capitalized subsidiaries of foreign banks, with strong restrictions on the pay-out of capital to the holding company, and close oversight by host country regulators.

71. This approach will not be welcomed by international banks who will claim that it will reduce the efficient allocation of capital and restrict international capital flows. It is likely to prove a price worth paying.

Restricting securities markets

72. Banks are only one part of modern financial system, and many non-bank operations in the securities market contributed to the current crisis. Excessive volatility in securities markets can have adverse effects throughout the financial system. Core financial institutions should not be allowed to undertake excessively risky market positions such as “naked” short sales, and governments should consider broadening such restrictions to all participants in financial markets.

73. Comprehensive regulation entails ensuring that equivalent instruments be treated the same, i.e. if there are restrictions on naked short sales, there should be analogous restrictions on the use of derivatives and credit default swaps.

Regulation of Credit Derivatives, Swaps

74. Since the default of a large corporation can have far greater monetary implications than the size of any of its outstanding liabilities it may be prudent for lenders to also hedge the risk of a default of the company affecting its suppliers, dealers, pensioners, stores local to the employees etc., so the outstanding value of credit default swaps may be larger than any single liability. However, there are systemic implications of a large CDS market where there is no centralized clearing house or regulated exchange trading. Hence, centralized clearing should be the preferred route and OTC should be subject to enhanced monitoring, margin set aside above and beyond that required on an exchange and disciplined pricing that does not rely upon mark to model methods. The regulator should further have access and information both for OTC and centralized clearing through a system of ex-post reporting to a centralized

agency.

75. The regulatory agencies should also be authorized to declare any CDS transactions that it considers to have become of systemic importance to comply with a range of requirements, including, a registration process, centralized clearing and where appropriate to the risks being taken, margin and capital requirements. While the regulator should have a preference for exchange traded instruments relative to over the counter instruments, if OTC instruments are approved, there should be adequate transparency in the form of mandated and regular reporting to the regulator and aggregative information should be put in the public domain as determined by the regulator.

Predatory lending and usury

76. Regulating predatory lending is mostly a matter of consumer/investor protection, but, as this crisis has shown, it is also a matter of risk management. The subprime mortgage market provided examples of predatory lending, but there have been other abusive practices as well (rent a centre, pay day loans).

77. The elimination of usury restrictions has been advocated on the grounds that it encourages risk taking. But it may have resulted in excessive risk taking and abuse of ill-informed borrowers. Regulators need to be attentive to the variety of forms that circumvention can take, e.g. through rent-a-centre and other commercial activities.

78. Recent years have seen particular abuses with credit cards. Such practices have flourished in part because of anti-competitive behaviour, which has helped generate above market returns. In some countries, such anti-competitive behaviour have been restricted, while in others proposals for restricting abusive and anti-competitive behaviour have, not surprisingly, met resistance from the industry. Governments are strongly encouraged to consider such actions, which would contribute to a more efficient and more equitable financial markets. Moreover, abusive lending practices lead to high returns to lending, and have contributed to the build-up of excessive household debt. The misery of the ill-informed borrower is compounded by the recourse by lenders to recovery agents who use unregulated and uncivilized means of loan recovery.

Lending and public banking to promote development

79. The objective of financial policy is not only to regulate institutions and the system in a prudential manner, but also to ensure that the financial sector can live up to its positive potential contribution to society, including ensuring access to credit for all and the provision of credit for long term development. In the past, many financial institutions engaged in red-lining, excluding lending to certain discriminated against groups. Certain key sectors of the economy did not have sufficient access to credit. Government created institutions, including the establishing and support of public banks, as well as supporting development banks, may need to play an important role in the provision of credit to underserved sectors and segments of society, financial sector policy in general and on occasion regulatory policy can play an

important role

80. While there has been a presumption that a fully private banking sector is the best system to ensure the most productive and efficient management of liquidity, risk and development, the current crisis and other experiences in various developing countries suggest reasons to support a much more substantial role for publicly owned banks. A public bank can substantially realign incentives driving bank managers and can harmonize the role of bank operations and supervision. Further, by making the inherent and incessant profit motive subordinate to social objectives, it allows the financial system to exploit the potential for cross subsidization and to direct credit—even if the bank incurs higher costs to targeted sectors and disadvantaged sections of society. Given that a significant determinant of poverty is limited access to finance, public banking can thereby permit financial inclusion. In the experience of several successful development strategies, public banking has allowed for the mobilization of technical and scientific talent to deliver both credit and technical support to agriculture and the small-scale industrial sector which have the most direct effect on job creation and poverty reduction. Moreover, public lending is less likely to engage in the abusive practices that marked America's financial sector in this decade. Development banks have played an important role in the development of several successful countries. Recent crises have shown another problem with private sector lending—it can be highly cyclical, exacerbating economic fluctuations. Nevertheless there is always a danger that public banks may have their portfolios manipulated for political rather than social reasons, and the record of publicly owned banks has been spotty. Some recent experiences, however, of public development banks with better and more transparent governance structures is encouraging. Public and private banks have to be coexisting elements of a sustainable financial system. The concept of subsidiarity, where government takes on especially those tasks that the private sector is not able to carry out more efficiently or risks of market failure are too high (e.g. full financial inclusion, direct credit to targeted sectors), may be one of the principles in establishing sustainable banking sectors.

81. In some countries, mandates for lending to underserved segments have played an important role, and have, in the long term, even proven profitable. Apart from implementing direct public banking, countries should encourage the availability of banking services to the un-banked and insurance to the uninsured. This could include a direct subsidy to offset the credit monitoring costs of dealing with small loans, or through mandating lending to certain groups such as the US Community Reinvestment Act (CRA) requirements. Because information is at the heart of banking, requirements that banks open up branches in underserved parts of a country can also be an important instrument of development.

82. We recognize that lending to the real estate sector can have a number of social benefits, but it is also a common source of excessive lending and asset market bubbles. Consequently, we recommend limits to real-estate-related lending such as loan-to-value limits on mortgage lending. We believe there is an argument for these limits being time-varying rising in a boom and falling in a crash. Restricting lending, e.g. to the real estate sector, may also be an important instrument in encouraging lending to other sectors. Such restrictions may both enhance stability and development.

83. Negative and positive “priority” lending may be most effective when broad based, leaving the private sector with the strongest incentives to find the best commercial opportunities within those constraints.

84. Incentives may be an important part of helping direct lending to areas where social returns might exceed private returns, such as micro-credit, SME and rural-sector lending. Similarly, there should be measures to restrain socially damaging activity.

85. In some banking systems, banks appear to solely or mostly invest in government paper. A number of reasons may be behind this, including the regulation of deposit and lending rates or crowding out of private enterprise by large government deficits rates. Governments should be encouraged to explore various mechanisms by which the banking system could be used to facilitate productive activity. One arrangement, for example, may be to accept savings directly by the government through a network of post offices to reduce the spread between the bank deposit rate and interest charged by banks to government paper.

Regulating other players

86. Financial markets have become more complex over time. Finance is provided by banks and through security markets. There are a host of other actors, some of which may have played an important role in the current crisis, some of which have become the subject of extensive controversy. Comprehensive and fair regulation must ignore past distinctions and be based on economic function.

87. In particular, there are two non-traditional financial firms that require additional attention: rating agencies and sovereign wealth funds.

Rating agencies

88. There is a consensus that the rating agencies did not perform their job well, mainly in respect of the rating of structured credit products Whether it was a result of a conflict of interest or incompetence—they are paid by those that they were asked to regulate—and the presence of this clear conflict of interest has undermined confidence. Moreover, some generated revenues by advising financial firms on how to improve their grading. Some reforms, such as increased transparency through requiring disclosure of the details of the ratings process may help; but even such mild reforms are not without their controversy. Financial firms may be reluctant to disclose information which they believe might be disclosed more publicly and disclosure of rating methodologies contributed to banks building structured products to rating. But greater transparency in the way that rating agencies discuss and present their analyses, clarifying assumptions made and sensitivities of results to these assumptions, should contribute to the functioning of financial markets. In addition, rating agencies should be required to provide information concerning their overall performance and/or an independent government agency should provide such information, which would enhance “positive” competition among rating agencies.

89. Part of the problem is caused by the market structure—a small oligopoly—which means that rating failures do not lead to significant market discipline. Many investors and hence borrowers are required by their investment by-laws to obtain a rating from each of the main agencies. It may be necessary therefore for the government to impose discipline by penalizing rating failures.

90. Given the difficulties of resolving the problems posed by credit rating agencies, it is important that regulators—and others charged with risk management—rely less on them. Rating agencies proved to be no less pro-cyclical than market prices and their use by regulators added to the pro-cyclicality of bank lending. Problems with individual ratings need to be viewed in the broader context of the provision of information. In the Enron/WorldCom scandals, conflicts of interest in the ratings provided by analysts paid by investment banks drew extensive criticism. In the recent food and energy crisis, information provided by some investment banks may have simultaneously enriched those providing the information and contributed to those crises. While the reforms concerning analysts pay were a move in the right direction, they do not go far enough. There should be disclosure, to the regulator, of positions of investment banks and others capable of "moving" markets, to at least identify potential conflicts of interest.

91. Credit rating agencies (CRAs) play a key role in financial markets by reducing information asymmetries between issuers and investors. Their role has expanded with financial globalization and received an additional boost with Basel II, which incorporates the CRAs' ratings into the rules for assessing credit risk. However, rating agencies have been subject to serious criticism, recently, for generous ratings to complex financial instruments backed by "sub-prime" mortgages. The risk assessments of rating agencies have been highly pro-cyclical, and tend to react to the realization of risks, rather than to risk build-up, in relation to both sovereign and corporate risk. The risk models of CRAs rely, to a large extent, on market-determined variables like equity prices and credit spreads, thus exacerbating pro-cyclicality. Additionally, the independence of the rating is compromised because a dual role of rater and advisor is often assumed by the same CRA.

92. As assessments of creditworthiness by CRAs came to be viewed as authoritative in financial markets, such ratings adversely affected financing for developing countries. Because CRAs operate as unregulated private institutions, the existing regulatory framework and surveillance mechanisms are minimal and inappropriate. To ensure CRAs' accountability, both to issuers and investors, a collective institution should be established to be responsible for assigning agencies for rating particular security issues and for paying them.

Sovereign wealth funds

93. Earlier conventional wisdom argued that ownership did not matter, so long as it was not the government of the country. Developing countries were urged to privatize state owned assets, paying little attention to the identity of the buyer who in some cases, the buyer was even a foreign government. It seemed permissible for a foreign government to own a country's assets, but not the country's own government. As entities owned and controlled by

foreign governments have taken a more active role in purchasing assets in developed countries, these views have evolved creating investor uncertainty over the rules of the game. Whatever rules are devised and agreed upon should be universally and fairly applied.

94. There may be particular industries or sectors where ownership matters. Governments should agree on those sectors. If national security provides a rationale for ownership restrictions in one country, there should be a presumption that it provides a rationale for similar limitations on ownership in other countries. If ownership matters, one should be as concerned by aberrant private sector behaviour as by that of a government owned enterprise. Indeed, some have suggested that governments may be a more responsible investor than private sectors, precisely because of the greater degree of accountability.

95. Some have suggested that a special code of conduct be imposed on sovereign wealth funds, including provisions relating to transparency and disclosure, including disclosure of the sovereign wealth fund's business model, and that such a code of conduct will suffice. Others have argued that that is just window dressing (on the part of countries that want the funds, but realize the political sensitivities): almost any action can be cloaked within a business rationale. While transparency and disclosure may be helpful, it is unconvincing that it would "solve" the problem. So too with a broader voluntary code of conduct. But any requirements imposed on sovereign wealth funds should be symmetrically imposed on private sector investors. The point is reinforced by the growing blurring of the line between private and public investors, with the bulk of the capital of many Western banks being provided by governments. Moreover, restrictions on sovereign wealth funds may be relatively meaningless, so long as there is no comprehensive disclosure of ownership. Ownership stakes could be mediated through third parties, without disclosure. If governments are concerned about ownership, there has to be accordingly comprehensive disclosure.

96. If there are certain behaviours of the foreign owner that are a source of concern, those behaviours should be restricted, whether on the part of private or government entities. Worries about their behaviour are thus symptomatic of a lack of confidence in the overall regulatory regime. Countries should identify the inadequacies in their regulatory structures and seek to remedy them.

Regulatory institutions

97. Regulatory failure. It is not enough to have good regulations; they have to be enforced. The failures in this crisis are not just a failure of regulation, but of regulatory institutions. Those assigned responsibility for regulation did not always effectively implement the regulations. All human institutions are fallible, and it may happen again, especially if those who are appointed to oversee the regulatory system do not believe that regulation has a role.

98. At the same time, it is clear that regulatory structures can be designed in ways that reduce the scope for the failure of regulatory institutions. Regulators may be under pressure during a boom. While the regulator is supposed "to take away the punch bowl just before the party gets going," pressures are often brought to bear to continue the party, since so many are

making so much money doing so. Specious arguments are brought forward—like you can't tell a bubble until it breaks: it is true that you can't be sure, but you can ascertain that there is an increasing probability of a bubble, as prices relative to incomes attain historically high or even unprecedented levels.

99. In light of this pressure, it may be necessary to "hard wire" much of the regulatory structure, leaving less discretion to regulators and supervisors. Provisioning requirements and countercyclical capital adequacy requirements of the kind discussed in previous sections should be rule based.

Capture and voice

100. Regulatory institutions have to be created with recognition of the risks of capture by interests and perspectives of those being regulated, and ensuring that users of finance such as small and medium-sized businesses, pensioners, consumers and perhaps other stakeholders are given voice. Pensioners who are likely to see the hard earned pension funds disappear as a result of poor regulation should, for instance, have a strong voice in regulatory structures, as should other groups representing retirees. Those who benefited from the continuation of the bubble often have excessive influence on the regulatory institutions as presently constituted.

101. The creation of a specific financial regulator (with appropriate governance structures) whose mandate is to ascertain the safety and appropriate use of various financial products may reduce the likelihood of regulatory capture. Moreover, the benefits and costs of regulatory duplication and segmentation may be worth reconsidering. All institutions are fallible, and the costs of regulatory mistakes are enormous, and overwhelm any costs of duplication. Sectoral regulators with simple objectives and rules may also be harder to capture.

Regulation and political processes

102. Regulation is part of the political process; failures in public governance contribute to failures in regulatory design. When the political process is unduly influenced by campaign contributions from and other forms of lobbying by the financial sector, failures in the design of financial regulations become more likely. In some countries, "revolving doors" and other pecuniary and non-pecuniary considerations present problems compromising the integrity, adequacy and appropriateness of financial regulation, supervision and enforcement.

Incentive structures

103. To the extent possible, regulatory institutions should be designed to have incentives to encourage good regulation. In this regard there is a consensus that credit rating agencies, paid for by those whom they regulate, should be taken out of regulation

Personnel

104. Many regulatory bodies face difficulties in attracting qualified personnel: the battle between the regulator and the regulated might seem to be an unfair one from the start, given the high salaries paid in the financial sector. But the skills and talents necessary for creating new products and circumventing existing regulations and accounting standards are different from those required for assessing the safety and soundness of financial institutions or the safety and efficacy of particular financial products. Nonetheless, it may be desirable, or even necessary, to link the salaries, financed by a financial sector tax linked to the salaries of those in the financial sector.

Regulatory Structure

105. Much of the discussion over regulatory design has focused on the problem of assignments of responsibilities, e.g. should there be a single regulatory authority for the entire financial sector? Old models of regulatory structure have been failing because different institutions have been providing services formerly associated with other institutions. Securities markets and insurance firms and futures exchanges all provide opportunities for market participants to speculate on the outcomes of particular events (securities, defaults). Should responsibility be assumed by the Central Bank? While there appears to be no single model, appropriate for all countries, there are certain principles which should guide the design of the regulatory structure.

106. While different countries, at different stages of development, may find different structures better in meeting their overall needs, one possible structure entails two Apex regulatory institutions, working closely together: A New Central Bank focusing on macro-economic issues, the other, a Financial Regulatory Authority, focusing on micro-issues, closely coordinated with each other so that, for instance, the CB would be aware of the macro-economic consequences of the actions taken by the FRA. This is especially important because micro-prudential regulations have macro-economic consequences. The FRA would have under it several sub-commissions, a Securities and Exchanges Commission, an Insurance Commission, a Financial Products Safety Commission, an Accounting Oversight Commission, and a Financial Systems Stability Commission. It would have cross cutting committees to ensure that similar functions performed by different institutions were treated similarly. The Financial Systems Stability Commission could impose high margin requirements or large down payments for products sold to retail customers, if it felt that there was growing excess leverage in the economy or in the market. The Accounting Oversight Commission would ensure that the information provided by firms was not misleading, and represented the best estimate of the overall state of the firm, including its vulnerability. It might overtime develop broader set of metrics that might be of use to investors and other regulators.

Global Regulation

107. This crisis in global financial markets differs from all previous crises in its global reach. The magnitude of the scale of flawed products (toxic mortgages) that were exported from the US is large, with severe consequences for importing countries. While it may not be

the only source of the problems facing some European countries, it is a major contributor. As the crisis has evolved, there has been a break-down of trust: investors no longer trust banks. Citizens no longer trust the regulators who were supposed to regulate them, and regulators in one country no long trust that the regulators in other countries—even those with seemingly good institutions—are doing their jobs properly.

Comprehensiveness

108. As financial markets become global, it is imperative to have global co-ordination of regulation. This is especially so as responsibilities for bail-outs remain at the national level.

109. Circumstances in different countries differ, which would suggest that the optimal regulation and regulatory structures might differ. Thus there are items of regulation which should be focused locally, with international co-ordination, and others where the focus of regulation is international. The dividing line relates to those issues which require a high degree of reciprocity, such as regulation aimed against money laundering and tax secrecy; and/or on those issues where inadequate regulation in one country has large effects on other countries (either because of network effects or because of an induced race to the bottom.)

110. The placement of this dividing line also depends on the representativeness of regulatory bodies. In existing global regulatory bodies, concerns of developing countries are often given short shrift. For instance, the Basle I standards encouraged short term lending (relative to long term lending) by developed to developing countries, exacerbating their volatility. Many have been concerned that Basle II would have had the effect of discriminating against developing countries whose institutions do not have the ability to develop the complicated—and we now realize, totally inadequate—risk management systems.

111. Part of the concern about these regulatory systems is that they were arrived at by international institutions with flawed governance structures—under representation of developing countries and emerging markets, and over-influence of those banks being regulated. Basle II is seen by many developing countries as an example of that.

International Banking Centres and International Tax Cooperation

112. Well regulated economies have to be protected from those that are under- or unregulated. The problems of tax competition and regulatory arbitrage are often linked. The lack of transparency and regulatory standards is some countries is harmful to the functioning of national tax systems as well as to financial stability. Tax evasion and inappropriate tax practices are major problems for developed as well as developing countries. Each year, developing and developed countries lose enormous amounts that could be used for the financing of development. We must strive for a universal no-tolerance policy towards financial centres that continue to harbour generalized tax and bank secrecy.

113. While particular attention on this issue is drawn to off-shore financial centres in developing countries, we note that so far, the principal sources of tax evasion, tax secrecy,

money laundering, and regulatory arbitrage have been connected to developed country, on-shore banking systems. Delaware and Nevada for instance are two US states that make the establishment of anonymous accounts far easier than almost all international banking centres. Bank secrecy remains an issue in several developed centres. London's light touch regulatory regime was a source of much regulatory arbitrage. The biggest money laundering cases involved banks in London, New York and Zurich. The European Commission has decided to refer four smaller member states to the European Court of Justice over non-implementation of the 2005 anti-money laundering directive and two large member states have been given a final warning.

114. The matter is best handled through multilateral agreements on issues of tax secrecy, which have reciprocity and are enforceable by international courts. The major financial centres should sign up to these agreements first and then welcome others to follow, with the threat that those who do not chose to do so, would not be allowed to have linkages with those financial centres that have signed up to the agreement.

115. Ad-hoc and discriminatory targeting of small international financial centres in developing countries while a blind eye is turned to lax rules in developed economies are neither fair nor effective. For instance while many developing country financial centres have several bilateral tax information agreements, the advanced economies do not reciprocate. We need to move away from bilateral to multilateral agreements. Under these multilateral agreements "rogue centres" should be ring-fenced from the rest of the international financial system, but this must be done in an objective manner that could include rich as well as poor countries. We note for instance that for foreign investors the US is effectively a tax haven and developed countries engage in greater tax incentives, subsidies and tax competition to attract foreign investment than developing countries can afford. Moreover, the development of developed country financial centres such as London, Luxembourg and Dublin, has been based on tax competition.

116. We do not sanction one rule for the rich and a tougher rule for the poor and the preservation of centres and practices in developed countries that are not permitted in developing countries. This is why our focus is on the removal of tax secrecy that facilitates tax evasion and shining a light on tax avoidance practices. We accept that for responsible small states that sign up to the multilateral agreements, which we suggest above on tax secrecy, exporting high-value services that are found around international financial centres is a viable development strategy that has in fact been promoted as such by the International Financial Institutions over the past two decades.

117. It is important to promote common standards in the tax field and to develop criteria for those countries that do not comply with acknowledged international standards. Common standards have to be enforced effectively, e.g. by restricting dealings with the respective jurisdictions (e.g. by requiring companies to close their branches or to prohibit their outsourcing to those financial centres; or by prohibiting transactions between financial institutions in those jurisdictions and those in more highly regulated countries). It is also important that multilateral development banks and governments adopt coherent policies in

order to contribute to efforts to combat tax havens.

118. Institutional arrangements for improving harmonization and cooperation on tax matters need to be strengthened. A new inter-governmental commission to strengthen international tax cooperation should be created under the auspices of the Economic and Social Council (ECOSOC) of the United Nations. The existing UN Committee of Experts on International Cooperation under ECOSOC will serve this commission in identifying, analyzing and proposing solutions for the commission's consideration. The IMF and other bodies could also have consultative status with the new commission. In order to effectively mobilize public resources, many developing countries need to urgently undertake measures to enhance their tax revenues and fiscal capacity by rationalizing their tax systems, improving collection, limiting tax evasion and widening their tax base. National efforts to enhance tax revenues must be complemented at the global level by strengthening international cooperation and technical coordination and assistance on tax matters. While the United Nations Committee of Experts on International Cooperation on Tax Matters has helped developing countries mobilize public revenues by enhancing international cooperation in areas such as limiting tax evasion, and strengthening tax administration and taxation of services and natural resource use, the Committee's ability to further international cooperation in such areas could be significantly enhanced. We support the idea of an International Tax Compact, which should complement existing initiatives and programmes, strengthen voice and participation of developing countries in ongoing processes and provide coordinated approach to support national tax systems in developing countries.

119. But tax cooperation has also its important national component. There is a need not only for more, but in particular for more stable domestic sources of finance for development. Combating tax evasion and improve tax collection is one priority here. Development cooperation needs to support domestic resource mobilization of developing countries which is challenged by tax evasion and avoidance. This is due to weak domestic tax systems, but also the existence of onshore and offshore financial centres. The international community is encouraged to start dialogue on how to tackle these problems within the proposed framework of an International Tax Compact.

International cooperation on taxation

Home versus host country regulation

120. Equality of treatment has been a mantra of regulation that demands greater circumspection. Not all consumers should use all products. The developmental priorities of financial policy will differ among countries. Macro-prudential regulation will differ between countries at different stages in the credit cycle. The trend in supervision has been away from host countries towards home countries and this will need to reverse. Indeed, since host countries still are responsible for the functioning of their real and financial sectors, they can fulfil that responsibility only with tight oversight of all financial institutions operating within their country. This entails host country supervision, and, as suggested elsewhere in the report, almost surely a requirement that banks operating in a country operate through subsidiaries

rather than branches.

121. Strengthening host country regulation, introducing counter-cyclical capital charges, redefining the boundary of regulation to be more comprehensive while promoting diversity, is all under the remit of domestic regulation (and permitted within the supervisory discretion in Basle II.) Of course, ideally, while these initiatives could be executed locally, the principles behind these domestic initiatives would be agreed and harmonized internationally by our global financial authority.

Beyond *financial* regulation

122. Ensuring a well functioning financial market requires, as we have noted, more than just financial sector regulation. Inadequate corporate governance contributed to incentive structures that served neither shareholders nor borrowers well. Failure to enforce anti-trust policies led to excessive concentration in the financial sector, and banks that were too big to fail (though not to be financially restructured). Given that there has been considerable consolidation in response to the crisis, some banks may have large market power in some markets, and the abuse of that market power is likely to lead to higher lending rates and a consequent slower recovery.

123. Recent experience in the developed countries has revealed a very disturbing process where some institutions have been revealed to be too big to resolve (TBTR). When faced with the challenge of restructuring such large and multifaceted institutions on the doorstep of failure, public officials have chosen deliberate forbearance on the grounds that it would disrupt the financial markets, and quickly thereafter the real economy, to put these institutions into a conservatorship. The avoidance of resolution on grounds that it would do tremendous harm to the economy rests on the argument that governments do not have the resolution powers for financial services holding companies and insurance companies that they have in the case of banks. In additions some have suggested that the sheer size and complexity of these institutions changing organizational form would start a run on other institutions that are heavily intertwined with the behemoth institutions on the threshold of insolvency. Still others have suggested that governments are incapable of taking over and running such institutions and that substantial "going concern " value would be lost irreversibly in the process. In essence, society is faced with a policy regime where officials claim they cannot protect government finances and the taxpayers from the excesses of the TBTR firm.

124. This TBTR regime goes beyond Too Big to Fail, whereby critical functions of restructured institutions have to be preserved. A TBTR regime implies that managements, creditors are immune from consequence. A policy regime such as this is not consistent with a market economy that performs its social function well in the longer term. A strategy of entangling a financial institution so deeply and largely into the fabric of the economy that it could not be permitted to be resolved puts society in a position of great fiscal danger. It no longer has control of the scale of fiscal losses than can be imposed upon it by the financial institutions managers. This puts the management of TBTR institutions in a very powerful

position that is incompatible with social goals. The incentives they experience are not aligned with social incentives to an extreme degree. Some activities undertaken, rationally by management, though reckless from a social perspective, can induce bailouts of unlimited magnitude with no consequences for managers (firing) or creditors in the event of loss. While gains accrue to the managers if risky activities pay off. In some countries, even at present, the scale of these institutions has reached a magnitude that the quality of guarantees on liabilities is drawn into question. This entire process is amplified by the fact that knowledge of TBTR status removes risk from the creditors of the institution and the funding cost advantage contained within the creditors' expectations give an advantage to TBTF enabling them to further increase their size.

125. It is imperative for policy officials around the world to come to grips with this challenge. The aforementioned enhanced resolution powers must be promptly enacted and strategies to limit the absolute size of financial institutions must be created to mitigate the costs for officials of choosing to restructure them. In addition extensive examination of large institutions on an ongoing basis can prepare officials for controlled restructuring. There is not basis for allowing these large institutions any degree of opacity vis a vis regulators who must always be prepared for the contingency of a resolution. While antitrust laws have often been invoked for anti competitive practices, a new consideration of the role of anti trust, akin to the spirit of Theodore Roosevelt in the early 20th century may be necessary to put the structure of capital markets back on a footing that is sound and manageable.

Beyond financial *regulation*

126. As we have noted, financial sector regulation is a key instrument of financial policy. But there are other instruments, which countries, especially developing countries, should consider to ensure that the objectives of a good financial system are attained:

Direct Lending

127. Even in more advanced industrial countries, there are certain areas where governments have traditionally taken an active role in lending. Public student lending programs have been far more efficient than private lending, and have avoided the corruption and abuses that have marked private lending. In many countries, including the U.S., the government has to introduce special programs to ensure adequate access for small and medium sized enterprises (e.g. partial guarantees, as under the Small Business Administration.) In many successful developing countries, development banks have played an important role at particular stages of their development. Given the record of abusive lending to poor individuals, governments may need to consider whether regulatory mechanisms suffice, or whether direct lending programs should be established.

Innovation

128. Government (financial policy) can also play an important catalytic role in the development of financial markets (as it has done in mortgage markets in many countries) and in the creation of new products (like inflation or GDP indexed bonds, or Danish mortgage bonds). Private financial markets have failed to make innovations that address many of the

critical needs associated with creating products that meet the needs of ordinary citizens. In some cases, after the potential of those markets has been established, the private sector can take over.

129. These innovations are important both domestically and internationally, e.g. in improving the distribution of risk bearing between developed and less developed countries. Examples of the kinds of innovations that might be helpful are discussed in Chapter 5.

Electronic payments mechanism

130. One important area of innovation is in the payments mechanism itself. Changes in technology enable the creation of a low cost electronic payments mechanism. Introducing this requires some cooperation among financial institutions. Unfortunately, in some countries financial institutions have colluded—to maintain a high cost payments mechanism. Therefore, regulators need to pursue a policy of incentivizing the use of electronic payments both for efficiency and financial inclusion.

Chapter 4: International Institutions

The Challenges Ahead – The Need for New Global Economic Governance

1. The response of international financial institutions to the global financial crisis has demonstrated the urgency to review the adequacy of their mandates. This review must be open to consideration of new institutional arrangements, whether ad-hoc and permanent, as well as to modification of internal governance mechanisms to provide more effective voice and representation of developing countries. More importantly, immediate attention needs to be paid to the policies and philosophies underlying their operations. Above all, it is imperative that reform should re-establish credibility as truly international institutions contributing to growth with equity and stability for all countries.

2. The existing system of international economic governance has relied on two basic principles: specialization and coordination. A set of global institutions—specialized agencies--each with a mandate to deal with a specific and limited set of issues. The first such institutions were the specialized agencies within the UN system, the World Bank and the International Monetary Fund. A third agency called for in the Havana Charter, the International Trade Organization (ITO) was to deal with commercial policy, employment policy coordination and the position of developing countries was never approved. Only the GATT survived, and provided the basis for the WTO, which is not formally part of the UN system. These three post-war international economic institutions were expected to work in a complementary fashion to promote sustained economic recovery and growth, full employment and thus economic welfare, as well as reconstruction and development of economic capacities and capabilities.

3. The overall coordination of UN activities concerned with economic, social, and ecological affairs, including the specialized agencies, was to be entrusted to the Economic and Social Council (ECOSOC), one of the UN system's main organs, acting under the authority of the General Assembly. Coherence is not a new concept in the arena of international relations, as the original UN model provided, in theory, for the coherent design of policies for the achievement of internationally agreed goals. Although the system has never worked the way it was originally envisioned, its internal logic remains compelling; the incomplete arrangements provided support to post-war reconstruction and the Age of Keynesian-inspired economic growth until the 1970s.

4. The underlying challenge to effective global economic governance originates from the absence, in a world of sovereign states, of an adequate body or bodies as a locus of coordination, accountability, to enforce transparency, and to elicit compliance. A wide range of issues from cooperation in trade in goods and services, cross-border environmental goods, cross-border labour policies, payments and clearing, regulation, contract enforcement, exchange rates and other related cross-border matters have to be addressed through coordinated arrangements and negotiated derogations of sovereignty for specific purposes.

Global Governance Implications of the Current Crisis

5. The current crisis reflects problems that go beyond the conduct of monetary policy and regulation of the financial sector. It has made clear that globalization of trade and finance calls for enhanced global cooperation and global regulation. The international community is confronted with multiple, interrelated threats of unprecedented scope. The collapse of the global financial system and the worldwide economic downturn, the growing divide between poor and rich within and between countries, the risk of unabated global warming that might result in systemic climate change, the energy and the food crises - these are all interconnected global challenges that threaten to unravel the fragile state of globalization. Because global economic integration has outpaced the development of the appropriate political institutions and arrangements for governance of the global economic system there is a pressing need for a substantial improvement in the coordination of global economic policy.

6. The crisis has brought to the fore severe structural lacunas in the existing global economic governance structure, in particular the lack of incentives for global collective action (e.g. with regard to the provision of global and regional public goods and poverty reduction) and the failure of the institutional framework to ensure coherence of global policy making.

7. The ability of the atmosphere to absorb greenhouse gas emissions had appeared to be available to all without cost. However, the limit has been reached where these emissions challenge the stability of the climatic system. The international community thus faces a collective action problem: who will take over what responsibility to provide an international set of rules or set incentives that would foreclose free-riding and ensure international cooperation in preserving the atmosphere.

Collective Action and Coherence

8. Effective collective action depends on a strong institutional framework, ensuring coherence in decision making. Managing global threats in an interconnected world critically depends on cross-sector and cross-institutional actions to assure system-wide coherence in norms, policy frameworks and operational standards. Political consensus and compromise within the international community are inconceivable without the design of complex inter-issue linkages, thereby facilitating a fair allocation of costs and benefits over a wide range of global concerns. As the crisis is global and multi-faceted, it is important to foster greater cooperation among governments, international organizations, and other stakeholders in support of a stronger, cleaner and fairer economy. It is key to achieve a greater coherence between financial, trade, social, environmental and development goals.

9. In order to pursue joint goals, such as adequate and appropriate provision of global and regional public goods, strong collective action is needed. By definition, without coordination countries do not have sufficient incentives to invest in global and regional public goods (e.g. economic, financial and ecosystem stability). The same is true for other common objectives, such as combating poverty. To achieve the goal of sustainable development, stronger collective action is needed in a number of inter-related areas:

10. With the adoption of the Millennium Development Goals, the international community reiterated its commitment to the overarching goal to eradicate poverty. Joint approaches have been agreed upon and many countries have developed a joint understanding on the relevant financing needs and the respective burden sharing. However, commitments have to be monitored and implemented.

11. Institutional arrangements failed to take the actions that might have prevented the current crisis from developing. Some institutions have even actually promoted arrangements that facilitated the transmission and contagion of the crisis across borders, thereby contributing to its amplification. Without the reform of these institutions, it will be difficult to ensure financial stability. There is clearly an urgent need to reform the international monetary and financial system to ensure that it is more inclusive and equitable, and to thus enable more effective and credible global economic governance. Already, some developed countries, such as the UK and France, and many developing countries, such as those in the Commonwealth, have called for an international conference to redesign the system of international economic governance into a new post-Bretton Woods system, designed to restore accountability and transparency in international economic policy-making and to overcome existing systemic weaknesses.

12. Developing countries now represent a much larger proportion of world economic activity than in 1944. Developing countries–as a group–also have a direct interest in a more equitable global governance system.

Global Economic Governance and the United Nations

13. Neither the Group of 7 of industrialized countries nor the Group of 20 represents a sufficiently inclusive global steering group for addressing global systemic challenges. The G7 have initiated a number of initiatives important for developing countries, and are engaged in a systematic dialogue particularly with African countries. While the G20 are more broadly based, there is still no representation of the remaining 172 countries. The shape of any future governance format must ensure inclusiveness and adequate representation of developing countries, including LDCs, promote complementarity and coherence and should establish links between existing and new fora.

14. There has been growing attention and interest in the working of the G-7 and G-20. However, such informal groups which are growing in significance should not be allowed to undermine the functioning of formal institutional arrangements and the discharge of their respective mandates as per the desirable standards of governance and transparency specified.

15. There currently is a unique opportunity for bringing forward global economic governance reforms. The current financial and economic crisis clearly calls for enhanced cooperation and coordination of existing and emerging actors on economic questions.

16. Sustainable progress in managing global governance requires a comprehensive, systemic and long-term oriented effort. As the world moves into an uncertain phase of global

interconnectedness and mutual vulnerabilities, unforeseen risks unfold just as unexpected opportunities for institutional innovations may arise. Not only the current challenges of the financial and economic crisis, but also other global issues such as climate change or the food and energy crisis clearly call for the international community to take a systematic and global approach towards a sustainable and socially balanced economic development. It is therefore important to strengthen international institutions, especially the United Nations, the body which is most universal, legitimate and accountable to the people of the world. This inclusive response will require the participation and the involvement of the entire international community. Apart from the G7, G8 or G20, it must encompass representatives of the entire G192.

17. The United Nations is the most legitimate forum for achieving greater coherence among different actors. Given the specific institutional foci of the IMF, the World Bank and other international institutions, there is a need for better coordination and political accountability and for a forum for consensus building to broaden and guide their policy agendas. An overarching theme of the UN Financing for Development (FfD) conference and the resulting Monterrey Consensus was the need to enhance the coherence and consistency of the international monetary, financial and trading systems, to ensure that they support the internationally agreed development goals, including social and environmental sustainability.

A Global Economic Coordination Council could lead the way forward

18. The variety of international institutions and organizations with specific mandates requires an overarching inclusive body allowing for an integrated view over the scope of mandates, topics and policies and the establishment of adequate instruments for effective global economic governance. A globally representative forum to address areas of concern in the functioning of the global economic system in a comprehensive and sustainable way must be created.

19. As an immediate step, an Intergovernmental Panel tasked with the assessment and monitoring of systemic risks in the global economy should be established. The Panel could serve as an internationally recognized source of scientific expertise in support of better coherence and effectiveness in the global governance system, fostering dialogue between policy makers, the academic world and international organizations. The Panel should primarily analyze systemic risks in relation to the global economy, their root-causes and implications for human development. It should establish criteria for the identification of systemic risks and issue recommendations as to preventive measures and sound economic policy-making, thereby also attributing an early-warning function to the Panel. The Panel should be made up of renowned experts from all continents, OECD countries, emerging and developing countries. It would not undertake its own research, but pool the global knowledge and resources of a large number of acknowledged experts. While its analysis would focus on economic issues, it would also take into account the social and ecological dimensions of economic trends and policies, and would analyze their long term developmental implications and identify obstacles to economic systems achieving developmental, social, and environmental goals. It should therefore adopt a multidisciplinary and long-term approach to

observed economic change. Its institutional set-up and functioning could follow the very successful example of the Intergovernmental Panel on Climate Change (IPCC). In consultation between science and politics, it should be assigned the role to work out normative and value-based standards for economic and financial decision-making, once established and operational, the Panel would serve as advisory body to the UN System (including ECOSOC), the Bretton Woods institutions and other international organizations dealing with economic, financial and social issues.

20. A longer-term proposal is the establishment of a Global Economic Coordination Council, at a level equivalent with the General Assembly and the Security Council. It would assess developments and provide leadership in economic issues while taking into account social and ecological factors. Based on this mandate it would promote development, secure consistency of policy goals of major international organizations, and support consensus building among governments on efficient and effective solutions for issues of global economic, social and environmental governance. The Council could also promote accountability of all international economic organizations, and identify gaps that need to be filled to ensure the efficient operation of the global economic and financial system. Representation could be based on a constituency system designed to ensure that all continents and all major economies are represented. At the same time, its size should be guided by the fact that the council must remain small enough for effective discussion and decision making. In addition, active participation by other important institutions, such as the World Bank, IMF, ILO, WTO, would be crucial. The intergovernmental Panel could play an important role in further defining the mandate, working mechanisms, composition and the interaction of the Council with the UN system. Once established, the Council could rely on consultancy and expertise provided by the Intergovernmental Panel.

Bretton Woods Institutions and Regional Development Banks

21. The International Monetary Fund (IMF) and the Multilateral Development Banks (MDBs) continue to have a very important role in the international economic financial architecture. The mandate of the IMF is to assure global financial and economic stability. It has been expected to survey the economic performance of its member countries, alert them of economic dangers and provide policy advice and financing to members facing balance of payments difficulties besides helping developing nations to achieve macroeconomic stability and support employment. The World Bank and the other multilateral development banks are also supposed to have a key role in supporting the developing countries. To achieve their objectives they provide concessional loans and grants to developing countries as well as technical assistance. Within their mandate of poverty reduction and the promotion of sustainable development and inclusive growth, they should play a counter-cyclical role in tackling the crisis. The MDBs have recently adjusted their policy approach, moving away from earlier market-fundamentalist approaches, starting with HIPC debt relief and the adoption of new poverty alleviation strategies.

22. However, there have been severe shortcomings in the mandate, policies, resources and governance of these institutions. These problems have impaired their ability to take adequate

actions to prevent and respond to the crisis; they have also had a negative impact on their mandate to promote sustainable development. The ability of the IMF to safeguard the stability of the global economy has been undermined by the vastly greater resources and volatility of globally integrated private financial institutions, uncoordinated national policy responses as well as the emerging influence of non-inclusive arrangements including those introduced by the G7, and the OECD. In fact, the IMF has been effectively sidelined in handling the present crisis; on its own admission it did not perform well in identifying systemic vulnerabilities or in anticipating the crisis.

23. The limited relevance of the Bretton Woods institutions also stems from their skewed voting structures and governance, the chequered record of their forecasting, policy and other recommendations, including the onerous conditionalities they have imposed on borrowing countries and their tendency to proffer pro-cyclical, rather than counter-cyclical policy advice. Major reforms are thus necessary.

24. The recommendation to recycle substantial amounts of capital to developing countries that have been the victims of a crisis in the developed world is in itself uncontroversial. The means to achieve those capital flows to the developed world on the other hand, is. On the one hand, both borrowers and lenders have been reluctant in recent years to utilize the IMF. In response to this demonstrated reluctance, some have advocated setting up a new institution with very different governance and objectives. The cost of such a fresh start is one of timeliness. The need to channel capital to developing countries is extremely urgent.

25. The IMF can address this aspect of the challenges because it already has a substantial staff who are present, active and experienced in the assessment and monitoring of many of the countries in question. The concerns utilizing the IMF centre on their prescriptions rather than on their capacity to do timely diagnosis. It appears that the culture of the IMF has for a long time embraced an economic philosophy and economic models that--like those espoused by the financial sector--have serious flaws, have contributed to the recent crisis, and have been shown by events to have failed.

26. For the IMF to regain its importance and to play a meaningfully positive role in the future resolution of crisis they will be required to significantly retool their thinking. For their prescriptions and policy recommendations to inspire the participation of borrowers and lenders alike, they will have to place much greater weight on the role of externalities and other market imperfections in the design of conditions and responses to meet the crisis. In addition, in periods of global underemployment such as the present, they must come to a more enlightened understanding of the role of deflationary bias, and the associated cross country externalities, in exacerbating the problems within a country and for the global economic system as a whole.

Mandates

27. There is a need for independent and even handed macroeconomic surveillance. The IMF has not implemented its mandate consistently and even-handedly. For example, in recent

decades, it has largely ignored its mandate to sustain growth and employment while focusing almost exclusively on curbing inflation. It has also promoted financial, including capital account, liberalization, although it's Articles of Agreement clearly allow governments to use capital controls. Before the current crisis, the IMF also failed to provide early warnings -- unlike the United Nations system in various publications such as the World Economic Situation and Prospects and the Trade and Development Report.

Better integrate global and regional public goods into the work of the MDBs

28. The participation of developing countries is essential if there is to be an adequate provision of global and regional public goods, such as climate protection and financial stability. Accordingly, these agendas can only be successfully realized if the developing country perspective is appropriately reflected in global decision making. At the same time, the developing countries' actions in support of the provision of global and regional public goods needs additional funding, if other developmental objectives are not to be compromised. The provision of global and regional public goods should thus be an important part of development institutions' work and mandate. The different dimensions of this issue urgently need to be assessed, for example the implications for the UNFCCC and the World Bank's respective mandates, its policies and governance structure.

Create a Pro-Development Climate Architecture

29. The climate financing architecture will be reviewed in the course of the UN climate negotiations. From a development perspective, the key issue is that climate-related tasks in the developing countries are considered as an integral part of a sustainable development agenda and that all partners act accordingly. To that end, the full set of existing development instruments, procedures and institutions must be used and further developed. Multilateral climate financing must come under the authority of the UN Framework Convention on Climate Change (UNFCCC) and serve to meet its climate change mitigation and adaptation objectives.

Governance

30. There is a growing international consensus in support of reform of the governance, accountability, and transparency in the International Financial Institutions. The governance reforms have to be based on a joint understanding of the respective mandates and a common understanding on the strategic directions of the respective institutions. On this basis, major reforms in the governance of these institutions, including giving greater voice to developing countries and greater transparency have to be accelerated. See in particular the Manuel report in this regard.

31. The inconsistency between the economic and financial weight of developing countries in the world economy, their role as recipients of IMF and World Bank funds on the one hand, and their representation in these institutions on the other, is one of the factors behind the loss of legitimacy and relevance of those organizations in addressing systemic issues. The decisions

for broader reform–taken by the Board of Governors of the Fund at the Annual Meetings in Singapore in 2006 and in Washington in 2008–have resulted in modest progress. Quota increases have only been made on an ad-hoc basis, first in 2006 for a small group of emerging market countries, and in April 2008, for the larger membership, leading to marginal changes and failing to shift significantly the balance of power between developed and developing countries. The April 2008 decision by the Board of Governors to adopt a new quota formula is not sufficient to address the problems in governance. In fact, the new formula actually shifts voting weight to industrial countries at the expense of middle- and low-income ones, with the modest progress achieved due to voluntary forgoing of votes by major industrial countries and ad hoc decisions. Therefore, a step towards more inclusiveness and representative governance at the IMF would require an improved quota formula and/or alternative procedural reforms.

32. A governance reform of the IFIs must also strengthen the weight of low-income countries, e.g. by recognizing the dependence of these countries on financial from both the World Bank through IDA and the IMF through the PRGF. This can be done by increasing quotas or by further increasing the share of basic votes. When the IMF was established in 1944, basic votes were set at 250 votes for each member and represented 11.3 per cent of total voting power when it had 44 members. However, as a result of the increase in quotas that has occurred over the years, the share of basic votes has fallen considerably and reached its lowest level of 2.1 per cent of total voting power for 184 members in mid-decade. The April 2008 decision taken by the IMF Board of Governors to reverse this trend by tripling basic votes only increased the total share of basic votes to 5.5 per cent of current voting power, and falls far short of restoring the share, let alone the weight of basic votes.

33. The application of double majority voting to a broader set of decisions could also compensate for voting imbalances in the Fund. At present, a double majority – 85 per cent of voting power and a 60 per cent majority of members – is required to amend the Articles of Agreement. Double majority voting (shares and chairs) should be extended to the selection of the Managing Director and the chair of the IMFC, as well as for key policy decisions and to approve access to lending operations. Also, the reform must consider eliminating effective veto powers over decisions to amend the Articles of Agreement. These changes could help strengthen the sense of ownership in the Fund by requiring a significant majority of members to support key decisions that determine the direction of the organization.

34. Some basic principles for IMF governance reform would apply to reforming other international financial institutions, such as the World Bank. However, the Bank's specific mandate as a development bank is distinct from the IMF and its governance should reflect this difference. Hence, in determining the participation rights of its members, distinct World Bank governance arrangements would be needed.

A roadmap with a time frame to enhance voice and representation in the IMF

35. To strengthen the effectiveness and legitimacy of the IMF its governance must be enhanced to ensure that it fully reflects changes in the world economy. Emerging and developing economies, including the poorest, should have greater voice and representation.

The next quota review is currently scheduled for 2013, but it would be helpful to accelerate this process and to bring it forward to 2011.

Reform of the World Bank's governance structure should be completed swiftly

36. The first stage of the World Bank's voice reform should be implemented rapidly. The doubling of basic votes and the third African seat on the Board will increase the influence of developing countries. The second stage, focusing on a reform of quotas, should be accelerated and completed by the Spring Meetings in 2010. Against the background of the challenges ahead, such as the financial crisis and climate change, the second stage of the reform process should start with an in-depth debate on the Bank's mandate and its strategic directions. The World Bank Group has already different "arms", such as IDA and IBRD, with their own governance structures. It has to be born in mind that new or reinforced fields, such as the increasing role of the Bank in the area of global and regional public goods, might also require new governance structures. With regard to the quota reform, three criteria should be taken into account for allocating votes: the member state's economic weight, their contribution to the development mandate of the World Bank (for example, measured in terms of contributions to IDA and trust funds) and the significance of borrowing levels from the Bank. The two latter criteria would reward member states for being closely connected with the Bank.

37. Within the Fund and the World Bank, a merit-based, transparent process for the selection of the senior management should be encouraged through implementation of clear guidelines. Conventions associated with the choice of the leaders of the World Bank and the International Monetary Fund make little sense in the twenty-first century. Progress should also be made in identifying those decisions where double majority voting is appropriate and a timely decision made on this reform.

Policy coherence for development also has to be improved on the national level

38. The current crisis has not only revealed a lack of international coordination and regulation; at the national level, too, players have failed to introduce the requisite reforms and regulations. Against the background of the current crisis, policy coherence for development is of utmost importance. It should be examined how the development- impact of government policies can be better measured and monitored.

39. In particular, national governments must ensure better policy coherence for development in the various international institutions. We need to acknowledge that the role and mandate of World Bank and IMF has changed since the foundation of both organizations. Given the wide impact of IMF programs and the steady expansion of its operations into the areas of development and poverty alleviation, it does not seem appropriate that the Fund should just reflect the views of representatives from finance ministries and central banks. In addition, the views of development, foreign and planning ministries should be better integrated. The same principle should be applied to the World Bank as it has along the way added new tasks to its mandate, in particular in the area of global and regional public goods such as health and environmental policy.

Policies and Instruments

Review policy advice

40. The World Bank and the IMF have already begun to move away from free market ideology, but the importance of taking frictions into account in policymaking (incomplete information, imperfect information, imperfect institutions, bounded rationality, etc.) is not equally accepted by all departments of these institutions. In particular, the advice offered in the past by the World Bank and the IMF on capital account and financial market liberalization was often problematic. In view of the current crisis, IFIs should overcome market fundamentalist concepts and should allow for more pragmatic approaches. In particular, there is a need to comprehensively review these issues and to draw lessons for the policies of these institutions.

41. The IFIs have to strengthen their capacity to implement counter-cyclical instruments. The global crisis puts recent progress in helping the poorest, and the 2015 targets of the Millennium Development Goals, at risk. The World Bank and other Multilateral Development Banks have already increased lending and mobilized additional financing for trade credit, infrastructure financing, recapitalization of banks and microfinance. But more needs to be done so that the MDBs also play their part in enabling countries to support global demand and cushioning the impact of the crisis on the poorest. In particular, the MDBs should, in close coordination with the IMF, move forward on flexible, fast disbursing, and front-loaded instruments designed to substantially and quickly assist developing countries facing financing gaps in the context of the current crisis. E.g. the IFIs should pro-actively develop flexible instruments designed to support specific development budget financing as contingency arrangements during times of market disruption for countries with sound policies, including backstopping social protection and deposit insurance arrangements that may not yet be fully funded. Also, the option to extend guarantees for credit enhancement of government issuances on the market should be examined. The IFIs should more actively take the role as market maker for new risk bearing instruments.

42. The World Bank and the IMF must further improve their strategies for preventing crises and reducing the scope for contagion, and helping countries cope with external shocks. Given, the absence of global systems of risk bearing and the lack of—and in some cases, resistance to—innovations in the private sector that would facilitate efficient risk bearing, there is a need to push ahead with the development of new instruments to better shield developing countries from the ever-increasing volatility of markets (commodities, foreign exchange, food, etc.). Examples would be local currency lending instruments and risk-mitigating facilities or GDP-indexed bonds (see chapter 5). MDBs must play an active role in the promotion of such financial products. Credit facilities with flexible debt service are another option to be explored more pro-actively. International financial institutions need to explore meaningful innovations that would enhance risk management and distribution and how markets might be encouraged to do a better job. In particular, while there have been some expansion in capital markets in domestic currencies in developing countries, developing countries still bear the brunt of

exchange and interest rate fluctuations. IFI lending in (possibly baskets of) local currencies and the provision of exchange and interest rate cover might be important steps in improving international risk markets.

43. Each country needs to find the model of financial sector development which is most appropriate for its current level of development, needs, and institutional capacity. The IFIs must consider that premature and inappropriate financial and capital market liberalization is prone to fail, as acknowledged even by the proponents of these liberalizations. The current crisis has illustrated how they may serve to exacerbate the impact of mistaken policies in developed countries on their own economies, even when they have managed them well. Developing countries face a difficult trade-off regarding the design and regulation of their financial systems. On the one hand, access to finance is necessary for economic development. On the other hand, a more sophisticated financial sector may also to lead to an increase in total risk. If the second effect dominates the first, financial liberalization may lead to an increase of systemic risk. In choosing where to position themselves, developing countries should recognize that there is no model that is right for all countries or at all times.

44. However, financial liberalization makes little sense if financial sector institutions are weak; appropriate sequencing of reforms is crucial. Liberalization opens the markets to short term, volatile capital flows which might lead to a destabilization of the financial market. Therefore timing and sequencing is important to allow for a step by step and cushioned opening to the international market. And financial and capital market liberalization needs to be linked to the development of an effective regulatory system, along the lines discussed in Chapter 2. The IMF and the World Bank have to strengthen these principles in their policy advice. They should link their policy advice regarding liberalization of financial and capital markets better to the country specific situation and its economic soundness.

45. The World Bank should strengthen the support it provides in the area of financial regulation. The experiences of financial crises in countries that were supposed to have good institutions and policies suggests that ascertaining what are good institutions and policies may be more difficult than was at once thought to be the case. These experiences may also highlight the dynamic nature of markets—what are good institutions and policies at one time, can quickly evolve into those that are not at another. It also highlights the important role that political processes have played in the shaping of the liberalization/deregulation agenda, and how difficult it may be to develop and maintain adequate protections in the context of liberalization. The World Bank should therefore review its own approach to financial sector policies in the light of experience from the recent crisis and thereafter with increase its support to financial sector development with a focus on financial regulation. Activities should include, in particular (a) strengthening national banking and financial market oversight; (b) establishing a multi-country crisis management system to respond to financial crises; (c) developing national credit registers; and (d) developing standards for responsible, fair, transparent banking transactions that meet the requirements of responsible finance. It is imperative for the World Bank to learn from the successful experience of other developing and emerging market economies, rather than to pursue models adopted in developed economies or premised on the growth of presumed ideal conditions.

The Bretton Woods institutions must support national capital account management

46. There is no evidence that capital account liberalization has contributed significantly to economic growth. One reason could be that much of the short-term lending finances consumption rather than investment. Also, the growth impact of capital inflows depends to a large extent on the strength of existing institutions and capacities. Capital account liberalization may contribute to economic volatility as these flows tend to be pro-cyclical. This implies high costs for the economy as it raises risk premia and forces governments to set aside large funds of reserves. Also, there are doubts whether new and increased regulation alone would be enough to curb explosive speculation on financial markets. Therefore, it might be necessary to re-examine the need for capital flow limitations, especially for high-volatility short-term flows. In the interest of long-term stability, it may be necessary to introduce some kind of capital controls, coupled with serious limitation of scope for the securitization processes and leveraged financing instruments. Clearly, past policy advice by the Bretton Woods Institutions in this area was often misguided. These institutions should pro-actively assist Member States on how to design and implement policies in the area of capital account management. Capital account management may involve price and/or quantitative instruments.

47. Avoid pro-cyclical conditionality. Conditionality has often required developing countries to pursue pro-cyclical policies or to adopt the kinds of monetary and regulatory policies which contributed to the current crisis. In addition, these conditionalities contribute to global asymmetries, disadvantage developing countries relative to the developed, and undermine incentives for developing countries to seek support funding, contributing to global economic weakness. While the IMF initiatives to reduce counterproductive conditionalities are to be commended, they might be insufficient, and in many cases countries are still required to introduce pro-cyclical policies. In order to avoid pro-cyclical conditionality, additional IMF- and other external resources must be mobilized. The economic models on which IMF's financial programming is based, should be re-examined in order to identify any built-in restrictive biases (e.g. with regard to the assumed private sector response to reduced government spending). One of the tasks of the Panel discussed in par. Above would be to evaluate and assess accuracy and bias in the models and policy frameworks.

Other international financial bodies

48. The governance of global financial regulation remains a question of concern. It is imperative that there should be consideration of a new global financial authority to co-ordinate financial regulation in general and establishes global rules in certain areas, such as with regards to money laundering and tax secrecy, Such a global financial authority might be based on a more representative Financial Stability Forum. The current proposals to re-establish the Financial Stability Forum with a wider membership as the Financial Stability Board (FSB) is a step with potential. However, there is no indication as yet that the FSB is considering the adoption of a robust regulatory environment. Continuing with the current structure or making marginal changes would not ameliorate the current situation, nor would it necessarily be more effective in preventing future crises, judging by the FSF's track record in

the decade since its establishment, especially in the run-up to the current crisis. While national regulatory authorities have the ability and mandate to protect the vulnerable within their borders, there is a difficulty in extending this mission across borders. While much of what it to be done at the international level will be difficult to achieve in the short term, there is a great deal that can be done at the domestic level without prior international agreement.

49. If the Financial Stability Forum (FSF) is to become the main instrument for the formulation of reforms of the global financial system, it must better take into consideration the importance of financial stability for economic development. The FSF was created in the aftermath of the 1997/98 financial crisis in order to promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to propagate from country to country and to enhance the institutional framework to support global financial stability. It is now apparent that the reforms that it has proposed, although important, have not been sufficient to avoid major global financial instability.

50. Strengthening and reforming the FSF into a Financial Stability Board (FSB), as agreed at the 2 April 2009 G20 Summit, should only be an initial step toward establishing much more representative, appropriate and effective financial regulation at both national and international levels. The task of ensuring coherence in regulatory principles among national authorities must be undertaken by such authorities supported by an accountable Secretariat which should have access to a diversity of viewpoints. For the FSB to take on the role as a global authority in identifying systemic risk for the financial system it would require an international capability that goes beyond the mandates and capabilities of the Financial Stability Forum and the Bank for International Settlements (BIS). International financial regulation will require coordination beyond central bank authorities (the major concern of the BIS) and must include securities and corporate regulators as well as accounting standards among its key priorities.

51. The FSF and all standard setting institutions must become more representative and accountable to adequately reflect the views of and the conditions in developing countries. Most developing countries are not represented in today's standard setting institutions. The Basle Committee of the Bank for International Settlements (BIS) and the FSF set important global economic standards in areas such as data dissemination, bank supervision, financial regulation and corporate governance. The inadequate representation of developing countries in these ad hoc bodies, however, makes their analysis and recommendations incomplete and biased in crucial aspects, as recently demonstrated by the Basel II capital adequacy criteria. Inattention to the fact that countries are at different stages of economic development with varying financial and institutional capacities poses a challenge for global acceptance of standards and codes developed by these non-inclusive bodies. This dilemma is a major obstacle to ensure universal and effective implementation. While standard-setters liaise with developing and transition economies from time to time, consultations do not substitute for participating in the decision-making.

52. The challenge is to create globally representative institutions, cognizant of the concerns of the advanced industrial countries, emerging markets, and developing countries. Even if it is not easy to change institutional cultures, more inclusive, representative and appropriate

representation in the BIS and FSF would result not only in a fairer system, but also in better regulation leading to a more stable global financial system with welfare-enhancing effects for all. Increased international public oversight in the governance of the international financial system requires that critical standard setting activities are, at a minimum, reported to an intergovernmental body for coordination.

53. The lack of accountability of important private standard setting bodies is an additional area of concern. Private entities such as the International Accounting Standards Board (IASB) and the International Organization of Securities Commissions (IOSCO) develop, for instance, standards for cross-border regulation that have systemic impacts on the international financial system, exempt from any political accountability. Increased international public oversight of governance of the international financial system requires that critical standard setting activities are, at a minimum, reported to an intergovernmental body for approval. This is particularly important in light of the greater interconnectedness among financial market segments. Global banks have increasingly expanded their operations into securities markets and own or control brokerage and security firms.

International lending and ODA

54. There is an urgent need for donors to fulfill their existing bilateral and multilateral ODA commitments which must be closely monitored. Developed countries must make a renewed effort to meet the commitments made in the Millennium Declaration, the Monterrey Consensus, the 2005 Global Summit, and the Doha Declaration by 2015. Failure to increase the levels of official assistance as required will have long-term effects. There will be an increase in poverty and malnutrition and the education of many young people will be interrupted, with life-long effects. The sense of global social solidarity will be impaired, making agreement on key global issues, such as responding to the challenges of climate change, more difficult. Failure to provide such assistance can be counterproductive even in a more narrow sense: it can impair the global recovery.

Additional funding for developing countries is needed

55. Funding is required to contain the negative impact of the crisis on developing countries as well as to offset the distortions of the level playing field created by some of the massive stimulus and bail-out programs of the advanced industrial countries, including large subsidies to financial institutions and corporations and extensive guarantees.

56. New funding needs exist to provide more effective safety nets, to help ailing financial institutions and to prevent a collapse of financial systems, to assist firms attempting to compete in a playing field that has suddenly become massively more distorted, to provide access to credit to firms who may lose access as the credit crisis worsens, and to stimulate the economy, including through investment in infrastructure projects addressing long term development and environmental problems. Some of these are necessary to prevent the current downturn from growing worse. Funds to provide a more effective safety net are essential if there are not to be major reversals in progress towards meeting the Millennium Development

Goals. Infrastructure and technology expenditures aimed at reducing greenhouse gases can simultaneously provide stimulus in the short run and help developing countries reduce their greenhouse gas emissions. While the initiatives of the World Bank and others to create such funds are welcome they appear to be incommensurate with needs.

Aid Effectiveness

57. The processes for achieving aid effectiveness need significant enhancement. The 2002 Monterrey Consensus asserted that "Effective partnerships among donors and recipients are based on the recognition of national leadership and ownership of development plans and, within that framework, sound policies and good governance at all levels, are necessary to ensure ODA effectiveness." The 2005 Paris Declaration on Aid Effectiveness sought to operationally these basic principles. Despite commendable early OECD leadership in this area, a more universal body, where all parties share responsibility for progress, can effectively lead in further enhancing aid effectiveness. The Development Cooperation Forum (DCF) of ECOSOC has begun promising work in this area.

58. Donor conditionalities and realizing national ownership of development strategies were the most contentious issues in negotiating the 2008 Accra Agenda for Action, which affirmed that national ownership and effective leadership are unattainable without a reform of conditionality. Achieving national leadership will require a shared understanding of what conditionality is appropriate and mutually acceptable. Aid recipients must meaningfully participate in the agenda-setting and operations of multilateral institutions which manage development aid. ODA should not undermine national accountability, democratic processes, parliamentary oversight and national capacities for designing, negotiating and implementing development strategies appropriate to domestic conditions.

59. Ironically, ODA has proven to be the most volatile of foreign flows to many of the poorest countries in the world. Improving the predictability of aid is necessary for aid effectiveness. The international community must make progress to genuinely align aid programs with national priorities.

60. The use of governance indicators (and more broadly, the CPIA indicators) for aid allocation and other international cooperation has been greatly discredited. These indicators are now a critical element in determining access to aid and debt financing for developing countries, and should be repudiated. They represent a hidden form of conditionality.

Expansion of resources by IFIs

61. Steps must be taken to ensure that the World Bank and the regional development institutions have sufficient financial capabilities, as these institutions must be able to provide counter-cyclical financing. We need to look at whether certain international financial institutions may possibly require a capital increase, which is doubtless the case with the Asian Development Bank. In order to be able to react more promptly in future crises, the MDBs' policies and facilities should be reviewed. There could prove to be a need for additional

facilities within their respective mandate and the establishment of a fast-track mode of project preparation. – In addition regional efforts to augment liquidity should be supported. Regional cooperation arrangements can be particularly effective because of a greater recognition of cross-border externalities and greater sensitivities to the distinctive conditions in neighbouring countries.

The IMF needs an immediate expansion of its resources

62. It is obvious that the IMF's current funding levels are not sufficient to allow it to respond appropriately to the worsening problems in developing countries. To allow the IMF to fulfil its mandate of stabilizing the global economy and to respond to increased members' demands in the current uncertain international environment, the Fund's position should be strengthened through a very substantial increase in the IMF's lending capacity along the lines already decided at the London G20 Meeting. This will require reviewing the various options, including the allocation of further special drawing rights (SDRs), bilateral loans, an expansion of the membership and scale of the NAB, the agreement of swap arrangements and a capital increase through contributions from member countries. The resource increase should go in parallel with decisive progress in long-overdue governance and voice reforms. The additional capital disbursement should not increase the dominance of the industrial economies. The international community has to ensure that low income countries have sustainable financing which does not increase debt commitments to launch countercyclical responses to the crisis. The current provisions of the G-20 in this regard are too limited in scope.

Review developing countries' debt sustainability in light of the financial crisis

63. Several developing countries are facing debt sustainability problems. The new Debt Sustainability Framework recently introduced by the IFIs may act pro-cyclically, because debt ratios tend to rise as tax revenues decline and expenditures might rise due to the crisis. In view of this, there should be an assessment of debt dynamics in the light of the current crisis, as well as a review of MDBs' policies. In those countries where the crisis is seriously threatening debt sustainability, consideration could be given to debt moratoriums and, where appropriate, partial debt cancellation within the framework of a permanent international debt regime (see chapter 5 for further details). Furthermore, low-income countries in particular need more access to highly concessional funds, if they are to meet their essential spending needs without getting back into debt difficulties. The various options, such as an early replenishment of IDA should be examined. Also, MDBs and other donors should make every effort to make repayment flexible in response to exogenous shocks.

Establish a new credit facility

64. In order to mobilize additional funds, the creation of a new credit facility is a matter of urgency. The new facility could draw upon financial contributions from all countries. It could leverage any equity funds contributed by borrowing, including on the market. Countries that have accumulated large reserves and commodity exporters could use their surpluses to make direct investments in developing countries. It would benefit both developing countries and the

world economy if savings from emerging markets could be at least partly transferred to developing country projects. Its ability to borrow could be enhanced through guarantees provided by governments, especially those of the advanced industrial countries. The funds could be channelled into investment projects in key sectors, such as agriculture. Another possibility is to use those funds to help developing countries finance guarantees for trade credit or for the debt of their corporations, forestalling the risk of a run on these corporations. The current financial system does not provide this intermediary service. Such a facility would be governed quite differently from existing global financial institutions, reflecting the new sources of global funds and the necessity of giving a greater voice to emerging markets and the less developed countries. It could be located under the umbrella of an existing institution–such as the World Bank or a Regional Development Bank, where developing countries are already strong represented–or established as a new institution. There are different views amongst Commission Members on the question, where the facility should be located.

Trade and Investment

65. The World Trade Organization (WTO) is the only universal body for setting trade rules and resolving trade disputes. The WTO is the only universal intergovernmental institution which, at the insistence of major industrial countries, does not have an institutional agreement with the UN (i.e. the "Arrangements for Effective Cooperation with other Intergovernmental Organizations – Relations Between the WTO and the United Nations" of 15 November, 1995 provides only for informational cooperation), even though it has separately acceded to coherence commitments with the Bretton Woods institutions. Given its status as a major stakeholder in the UN financing for development process, the WTO should be brought into the UN-led system of global economic governance, while maintaining its legal and institutional constituency.

66. Through the WTO dispute settlement mechanism, small or weak countries have a means to defend themselves against unfair trade practices, but asymmetric legal and other resources as well as limited developing country participation in drawing up existing rules and regulations limit its potential to promote justice and development. Imbalances in its accession practices, trade dispute mechanisms, and negotiation modalities have also placed developing countries and new members at a disadvantage, besides deterring the possibility that it might serve as a model for a similar organization for international finance.

67. Reform of rules governing international rules has the potential to stem protectionism and to could provide a signal of confidence in time of crisis. However, after the initiation of the Doha Round negotiations, the development thrust has been lost, and whatever the merits of the current proposals, they do not deserve to be called a "development round." This experience does do not augur well for progress on international financial regulation.

68. The current state of the Doha negotiations on multilateral trade risk descending into a "one size fits all" approach with narrow focus on market access to all countries, irrespective of their existing share of global trade and their economic potential. It has been increasingly

reduced to an endless bargaining between industrialized countries and emerging markets about market access in industrialized goods. Consequently the original spirit of development orientation has faded away, the likely benefits to low income countries diminished and completion of the round is endangered by deadlocked positions of major WTO members. Serious studies suggest that the conclusion of the round, regardless of its symbolic value, is unlikely to make much difference for low income countries and particularly least developing countries. An agreement at the existing stage of negotiations could or would be at the cost of its development content, without providing any change to international market dynamics in favour of developing counties.

69. An important step forward would be the elimination of all forms of export subsidies by the end of 2013, (as agreed to during the Hong Kong Ministerial Conference of December 2005). Making such commitment a legally binding one by concluding the Round as a "single undertaking" should effectively prevent those developed countries from distorting export markets in this way beyond 2013.

70. The global crisis has been marked by rapid decreases in trade. Throughout the world, protectionism has increased. In its initial communiqué, the G-20 warned of these dangers and the members committed themselves not to engage in protectionism. Yet, pressures for protectionism have been difficult to resist. The dangers of trade contraction represent a far more serious risk to the global economy than in the Great Depression, because trade today is so much more important for many economies. Those Low Income Countries those are heavily dependent on the exports of only a few raw materials will suffer severely from trade contraction.

71. Reductions in non-tariff barriers could substantially stimulate the global economy. As tariff barriers come down, the importance of non-tariff barriers increases, and some such as phyto-sanitary conditions are particularly and differentially harmful to developing countries.

72. Trade restrictions, subsidies, guarantees and domestic restrictions on procurement contained in some stimulus packages distort world markets. Although international agreements contain the same rules for each country, due to very different economic and social points of departure, seemingly "symmetric" provisions can have markedly asymmetric effects. Subsidies, implicit and explicit, can be just as distorting to open and fair trade as tariffs. As has been recognized, subsidies can create an un-level playing field just as tariffs, but these are even more unfair, since only rich countries can afford subsidies. Government procurement provisions under the financial packages are sometimes heavily distorting competition at the expense of developing countries, since members of the WTO provisions on government procurement are mainly industrialized countries, i.e. Most Favoured Nation (MFN) provisions only apply to them. Whether there ever was a level playing field may be debated; that there is not now one is clear. Firms in developing countries simply can't compete against those who receive massive assistance from their governments in the more developed countries. While the domestic imperatives that give rise to domestic subsidies are understandable, efforts need to be made to finance additional support to developing countries to mitigate the impact of the crisis as well as of both open and hidden subsidies (i.e. state assistance through lending

programs and guarantees) in order to avoid further distortions. The WTO should systematically assess the appropriateness of policies conducted by Member States in the framework of their stimulus packages, giving adequate attention to national sovereignty and to the respective levels of development.

73. Capital and financial market liberalization, pushed not only by the IMF, but also within certain trade agreements, exposed developing countries to more risk. In particular, trade-related financial services liberalization has been advanced under the rubric of the WTO's General Agreement on Trade in Services (GATS) Financial Services Agreement with inappropriate regard for its consequences on orderly financial flows, exchange rate management, macroeconomic stability, dollarization, and the prudential regulation of domestic financial systems. It needs to be emphasized that externalities exerted by volatility in the financial sector have severe negative effects on all areas of the economy and are an impediment for a stable development path. Contracting parties directly involved in these agreements - many of which are driven by sectoral interests – often do not realize the incoherence and vulnerabilities that these commitments in the area of trade impose on other aspects of their economy or the international economy. Ironically, the Agreement provides the only significant regulatory framework for international financial services, but was not conceived and negotiated with this recognition. This Agreement needs to be reviewed to ensure that it becomes more consistent with the need for an inclusive international regulatory framework more conducive to crisis prevention and management, counter-cyclical and prudential safeguards, provision of development and inclusive finance as well as generally cheaper and better finance for developing countries. Agreements which restrict countries' revising their regulatory regimes in light of what has been learned about their deficiencies in this crisis obviously have to be altered.

74. Developing countries need policy frameworks that can enable them to protect themselves from regulatory and macro-economic failures in systemically significant countries. To achieve this, policy space is a necessary precondition. Policy space is restricted not only by a lack of resources, but also by multilateral and bilateral agreements and by the conditionalities accompanying assistance. The ILO Commission on the Social Dimension of Globalization (2004) pointed out, that developing countries today cannot take advantage of many policies that have been used by industrialized countries in their developmental process. Many bilateral and regional trade agreements contain commitments that restrict the ability of countries to respond to the current crisis with appropriate regulatory, structural, and macro-economic reforms and support packages. Not only deregulation policies akin to those that are now recognized as having played a role in the onset of the crisis been imposed on developing countries, but that have also faced restrictions on their ability to manage their capital account and financial systems (e.g. as a result of financial and capital market liberalization policies). These policies are now placing a heavy burden on many developing countries.

75. All trade agreements need to be reviewed to ensure that they are consistent with the need for an inclusive and comprehensive international regulatory framework which is conducive to crisis prevention and management, counter-cyclical and prudential safeguards, provision of development and inclusive finance. Commitments and existing multilateral agreements (such

as GATS) as well as regional trade agreements, which seek greater liberalization of financial flows and services, need to be critically reviewed in terms of their balance of payments effects, macroeconomic stability and financial regulation. This is of particular importance for small and vulnerable economies with weak institutional capacities. The IMF needs to adhere to its Articles of Agreement and should not promote capital account liberalization. Bilateral, plurilateral and regional trade and investment agreements have continued to increase until very recently. They often undermine multilateral trade and sustainable development efforts, and greatly strengthen investment and intellectual property protection, with greater benefits to developed countries the undifferentiated enforcement of Intellectual Property rights threatens the ability of developing countries to provide public health services, while policies dealing with the mitigation of biopiracy and protection of traditional knowledge of developing countries have been neglected.

76. There are a number of lessons to be drawn from experience with financial liberalization:

77. In order to achieve efficient domestic financial market regulation, the exceptions granted for prudential regulations allowed in the multilateral annex for financial services should be interpreted to allow policy space, in particular to provide sufficient time and allow public support (credit and guarantees) to restructure the banking sector in case of financial market distress.

78. The reciprocal impact of liberalizing trade in financial services and liberalizing capital account transactions need to be thoroughly considered by developing country authorities. In case of liberalization there needs to be consistency between both areas as well as the implementation of regulatory and supervisory frameworks for the financial sector.

79. Macroeconomic stability and an efficient regulatory framework and functioning institutions are a precondition for liberalization of financial services and the capital account, not vice versa. Strategies and concepts of opening up developing economies need to include appropriate reforms and sequencing.

Commodities Trade and Compensatory Financing

80. The volatility of export earnings of countries dependent on primary commodity exports has long been recognized as a key source of instability in the global economic system. Unless they take strong protective measures, these countries not only experience boom-bust cycles, but also tend to find themselves in debt distress and in need of additional aid when commodity prices collapse. Developing countries that are dependent on exports of commodities with high price volatility need to establish stabilization funds and to otherwise manage their macro-economy to reduce the extent of the boom-bust cycle, including by restricting borrowing during the boom phase. But, inevitably, such management will be imperfect, and there will be need for compensatory finance. When it is provided, it is important that it be done in ways which do not impose counterproductive conditionalities. The international community, including the IFI's, should explore ways of mitigating the risks

from commodity fluctuations, including perhaps by providing loans in which repayments vary with commodity prices.

Appendix: The Doha Round and Development

81. Export subsidies, however, do not constitute the bulk of the distorting trade arsenal of developed countries. Developing countries would greatly benefit if other forms of distorting support are substantially reduced in line with the Doha mandate. This means bringing down permitted levels of Overall Trade-Distorting Domestic Support (OTDS), and further limitation to the various "boxes" (AMS, Blue Box and green box or de minimis) as well as effective monitoring in order to prevent big subsidizing developed nations from shifting their domestic programs from one "box" to another. This is to be complemented by product specific disciplines that restrain maximum allowed levels of support by developed country on a per product basis. This is an especially important outcome of the Round for developing countries as it improves market conditions for agricultural goods of particular interest to them.

82. The cotton dispute is a dramatic example of how trade distorting export subsidies and internal support in the rich developed economies can undermine income generation and growth prospects in poor countries, affecting their capacity to become players in their own right in the global marketplace, and thereby relegating them to dependence on aid, or on other kinds of non-binding commitments or concessions over which they have no control.

83. The fact that distorting cotton subsidies remain in places, in spite of the ruling of the WTO's Appellate Body against them, threatens the credibility of the WTO dispute settlement system.

84. In the important area of industrial goods or non-agricultural market access (NAMA), there cannot be full reciprocity in tariff reduction if the asymmetries that have worked historically to the detriment of developing countries are to be addressed. Furthermore, developed countries should not try to extract additional concessions from developing countries in sectoral negotiations that would negate the principle of less than full reciprocity. Special attention needs to be given to the problem of tariff escalation, which restricts the ability of developing countries moving up the value chain.

85. Moreover, an acceptable package must also include binding commitments on special and differential treatment for developing countries through longer transition periods for LDCs to implement their obligations, and other mechanisms that allow developing countries greater flexibility in coping with the challenges posed by gradual trade liberalization.

86. Much could be done, of course, on a voluntary basis. Meaningful undertakings by developed countries and developing countries in a position to do so of full 13 duty-free quota-free (DF-QF) treatment in favour of LDCs would be an important step towards mitigating the effects of the global financial crisis on the poorest and most vulnerable. But voluntary measures are not substitute for binding commitments, because they can be withdrawn at any

time, and the threat of such withdrawal can be used as an important political and negotiating weapon.

87. Supporting South-South trade can also make a big difference for developing countries during the global economic recession, since these trade flows have been increasing well above world trade average growth, contribute to export diversification and improvements in the regional value addend chain, and are becoming a significant source of dynamism for the regional and global economy. More attention should be paid to enhancing the Global System of Trade Preferences among developing countries (GSTP), along with additional and non-conditional facilities for South-South trade financing.

88. In devising a Doha Round “Aid for Trade” package, a set of baseline rules are called for: they should not be construed as a substitute for the development gains to be derived from negotiations on market access and the approval of balanced trade rules; they should be funded with additional resources in concessional terms or grant form; provided without conditionalities and taking into account the specificities of each country; they should not be used as a bargaining tool; they should be commitments enforceable like other commitments in the Trade Agreements, and there should be no conditionality, other than that implicit in adhering to the Doha agreement.

89. Mechanisms for monitoring respect for and implementation of S&D provisions, as well as for allowing members to request AFT in accordance with their own priorities and needs should be created as an integral part of the Doha Round “single undertaking”.

90. Further hiking up levels of intellectual property protection beyond the standards set in the TRIPS Agreement, or imposing trade distorting or public health threatening levels of IP enforcement that negatively affect access to medicines by poor developing countries would certainly not be a welcome result in any negotiation premised on a development perspective. What is positive in this sense about the Doha Development Round is that changes to IP obligations are not on the negotiating table except for two very specific and narrowly defined areas, of which one, an amendment to the TRIPS Agreement to mitigate biopiracy and protect traditional knowledge, has actually become a point of proactive negotiation by the virtual majority of developing countries members of the WTO. A mandatory requirement for disclosure of the country providing/ source of genetic resources and mechanisms such as Access and Benefit Sharing and Prior Informed Consent should be implemented in the TRIPS Agreement.

91. By now it is clear that an agreement on modalities for concluding the Doha Round has to encompass all areas of the mandate in order to create a critical mass of bargaining elements that would allow developed members to overcome long entrenched domestic lobbies that otherwise will resist the call for the elimination and reduction of trade distorting subsidies.

92. Even the commitment to phase out export subsidies by 2013 agreed to in Hong Kong hinges upon a series of other mandated negotiating objectives being met. It is in the nature of negotiations that early harvest outcomes, based on selected elements of the negotiating

modalities -- however attractive they may seem – risk reducing the gains that would accrue to developing countries, and may have the effect of making an outcome in areas of crucial relevance to developing countries less likely politically; not more.

93. A successful conclusion of the Doha Round would set the basis for adapting the WTO to the actual needs of the world economy. Climate change and the social dimension of globalization are just two examples of new issues with an impact on international trade which are not yet dealt with in the WTO. There is strong need to differentiate between countries according to criteria such as national income, economic power and trading potential and to develop a scheme for clustering developing countries adequately. Rules, transition periods, asymmetric liberalization and burden sharing then can be designed systematically, while ensuring incentive compatibility, alongside economic power and development prospects of countries. Major reports about the future of the WTO, such as the Sutherland and the Warwick report point into this direction and provide concrete proposals. On this basis, a discussion on possible reforms of WTO should directly be addressed after the conclusion of the Round.

Chapter 5: International Financial Innovations

1. In previous chapters, we have analyzed what macroeconomic policy and regulatory reforms are needed to guarantee a sustainable and development friendly recovery of the world economy. In chapter 4 we looked at reforms of current financial institutions and broader institutional innovations. In this chapter we take a look at a final set of innovations: those that relate to the global reserve system, the management of sovereign debt defaults, and innovations aimed at better distributing the risks between lenders and borrowers in world markets and at increasing development financing.

The Global Reserve System

2. Since the breakdown of the Bretton Woods system and the suspension of the gold convertibility of the dollar, a system of flexible exchange rates among major currencies has predominated. Although alternative national and regional currencies (such as the euro) compete with each other as international reserve assets and means of international settlement, the dollar has maintained its predominant role in both regards, a predominance that became firmly established after the Second World War. In a significant sense, therefore, the post-Bretton Woods system has been a "fiduciary dollar standard".

3. This system has proven to be unstable, incompatible with global full employment, and inequitable.

4. One of the main problems of the Bretton Woods system was identified by Robert Triffin in the 1950s: the use of a *national* currency (the US dollar) as the *international* reserve currency generated a difficult dilemma: dollar deficits were necessary to increase global liquidity, but at the same time eroded the confidence in the dollar as a reserve currency, which generated in particular increasing risks as to the capacity to maintain the dollar-gold parity. Although abandonment of dollar convertibility and flexible exchanges rates eliminated some of these problems, it created new ones. Instead of uncertainty over the ability to maintain the dollar-gold parity, the "Triffin dilemma" is now associated with the large swings in the current account imbalances of the U.S. and associated volatility of the dollar exchange rate, and in the long run with the risk of the loss in the value of foreign exchange reserves held in dollars as U.S. imbalances grow.

5. The instability and incapacity to guarantee full employment are also associated with the fact that, even after the introduction of flexible exchange rates, the system was unable to eliminate the deflationary (contractionary) bias associated with asymmetric adjustment to payments imbalances falling on deficit countries –the fact that deficit countries face stronger pressures to reduce their payments imbalances (the major exception being the reserve issuing country) than surplus countries face to correct theirs. Flexible exchange rates also introduced new forms of instability in a world of increasing free capital mobility: those associated with the volatility of capital flows, particularly but not only short-term flows.

6. Finally, the inequities are generated by the fact that, as a result of a sequence of severe crises, developing countries learnt that they need better instruments to protect themselves against global financial and economic instability. Coupled with the increasing unwillingness

of developing countries to submit to the conditionality associated with IMF support, this has led a massive accumulation of reserves over the past two decades. However, as these reserves are mostly held in hard currency, they also represent a transfer of resources to the United States and other industrialized countries.

7. Many believe that this problem could be eliminated by creating a supranational international reserve currency. Indeed, the idea of an international reserve currency issued by a supranational bank is not new. It was broached more than seventy five years ago by John Maynard Keynes in his *Treatise on Money*, and refined in his Bretton Woods proposals for an International Clearing Union. There currently exist a number of alternative proposals for a new global reserve currency, for how the system might be administered, how the emissions of the new currency might be allocated, and how the transition to the new system might be managed. Considerable international discussion will be required for the international community to decide the precise arrangements. However, this is an idea whose time has come. This is a feasible proposal and it is imperative that the international community begins working on the creation of such a new global reserve system. A failure to do so will jeopardize prospects for a stable international financial system, which is necessary to support a return to robust and stable growth.

Instability

8. The current international system is marred by a number of sources of instability. One of the major problems, as noted, is that as holdings of the reserve currency accumulate over time, confidence in its value as a store of value is likely to wane. After abandonment of fixed exchange rates in the early 1970s, the main manifestation of the creation of excess dollar liquidity was a tendency for the U.S. dollar to depreciate. When the U.S. responds with action to reduce its external deficit – in part to restore the credibility of its reserve currency status — this generates dollar appreciation accompanied by contractionary pressure on the world economy. Irrespective of the phases of the global cycle of liquidity demand, U.S. monetary policies are implemented with little consideration of their international impact and are thus a potential cause of instability in exchange rates and global activity.

9. Since the 1960s, the system has indeed been plagued with cycles of confidence in the U.S. dollar. These cycles have become particularly intense since the 1980s, leading to unprecedented volatility both in the U.S. current account deficit and the effective exchange rate of the U.S. dollar. As a result, the major attribute of an international store of value and reserve asset, a stable external value, has been eroded. There is another sense in which the current system is unstable.

10. By definition, for the world economy, the sum of all deficit countries' balance of payments must equal the sum of all other countries' surpluses. But the way surplus and deficits are brought into equality is not necessarily smooth and will usually involve changes in incomes of individual countries. If a large number of countries choose policies aimed at increasing their trade surpluses, or if international institutions encourage deficit countries to improve their balance of payments, the deficits of the remaining country or countries will become increasingly large. With the dollar as the major international reserve currency, unless the U.S. is willing to be the "deficit country of last resort", the adjustment will take place through a decline in global income. In turn, if the U.S. macroeconomic policies are overtly

expansionary, unless other countries accept balance of payment surpluses the adjustment will take place through expanding global income and inflation. In both cases, the result is likely to be growing global imbalances, exchange rate instability and the erosion in confidence in the dollar as a reserve currency.

11. The introduction of flexible exchange rates in the presence of growing private international capital flows failed to meet the expectations that adjustment of balance of payments would become smoother while leaving each country the necessary autonomy to guarantee their domestic macroeconomic policy objectives. The basic reason is that countries can avoid adjustment as long as they can attract sufficient external flows. When these prove to be insufficient to cover funding for the imbalance or are reversed because of lack of confidence, the adjustment takes the form of a financial crisis. The asymmetry remains, but the negative impact on the deficit country is much greater, as the continued financial crises since the mid-1970s has made clear.

Self-insurance and Deflationary Bias of the Global Reserve System

12. Global imbalances, associated in part to the way different countries reacted to the financial instability of the late 1990s and early 2000s, played an important role in the macroeconomic conditions leading to the current world financial crisis. The asymmetric adjustments to these global imbalances in their turn played a part in generating the insufficiency of global aggregate demand that has converted a U.S. financial disruption into a global economic recession. Unless both problems are remedied, it will be difficult to restore the economy to robust, stable growth.

13. These difficulties in the design of the international financial system led to large accumulations of reserves by developing countries in recent years, and especially after the Asian and Russian crises of 1997-1998. These crises, as those that preceded it in the late 1970s and early 1980s, showed that developing and emerging countries are subject to strong pro-cyclical capital flows. If authorities react by allowing capital surges during booms to generate rapid exchange rate appreciation and the build up of current account deficits, the outcome is almost certainly a twin balance of payments and domestic financial crisis later on. This problem is particularly acute when the boom is in the form of short-term, largely speculative capital flows, a point that came to be increasingly recognized after the Asian crisis. The decision to build stronger current account positions and to accumulate large foreign exchange reserves in the face of booming capital inflows in 2004-2007 were therefore a common response of these countries to create policy space to respond to the negative impact of the expected recurrence of crises. Similarly, commodity exporting countries have experienced in the past repeated crises, when sharp improvements in the terms of trade are accompanied by unsustainable demand booms and by exchange rate appreciation that generate "Dutch disease" effects. More generally, since the Asian crisis developing and emerging market countries have found it increasingly attractive to save that part of exceptional export proceeds that were considered to be temporary. High commodity prices in the years preceding the current crisis exacerbated the problems that this posed for global balances.

14. These policies could be considered as a form of "self-insurance" or "self-protection" against capital reversals, adverse movements in the terms of trade and excessive exchange

rate volatility associated with financial crises. The fact that the only available "collective insurance", in the form of IMF financial assistance, is highly conditional and often imposes procyclical policies during crises, reinforced the view that self-protection in the form of reserve accumulation was a better strategy.[1]

15. As a result of these factors reserve accumulations rose to 11.7% of world GDP in 2007 vs. 5.6% a decade earlier, at the time the Asian crisis struck. Reserve accumulations in the period 2003-2007, in the run up to the crisis, amounted to an annual average of $777 billion a year or 1.6% of global GDP. The major concern is that if the current crisis is as long and as deep as feared, and if the assistance provided to developing countries is inadequate, there will be attempts to preserve strong external balances through protectionist measures, beggar-thy-neighbour exchange rate policies, and stronger "self-insurance" through reserve accumulation—all measures that will impede a rapid response to the crisis.

16. When reserve accumulation is the result of current account surpluses and not only of the attempt to offset private autonomous foreign capital inflows, there is a reduction in global aggregate demand.[2] In the past, the negative impact on global aggregate demand of these reserve accumulations was offset by other countries running policies that resulted in large current account deficits, particularly loose monetary and fiscal policies in the United States. But such policies, as we have seen, have been the source of global instability.

17. The question posed by the autonomous reduction in United States' deficits is, what will now sustain global aggregate demand? It is unlikely to be another American bubble leading to another period of large and unsustainable American deficits and the continuation of global imbalances. Such a course risks a repeat of the current crisis. Thus, something has to be done about the underlying sources of the insufficiency of global aggregate demand.

18. A global reserve currency whose creation was not linked to the external position of a national economy could provide a better system to manage the deflationary bias that the system faces during crisis, as well as the broader problems of instability analyzed above. It would be possible to regulate the creation of global liquidity, and reduce the ability of a reserve currency country to create excessive liquidity. And the system can be designed in ways to put pressure on countries to reduce their surplus and thus reduce their contribution

[1] There may be other reasons, such as the need to provide for an aging population that would lead countries to adopt policies to increase domestic savings and hold them in the form of foreign assets. The associated "imbalances" would then simply reflect differences in the propensities of different countries to save and invest. This has led to the general idea that financial flows would be from developed with high saving aging populations to developing countries with younger populations and higher returns on investment. However, this has not been verified in the statistics on international capital flows. Restrictions on the ability to use industrial policies to encourage nascent industries in emerging countries (as many of the currently industrialized countries did in their earlier phases of development) under recent WTO agreements may have led some countries to substitute exchange rate policies to effect similar outcomes, and this too may have contributed to reserve accumulations.

[2] These reserves are sometimes called "owned reserves" to differentiate them from "borrowed reserves", when their counterpart are capital inflows.

to the insufficiency of global aggregate demand. This would contribute to the reduction of global imbalances.

19. Other innovations to improve risk sharing mechanisms would reduce the demand for reserve accumulations, and therefore reduce the magnitude of the requisite emissions (see below).

Inequities

20. The current system is also inequitable because it results in developing countries transferring resources to the industrial countries that issue the reserve currencies. In particular, the build up of dollar reserves represents lending to the United States at very low interest rates. This transfer has increased through time due to the realization by developing countries that large foreign exchange reserves are their only defence in a world of acute financial and terms of trade instability.

21. Developing countries are, in effect, lending to developed countries large amounts at low interest rates—in 2007, the last year for which data was available, $3.7 trillion. The difference between the lending rate and the interest rate which these countries pay to developed countries when they borrow from them is a transfer of resources to the reserve currency countries that exceeds in value the foreign assistance that developing countries receive from the developed countries. The fact that developing countries choose to hold such reserves provides testimony to their perception of the costs of instability, of the adjustment costs that they would have to bear if they did not have these reserves.

Cost to the reserve currency country

22. The United States also incurs costs associated with its role as supplying global reserves. The demand for global reserves has led to increasing current account deficits in the United States that have had adverse effects on U.S. domestic demand, but when dollars are held to meet increased demands for liquidity in surplus countries, they fail to produce any countervailing adjustment in foreign demand. In addition, periodic needs to correct these deficits require contractionary monetary or fiscal policies that have adverse domestic effects on the U.S. economy.

23. Countries holding substantial dollar reserves have started to call for a constraint on U.S. policies that might cause depreciation in the international value of the dollar and thus a decline in the value of their reserve holdings. China, as the major holder of dollar reserves, has already noted the risks to its dollar reserves should the US adopt policies leading to a depreciation of the dollar. The only way to respond to this call would mean for the U.S. a loss of policy autonomy as it would have to take the effects on the rest of the world in designing its monetary policy. Maintaining autonomy to U.S. policy, as it would be required to respond the current crisis, would be the basic advantage for the U.S. to move to a global reserve system, beyond the benefits it would receive from a more stable global financial and economic system.

A two (or multiple) reserve currency system may be worse than a single reserve currency

24. It must be emphasized that a system based on multiple, competing reserve currencies would not solve the inequities of the current system, as reserve assets would still be provided by industrial countries. It would also add an additional element of instability to a purely dollar-based system, associated with the exchange rate volatility among the currencies used as reserve currencies. Indeed, this problem is already present in the current system. Such volatility results in major gains and losses by central banks on their reserve holdings, a feature that increases the risk associated with holding specific reserve assets and, therefore, undermines their value as what they are meant to be: low-risk assets.

25. The basic advantage of a multi-polar reserve world is, of course, that it would provide room for diversification. However, if central banks and private agents were to respond to exchange rate fluctuations by changing the composition of their international assets, this would feed into exchange rate instability. Under these conditions, a multiple currency reserve system would generate growing calls for a fixed exchange rate arrangement, but fixing the exchange rates among major currencies in a world of free capital mobility would be a daunting task. It would also require policy coordination and loss of monetary sovereignty that seems unlikely under current political conditions.

Call for a Global Reserve Currency

26. These long standing deficiencies in current arrangements have become manifest in the lead up to the current global financial crisis, and can make it deeper. If countries choose increased protection in the form of higher domestic saving and accumulation of reserves as a response to the uncertainty of global market conditions, this would lead to further deepening of the aggregate demand problems that the world economy is facing. The increases in the U.S. national debt and the balance sheet of the U.S. Federal Reserve have led to concerns in some quarters about the stability of the dollar as a store of value. The low (almost zero) return on holdings of dollars means that those holding dollars as reserves are receiving virtually no return in exchange for the foreign exchange rate risk which they bear.

27. These are among the reasons that it is desirable to adopt a truly global reserve currency. Such a global reserve system can also reduce global risks since confidence in and stability of the reserve currency would not depend on the vagaries of the economics and politics of a single country.

28. The current crisis provides, in turn, an ideal opportunity to overcome the political resistance to a new global monetary system. It has brought home problems posed by global imbalances, international instability, and the current insufficiency of global aggregate demand. A global reserve system is a critical step in addressing these problems, in ensuring that as the global economy recovers it moves onto a path of strong growth without setting the stage for another crisis in the future. It is also a propitious moment because the United States may find its reserve currency status increasingly costly. Moreover, the US has embarked on a response to the crisis that will involve large domestic and also potentially large external imbalances, with unpredictable implications for the international reserve system. Thus, both the United States and foreign exchange reserve holding countries may actually find it acceptable to move in the direction of a new system. The former would be able to take policy decisions with less concern about their global impact; the latter would be less concerned about the impact of US policies on their reserve holdings.

Institutional frameworks for a new global reserve system

29. In setting up such a system, a number of details need to be worked out. Among these are, who would issue the reserve currency, in what amounts, to whom would they be issued, and under what conditions.

30. The issues are largely separable. The responsibility for managing the global reserve system could be given to the IMF, which currently issues the only global currency, Special Drawing Rights (SDRs), on which the system could be built, but it could also be given to a new institution, such as a "Global Reserve Bank". If we turn to existing institutions, this should not inhibit asking more fundamental questions about the necessary reform of their structure in support of the global monetary system.

31. In one possible approach, countries would agree to exchange their own currencies for the new currency –say International Currency Certificates (ICC), which could be SDRs—and vice-versa in much the same way as IMF quotas are made up today (except that developing countries would only contribute their own national currencies, not the proportion of IMF quotas in convertible currencies). This proposal would be equivalent to a system of worldwide "swaps" among central banks. The global currency would thus be fully backed by a basket of the currencies of all members.

32. In an alternative approach, the international agency in charge of creating global reserves would simply issue the global currency, allocating ICC to the member countries, much as the IMF Special Drawing Rights are issued today. There would be no "backing" for the global currency, except the commitment of central banks to accept it in exchange for their own currencies. This is what would give the ICC (or SDRs) the character of an international reserve currency, the same way acceptance by citizens of payments in a national currency gives it the character of the domestic money. However, if the issues of global currency received by countries are considered deposits in the IMF or the Global Reserve Bank, and the institution in charge of managing the system is allowed to buy the government bonds of member countries or lend to them, then those investments would be the "backing" of the global currency just as domestic moneys are "backed" today by the assets of national central banks (the government bonds in their hands and their lending to private sector financial institutions).

33. Under any of these schemes, countries could agree to hold a certain fraction of their reserves in the global currency. The global reserve currency could also pay interest, at a rate attractive enough to induce its use as an investment for central bank reserves. Exchange rates would be managed according to the rules that each country chooses, subject to the condition that exchange rate management does not affect other countries –a rule that is already included in the IMF Articles of Agreement and must be subject to appropriate surveillance. As with SDRs, the exchange rate of the global currency would be the weighted average of a basket of convertible currencies, the composition of which would have to be agreed.

34. In the alternative in which the global currency is considered to be a deposit in the IMF or Global Reserve Bank, earnings by these institutions' investments (lending to countries

undergoing balance of payments crises, or otherwise in Treasury securities of member countries) would finance the interest paid to those countries that hold deposits of the global currency (possibly in excess of the original issues they received). Obviously the major advantage to holding the global currency is that the diversification away from individual currencies would generate more stability in the value of reserve holdings.

35. The global currency could be allocated to countries on the basis of some formula ("quota"), based on their weight in the world economy (GDP) or their needs (some estimation of the demand for reserves). Since developing countries hold reserves which are, in proportion to their GDP, several times those of industrial countries (26.4% of GDP in 2007 vs. 4.8% for high-income OECD countries), to manage the trade and capital account volatility they face, a formula that would allocate the currency according to some definition of demand for reserves would result in larger proportional allocations to these countries. One possibility is, of course, to give developing countries all allocations. Note that the current SDR allocation is based on a particular "quota" system, that of the IMF, which continue to be subject to heated debate because richer countries on average get a larger share of new allocations–i.e., the opposite to what a criteria based on need would indicate.

36. The allocation can and should have built into it incentives and/or penalties against maintaining surpluses. Countries that maintained surpluses would lose all or part of their quota allocation if they are not utilized in a timely manner to increase global demand.

37. The size of the annual emissions should be targeted to offset the increase in (non-borrowed) reserves, i.e. reductions in global purchasing power resulting from reserve accumulations. Simpler versions of this proposal would have annual emissions fixed at a given rate of say $150 to $300 billion a year (the first figure corresponds to the world demand for reserves in 1998-2002 but the demand for reserves was much larger in 2003-2007, indicating that even $300 billion a year might be insufficient).

38. More sophisticated and elaborate versions of this proposal would have emissions adjusted in a countercyclical way—larger emissions when global growth is below potential. It might be easier to get global consensus on either of these simpler variants, but more detailed versions would be able to support a variety of global needs (e.g. generate badly needed revenues for development or global public goods).

39. One institutional way of establishing a new global reserve system is simply a broadening of existing SDR arrangements, making their issuance automatic and regular. Doing so could be viewed simply as completing the process that was begun in the 1960s, when SDRs were created. The simplest version, as noted, is an annual issuance equivalent to the estimated additional demand for foreign exchange reserves due to the growth of the world economy. But they could be issued in a counter-cyclical fashion, therefore concentrating the issuance during crisis periods. One of the advantages of using SDRs in such a counter-cyclical fashion is that it would provide a mechanism for the IMF to play a more active role during crises.

40. Still another mechanism to manage SDRs in a counter-cyclical way was suggested by IMF economist Jacques Polak three decades ago: providing all financing during crises with SDR loans, which would generate emissions that would be automatically extinguished once loans are paid back. This would be the global equivalent to what the central banks of industrial countries have been doing on a massive scale during recent months.

41. Indeed, a large counter-cyclical issue of SDRs is the best mechanism to finance world liquidity and official support to developing countries during the current crisis. This was recognized by the G-20 in its decision to issue the equivalent of $250 billion in SDRs. However, this decision also illustrates the problems associated to tying SDRs issuance to IMF quotas, as somewhat less than $100 billion of the proposed emissions would benefit developing countries. This implies that this issue is closely tied to the ongoing debate about reform of IMF quotas. None of the proposed reforms to quotas deals adequately with the issue of equity, and indicates that different rules may have to be applied to quotas and SDR issues, as indicated above.

42. Although developing countries would only receive part of the allocations, the capacity of the Fund to lend would be considerably enhanced if the current system was reformed in such a way as unutilized SDRs, particularly from industrial countries, could be used by the IMF to lend to member countries in need –such as the proposal of treating unused SDRs as deposits in the IMF. However, unless there are strong reforms in the Fund's practices, the ability of the emissions to address the liquidity and macroeconomic management problems noted earlier might be impaired, as developing countries might be reluctant to turn to the IMF for funds. Reforms in that direction were adopted in March 2009 with the creation of the Flexible Credit Line with only ex-ante conditionality, the doubling of all credit lines and the elimination of structural benchmarks in conditional IMF lending. But additional reforms to make access less onerous will be needed.

43. A simple way to further the use of SDR allocations to advance developmental objectives (which may still require changing the Articles of Agreement) would be for the IMFC and the IMF Board to allow the IMF to invest some of the funds made available through issuance of SDRs in bonds issued by multilateral development banks. This would be similar to the proposal for a "development link" made by the UNCTAD panel of experts in the 1960s (see below).

44. Thus, a well designed global currency system would go a long way to correct the "Triffin dilemma" and the tendency of the current system to generate large global imbalances and the deflationary biases that are characteristic of balance of payments adjustments during crises. Depending on the way emissions are allocated, the system could also correct the inequities associated with the large demand for reserves by developing countries, and provide collective insurance against future shocks. If emissions were issued in a countercyclical way, they could perform an even more important role in stabilization.

Historical antecedents

45. When Keynes revised his idea of a global currency in his proposal for an International Clearing Union, as part of the preparations for what became the Bretton Woods Conference, his major concern was the elimination of asymmetric adjustment between deficit and surplus countries leading to the tendency towards deficiency of global aggregate demand and a constraint on the policy space needed for policies in support of full employment. He also had in mind the significant payments imbalances that would characterize the post-war order and therefore the need to provide a better source of liquidity, both globally and for countries that would leave the war with structural payments deficits. Of course, the first of these

problems, the asymmetric adjustment, was not corrected by the Bretton Woods system, and the second was only partly corrected.

46. In turn, when Special Drawing Rights (SDRs) were created in the 1960s, the major concern was how to provide a more reliable source of global liquidity to gold and reserve currency holdings (mainly dollars, but also British pound sterling at the time). It was believed that the existing sources of international liquidity were not reliable, as they depended in the first case on gold production and in the second on deficits of the reserve currency countries, particularly the United States. As the initial problems of global liquidity –the "dollar shortage"—were overcome, the attention shifted to risks of excessive dollar liquidity and, particularly, that the U.S. gold reserves would not be sufficient to support dollar-gold convertibility. This finally generated the demise of the Bretton Woods "dollar-gold-exchange standard" and the adoption of flexible exchange rates among major currencies.

47. At the time SDRs were created, it was hoped that they would become a major component of global reserves, thus creating a system in which the growth of global liquidity would depend on deliberate international decisions. This expectation has not been fulfilled, as SDRs have been created only episodically and in a total of a little over 20 billion SDRs, which represent only a minimal fraction of current world reserves. The nature of the problems of provision of global liquidity was obviously transformed with development of the private financial markets in Eurodollars and other Euro currencies and the introduction of a flexible exchange rate system. These problems associated with the provision of global liquidity are less important today, except during extraordinary conjunctures such as those generated during the severe shortage of liquidity, such as those created by the global liquidity crisis in August 1998 and the world financial crisis since September 2008. But a major problem remains: dependence of global liquidity on the vagrancies of US macroeconomic policies and balance of payments imbalances, which can generate either excessive or limited world liquidity. The recurrent problem of developing country access to international liquidity is still an embedded feature of the system, as a result of the pro-cyclical capital flows. Therefore, although there are no longer risks of insufficient liquidity in the international system, there are problems associated with the control of global liquidity and significant equity issues in the access to such liquidity by developing countries.

48. In Keynes' initial proposal for a post-war arrangement, there was no need to address the problem of equity in issuance since the creation of clearing credits was entirely endogenous. This question was also evaded in the initial issuances of SDRs, although some ideas were proposed at the time on how to tie the issuance of a global currency to development financing, particularly in the proposal made by an UNCTAD expert panel to link the question of liquidity provision for developed economies to the needs of developing economies for development financing. But, as we have seen, equity issues cannot be ignored today, as the current system subjects developing countries to recurrent problems of illiquidity or induces them to accumulate large amounts of foreign exchange reserves.

Transition to the new system

49. The reform of the global reserve system could take place through a global agreement or through more evolutionary approaches, including those that could build on a series of regional initiatives.

50. If a large enough group of countries agreed to pool reserves in a system in which they agreed to create and hold a common reserve currency, which they would stand ready to exchange for their own currencies, a regional reserve system or even a system of near-global coverage could be established without the agreement of all countries. So long as the new currency is convertible into any hard currency that itself is convertible into other currencies, it could serve effectively as a reserve currency. The countries participating might also agree to reduce, over time, their holdings of other reserve currencies.

51. Membership in this new "Reserve Currency Association" could be open to all that subscribe to its Articles of Agreement. The advantages of participation are sufficiently great that it is likely to grow over time, embracing more countries, holding a greater fraction of their reserves in the new global reserve currency. Eventually even the United States would probably find it desirable to join. Thus, gradually, through a stable, evolutionary process, we may have achieved the creation of a new Global Reserve System, an alternative to the current system. Of course, there is also a risk of adverse selection: as long as participation is voluntary, soft currency countries would be those more willing to participate, and convertible global currencies outside the scheme could remain as the preferred currencies.

52. Existing regional agreements might provide an alternative way of evolving towards to a global Reserve System. Regional mechanisms have the advantage of their own and can be based either on swap arrangements among central banks or on foreign exchange reserve pools. Given the reluctance of governments to give up control over their reserves, swap arrangements may be more acceptable. Reserve pools offer, however, other advantages, such as the possibility of allowing the reserve fund to borrow during periods of stress, and, as noted, to issue a currency or reserve asset that could be used at a regional or global level. In the 1980s, for example, the Latin American Reserve Fund was allowed to issue Andean pesos.[3] This asset, which has never been used, was expected to be used in intra-regional trade, with periodic clearing of those held by central banks. The Chiang Mai Initiative, created in 2000 by members of ASEAN, China, Japan and the Republic of Korea is another important example of regional cooperation.[4] Were this Initiative to evolve into a reserve fund, it could back the issuance of a regional asset that could actually be attractive to central banks in other parts of the world to hold as part of their reserve assets. However, if the Chiang Mai Initiative is to achieve the objectives set forth for a global reserve currency, and if it is to play a more effective role in stabilization, it would be necessary to eliminate the provision that, after a certain threshold of use of existing swap facilities, countries would have to be subject to IMF conditionality.

53. A common criticism of regional arrangements is that they are not effective in providing diversification against systemic crisis, given that regional members are more likely to be adversely affected at the same time. Although this implies that they are a complement and

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[3] The Latin American Reserve Fund was created by the Andean countries in the 1978 and was then called the Andean Reserve Fund. Current members are Bolivia, Colombia, Costa Rica, Ecuador, Peru, Uruguay and Venezuela.

[4] This Initiative works as a system of bilateral swaps by member central banks, which are in the process of being arranged on a multilateral basis. The system has so far not been used. ASEAN has a swap arrangement of its own that has a longer history.

not a substitute for a global solution, the underlying analysis is imprecise. Although the ability of regional arrangements to address external shocks depends on negative events not being correlated across participating countries, they could still be useful if shocks affect member countries with different intensities or with lags, since this would allow some countries to lend their reserves to those experiencing a more severe or earlier shock. Furthermore, lending at the onset of a liquidity squeeze could prevent a crisis in a given country from affecting other countries, thereby reducing the correlation produced by contagion. More generally, a country would benefits from the regional arrangement if the variability of the regional reserve pool is lower than that of its individual reserves, and if potential access to the pool reduces the possibility of attacks on individual members and therefore acts as a mechanism of collective insurance that is more powerful than self-insurance. Statistical analysis by the UN Economic Commission for Latin American Reserve and the Caribbean provides supports for this approach, as it indicates that correlations of relevant macroeconomic variables among countries in the region may be lower than usually assumed.

54. Regional initiatives could become an embedded part of the global reserve system. Some have suggested that the reformed IMF should be a network of regional reserve funds. Such a decentralized system would have many advantages, including the possibility of solving problems associated with crises in the smaller countries at the regional level. The system would also be attractive for medium and small-sized countries that could have a stronger voice at the regional level. One way to link regional and global arrangements would be to make contributions to regional arrangements one of the factors that could be taken into account in determining SDR allocations.

SOVEREIGN DEBT DEFAULT AND RESTRUCTURING

Inadequacies of the existing system (or "non-system") to manage debt crises

55. Sovereign debt crises have been a major source of the difficulties faced by developing countries in achieving sustained growth and development at different times since the 1980s. Social costs of these crises have been extremely large, and included long periods of lost income and jobs, increased poverty and, in some cases, worsening income inequality. Given the instability of external capital flows, severe financial crises hit even countries that were judged by international opinion to have been soundly managed. In several cases, crises originated in the need for a government to take over the responsibility for servicing private-sector debts, of the banking system or key firms that were judged "too big to fail" –in a way not too different to how the US and other industrial country governments have done during in the current global crisis. In other cases, the inability of the central bank to provide foreign exchange for private external debt servicing has led to effective official responsibility for the debt. This "nationalization" of private sector external debts was indeed a feature of the Latin American debt crisis of the 1980s and has been quite common in developing country debt crises since then.

56. Not only are current "work-out" processes protracted and costly, often the debt write-down has been insufficient to provide sustainability. The existence of debt overhangs depresses growth, contributes to poverty, and crowds out essential public services. Often, because write downs have been insufficient, they are soon followed by another crisis. And because of the adverse terms and high costs imposed by the work-out, developing countries

are reluctant to default in a timely way, resulting in delays in dealing with the underlying problems.

57. Moreover, worries about a protracted crisis in one country having spill-overs for others has motivated massive bail-outs, contributing in turn to problems of moral hazard, enhancing the likelihood of future crises.

58. Whether owing to risky policies or the intensified economic fluctuations of liberalized financial environments, the existing system of protracted and creditor-biased resolution of sovereign debt crises is not in the global public interest, and is far from the interest of the poor in the affected countries.

59. The existing "system" (or really "non-system") arose as piecemeal and mostly ad hoc intergovernmental responses to sovereign debt crises as they occurred over the past half-century or so. The fact that, as noted, the solutions that the current system provides take time to be adopted and provide inadequate relief, implies that the system for addressing sovereign debtors is clearly inferior to that provided in many countries for corporations and sub-sovereign public entities by national bankruptcy regimes. The latter not only aim to find a quick and equitable solution, but also one that achieves nationally desired economic and social outcomes, particularly a "fresh start" (or "clean slate") when a bankrupt entity is reorganized. The sovereign system is plagued also by horizontal inequities. Official lenders have always complained that private creditors do not follow restructurings agreed in the Paris Club, and the magnitude of debt rescheduling and relief accorded in individual cases has clearly depended on the weight and negotiating capacity of the debtor country.

60. The system for sovereign debtors has operated under the informal and imperfect coordination of the debtor and its creditors by the International Monetary Fund (IMF), under the guidance of the G7 major industrialized countries. The latter countries set the overall policy directions for the IMF and the other involved institutions, such as the Paris Club, where debts owed to governments are restructured. The system assumes a developing country government in debt distress will adopt an IMF-approved macroeconomic adjustment program, that the program will be effective, and that all the relevant classes of creditors (banks, bondholders and suppliers, government creditors and multilateral institutions) will cooperate in providing the overall amount of relief and financial support deemed necessary on the basis of the Fund documents. Often there is very little real debt relief, only a mere rescheduling of the obligations. And often the magnitude of relief is based on excessively optimistic growth projections—setting the stage for problems down the line.

61. These assumptions never fully held and what confidence there was in the system was severely affected by how the Heavily Indebted Poor Countries (HIPC) Initiative and the East Asian, Russian, Ecuadorian and Argentine crises were handled. The HIPC Initiative was initially judged insufficient to give the poorest countries a fresh start and, after almost a decade of long negotiations, it was supplemented in 2005 with the Multilateral Debt Relief Initiative. Nevertheless, the HIPC initiative was represented the first comprehensive approach to the solution of the debt problem of poor developing countries. The initiative came along with a framework which placed poverty reduction strategies at the centre of development cooperation, based in part on a broad social dialogue including the participation of civil society.

62. Apart from that, some of the individual, non-HIPC renegotiations that took place after the East Asian crisis are seen as unsatisfactory. Most country "workouts" from debt crises in this period were under cooperative voluntary arrangements with the bondholders that did not reduce the level of debt. The transparency of some of these renegotiations processes – including the pressures exerted on debtor countries by other nations and IFIs— has also been questioned.

63. Moreover, while creditors have a seat at the table, other claimants—government retirees, for instance, which have been promised a particular level of pensions—do not. Chapter 9 of the US bankruptcy code, which applies to municipalities and other sub-sovereign public entities, gives priority to these "public" claimants on government revenues. In contrast, international procedures seem to pay insufficient attention to their interests.

64. Finally, some critics of current practices suggest that they are unnecessarily "painful" because they are designed to provide strong incentives for countries not to default on their obligations. Small and weak countries may be forced to pay the price for ensuring that the overall system exercises discipline on borrowers.

65. Argentine's rapid growth after its 2001 default, in spite of the long delay in the final resolution, shows that eliminating debt overhang can provide conditions for rapid economic growth even in seemingly adverse conditions. Despite rapid growth, however, this country faced significant problem regaining access to private financial markets.

Call for an International Debt Restructuring Court

66. Some have argued that new debt restructuring procedures are not needed; all that is required are small reforms in debt contracts – e.g. collective action clauses. But no country relies solely on collective action clauses for debt resolution, and there is no reason to believe that doing so for international debt would be sufficient either. For instance, collective action clauses do not provide effective means of resolving conflicts among classes of claimants.

67. It is easy to agree that the amount of debt relief accorded to different countries should depend on their circumstances. However, it is artificial to have one set of rules for determining that relief for selected developing countries—as was the case for the HIPCs and later the Multilateral Debt Relief Initiative—and another for the rest of the world. Rather, we need a single statutory framework for debt relief in which creditors and the debtor restructure the debt so as to provide a fresh start, based on the country's unique economic condition. The debt workout regime should be efficient, equitable, transparent and timely in handling debt problems ex post (as problems become apparent, and especially after default) while promoting efficiency ex ante (when the borrowing takes place).

68. A well-designed process should protect the rights of minority, as well as majority, creditors—as well as "public" claimants. It should give debtors the opportunity to call default through a structured process. The principles of human-centred development, of sustainability and of equity in the treatment of the debtor and its creditors, and among the creditors, should apply equally to all sovereign debt crises resolved through the international system. As in national bankruptcy systems, principals should be encouraged to reach a

workout on their own to the extent possible. But whether such an agreement can be reached, and the nature of the agreement, can be affected by the backdrop of the legal structures.

69. Achieving these objectives require a more structured framework for international cooperation in this area. For the same reason that governments adopt bankruptcy legislation and do not rely solely on voluntary processes for resolving corporate bankruptcies, an efficient sovereign system requires something more than a moral appeal to cooperation. This means the creation of a sovereign debt workout mechanism.

70. This entails the creation of an "International Debt Restructuring Court", similar to national bankruptcy courts. This Court would ensure that agreed international principles regarding priority of claims, necessary overall write downs and the sharing of "haircuts" were followed. It could differentiate between distinct debt categories which might include government, government guaranteed and government acquired private debt so as to make transparent the actual effective liabilities of the sovereign. It could also determine what debts could be considered "odious". And it would be able to grant potential private or public creditors authority to extend "debtor in possession" financing, as in corporate restructurings, National courts would have to recognize the legitimacy of the international court, and both creditors and debtors will therefore follow its rulings.

71. Once proceedings have started, the "Court" might act as a mediator, attempting to establish international norms for sovereign debt restructurings. With a view to realizing a comprehensive workout, it would encourage the creditors to coordinate their positions within and across different classes of lenders, in the long run including the government creditors that operate today through the Paris Club as well as multilateral creditors. Were mediation to fail or become unduly lengthy, the Court should have the power to arbitrate. It might also work in cooperation with the IMF, the World Bank, or regional development banks, to help provide interim finance to maintain economic strength while negotiations take place. But such lending should not be a mechanism simply for bailing out creditors who failed to do due diligence in providing lending.

72. Beyond the problems of sovereign debt restructuring, there are also serious problems in managing cross-border private debt workouts, with conflicts between different jurisdictions and with concerns about "home" country bias. The International Debt Restructuring Court could extend its reach to consider bankruptcy cases involving parties in multiple jurisdictions.

73. In earlier discussions of sovereign debt restructuring mechanisms, it was presumed that the IMF, or a separate and newly established division of the IMF, would act as the bankruptcy court. However, while it may be desirable to institutionalize the sovereign debt restructuring mechanism under the umbrella of an international institution, the IMF in its current form is unlikely to be the appropriate institution, as it is also a creditor and subject to disproportionate influence by creditor countries. It is therefore unlikely to be seen as a "neutral" mediator. The arbitration process of the International Centre for the Settlement of Investment Disputes (ICSID) within the World Bank has similarly failed to generate confidence from the developing countries as a fair arbitrator of investor-state disputes under bilateral investment agreements.

74. Any procedure must be based on widely shared principles and processes with political legitimacy. Agreed upon goals—such as that the work-out must be fair, transparent sustainable, and promote development—would boost its credibility with debtors—indeed with all stakeholders, including creditors who would appreciate the reduction of uncertainty under clear rules of the game and the knowledge that any post-workout debt situation would have a larger chance of being sustainable. But translating these goals into agreed upon principles and procedures may be difficult, given the conflicts of interests.

75. There is nothing immutable in the current approach to resolving sovereign debt crises. It arose in the political and economic environment created after the Second World War, and the need to develop a better system remains on the international policy agenda. The international community needs to actively resume the effort to define the specific mechanism to institutionalize the principles advanced here.

Foreign Debt Commission

76. The crisis also gives urgency to reform of institutional structures for debt relief, as an increasing number of developing countries, especially the most vulnerable low-income countries, may face difficulties in meeting their external debt commitments. This crisis therefore gives urgency to these reforms. Unless these debts are managed better than they have been in the past, the consequences for developing countries, and especially the poor in these countries, can be serious.

77. Although, as argued above, there is a need for new procedures for restructuring sovereign debt, this reform will take time, as it would require a new international treaty. In the interim, something needs to be done to ensure that debts are better managed—and this may be true even in the long run. It is important to take actions to manage debt better, so that countries are not forced into default.

78. The United Nations should therefore set up a Foreign Debt Commission to consider external debt problems of developing countries and economies in transition. The commission, with balanced geographic representation and technical support from the Bretton Woods, regional and other financial institutions, would address these issues and provide advice on ways to enhance external debt crisis prevention and resolution.[5] It would also examine existing and advise on the design of better debt sustainability frameworks for the international community to follow. It would help debt-distressed countries return to debt sustainability, extend Paris Club-plus type approaches to new official creditors, set up an interim mediation service, and craft on the basis of that experience more permanent debt mediation and arbitration mechanisms.

Innovative Risk Management Instruments

79. The volatility of private capital flows to developing countries has generated increasing demand for policies and instruments that would allow these countries to better manage and

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[5] See United Nations, "Doha Declaration on Financing for Development: outcome document of the Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus" (A/CONF.212/L.1/Rev.1), Doha, Qatar, 29 November -2 December 2008, paragraph 67.

minimize the risks associated with increasing international financial integration and, in particular, to better distribute the risks associated with this integration among different market agents. As has been demonstrated during past and current crises, the pro-cyclical and herding behaviour of international capital flows tends to generate boom-bust cycles, which are particularly damaging for developing countries, and it also reduces the scope they have to undertake counter-cyclical macroeconomic policies. Moreover, many developing and emerging countries borrow short term, in hard currencies, forcing them to bear the risk of interest rate and exchange rate fluctuations. And finally, inadequate debt resolution mechanisms impose high costs on developing countries.

80. In light of this, there have been a variety of ideas and proposals for introduction of innovative financial instruments. The proposed instruments include tools that enable better management of risks arising from the business cycle and fluctuations in commodity prices, particularly GDP and commodity linked bonds and financial guarantees that have a counter-cyclical element embedded in their structure. Promoting local currency bond markets has also been seen as a way to enhance financial development and reduce the currency mismatches that affect debt structures in developing countries.

81. GDP-linked bonds are conventional bonds that pay a low fixed coupon augmented by an additional payment linked by a pre-determined formula to debtor country's GDP growth. This variable return structure links returns to the ability to service and thus reduces the likelihood of costly and disruptive defaults and debt crises. The reduction of a country's debt service when the economy faces financing difficulties can also facilitate a more rapid recovery, as it allows higher public spending in difficult times. For investors GDP-linked bonds reduce the probability of default, and thus the costs of expensive renegotiation, and offer a valuable diversification opportunity. Returns should be higher than with conventional bonds.[6]

82. Since private financial markets are unlikely to develop these instruments autonomously, because of the externalities associated with their introduction multilateral development banks should take an active role in their development. In particular, these institutions could have an active role as "market-makers". The expertise developed by the World Bank as market-maker for the sale of carbon credits under the Kyoto protocol provides a precedent for these activities. The World Bank and regional development banks could, for example, make loans whose servicing would be linked to GDP. The loans could then be sold to financial markets, either individually or grouped and securitized. Alternatively the World Bank or regional banks could buy GDP-linked bonds that developing countries would issue via private placements. The fact that major multilateral development banks became active in this type of lending could, furthermore extend the benefits of adjusting debt service to growth variations to countries that do not have access to the private bond market. GDP-indexed securities are

[6] The introduction of these securities must overcome, however, some practical difficulties. One possible set of concerns is associated with lags in the provision and frequent revisions of GDP data, as well as over the quality of these estimates, but these issues should be easy to resolve through international standard setting and the provision of technical assistance. More important in this regard is how to manage concerns that have been raised about the liquidity of such instruments, especially when they are newly issued. Such concerns were similarly raised when inflation indexed bonds were first introduced, but they are now accepted worldwide. Governments and multilaterals might have to help create a thicker market.

particularly appropriate for Islamic finance, as they can be made compatible with Sharia law which prohibits charging of interest.

83. There might also be alternative ways of ensuring flexible payment arrangements that would allow automatic adjustment for borrowers during bad times. For instance, one possibility is for coupon payments to remain fixed and the amortization schedule to be adjusted instead. Countries would postpone part or all of their debt payments during economic downturns; and they would then make up by pre-paying during economic upswings. A historical precedent was set by the United Kingdom when it borrowed from the United States in the 1940s. The Anglo American Financial Agreement was negotiated by John Maynard Keynes and included a "bisque clause" that provided a waiver of 2% interest payment in any year in which the United Kingdom foreign exchange income was not sufficient to meet its pre war level of imports, adjusted to current prices.

84. Commodity-linked bonds can also play a useful role in reducing country vulnerabilities. Examples of commodity-indexed bonds include oil-backed bonds, such as the Brady bonds with oil warrants that were first issued on behalf of the government of Mexico. In such instruments, the coupon or principal payments are linked to the price of a referenced commodity. Again, it might be desirable for international institutions to help create a market for such bonds.

85. However, the greater complexity of this instrument, in comparison with conventional bonds, and the commodity price risk that the investor faces, may make commodity-linked bonds expensive. Again, it might be desirable for international institutions to help create a market for such bonds. While they are likely to be less useful than GDP-indexed bonds for the growing number of developing countries that have a fairly diversified export structure and therefore lack a natural commodity price to link to bond payments, they have the decided advantage that the risk being "insured" through the bond is not one affected by the actions of the country (i.e. moral hazard is less of a problem.)

86. Another way of addressing the problems created by the inherent tendency of private flows to be pro-cyclical is for public institutions to issue guarantees that have counter-cyclical elements. For example, Multilateral Development Banks (MDBs) and Export Credit Agencies (ECAs) could introduce an explicit counter-cyclical element in all the risk evaluations and the guarantees they issue for lending to developing countries. This requires MDBs and ECAs to assess risk for issuing guarantees with a long-term perspective. When banks or other lenders lowered their exposure to a country, MDBs or ECAs would increase their level of guarantees, if they considered that the country's long-term fundamentals were basically sound. When matters were seen by private banks to improve, and their willingness to lend increased, MDBs or ECAs could reduce their exposure. Alternatively, there could be special stand-alone guarantee mechanisms for trade and/or long-term credit, for example within multilateral or regional development banks, which had a strong explicit counter-cyclical element. This could be activated in periods of sharp decline in capital flows and its aim would be to try to catalyze private sector trade or long-term credits, especially for infrastructure.

87. Finally, a number of developing countries have encouraged development of domestic capital markets, and in particular local currency bond markets. These markets in fact

boomed after the Asian crisis, multiplying fivefold between 1997 and 2007 for the twenty large and medium-sized emerging economies for which the Bank of International Settlements provide regular information. This trend can be seen as a response of emerging economies to the volatility and pro-cyclical bias of international capital flows and the volatility of exchange rates. It can be viewed as a means of creating a more stable source of local currency funding for both the public and private sectors, thereby mitigating the funding difficulties created by sudden stops in cross-border capital flows, reducing dependence on bank credit as a source of funding and, above all, lowering the risk of currency mismatches. For foreign investors, it could actually be attractive to form diversified portfolios of emerging market local currency debt issued by sovereign governments or developing country corporations, with a return-to-risk that competes favourably with other major capital market security indices.

88. Further development of these markets is desirable. First, developing countries bond markets are still largely dominated by relatively short-term issues and, therefore tend to correct currency mismatches but to increase maturity mismatches. Second, it has proved to be much easier to develop large and deep local markets for public sector than for corporate debt. As a result, large corporations continued to rely on external financing. To the extent that such external financing is shorter term than that many developing country governments are able to get in global debt markets, the overall debt structure of countries tends to become shorter term—and therefore riskier. Indeed, the rollover of external corporate debt is viewed as the major problem facing many emerging economies today. Third, many of these markets are not very liquid. This problem has actually become more acute during the recent market downswing. Fourth, although local bond issues did attract foreign investors, they were largely or at least partly lured by the generalized expectations of exchange rate appreciation that tended to prevail in many parts of the developing countries during the recent boom. As the world financial crisis hit, there were large outflows of these funds, and in this sense reliance on these short term portfolio flows did not correct but may have enhanced pro-cyclicality of financing, much as short-term external bank debt did during previous crises.

89. Therefore, although the development of local bond markets is a major advance in developing country financing since the Asian crisis, its promise remains a partly unfulfilled in terms of risk mitigation. It is important for developing country governments, with support from international organizations to correct some of the problems that have been evident and to continue investing in the development of deep and longer-term domestic bond markets.

Innovative Sources of Financing

90. For some time, the difficulty in meeting the UN official assistance target of 0.7 per cent of GNI of industrial countries as official development assistance, as well as the need for adequate funding for the provision of global and regional public goods (peace building, fighting global health pandemics, combating climate change and sustaining the global environment more generally) has generated proposals on how to guarantee a stable sources of financing for these objectives.

91. This debate has led to a heterogeneous family of initiatives. A distinguishing feature of developments in recent years is the fact that the old idea of innovative finance has started to

lead to action, with the launch in Paris, in 2006, of "the Leading Group on Solidarity Levies". The Leading Group now involves close to 60 countries and major international organizations.

92. Some of the initiatives that have been proposed encompass “solidarity levies” or, more generally, taxation for global objectives. Some countries have already decreed solidarity levies on airline tickets but there is a larger set of proposals. There have also been suggestions to auction global natural resources–such as ocean fishing rights and pollution emission permits— for global environmental programs.

93. The receipts from these innovative initiatives could be directed to support developing countries to meet their development objectives, including their contribution to the supply of global public goods, as well as international organizations that are active in guaranteeing the provision of such goods. The existing taxes on airline tickets, for example, are being used to finance international programs to combat malaria, tuberculosis and HIV-AIDS.

94. The suggestion of taxes that could be earmarked for global objectives has a long history. To avert their being perceived as encroachments on participating countries' fiscal sovereignty, it has been agreed that these taxes should be nationally imposed, but internationally coordinated. While universal participation is not indispensable, it would serve the interest of development, as more resources would be raised. Some suggestions aim at both raising funds for global objectives and mitigating a negative externality at the global. Two suggestions deserve special attention: a carbon tax and a levy on financial transactions.

95. Since carbon dioxide is the main contributor to global warming, a tax on its emissions can be defended on environmental efficiency grounds and would also have the advantage of correcting a negative externality in addition to being a significant source of development financing, which according to some estimates could reach as much as $130 billion per year. However, carbon taxes should not be implemented in both developed and developing countries. A uniform global carbon tax, even if introduced gradually, would mean that developing countries will be taxed at several times the rate for industrial countries, as a proportion of their respective GNPs. This would impose a disproportionate burden of adjustment on developing countries, although per capita emissions of greenhouse gases in developing countries are low compared with those in industrial countries. Carbon taxes will also have adverse distributional impacts in developing countries. A high tax on an essential good (e.g. energy, but also food or water) could render it unaffordable by lower income groups. This would not only be regressive, but would also be socially unacceptable and environmentally unpredictable.

96. An alternative to carbon taxes, which is now being used, is the auctioning emissions rights. Emissions trading is one of the Kyoto Protocol mechanisms and has been implemented by means of a European trading scheme which provides for an overall capping of emissions. The mechanism makes pollution with greenhouse gases costly for the emitter who has to acquire emission certificates. In this way, public revenues are generated which can be used to finance both mitigation and adaptation to climate change in developing countries, thus contributing to "climate justice".

97. Similar mechanisms can be designed to pay for environmental services. Such schemes are operational locally in different areas of the world. They allow for consumers of a given

public good to compensate for some of the costs borne by those in charge of producing or preserving it. For instance, downstream users of water can pay those who manage the upstream forest to ensure a sustainable flow of this service into the future. It can be envisaged that similar instruments could pay for the provision of global environmental services, such as the preservation of rainforests.

98. Estimates of the revenues from a currency transaction tax range from $15 to $35 billion. However attractive the tax might be in terms of revenue potential, its implementation is constrained by a number of obstacles. Particularly, the tax base will have to be defined so as to exclude certain transactions that provide very short-term liquidity to markets (e.g., when this tax is applied at the national level, interbank lending is usually exempted) and special treatment for derivatives to avoid double taxation. It will also have to be protected from erosion, for even if all major financial centres participate, there is a risk that smaller centres will attract an increasing volume of activity from those wishing to evade the tax. Finally, strong opposition by a number of stakeholders would have to be overcome.

99. Alternatively, a levy on trade in shares, bonds and derivatives could be introduced. Implementation would be easier than in the case of a currency transaction tax, as a small number of participating countries suffices at the beginning. In later stages, over the counter and currency trading could be included. Large stock exchange centres exhibit positive agglomeration externalities; therefore a small tax would not lead to a flight of trade towards alternative, smaller exchanges.

100. Another set of proposals rely on the use of financing mechanisms. One mechanism that already has a long history of application is swaps of debt for development objectives. It has been recently used in the Debt2Health initiative launched in Berlin in 2007, which converts portions of old debt claims on developing countries into new domestic resources for health. The International Finance Facility was proposed by the UK in 2003 to up-front commitments for future flows of ODA, by issuing bonds backed by public or private sector donors' pledges. The first of these mechanisms, the International Finance Facility for Immunization, is already in place.

101. Public-private sector partnerships can also be used to guarantee certain international objectives. A mechanism of this type is the Advanced Market Commitments proposed by Italy, through which government donors commit funds to guarantee the price of vaccines once they have been developed, provided they meet a number of criteria on effectiveness, cost and availability. This helps encourage pharmaceutical firms to focus on research into neglected diseases which mainly affect poor countries.

102. Finally, from the outset, the Leading Group has been focusing on illegal financial flows from developing countries, including those lost by developing countries through tax evasion and other illegal means. It has set up for that purpose a task force on Global Financial Integrity, under the direction of Norway. The importance of combating tax evasion has already been underscored in chapter 3.