

Chapter V

Reforming the international financial architecture

Summary

- ◆ Instead of increasing investment and growth, capital and financial market liberalization had the opposite effect by increasing volatility and uncertainty, which negatively impacted the long-term investment that is critical for structural transformation and development.
- ◆ The emergence of global imbalances and the consequent global economic crisis are key symptoms of financial system incoherence. Rebuilding and reforming the global financial system are necessary coherence with national investment and poverty reduction imperatives is to be achieved.
- ◆ Reforming global rules in order to re-establish the capacity of public authorities both globally and nationally to curb excessive private risk-taking and ensure that finance serves the real sector, instead of the other way around, is an urgent priority. Because national authorities are the first line of defence against financial market volatility, their capacities for controlling volatile capital flows must be backed by international institutions.
- ◆ It is necessary to end the competition over foreign investment using regulatory and tax policies that characterized individual country policies in the past three decades. Competition practised through other means must be backstopped with well-coordinated macroeconomic and financial regulatory mechanisms.

Introduction

There is general agreement that weaknesses in the system of international financial cooperation played a key role in the current global economic crisis. These weaknesses also played a role in the fuel and food crises.

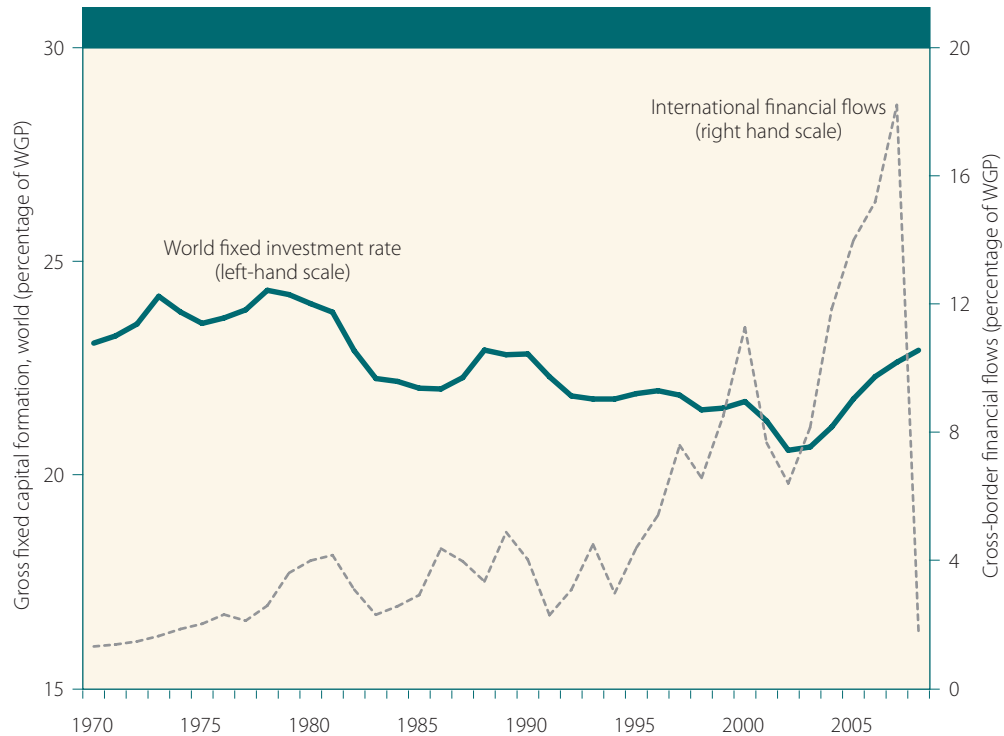
Ensuring that developing countries are able to increase their rate of investment continues to be as big a challenge today, perhaps, as it was in the early days of development thinking. During the 1980s and 1990s, structural adjustment programmes coupled with the liberalization of private capital flows had been expected to increase the rate of investment in developing countries. Instead, the rate of fixed investment stagnated in most parts of the world, despite a significantly higher level of international financial flows (see figure V.1). As will be discussed below, a qualitative improvement must accompany a quantitative increase in investment if sustainable development objectives are to be met; this will require an investment regime that is capable of underpinning private risk-taking by virtue of having sufficient stability and sufficient signalling from States as regards general directions.

Greater capital mobility has given developing countries ostensibly greater access to financial resources, but owing to the volatile and boom-bust pattern of financial flows in deregulated markets, it has also made macroeconomic policy management more challenging.

International financial system weaknesses played a key role in the current crisis

Greater capital mobility made macroeconomic policy making more difficult

Figure V.1
Rapid financial growth but stagnant fixed investment, 1970-2009



Source: UN/DESA, based on United Nations Statistics Division, National Accounts Main Aggregates Database; and International Monetary Fund, *International Financial Statistics*.

Note: Fixed investment refers to the world total of gross fixed capital formation, according to definitions used in national accounts. Financial flows are measured as the sum of changes in cross-border debt security assets, direct investment abroad, changes in other cross-border investment assets, and net errors and omissions, according to definitions used in balance-of-payments statistics.

Capital mobility has also stimulated regulatory and tax competition among public authorities. Before the global financial crisis, competition associated with expanding financial centres had become a race to deregulate finance—a race that, in the end, had no winners.

In today's world of increased economic and political interdependence, achieving broad-based, rapid and sustained growth in incomes and employment involves policy challenges that are even more complex than those of the past. The fact that pension funds, for example, are now invested internationally has led to the creation of a channel through which a weakness in one financial market can be transmitted to other financial centres and to the real sector.

The gaps and traps left by financial liberalization

Global financial deregulation placed too much confidence in the power of financial markets to self-regulate

The past several decades have seen a push towards global financial deregulation based on a misplaced confidence in the power of financial markets to self-regulate, despite the evidence derived from earlier crises that deregulated financial markets are prone to crises and instability. In developed markets, policymakers seemingly lacked the will to develop a new regulatory framework to deal with significant changes in risk-taking stemming from the growth of credit default swaps, securitizations and other derivative products. To the contrary, some of the crucial mechanisms to protect the financial system that had been put into place in the aftermath of the Great Depression were dismantled. Regulatory and tax competition among expanding financial centres led to a race to the bottom, compounding the problem. In this environment, the “shadow banking system” outside the regulatory umbrella grew enormously, introducing significant risks into the global financial system.

In developing countries, the counterpart of this phenomenon was the deregulation of domestic financial and capital markets, often undertaken as part of structural adjustment programmes. In particular, countries, experiencing marked pressure from the international community, removed capital controls on external private capital flows in an attempt to increase the rate of inflows to support domestic investment. This was part of the decades-long evolution to place financial markets at the centre of economic decisions, yoking economic policy coherence to the notion that whatever projects financial markets designed to finance would be in line with strong growth and development. However, instead of attracting long-term sustainable investment to achieve structural transformation for development, the move to open capital markets led to short-term inflows and increased volatility, while limiting the macroeconomic policy space necessary for responding to the boom-and-bust behaviour of capital flows.

Following the Latin American and Asian crises of the 1990s, many emerging and developing countries used the boom period 2003-2007 to strengthen their internal and external balance sheets to better avoid or manage crises. As part of this strategy, public authorities accelerated their purchases of liquid low-earning developed-country financial assets as a form of self-insurance. This policy was also congenial to countries that had robust export sectors and were concerned with protecting international competitiveness. The end result was a flow of financing from developing countries to developed economies and an increase in global risk, as the accumulation of reserves contributed to growing imbalances, with the potential to destabilize the global economy.

Structural adjustment programmes often required the deregulation of domestic financial and capital markets

During the boom in 2003-2007, many developing countries attempted to carve out policy space by strengthening balance sheets

Financial market crises

The period of global financial deregulation, which, arguably, started in the 1980s, was characterized by a series of market crises. The savings and loan crisis in the United States of America in the late 1980s was followed by the Mexican “tequila” crisis in 1994, the Asian financial crisis in 1997-1998, payments and currency crises in the Russian Federation, Brazil, Turkey and Argentina between 1998 and 2001 and the bursting of the “dot-com” bubble in United States financial markets in 2000. As shown in figure V.2, the banking crises of the early 1900s and the recent wave exhibited similar periodic patterns, marked by severe real-sector collapses following banking sector crashes.¹

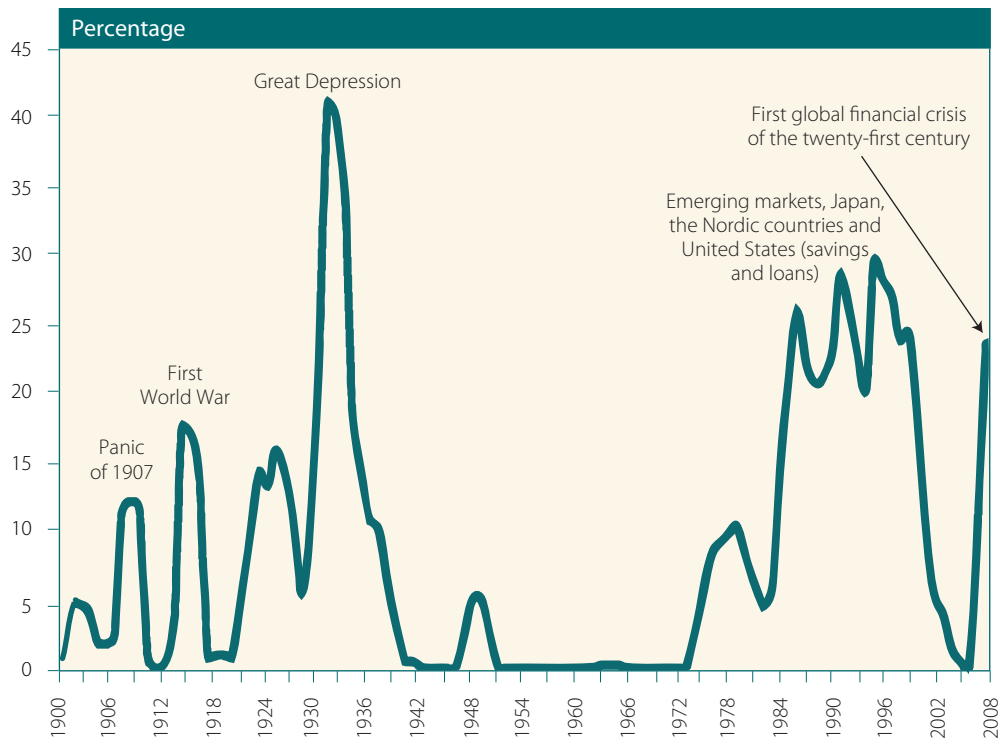
The frequency of crises subsided after the 1930s, once regulations devised to limit runs on banks and protect depositors had been put into place, and increased again only in the deregulatory period of the 1980s (see table V.1). It should be noted that the decades between the spikes were the heyday of the global Bretton Woods capital regime, a period of stable and relatively high growth.

Although the recent global crisis was unique in terms of its size and systemic reach, compared with other post-1930s crises, it still resembled them. Those crises were generally characterized by bubbles induced by excess liquidity which subsequently burst when the liquidity was withdrawn; similarly, the period of the mid-2000s build-up to the recent crisis was one of massive global liquidity. Growing global imbalances, with developing countries saving huge amounts in the form of dollar reserves, allowed the United States to borrow cheaply from abroad, keeping long-term interest rates low and increasing leverage in the system (United Nations, 2006b).

The period of global financial deregulation was characterized by a series of market crises

¹ Reinhart and Rogoff (2008) document the international banking and financial crises that occurred over eight centuries.

Figure V.2
Proportion of countries^a in the world economy with banking crises, 1900-2008



Source: Reinhart and Rogoff, 2008, figure 1.

Note: The figure presents the (three-year moving averages of the) proportion of countries with banking crises weighted by their economic size. Three sets of GDP weights have been used: 1913 weights for the period 1800-1913; 1990 for the period 1914-1990; and 2003 weights for the period 1991-2006. For the period 2007-2008, Austria, Belgium, Germany, Hungary, Japan, the Netherlands, Spain, the United Kingdom of Great Britain and Northern Ireland and the United States of America are included as crisis-ridden countries.

a Countries weighted by their share of world income.

Table V.1:
Frequency of banking crises

	<i>Developed countries</i>	<i>Developing countries</i>
1947-1979	3	17
1980-2007	17	127

Source: UN/DESA, based on data in Reinhart and Rogoff (2008), table A.3.

Contrary to the original presumption, the majority of the inflows went to finance consumption and real estate bubbles

In the emerging market crises, excess liquidity became manifest through large international capital flows which were pro-cyclical in nature, increasing during boom periods and quickly turning into outflows during economic contractions. During the boom periods, domestic agents took advantage of the inflows by borrowing relatively cheaply, often in the form of foreign currency loans. Contrary to the original assumption that capital market liberalization would increase long-term investment in poor countries, the majority of the inflows (which were generally short-term in nature) went to finance consumption and real estate bubbles, which burst when the inflows turned into outflows. The capital outflows often led to a devaluation of the domestic currency and a spike in domestic interest rates, leading to widespread defaults (including some sovereign defaults), banking crises, lost wealth and increased poverty, as discussed in chapter II. Instead of increasing investment, capital and financial market liberalization had the opposite effect of increasing volatility and uncertainty, which negatively impact long-term investment.

Lower developing-country investment rates

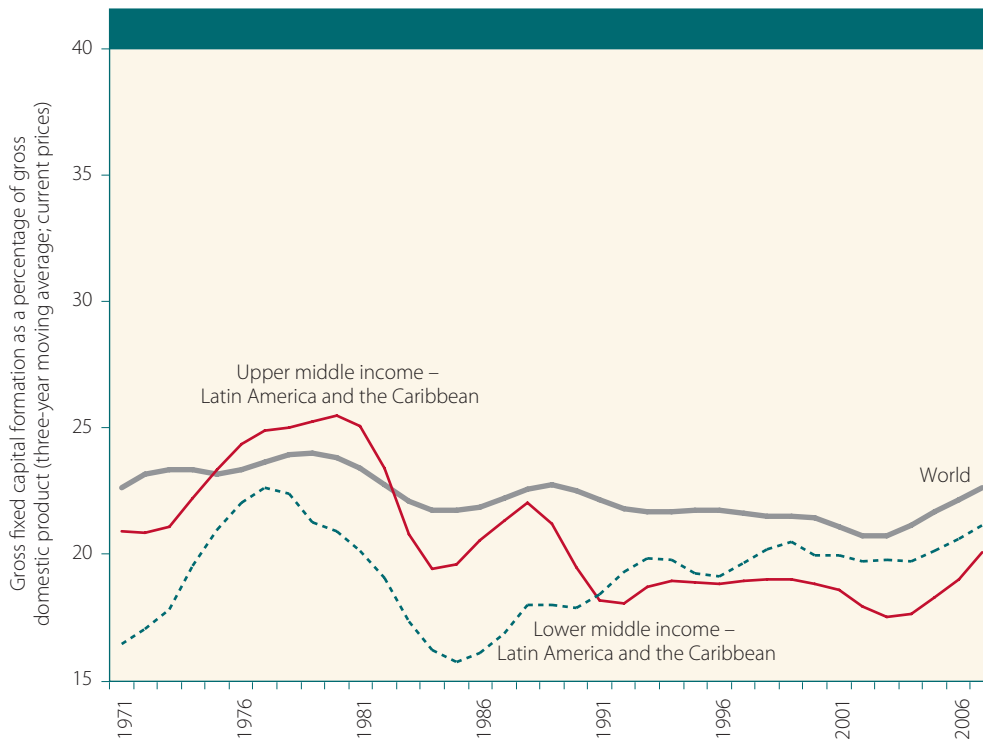
The start of global financial liberalization in the early 1980s coincided with the developing-country debt crises, which saw severe drops in investment rates in Latin America and Africa. Financial liberalization had been expected to help engineer a revival of investment rates. The performance, however, did not match the expectation. As figures V.3 and V.4 show, real investment in countries with open capital markets either stagnated or fell (as in Latin America) or ratcheted up during boom periods only to collapse during busts (as in Asia). In Latin America and the Caribbean, middle-income countries experienced rates of investment in fixed capital that were temporarily higher than world averages during the debt boom precipitated by the private bank recycling of petrodollars in the 1970s, but that fell below this rate during the debt crisis and never exceeded the world average again (despite the high level of capital inflows during the 1990s) (see figure V.3). In contrast, the performance of lower-income developing countries, which experienced much smaller levels of financial inflows, showed slow but steadier improvements relative to world rates (as well as to those of middle-income countries). In the context of open capital accounts, the decision of Latin American countries to pursue macroeconomic stability as indicated by their lower inflation and reduced fiscal deficits led to more volatile real economic growth rates (see box V.1).

Asia's lower middle income developing countries, many of which maintained some form of capital controls throughout the period (such as China and India), achieved investment rates in the 1970s and 1980s that were higher than those of the world as a whole and managed to sustain these rates or raise them further in the 1990s and early

Financial liberalization had been expected to help engineer a revival of investment rates

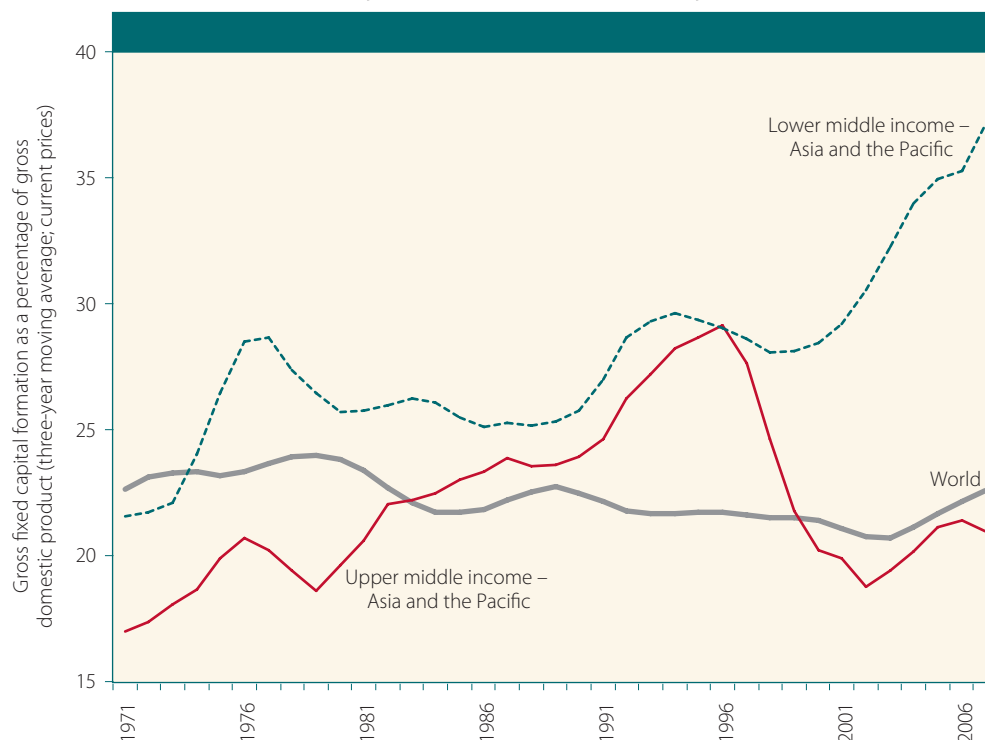
Middle income East Asian economies experienced a spike in investment in the mid-1990s

Figure V.3
Fixed investment rates, world and Latin America and the Caribbean, 1971-2007



Source: UN/DESA.

Figure V.4
Fixed investment rates, world and Asia and the Pacific, 1971-2007



Source: UN/DESA.

Box V.1

Regional financial cooperation in Asia and Latin America

Debates on reforms of the international financial architecture often pay too little attention to the possible role of regional arrangements in macroeconomic policy coordination and the development of regional institutions able to perform the functions traditionally assigned to the international financial organizations. There are nevertheless a number of supporting arguments in favour of regional cooperation in macroeconomic and financial areas, since the current globalization process is also one of “open regionalism”; and increased regional interdependence requires a certain degree of coordination and mutual surveillance of macroeconomic policies. The regional nature of the severe currency crises of the 1990s created a strong stimulus for countries to engage in regional cooperation in order to elaborate commonly agreed targets and mutual surveillance mechanisms and provide financial assistance to each other in order to avoid the contagion effects of a financial crisis. There are also barriers to such cooperation, however, such as the inadequate capacity of countries to provide the necessary financial services, the lack of a proper institutional framework and the possibility of inequitable distribution of the benefits of such cooperation.

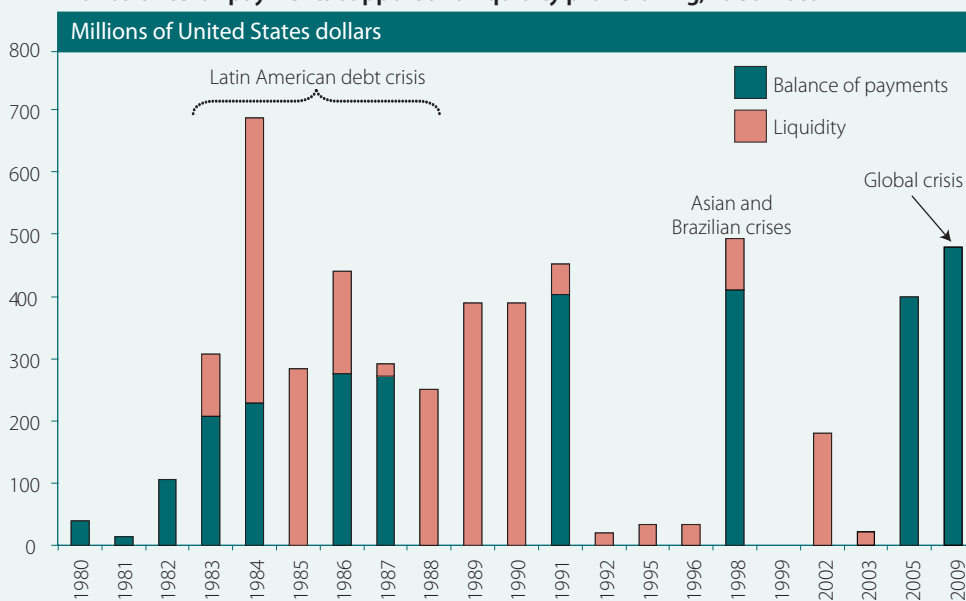
Within a context where financial crises tend to be regional, regional financial cooperation can play a relevant role that is complementary to that of new global mechanisms for managing the world economy. The large currency and financial crises in emerging market economies since the 1990s have had important regional dimensions. Countries should have a vested interest in helping to put out a fire in neighbouring countries—before it spreads to them. Pooling foreign-exchange reserves regionally will likely also reduce costs to individual countries, just as universal health insurance reduces costs to individuals. After the East Asian crisis, Japan had proposed the creation of an Asian monetary fund, but this proposal—while well received in the region—was not pursued after objections were presented from outside the region. The collective liquidity support provided under the Chiang Mai Initiative, involving bilateral currency swap arrangements among the Association of Southeast Asian Nations (ASEAN) member countries plus China, Japan and the Republic of Korea,

Box V.1 (cont'd)

was converted to a multilateral regional arrangement in January 2010 (United Nations, Economic and Social Commission for Asia and the Pacific, 2010); the effectiveness of the Chiang Mai Initiative in dealing with financial crises is still to be tested. This regional framework is complementary to the International Monetary Fund (IMF) global facilities and does not negate the need for a crisis prevention framework for IMF itself.

In Latin America and the Caribbean, apart from the Inter-American Development Bank, the main subregional financial institutions include the Latin American Reserve Fund (FLAR) established in 1978 and several development banks, including the (Central American Bank for Economic Integration (BCIE), in operation since 1961; the Andean Development Corporation (CAF), in operation since 1970; the Caribbean Development Bank (CDB), in operation since 1969; and the Latin American Integration Association (ALADI), established in 1980. In spite of increased financial integration among the region's countries, mutual support for balance-of-payments financing remains extremely weak and the only viable institution in the area of liquidity financing is the Latin American Reserve Fund. The scope of the Fund's operation is limited, however, although it did provide counter-cyclical financing during several crisis episodes in the region, (see figure; and United Nations, Economic Commission for Latin America and the Caribbean, 2010). The fact that Mexico is not a member of the Fund did not contribute to a resolution of the 1994 tequila crisis.

Annual credits granted by the Latin American Reserve Fund (FLAR) for balance-of-payments support and liquidity provisioning, 1980-2009



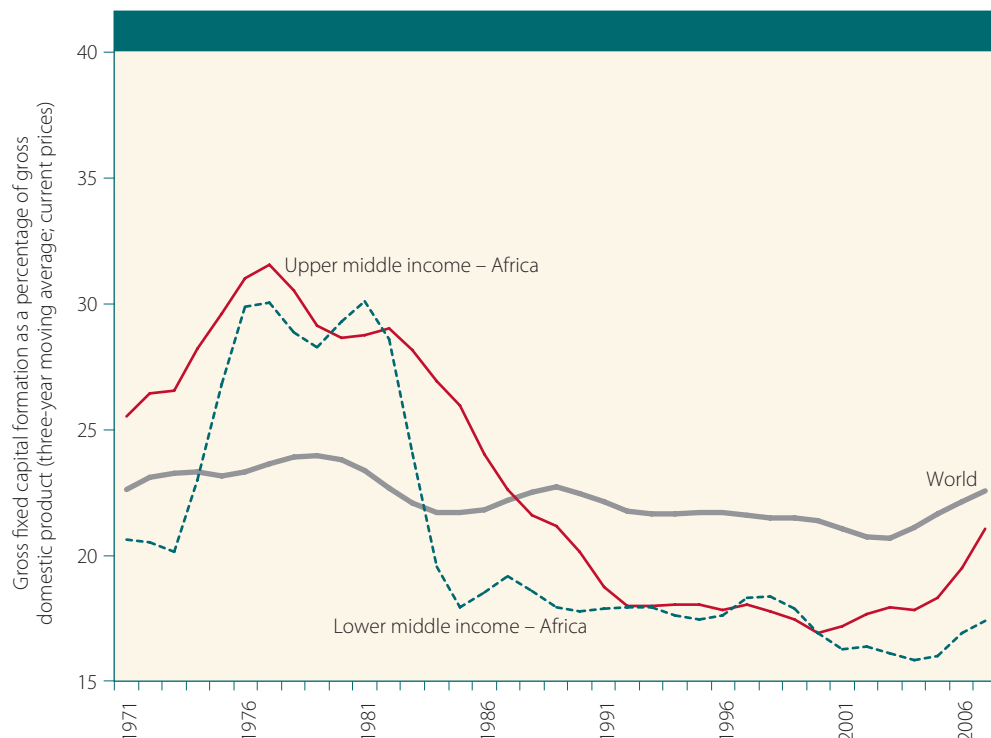
Source: United Nations, Economic Commission for Latin America and the Caribbean (2010), figure 8.

The implications of regional financial cooperation for the international financial system will vary from region to region. Efforts to deepen and expand regional monetary cooperation may be viewed as policy responses that are being driven by the dilemmas spawned by increased trade linkages within the region, as had been the case earlier in Europe, and by the systemic uncertainties created by the present global financial payments system. As part of broader reforms of the international financial architecture, these regional efforts have the potential to bolster the international system's capacity to consult and coordinate on collective issues and assist in their implementation. A more active use of regional financial arrangements is desirable as a complement to the role of IMF. More intensive macroeconomic policy dialogue and stronger forms of regional surveillance and policy consultations could internalize, at least in part, the externalities that national macroeconomic policies impose on regional partners. Thus, while IMF should play a central role in policy coordination at the global level, there is much room for regional and subregional processes of a similar nature. In a similar vein, while regional and international contagion effects in financial markets and management of the main balance-of-payments crises should be the main concern of IMF, regional funds could constitute effective rescue mechanisms for smaller and more local financial crises.

2000s (figure V.3). Middle-income countries in Asia and the Pacific (mainly in South-East Asia) experienced a spike in investment during the period of financial liberalization of the mid-1990s (during the Asian real estate bubble), but then suffered a steep drop in investment to below world rates (the drop began in 1997 during the financial crisis).

Africa's investment rates (figure V.5) had been higher than world average in the 1970s during the commodities boom, then fell below the world average in the era of liberalization and began to recover only during the 2000s commodity boom, which was brought to an end in 2008 by the global crisis.²

Figure V.5
Fixed investment rates, Africa, 1971-2007



Source: UN/DESA.

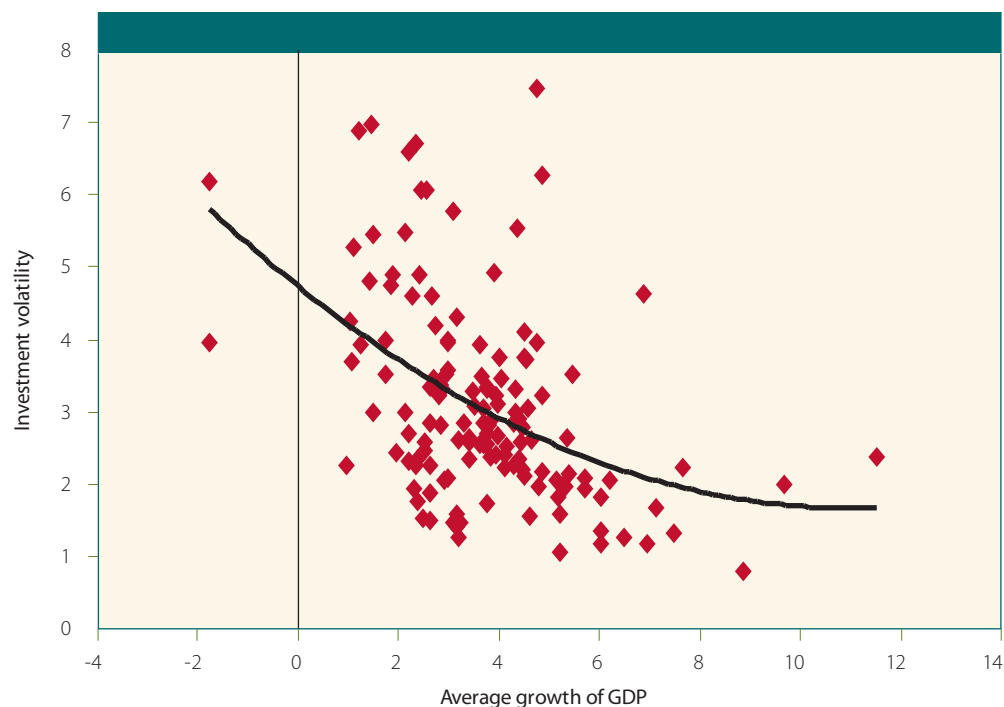
Lower and unstable growth rates

The key channel of impact on long-term growth of private capital flow volatility is investment volatility

Fluctuations in capital markets are reflected in the pro-cyclical pattern of the cost of borrowing, the availability of financing, and maturities (Griffith-Jones and Ocampo, 2007). The result is short-term volatility and the short periods of interruption of financing observed during the crises in Mexico, Asia and the Russian Federation. More importantly, they also involve medium-term cycles and losses of real gross domestic product (GDP) growth, as the experience of the past four decades indicates. The key channel of impact on long-term growth of private capital flow volatility is investment volatility. Figure V.6

² The investment rate is the product of many factors, not the least of which is output stability in the case of demand-constrained economies (Hailu and Weeks, 2009). Among Latin American middle-income countries, the demand constraint imposed by the debt-service treadmills in the 1980s had been critical. Commodity price fluctuations played an important role in economies of Africa (and thus global economic growth for those economies is critical under demand-constrained dynamics), as did the economic dislocations attendant on the profound shift in development strategy beginning in the 1980s.

Figure V.6
Growth of GDP and investment volatility among developing countries, 1971-2000



Source: United Nations (2008), chap. II, figure II.1.

Note: At constant prices of 2000 for the period 1971-2006.

Investment volatility is measured by the coefficient of variation (CV) of the annual growth rate of gross capital formation at 2000 prices in 1971-2006. The coefficient of variation is defined as the standard deviation divided by the mean for the period.

indicates a robust non-linear relationship between higher investment volatility and lower GDP growth. As discussed in greater detail in *World Economic and Social Survey 2008* (United Nations, 2008), a predictable macroeconomic environment is an essential component of a strong investment climate. A volatile business climate can increase uncertainty, making investors reluctant to expand capacity; this in turn can slow productivity growth, thereby increasing the potential for further uncertainty.

Volatility of international private financial flows

There are a host of factors that account for the short-term behaviour of international investors, including rational responses to uncertainty and risk in developing markets, implying that countries should increase transparency, take steps to reduce uncertainty and develop their local capital markets. Alternative explanations for the short-term nature of capital flows have to do with the pro-cyclicality of international finance, which is exacerbated by financial deregulation in developed countries (Stiglitz and others, 2006).³ In addition, the compensation packages of bankers and investors provide them with incentives to engage in short-term behaviour and risk-taking. Investors, for example, who are usually hedge fund and mutual fund managers, are paid annually based on performance, thus limiting their

Capital regulations in the developed countries exacerbate pro-cyclical private flows

³ See Griffith-Jones and Ocampo (2007). These regulations encouraged ultimately unsustainable short-term lending to East Asian countries which had to be intermediated in the domestic financial sector in the lead-up to the region's 1997 financial crisis (Montes, 1998). The explosion of short-term lending followed the region's capital-account liberalization in the early 1990s, a trend promoted by Bretton Woods staff. See, for example, Claessens and Glaessner (1998), Claessens and Jensen, eds. (2000), Caprio and Honohan (2001) and Honohan (2004).

time-horizon to one year.⁴ The implication is that reforms made to international capital requirements and compensation packages should also help to reduce the pro-cyclicality and volatility of international capital flows.

Capital-account management in the face of the volatility of capital flows

During the Asian crisis, many countries were pressured by IMF to tighten fiscal deficits that were already at prudent levels

Managing the macroeconomic volatility induced by private financial flows has become a key challenge for countries that have opened their capital markets. It is difficult for policymakers to loosen monetary policy during a crisis, especially when the economy is characterized by currency mismatches. When the currency devalues, foreign currency liabilities rise relative to domestic currency assets, which has the potential to cause widespread private sector and/or sovereign defaults. Thus, central banks are often forced to raise interest rates to stem capital outflows. This has a feedback effect with respect to fiscal deficits, especially in countries with large amounts of short-term debt, as the cost of borrowing increases. Often, credit dries up as foreigners refuse to lend, forcing policymakers to reduce spending during the downturn. During the Asian crisis, for example, many countries were pressured by the International Monetary Fund (IMF) to tighten fiscal deficits that were already at prudent levels and to raise interest rates.

Developing countries had moved ahead of the international financial institutions by self-insuring

The IMF first acknowledged the link between open capital markets and increased volatility several years later in a paper published by the Fund's research department (see Prasad and others, 2003). Capital market liberalization commitments continued nonetheless to be encouraged in practice and, as discussed in chapter IV, began to be included in bilateral trade agreements between the United States and other countries, even countries like Chile, which had previously used capital market restrictions effectively. Furthermore, Prasad and his colleagues later softened their earlier views. In 2006, the same authors (Kose and others, 2006) suggested that financial liberalization had "collateral benefits", such as increased financial market and institutional development, that were difficult to prove through econometric analyses of the data. This was maintained despite the fact that the majority of research showed that the volatility associated with capital market liberalization often had a destabilizing effect on both financial market and institutional development. In February 2010, IMF staff published an unofficial note in which they acknowledged that capital market interventions, such as taxes and other controls, are legitimate policy tools which can be used to reduce volatility associated with international capital flows (see Ostry and others, 2010). By that time, however, developing countries had already devised other means of coping with volatility; many, motivated in part by the desire to build self-insurance against future shocks, took advantage of the relative calm of the period 2003-2007 to accumulate reserves.

Countries with accumulated reserves had greater capacity for stimulus when the crisis struck

The strategy of building up international reserves—a costly one, particularly in terms of the opportunity cost of forgone domestic investment—paid off for economies whose reserves were ample when the 2008-2009 financial crisis struck. Such reserves were used to help moderate currency volatility, provide dollars to the local market, and create fiscal policy space. Reserves enabled seven East Asian economies, for example, to operationalize stimulus packages amounting to over 5 per cent of GDP.

⁴ Hedge fund managers receive annual performance fees. Mutual fund companies generally earn management fees based on asset size, but the growth of assets is usually tied to recent performance, and individual managers are generally compensated by the company based on the performance of their funds (see Sharma and Spiegel, forthcoming).

Reserve accumulation and ensuing global imbalances: a fallacy of composition?

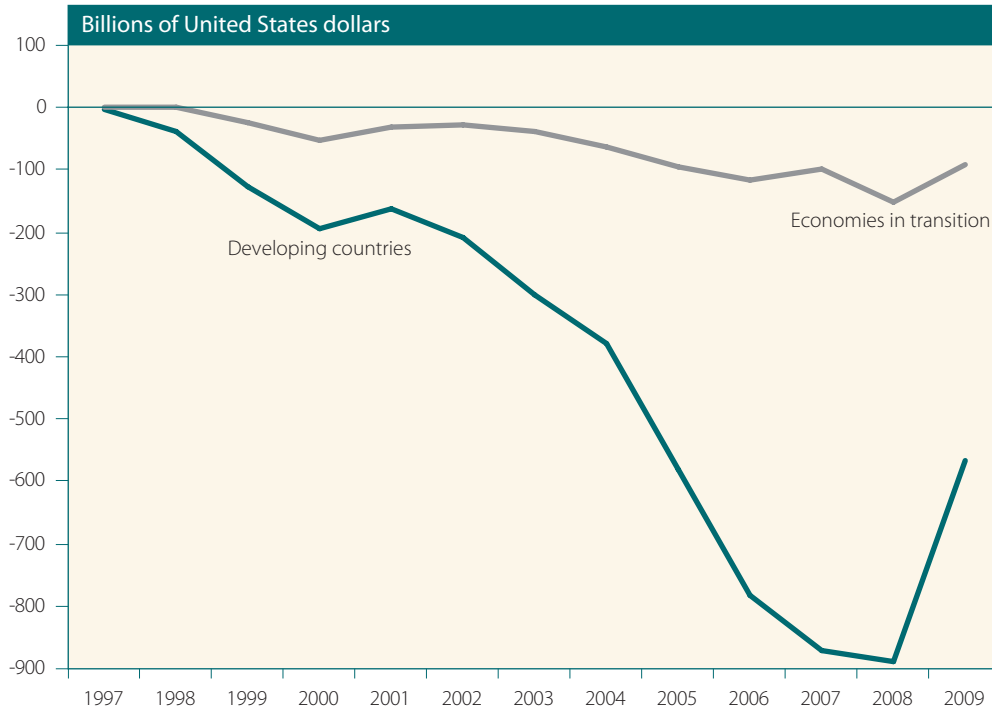
As indicated above, international reserve accumulation by monetary authorities constituted the most prominent policy shift effected in the wake of the Asian financial crises of the late 1990s. Reserve accumulation had risen to 11.7 per cent of world GDP by 2007, compared with 5.6 per cent of world GDP at the time of the Asian crisis (United Nations, 2009d). For developing and emerging countries, this policy served several purposes. For one thing, it provided self-insurance against sudden capital flow stoppages and in so doing, reduced the likelihood, should such stoppages occur, of a recourse to IMF pro-cyclical adjustment. (To avoid such a course was an objective pursued even by countries without strong export surpluses.) The policy also protected export-oriented stances by preventing exchange appreciation.

The obverse of this shift towards raising reserves was an increase in the demand for dollars and the provision of financing for widening current-account deficits incurred by the United States. There emerged a pattern of widening global imbalances including the unsustainable flow of investment resources from (paradoxically) poor countries as a group to the developed world (figure V.7).

The strategy of reserve accumulation to self-insure against volatile private capital movements is not sustainable because it suffers from a fallacy of composition. It would be sustainable only if there were at least one country large enough and willing to run consistent and ever larger current-account deficits. That the United States was providing the dominant reserve asset and had unlimited capability to do so meant that the process would continue long enough to become a global crisis.

International reserve accumulation by monetary authorities represented the most prominent policy shift

Figure V.7
Global imbalances: net financial transfers to developing countries and economies in transition, 1997-2009



Source: UN/DESA.
a Estimate.

To reverse global imbalances, developing countries would need to decrease, not increase, self-insurance. Yet, the success of self-insurance as protection during the crisis suggests that it will probably become even more popular going forward. It is unlikely that countries will become less dependent on self-insurance without a real decline in the vulnerabilities associated with volatile international capital flows.

The crisis demonstrates that the accumulation of deficits by reserve currency countries is not self-correcting

The current system requires that the country (or countries) providing the global currency run deficits to ensure sufficient liquidity to support the growth of global output and trade. The 2008-2009 global economic crisis demonstrates that the accumulation of deficits by the reserve-currency country, sustained by other countries because of their national policy objectives, is not self-correcting and leads to a crisis of global proportions whose costs are incurred by many innocent parties. The extent to which the authorities in major industrialized economies feel compelled to accumulate assets, for reasons related either to exchange rates or to self-insurance, will determine in turn the magnitude of the inevitable deflationary impact of such accumulation on developing economies' macroeconomic performance.

There are several instances where externalities arising from United States monetary policy have gone on to impact the rest of the world

One of the drawbacks associated with making the dollar the reserve currency is that the global economy becomes tied to United States monetary policy, while the United States Federal Reserve manages monetary policy based only on the state of the United States economy. There are several instances where externalities arising from United States monetary policy have gone on to impact the rest of the world. Perhaps the most significant case occurred in the early 1980s, when the Federal Reserve raised interest rates to 20 per cent to combat stagflation in the United States, thereby making it extremely expensive for developing countries to refinance their debt, and ushering in the 1980s developing-country debt crisis. During the present crisis, the Federal Reserve has kept interest rates low. One of the externalities associated with this policy is a huge increase in global liquidity from the Federal Reserve (and the European Central Bank), which is finding its way back into developing-country markets, thus creating a new surge in capital flows and potentially fuelling new bubbles. As a result, there have been new calls across the developing world for capital market regulations.

The way forward

The international financial system is failing to deliver sufficient and stable development financing

The international financial system is failing to deliver development financing in sufficient volume and with sufficient predictability to facilitate the kind of long-term investment and risk-taking needed to enable poor economies to achieve structural transformation. Reversing this unsustainable pattern will require the introduction of reforms to the global financial architecture, as well as a redirection of macroeconomic stances in developing countries and the retooling of monetary and fiscal policies.

Retooling development finance at the national level

Development-oriented macroeconomics

Development-oriented macroeconomics protects long-term investment plans in the face of downturns

The challenge of integrating macroeconomic policy objectives with those related to social development and poverty eradication was examined in chapter II. A development-oriented macroeconomic stance is predicated on the notion that current spending, particularly private and public sector investments, is the "bridge" to future employment and output

growth. Promoting current investment so long as it provides a reasonable probability of future return in terms of more output and durable jobs would be a consistent priority. Development-oriented macroeconomics protects long-term investment plans even in the face of increased public deficits induced by a downturn as long as it meets the criterion of ensuring permanently increased domestic capability in desired sectors in the future. This contrasts with the approach that prioritizes the achievement of fixed public deficit targets, independent of the cycle and the nature of the investment projects that have to be postponed or eliminated to meet them. It also contrasts sharply with the view that all current private-sector investments (investment implies that current-period private spending exceeds current-period income) that can be financed (most unsafely from external financing because of the potential for currency mismatches) must be protected, independent of the business cycle and the nature of the project involved.

A particularly cogent example of such a stance was China's macroeconomic response to the Asian crisis which began in 1997. According to Lin (2009, p. 31):

The Chinese government adopted a fiscal stimulus package in 1998-2002 to remove bottlenecks in infrastructure. In 1997 China had only 4,700 kilometers of highway, by 2002 this had increased more than five times to 25,000 kilometers. The transportation capacity improved greatly as did port facilities and the electricity grid. With that kind of fiscal stimulus, China maintained its average annual growth rate at 7.8 percent. More importantly, after the crisis the growth rate accelerated. Between 1979 and 2002, the average annual growth rate in China was 9.6 percent. And between 2003 and 2008, the growth rate actually increased from 9.6 percent to 10.8 percent. This growth was made possible by investment targeted to freeing-up bottlenecks, that is, those sectors constraining growth in the economy. As a result, though government debt as a percentage of GDP initially rose from about 30 percent of GDP to 36 percent in 2002 it then declined as growth increased. By 2006-2007, government debt had fallen to 20 percent of GDP.

Counter-cyclical macroeconomic policy in developing countries is desirable (see chap. II, as well as Ocampo (2003) and Ocampo and Vos (2008)) because it facilitates long-term private-sector risk-taking and investment. Most importantly, macroeconomic policy in developing countries should be endogenously counter-cyclical in order to protect necessary long-term public investments and other public spending on such future capacities as would be built into core social development programmes.

The implication of this stance is that, first of all, developing countries must construct the space and capability for development-oriented macroeconomic policy. This will be discussed below under the rubric of retooling monetary policy and retooling fiscal policy and stabilization funds. Second, in the context of limited investment resources in low-income countries, development-oriented macroeconomic policy requires constant management of external financing deficits, both public and private. In recent years, however, developing countries as a group were, instead, managing surpluses against developed countries; this state of affairs would be incoherent with respect to such a stance.

Retooling monetary policy

In developing countries particularly, monetary policy must be directed towards a broader set of targets. A basic reason why is that economic performance in developing economies is more dependent on the external sector. Another reason is that, as history suggests, benign

Counter-cyclical macroeconomic policy facilitates long-term private sector risk-taking and investment

Developing countries must construct the space for development-oriented macroeconomic policy

Monetary policy must take on a broader set of targets

institutional development in the domestic monetary and financial system does not occur without State leadership and regulation. Enhancing the domestic capacity to intermediate between savers and investors, particularly through the development of the domestic bond markets, increases the potency of monetary policy (United Nations, 2006b). States have had key roles to play in the establishment of liquid bond markets. Policies oriented towards expanding access by the population to financial services, as part of the social development effort discussed in chapter II, should be part of the monetary policy toolkit.

Inflation targeting has tended to sacrifice employment, wages and output

Inflation targeting, both in actual practice and as a still-to-be-achieved standard, has become the basis for a dominant monetary framework in both developed and developing countries. Its attraction lies in its “one (pre-announced) target/one policy instrument” approach, coupled with mechanisms holding monetary officials publicly accountable for meeting the target—after a period, in many developing countries, of structural reform establishing central bank political “independence”. Because inflation targeting has been applied utilizing very low inflation targets⁵ and has focused only on restraining prices of real goods and services, it has tended to sacrifice growth of employment, wages and output in favour of price stability. Interest rate-setting under inflation targeting reduces the scope for exchange-rate targeting, which is critical to sustaining exports and protecting domestic production and employment. Inflation targeting, coupled with central bank independence, also limits the ability of the government to borrow from the central bank in order to sustain development and social expenditures, which may affect growth in the long run.

It is often argued that inflation is harmful for the poor, but in fact it is the prices of food and other essential goods and services, and not aggregate inflation, that have the most direct impact on poverty. However, monetary policy is not the best tool for stabilizing prices of food and essential goods. In most cases, stabilization of prices of food and essential goods requires subsidies and hence falls within the domain of fiscal policy. Thus, it requires greater coordination between monetary and fiscal policy, especially when subsidies require government borrowing from the central bank.

Monetary policy should embrace a more diversified set of targets and instruments

Retooling monetary policy will require reinstating a more diversified set of targets and instruments for monetary policy. There should also be a reconsideration of targeted credit programmes, particularly those with large poverty reduction and low inflation impact. In a recent set of country studies from Latin America, the authors, writing from historical experiences of high inflation, expressed their belief that inflation as a sole target was inadequate and emphasized the importance of the real exchange rate as a key focus of monetary policy.⁶ Studies from Asia and Africa have suggested employment targeting, which would make monetary policy congruent with normal fiscal policy objectives.

Paying attention to asset price inflation is important

The global financial crisis highlights the importance of paying attention to the role of asset price inflation in monetary policy. The fact that asset price increases received little attention (and almost none under inflation targeting) facilitated the expansion of credit and leverage in the boom phase, which often increased systemic risk. Expansion of the use of tools of monetary policy to increase margin requirements so as to reduce leverage or to impose ceilings for lending in specific sectors (a case of selective credit dis-allocation) has often been needed in resisting asset price bubbles. The role of prudential regulation in limiting systemic risk arising from asset bubbles is discussed below.

Open capital accounts subject developing countries to asset price-driven cycles

Open capital accounts subject developing countries to asset price-driven cycles, reducing the power of monetary policy. With open capital accounts, developing countries have seen even perverse outcomes of the implementation of interest-rate policies. For example,

⁵ Recently, in a staff paper (Blanchard, Dell’Ariccia and Mauro, 2010) reflecting a change of heart, IMF opined that an inflation rate of 2 per cent was too low and proposed a target of 4 per cent.

⁶ Multi-country evidence can be found in Epstein and Yeldan, eds. (2009).

attempting to prick a domestic asset bubble by raising the interest rate can provoke more capital inflows from the global savings pool and further inflate the domestic bubble. Putting in place effective capital controls helps to re-establish monetary policy tools.

Retooling fiscal policies and stabilization funds

Retooling fiscal policy must be directed at recovering its capacity to mobilize financing for long-term public investment and social development, as discussed in chapter II. Domestic resource mobilization is the key challenge. For many countries, continued reliance on trade taxes is consistent with a still underdeveloped tax system, on the one hand, and social and industrial development objectives, on the other, which reverses the priorities of recent decades. Precipitous tariff reductions, particularly in least developed countries, have not only reduced tax revenues that have not been made up by value-added taxes, but have also increased the vulnerability of small domestic enterprises with respect to competition from foreign imports.⁷ Developing countries must steadily broaden their tax bases to include, in particular, income and property taxation. An increased reliance on revenues from income and property, in contrast with priorities in recent decades, ensures that tax revenues more than match economic growth so as to ensure the timely build-up of public capabilities in anticipation of increased demands on these capabilities as the economy grows more complex. Effective income and property taxation would be facilitated significantly by strengthened international tax cooperation (see below) focused on more effective revenue streams from global value chains and reduced tax competition. As automatic stabilizers, a more progressive tax system and a larger publicly supported social sector offer counter-cyclical advantages.

Avoiding pro-cyclical biases in fiscal policy is important (United Nations, 2009d). Targeting the “structural deficit” (the budget balance if cyclical fluctuations are not included) implies that public deficits will be allowed to decline in booms and increase in downturns. The desired level of the structural deficit could be set so as to be consistent with medium-term objectives in output and employment.

Establishing stabilization funds could be effective in economies where commodity prices have strong effects on the macroeconomy (United Nations, 2009d). These funds have been utilized successfully in Algeria, Chile, Colombia, Ecuador, Kuwait and Mexico, albeit less successfully in the Bolivarian Republic of Venezuela. The design and operation of these funds are by no means straightforward matters, depending as they do on the strength of fiscal institutions; appropriately designed international compensatory finance mechanisms are therefore indispensable (see below).

Debt management

Because of the implications of deficit spending, coherence between a development-oriented macroeconomic policy and debt management will be critical. Developing-country authorities must not only effectively manage their own domestic and external debt obligations, but also monitor and regulate those of the private sector, particularly its external liabilities, given that even completely private debt contracts become public responsibilities in the event of a financial or payments crisis. Regulating private external liabilities will require effective policies associated with capital-account controls. In the case of public liabilities, the mix of external and domestic obligations requires special attention. Policies that expand domestic public debt merely to sustain external service obligations tend to crowd

Domestic resource mobilization is the key challenge

Establishing stabilization funds could be effective

Developing-country authorities must monitor and regulate private sector external debts

⁷ See Baunsgaard and Keen (2005); and Memis, Montes, and Weeratunge (2006).

out domestic investment and induce higher domestic borrowing costs, and hence must be avoided. In such a situation, a more coherent policy would entail restructuring external debt obligations, which only underlines the need for a coherent international debt mechanism, as discussed below.

Financial sector development and prudential regulations

The public sector has to play a leading role in domestic financial market development

The public sector has to play a leading role in domestic financial market development in developing countries. At low levels of development, this is not a matter of choice: Public sector liabilities are often the only generally traded financial assets in the banking sector, which is why effective public sector debt management is a necessary condition for domestic financial development. As development proceeds, a deep and well-functioning domestic financial sector can help scale up financing of government investment priorities.

Domestic prudential authorities have also been under pressure to adopt international prudential standards

Building and retaining both macro- and microprudential regulatory capabilities are critical to financial sector development. As discussed in chapter IV, commitments under the General Agreement on Trade in Services (World Trade Organization, 1994) and free trade and bilateral investment treaties have caused a premature dismantling of capital controls and regulatory oversight over the mix of private financial services.⁸ It is important that ongoing global efforts directed at financial regulatory reform clearly demonstrate that domestic authorities' regulatory responsibilities take precedence over commitments under the General Agreement on Trade in Services. Domestic prudential authorities have also been under extreme pressure to adopt international prudential standards, such as those emanating from the Bank for International Settlements, in order to retain access to external financial resources and services. Owing to the limited participation of developing countries in their design, the most recent international banking prudential standards possess many features that are either irrelevant to, or too costly to implement in, developing countries. Moreover, as the crisis has also proved these standards to be highly counter-cyclical, they are now subject to redesign as part of global regulatory reform efforts. This should offer the opportunity to elicit greater developing-country participation in standards design, including the possible incorporation of rule-based differential treatment for countries with less developed financial sectors. Strengthened domestic capacity in prudential regulation will require a domestic capacity to adapt and implement international standards based on local conditions, with a view to ensuring that those regulations are counter-cyclical in nature. Financial regulations should also promote greater access to finance, including through the provision of credit to underserved groups, while protecting consumers.

Regulations can be designed to be counter-cyclical

Regulatory structures should also be designed to reduce asset and liability risks, such as currency mismatches, and these rules need to encompass cases of indirect exposure of firms and other domestic agents that have borrowed from the banking system, as such exposure can have systemic impacts, like those experienced by countries in Eastern Europe during the recent global crisis. There are numerous ways to achieve these objectives (see Stiglitz and others, 2006) including through outright restrictions on foreign-exchange exposures and loans, higher capital requirements for short-term lending in foreign currencies, and adverse tax treatment for foreign currency-denominated borrowing (especially when it is short-term). The goal would be to establish a simplified set of rules which reflect local regulatory capacity. Similarly, Governments can target exposures to risky sectors that

⁸ Gallagher (2010) provides details on how commitments under the General Agreement on Trade in Services and investment treaties restrict the regulation of financial services.

are prone to speculative bubbles, such as real estate, by imposing restrictions or higher capital requirements on these sectors. These types of regulations can be designed to be counter-cyclical, so that the cost is tied to the proportion of a bank's assets in the sector concerned, based on the forward provisioning discussed above.

Since the 2008 crisis, increased attention has been paid to regulations that focus on systemic risk, such as leverage across the financial system and risks generated by large interconnected institutions. These macroprudential regulations aim at reducing the pro-cyclicality of finance and its effects on the real economy, and are designed to limit credit growth during boom periods and ease credit contractions during economic slowdowns. Hence, in order for macroprudential regulation to be effective, regulators need to be able to monitor systemic risk throughout the entire financial system, including the shadow banking system. The existing regulatory structure needs to be redesigned so as to enable it to address this gap in the system, as well as other failures discussed above.

Through the complexity, lack of transparency and the increased leverage involved, the growth in derivative products has increased risk in the financial system. This is a key issue for developed-country markets, where multilateral progress in undertaking reforms has been slowed by technical disagreements and competitive pressures among financial centres. For developing countries, what is at stake is the impact of derivatives on the overall stability and flexibility of international financial markets, including their ability to operate development trust funds (see below), and their specific impact on commodity prices. In recent years, financially driven trading on futures contracts appeared to have had significant and abrupt price impacts which in turn introduced difficulties related to balance of payments, fiscal deficits and the availability of fuel and food in many developing countries.

Capital controls

As argued above, capital flows to developing countries are often short-term in nature and appear not to have contributed to higher rates of long-term investment. Rather, they have tended to contribute to economic volatility in many developing-country contexts. The pro-cyclical nature of these flows makes macroeconomic management more challenging.

Since the Asian crisis of the late 1990s, a primary policy response of developing countries with respect to mitigating the effects of volatile capital flows has been to amass large international reserves. However, the cost of this form of self-insurance has been high and potential unwinding, in this regard, is an additional source of global instability, as discussed above. Capital controls could be regarded as an alternative and possibly less costly policy tool for addressing capital flow volatility.

There are several different types of capital controls, including price-based ones, such as taxes on inflows, that act as "speed bumps", similar to the forward-looking provisioning discussed earlier. By making capital inflows more expensive, these controls reduce the volume of inflows during a boom, thereby limiting the expansion of the bubble. Chile and Colombia used price-based controls effectively in the late 1990s, and Brazil implemented them in the fall of 2009, in the face of resurging short-term capital inflows. Alternatively, some countries, like Malaysia during the Asian crisis, instituted quantity-based controls on inflows, outflows or both. What type of controls work best depends on the specificities of the country's markets, as well as the strength of its administrative capacity to apply capital controls. Countries often have been reluctant to use capital controls, fearing a possible backlash from the markets. Regional coordination, with a group of countries implementing

Leverage across the financial system and risks generated by large interconnected institutions are a source of systemic risk

Financially-driven trading on futures contracts appeared to have had significant and abrupt impacts on commodity prices

There are several different types of capital controls

controls at the same time, could help shield any one country from having to bear solely the stigma associated with such an undertaking, but it would not reduce the perception in the markets of increased risk. IMF could have a significant role to play here. Given the wider recognition that capital-account liberalization is proper only for economies that have reached a certain level of development (Kose, Prasad and Taylor, 2009) and the fact that the Fund is still bound by its Articles of Agreement to enforce capital controls, it is time for this and other institutions to enhance their capacity to monitor the workings of private international asset markets—including through increasing staff skills—so as to be in a position to assist countries in implementing effective capital-account controls.

Closed-end trust funds for development financing

Trust funds constitute one means of putting developing countries in the driver's seat in respect of the use of external assistance

As first mentioned in chapter III, establishing closed-end trust funds is a potentially effective means of putting developing countries in the driver's seat in terms of the application of external funding and the management of aid and capital flows for macroeconomic stability. The setting up of trust funds for individual countries and for subsets of countries already has precedents and can be expanded.

Ensuring that these funds were controlled by recipients would be a key requirement. The funds could issue "A" voting shares and "B" non-voting shares, with rules on how many of each type parties of different kinds could purchase. They could also issue their own bonds to provide private investors with one non-speculative means of possibly sharing in the development of a country. As in the case of advance market commitments, these funds could become the preferred destination of official development assistance (ODA.) In establishing these funds, there should be clear rules regarding what kinds of flows they would receive and for what kinds of purposes their resources could be utilized and under what conditions.

Recycling resources in international reserves to domestic investment is one possibility

Trust funds could be a depository of commodity stabilization funds and part of a country's reserves could be invested in trust funds (D'Arista and Erturk, 2010). The trust funds could issue GDP-linked bonds, in which multilateral financing institutions might consider taking portfolio positions. In the Asia and Pacific region, there have been proposals on establishing financing mechanisms designed to redirect the substantial international reserves accumulated by some developing countries in developed-country financial instruments towards financing regional infrastructure requirements (United Nations, Economic and Social Commission for Asia and the Pacific, 2006).

A closed-end structure for these funds is consistent with its development assistance purpose

The advantages of a country-controlled trust fund mechanism designed to absorb aid flows are particularly attractive. Bilateral donors and existing global funds would contribute to trust funds, which would disburse funds to and collect resources from recipient countries in accordance with programmatic and budgetary needs. Donors would be able to disburse their aid without necessarily undermining the macroeconomic stability of the recipient countries since the trust fund could serve as a smoothing mechanism for the use of donor funds. A closed-end structure for the fund is most consistent with its development assistance purpose: a closed-end fund is not obligated to service redemptions even though its shares could be traded in financial markets. Countries could invest part of their international reserves in the fund which would in effect serve as a means of recycling their savings for their own development needs. Trust funds could be administered by professional investment advisers and controlled by the country government in which donors would be adequately but not overwhelmingly represented.

The trust funds could also be allowed to purchase government securities of developing countries so as to tie aid to future domestic resource mobilization efforts. Experience exists in this area: in a number of cases, multi-year aid commitments have been converted into bond purchases to fund and front-load resources for tropical medicines. Recipient countries, in turn, could also be allowed to periodically deposit part of their savings into these funds as insurance against shocks, and draw upon them in response to shocks. In the same vein, the trust funds could serve as a vehicle for channelling resources made available through international compensatory financing mechanisms and allocations of special drawing rights (SDRs). This would help align use of short-term financing needs with long-term development objectives. In fact, one proposal contained in the Monterrey Consensus of the International Conference on Financing for Development (United Nations, 2002) was to use SDRs for development purposes and the ODA trust funds could provide the institutional setting within which to do so.

D'Arista and Erturk (2010) present other possible features of these funds as related to their structure, their governance and their investment strategies.⁹ These funds could issue their own liabilities in a variety of national currencies and use the proceeds to pay for stocks and bonds of private enterprises and public agencies denominated in local currencies across a wide spectrum of developing countries. The funds' liabilities would be marketed both to private institutional investors in advanced economies and to official investors from emerging economies and would also qualify as international reserves guaranteed by a multinational agency and its member countries. Investing the reserves of developing countries in these funds would redirect external savings back into the economies of the countries that owned the reserves rather than into the financial markets of strong-currency countries. Moreover, their closed-end structure would ensure that long-term funds were provided and that sales of the funds' liabilities by investors did not force redemptions that could disrupt development projects.

Retooling the international financial architecture

Global monetary and financial arrangements are inconsistent with the requirements of development-oriented macroeconomic policy. These rules and mechanisms will need to be transformed if policy coherence is to be achieved. This being said, it must be emphasized that the reforms discussed below constitute an ensemble of interlocking pieces which have to be set in place simultaneously.

Multilateral macroeconomic coordination and surveillance

There is a need to revise multilateral surveillance and direct it towards taking on board international spillovers of national economic policies. Surveillance by IMF had previously focused on problems in emerging markets and developing countries, while devoting insufficient attention to major financial centres and the vulnerabilities within global financial markets. The global financial crisis has made clear the fact that there is an urgent need to strengthen vigilance over risks emanating from the major developed countries, especially the reserve currency-issuing countries. This will require better cooperation on the part of monetary and financial authorities from mature financial markets and advanced economies, which must bear the burden of greater responsibility for systemic stability.

⁹ The following description is based on the paper of D'Arista and Erturk (2010, p. 21) which was commissioned for this publication.

There are precedents for turning multi-year aid commitments into bond purchases

Required reforms constitute an ensemble of interlocking pieces which have to be set in place simultaneously

Surveillance activities need to devote more attention to major financial centres

Institutionalizing
macroeconomic coordination
avoids conflicts over
surveillance activities

Surveillance must differentiate among countries in terms of their influence on systemic stability, and must be more rigorous for countries issuing major reserve currencies.

Strengthening and institutionalizing international macroeconomic coordination are essential to reducing the policy conflicts over surveillance activities. Macroeconomic coordination must be development-oriented. First, it must ensure that the composition of aggregate demand assigns greater weight to investment in support of future productivity growth and the transformation needed to establish low-emissions and renewable energy sectors and infrastructure required to meet the challenge of climate change (see box V.2). Second, demand across countries will have to be rebalanced in such a way as to ensure that financing is actually channelled to developing countries, rather than to developed countries. Sustaining strong demand in the developing countries, particularly investment demand, would be consistent with a development-oriented macroeconomics. In the current situation, rebalancing demand by relying on consumption demand in the United States would also be undesirable—and unlikely—since United States households already increased savings to

Box V.2

Challenges in financing the global climate change response

The estimated additional investments needed to address the adaptation to and mitigation of climate change are large in absolute terms. It is often pointed out that these constitute only a small fraction of world output, in the order of 1 and 2 per cent of world gross product (WGP) per annum by 2030. At present levels of WGP, this would amount to between \$0.6 trillion and \$1.2 trillion per annum in new investments. As analysed in detail in *World Economic and Social Survey 2009: Saving the Planet, Promoting Development* (United Nations, 2009a), rather than delayed until 2030, many of these investments will need to be front-loaded, both to effectuate the urgent shift to a low-emissions economy and to minimize the damage from unavoidable changes in the climate.

Climate change is already affecting livelihoods in many countries, especially developing countries and small island developing States, including through more frequent and intense weather shocks. Measures for climate change adaptation therefore need to be implemented now so as to avert major impacts in the form of greater food insecurity, water scarcity and lives lost through natural disasters, among others. Technologies to generate clean energy for climate change mitigation do exist, but are still utilizable only at a multiple of the cost of those technologies using coal and fossil fuels which are the main source of greenhouse gas (GHG) emissions. To make renewable energy more affordable and accessible in amounts sufficient to meet higher demand from developing countries as they try to accelerate economic progress and to ensure that GHG emission-reduction targets are met in a timely manner, clean energy production will need to be carried out on a much larger scale, which would require massive investments starting today.

Front-loading of such investments will put pressure on the financial system in respect of mobilizing the required resources. *World Economic and Social Survey 2009* (United Nations, 2009a, table VI.2) estimates that 34–57 per cent of the additional global investments for climate change mitigation and most of those for adaptation would need to take place in developing countries. Despite the recent proliferation of climate-related funds, the amount currently promised and expected to be available for meeting the climate challenge in the near term, from bilateral and multilateral sources, is woefully inadequate. Current dedicated climate resources have been estimated at about \$21 billion and are very heavily skewed towards mitigation. Estimates of the annually required total amount of climate financing for developing countries vary, but on all counts they are a large multiple of that figure and total up to as much as about five times the 2008 levels of official development assistance (ODA). The difficulty involved in reaching even those levels of ODA suggests that global financing for climate change will require a much more determined effort on the part of advanced countries to provide bold leadership on the climate issue and bolster international cooperation. And it will also require an effort on the part of developing countries to mobilize a larger share of their resources for cleaner investments along a new, sustainable growth path.

Box V.2 (cont'd)

The purpose of a sustained injection of external financing in amounts large enough to give the “big push” needed to embark on a low-emissions development path is to simultaneously accelerate and sustain growth in developing countries at levels higher than in the past. As discussed in the 2009 *Survey*, this initial big push from official sources of finance, in combination with various policy mixes, including price incentives, regulation and targeted industrial policies, would begin to raise domestic sources of finance for investment in both the public and the private sectors. The evolving mix of public and private investment will no doubt vary among countries, but for many developing countries, and possibly for some developed countries, public investment would have to take the lead, along with stronger regulations, before large-scale private investment began to materialize.

The need for sizeable external financing to address climate change in developing countries appears to be at odds with present patterns of global resource transfers. Net financial transfers to developing countries have been negative over the past two decades at least (see figure V.7). The resource flow from poor to rich countries exceeded half a trillion dollars annually in the last three years. A big push oriented towards investing in clean energy in developing countries would thus require reversing this trend. It also follows that the mobilization of climate financing will need to be aligned with coordinated policy efforts to deal with the problem of global imbalances.

The United Nations Framework Convention on Climate Change^a commits developed countries to: (a) providing “new and additional financial resources to meet the agreed full costs incurred by developing countries” in complying with their national communication requirements under article 12 of the Convention (article 4, para. 3); and (b) providing “such financial resources, including for the transfer of technology” needed by developing countries “to meet the agreed full incremental costs” of implementing mitigation and adaptation actions and other commitments identified in article 4, para. 1.

At the fifteenth session of the Conference of the Parties to the United Nations Framework Convention on Climate Change, held in Copenhagen from 7 to 19 December 2009 (the United Nations Climate Change Conference 2009), the Conference of the Parties took note of the non-legally binding agreement entitled the “Copenhagen Accord”.^b

The Accord, which had been agreed by the Heads of State, Heads of Government, Ministers and other heads of delegations present at the Conference, contains voluntary goals and actions on climate change that address key components of the Bali Action Plan, adopted by the Conference of the Parties at its thirteenth session, held in Bali, Indonesia, from 3 to 15 December 2007.^c The Accord tackles one of the major stumbling blocks introduced in prior negotiations by recognizing the need to mobilize new and additional predictable financial resources. As steps in the direction suggested above, the additional financial resources for addressing climate in developing countries would need to reach \$30 billion for the period 2010-2012 and to be scaled up to \$100 billion per year by 2020 (para. 8). The Accord also acknowledges the need for the establishment of a Copenhagen Green Climate Fund as an operating entity of the financial mechanisms of the United Nations Framework Convention on Climate Change to support projects, programmes, policies and other activities in developing countries related to mitigation, adaptation, capacity-building, technology development and transfer (para 10).

Aside from having to contend with the insufficient scale of funding, climate change financing must also wrestle with the proliferation of funds and a spaghetti bowl of funding mechanisms and conditions (Opschoor, 2010; and United Nations, Economic and Social Council, 2010). The related problems are akin to those associated with the broader aid architecture discussed in chapter III. The World Bank alone has three specific funds: a Clean Technology Fund, a forest fund and an Adaptation Fund. In the climate negotiations, developing countries have proposed that all climate change-related funding be placed under the umbrella of the United Nations Framework Convention on Climate Change. Whether this proposal will be adopted or not, the establishment of the Copenhagen Green Climate Fund should be seen as offering the opportunity to get a head start on the much-needed reform of the climate change financing architecture at large, including the streamlining and consolidation of funding mechanisms, in order to create greater cohesion, transparency and accountability in the allocation of the required resources.

^a United Nations, *Treaty Series*, vol. 1771, No 30822.

^b See FCCC/CP/2009/11/Add.1, decision 2/CP.15.

^c See FCCC/CP/2007/6/Add.1, decision 1/CP.13.

about 3 per cent of GDP during 2009 (from almost zero in the years leading to the crisis). Since rates of capacity utilization are at historic lows, private investments are also expected to remain weak in the major developed economies. With the prospective phasing out of the fiscal stimulus, net exports of the major deficit countries would need to increase. Starting with China and other parts of developing Asia, major surplus countries will need to absorb the rising exports of deficit countries. In surplus countries, this could be through fiscal stimulus. According to *World Economic Situation and Prospects 2010* (United Nations, 2010, p. 31):

The stimulus packages that are in place are already supportive of this kind of rebalancing but are as yet not strong enough, and the change will only come gradually. GDP of the countries of emerging Asia is roughly half that of the United States, so they would need to lower their combined current-account surpluses by about 6 per cent of their combined GDP to lower the United States deficit by, say, 3 per cent of its GDP.

The objective of the Group of Twenty (G-20), which is to achieve a strong, sustainable and balanced world economic growth, can be operationalized only within this kind of framework. Sustainable rebalancing of the world economy will take many years and such a framework cannot be left to ad hoc consultations at the G-20 level. The monitoring of business cycles at the global level and the triggering of multilateral discussions and responses should be institutionalized within the multilateral system. The technical capacities of global agencies with macroeconomic and financial mandates, in respect of designing counter-cyclical policy, must be enhanced. Enforcement mechanisms will need to be designed to make policy coordination effective and accountable.

Monitoring of business cycles at the global level should be institutionalized

International coordination of financial regulation

Delivering sufficient long-term finance for development can be achieved only within the context of a sound international financial system. Financial markets are now global and a failure in the financial system in one country can impose negative externalities on others, as was seen in the emerging market crises of the 1990s and the 2000s and in the more recent global crisis. Inasmuch as countries are all unique, some regulations will likely always be developed to fit the circumstances of a specific country. However, without global coordination, there is the danger that investors will engage in regulatory arbitrage between different regulatory frameworks, often through complicated derivative products, thereby disseminating increased risk throughout the global financial system.

Financial market regulation should aim at ensuring the safety and soundness of the financial sector, while maintaining a broad focus on systemic stability. Authorities in larger mature financial markets bear the onus of responsibility for ensuring that their market activities do not unduly destabilize the international economy. Many features of the existing risk assessment methods and prudential rules, such as Basel I and Basel II, such as loan-loss provisioning, have been seen to exacerbate cyclicity (United Nations, 2008). In the Asian financial crisis of the late 1990s, Asian countries particularly were adversely affected by prudential rules in the major financial markets, and as a result experienced a credit crunch on top of the sudden stop in short-term capital inflows. There is a need for a global mechanism capable of setting standards applicable to all. The conversion of the Financial Stability Forum to the Financial Stability Board represents a step in this

Financial markets are now global and a failure in the financial system in one country can impose negative externalities on others

direction. However, the Financial Stability Board suffers from inadequate representation and inadequate enforcement power. An evolution towards a World Trade Organization-like regime, with enforceable rules, has also been suggested. The Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System proposed taking steps to lay the groundwork for a global financial authority charged with coordinating financial regulation, including oversight of global rules in certain areas, such as money-laundering and tax secrecy.

Counter-cyclical financing to mitigate external shocks

Protecting economic growth from commodity price changes in such a manner as not to introduce debt vulnerabilities has long been identified as a financing-for-development need. There are two general kinds of external shocks: commodity price shocks and global demand shocks. The IMF Compensatory Financing Facility, which had been a mechanism of long standing designed to deal with the first kind of shock, was particularly valuable for low-income countries. The Facility was gutted in 2001 and folded into the poverty reduction strategy, which effectively made access to finance in order to deal with commodity shocks conditional on domestic economic policy and governance reforms, even though the balance-of-payments problem in the case of commodity price shocks is not due to domestic policies or mis-governance.

The principles according to which such financing should be provided are clear enough. Resources should be made available: (a) in a timely manner, (b) in sufficient quantity to permit the affected country to finance essential imports and (c) with no conditionality with respect to covering an external deficit that had nothing to do with domestic policy. Recent reforms of IMF credit facilities, in effect restoring many of the features of the previous “compensatory financing” facilities, will need to be institutionalized as far more than a crisis response, and in a form that would include increased access for all low-income countries.

The provision of properly designed compensatory financing mechanisms as described above is particularly relevant to commodity shocks. For global demand shocks, there exists a need for the capacity to provide—and by extension create—global liquidity through the possibly increased use of SDRs—a capacity that, as the current crisis demonstrates, is available only on an ad hoc basis (see below for a further discussion).

There are associated policies, which by nature are also counter-cyclical, whose introduction would improve macroeconomic performance. In respect of traditional external commodity price shocks, countries should be building up stabilization funds during periods when prices are high in order to ride out the periods of price slumps. In the long run, developing countries must acquire sufficient policy space and demonstrate sufficient audacity if they intend to diversify domestic production so as to progressively reduce dependence on commodity earnings (see chaps. II and IV). Incorporating state-contingent features in external assistance programmes and debt contracts can be critical to debt-distressed commodity-dependent countries (Nissanke and Ferrarini, 2007).

International tax cooperation

The potential for increasing development finance simply through a strengthening of the capacity of developing countries to collect their proper share of taxes—particularly from international private enterprises (part of global value chains) (see chap. IV) that operate within their

Providing for support in response to external commodity price shocks has been critical

Commodity-dependent countries should be building up stabilization funds during an upturn

Cooperation is required to strengthen the capacity of countries to collect their fair share of taxes

borders and in turn pay taxes in countries that provide ODA—was examined in chapter III. The conservative estimate¹⁰ of \$250 billion per year as representing additional tax revenues from these sources that could be made available to developing countries would be equivalent to a tripling of the resources now being provided through ODA (FitzGerald, 2010).

With the widespread dismantling of capital controls, the international relocation of assets not only for tax purposes but also for regulatory arbitrage, if not evasion, has been facilitated by the infrastructure built up as the international financial industry grew. Heightened capital mobility, in the absence of tax harmonization and financial regulatory coordination among countries, has in turn spurred regulatory and tax competition among jurisdictions, which has resulted, whether intentionally or not, in a clear-cut diminishment of the capacities of tax and financial authorities to secure the information required for financial supervision and tax collection.

In the context of transnational economic activities, developing countries have to find a “balance between maximizing their share of revenues and maintaining a climate that attracts inward investment” (FitzGerald, 2010, p. 5). A basic principle should be that, whatever tax and regulatory stances sovereign countries choose, they must not be undermined by the tax and regulatory stances of other countries. Strict reporting and regulation in one country can be circumvented in the absence of the cooperation of others because of the ease with which assets can be transferred. Because State revenue generation must keep in step with the growth process if State capabilities are to develop, reliance on income and capital taxation is unavoidable. However, with the international mobility of assets and the capabilities of transnational corporations with respect to reapportioning income to their own tax advantage using transfer pricing, “effective income taxation . . . becomes an international rather than a national development issue” (ibid., p. 6).

Strengthened international information exchange and cooperative enforcement will be required. Greater capacity on the part of and cooperation among Governments with respect to monitoring transnational financial activities—a need heightened by the global crisis will be required to protect both their tax bases and the viability of their financial regulations. Undertaking this task within a broader framework than that possible under the auspices of the Organization for Economic Cooperation and Development (OECD) will thus be critical. This need is already being realized through the coordination of financial regulation spearheaded by the G-20. It will be necessary to widen the scope of multilateral tax cooperation along the same lines, which might require greater reliance on the framework provided by the United Nations.

International debt contractual arrangements and resolution

Another set of important reforms centre on the issue of sovereign debt restructuring. As is the case for banks that are “too big to fail”, there is no legal framework within which a country can restructure its debt. The result is that sovereign restructurings have been incomplete, chaotic or both and have entailed huge costs, as discussed above. The uncertainty surrounding the restructuring process is another reason why countries have been building self-insurance in the form of reserves (Herman, Ocampo and Spiegel, 2010; and Ocampo and others, 2010). To address this issue, some form of sovereign bankruptcy

¹⁰ The estimate is based on the assumption that one half of the stock of assets from developing countries held abroad [in turn, estimated using flow data calculated by the Global Financial Integrity study (Kar and Cartwright-Smith, 2008) for the mid-2000s] is owned by developing-country residents. A 7 per cent rate of return and a 20 per cent tax rate are then applied to assets held abroad by developing-country residents in order to arrive at lost tax revenues.

Strict reporting and regulation in one country can be circumvented without the cooperation of other countries

Sovereign restructurings have been incomplete

framework, with a fair arbiter, needs to be developed. There have been many proposals put forward regarding the form that such a court or arbitration mechanism should take,¹¹ but to date the international community has not moved forward on any of them. Owing to the new crisis in the euro area sparked by the obligations of Greece, the issue of sovereign debt restructuring has been raised once again. This gap in the financial architecture must be filled if the global system is to become more stable.

Current debt-relief and restructuring approaches, and their associated conditionalities, have not paid sufficient attention to basic growth requirements and the corresponding expansion of policy space genuinely needed to make possible the overcoming of debt distress (United Nations, 2005; United Nations, General Assembly, 2007). The present arrangement at the Paris Club of Industrial Country Creditors violates commonly accepted norms of good governance which would call into question any process in which an ad hoc committee of creditors passes judgement on debtor country obligations (United Nations, General Assembly, 2007) that are enforced under the auspices of IMF. This process also conflicts with the spirit of political agreement reflected in the Monterrey Consensus, which affirms that “[D]ebtors and creditors must share the responsibility for preventing and resolving unsustainable debt situations” (United Nations, 2002, para. 47).

Moreover, the arduous Paris Club process does not result in a true resolution of debt claims. Other donors and lenders, who are not associated with the Paris Club, are becoming significant players in this arena and must find other means to enforce their claims. Debt-relief commitments under the Heavily Indebted Poor Countries (HIPC) Initiative are hobbled by the non-participation of these other creditors. In the absence of an international legal regime responsible for adjudicating debt claims, some private parties, who have come to be called “debt vultures,” have managed to institute legal proceedings in financial sector jurisdictions with a view to profiting from sovereign debt distress. There is thus a need for a fair and internationally accepted debt workout mechanism for official debt obligations that applies to all creditors.

On the lending side, improved international financial regulation is needed to stem excessive risk-taking and capital flow volatility. A 2007 report of the United Nations Secretary-General warned that “limited progress has been achieved in surmounting the incentive structure that has seen overextension of private credit to developing countries during episodes of greatly increased global liquidity” and that the “present liquidity conditions are not expected to persist much longer” (United Nations, General Assembly, 2007, para. 107). Indeed, the global liquidity conditions have shifted drastically. As indicated by the Group of Thirty (2009), there is a critical need to plug gaps and weaknesses in the coverage of prudential regulation and supervision; to improve the quality and effectiveness of prudential regulation and supervision, including through appropriate capital controls and macroprudential regulatory reforms; to impose counter-cyclical biases in rules for reserve requirements and loan-loss provisioning; and to strengthen institutional policies and standards, including in accounting and public disclosure, and the transparency of financial markets and products.

Global reserve and payments system

As discussed above, the build-up of global imbalances to global crisis levels may be traced back to a trap inherent in the reserve and payments system, whereby reserve-creating countries are able to run payments deficits as long as other countries find it in their

Debt relief approaches have paid insufficient attention to growth requirements

There is a need for a fair and internationally accepted debt workout mechanism

The build-up of global imbalances may be traced back to a trap in the global reserve and payments system

¹¹ See Herman, Ocampo and Spiegel (2010) for alternative proposals.

interest to keep building up their international reserves in the currencies of the reserve-creating countries. If this trap is not eliminated, all financial regulatory reform will come to nought, because the mechanism facilitates an almost unlimited supply of credit from reserve-accumulating countries, resulting in increased global liquidity, which in turn has to be intermediated by the financial industry. What is required is a reserve and payments system that does not rely on national deficits to provide reserve assets.

Before the crisis, there had already been a move towards a multi-currency reserve system, which became more pronounced with the introduction of the euro. At this point in time, it is impossible to predict how the situation will evolve, absent an explicit political process. Currently, authorities managing both the euro and the dollar find themselves heavily restrained from attempting to prop up their currency's reserve status. While a multi-currency system could be the default outcome, further evolution in that direction would be undesirable, since it might revive the instabilities seen in the 1930s and exacerbate the instabilities already in play among the major currencies.¹² For developing countries, such instabilities would hamper exchange rate setting as a policy tool, unless they continued to accumulate international reserves. First, a multi-currency system would make it harder to target a real exchange-rate level consistent with stable growth in the face of the gyrations in exchange values among the major currencies. Second, under a multi-currency system, short-term capital flow movements stimulated by interest-rate differentials or business sentiment or both in the major markets tend to be sizeable and thus the dominant determinant of exchange-rate fluctuations. A system of more stable exchange values, whether anchored on one currency (as was the case for the system that existed before 1971) or on a special drawing right-type asset, would moderate these flows and reduce developing-country exchange rate setting dilemmas (United Nations Conference on Trade and Development, 2009b).

A feasible evolutionary path towards a more stable system is one along which there is an increased use of SDRs, within a system of nationally supplied reserve assets, dominated by the dollar. The current crisis has already seen a more than 10-fold ad hoc increase in the total quantity of SDRs in existence. The SDR, already the unit of account of IMF, is a basket of four currencies—the dollar, the euro, the Japanese yen and the pound sterling. The weight of each currency in the basket, last revised in November 2005, is based on the value of the exports of goods and services and the amount of reserves denominated in the respective currencies held by other members of IMF. In the future and given the changing weights in the global economy, other currencies, including those of emerging market economies, would need to be included in the SDR basket.

The members of IMF could start a process directed towards increasing the use of SDRs as a currency for central bank operations among themselves (though under the present rules, the United States has a single-country blocking vote on the issue of increased SDR allocations). SDRs could be increased through periodic allocations in line with the expansion of international commerce. The Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and

¹² Attempting to stabilize exchange rates among the major currencies in a multi-currency system is particularly difficult. According to D'Arista and Erturk (2010, p. 14):

When a central bank bought another country's currency to push up that currency's value, it invested its holdings in credit market assets such as bank deposits or government securities issued by that country and thus added to the recipient country's credit supply. Assuming the acquired currency had fallen in value as a result of expansive monetary or fiscal policies, intervention would have the pro-cyclical effect of augmenting that expansion.

Financial System proposed regular or counter-cyclical issuance of SDRs (United Nations, General Assembly, 2009b; D'Arista and Erturk, 2010). IMF could begin by using only SDRs in its standby lending and extinguishing them as loans are paid back. SDRs could also be invested in bonds issued by regional development banks.¹³ The Commission also advocates using SDRs to support regional financing requirements (United Nations, General Assembly, 2009b).

Proposals to shift to the allocation of SDRs based on need or performance, instead of on the economic significance that determines voting shares in IMF, are of great interest. Ocampo (2009) proposes giving larger allocations to countries with the highest demand for reserves and allowing IMF to use unutilized SDRs to buy bonds from developing countries. Ocampo proposes generous overdraft or “drawing” facilities which could be used on an unconditional basis by all member countries and recommends that IMF be authorized to suspend the right of countries with large surpluses or excessive reserves to receive SDR allocations.

To turn the SDR into an investment asset or a unit of value (roles that the United States dollar plays at this time), more institutional changes and more time would be required, along with possibly giving IMF the role of a market maker for the buying and selling of SDRs at spreads comparable to those on the United States dollar (Eichengreen, 2009). Additional international agreements (regarding what kind of debts SDRs might discharge, for example) could also increase its viability as an investment asset.

To summarize, reducing dependence on the dollar through increased use of a created currency made up of a basket of currencies such as the SDR could be a significant step towards greater stability in the world economy. Greater SDR use would constitute an additional tool for creating the international liquidity needed for the conduct of a global counter-cyclical policy, for which there is already a precedent, as reflected in the April 2009 decision of the G-20. Greater reliance on the SDR could also open up the possibility of utilizing such a created currency for development or other global purposes. SDRs can be used to swap for bonds of developing countries or backstop the issuance of global bonds whose proceeds could be used for specific purposes. This latter approach basically describes the mechanism for climate change financing proposed in a recent IMF staff paper (Bredenkamp and Pattillo, 2010). Developed countries would pledge their SDR allocations to a “green fund” which would then float bonds backed by the SDRs to fund climate change spending.

Regional arrangements

A flurry of initiatives have arrived on the scene based on regional monetary and financial cooperation, including in the areas of macroeconomic and exchange-rate coordination, crisis responsiveness and prevention, and mobilization of development financing. While many of them are best characterized as being long on ambition and short on performance, regional arrangements do offer clear advantages to the international system and international discussions should therefore increasingly recognize their potential (Ocampo, 2001).

In the area of monetary and financial cooperation, regional arrangements could exploit pooling advantages, both in terms of risk and in investment. Notwithstanding the fact that regions are subject to contagion, risk pooling of international reserves can be a first line of defence, especially in the context of regional surveillance and mutual commitments

¹³ It might be necessary to activate the substitution account mechanism to facilitate the conversion of SDRs into actual currencies.

among pool members regarding remedial action.¹⁴ Pooling to create larger bond markets and investment funds has been discussed as a response to infrastructure requirements, including for increased integration in the Asia and Pacific region (see box V.3).

Box V.3

Funding of regional development gaps in Asia and the Pacific

The global economic crisis has underlined the need for regional cooperation in funding development gaps—a process in which Governments coordinate their fiscal spending around a commonly shared paradigm of inclusive and sustainable development. Countries in Asia and the Pacific have accumulated vast amounts of foreign-exchange reserves, motivated in part by the desire to create a buffer in case of large external shocks. Yet, holding such reserves comes with costs. This is so in part because the region's reserves are currently being invested in low interest earning deposits in the developed world, while a significant share of the reserves accumulated between 2001 and 2008 (about half) were in fact “borrowed” (that is, through running capital-account surpluses) at rates typically higher than the return on reserves. There may also be important opportunity costs, as there are at the same time important long-term investment needs to be financed. These opportunity costs likely outweigh the benefits of holding reserves for precautionary needs when the stock of reserves goes beyond the minimally required level and when long-term financing is scarce. Reserve holdings in Asia have increased to from two to three times the stock of three months of imports and the stock of short-term external debt, hence it is likely that their size extends well beyond the size of what would be considered a comfortable buffer.

Capital markets for long-term financing in the region remain relatively underdeveloped and there is vast scope for using official reserves to foster such markets. There have been some moves in recent years towards greater integration of regional equity markets and promoting the development of local-currency bond markets at the regional level, but progress has remained limited. Intraregional investment in local currency bonds has remained subdued owing to the existence of too many legal and institutional impediments, as well as a lack of investment information (Arner, Lejot and Rhee, 2005). The move forward of the Asian Bond Market Initiative, intended to foster the growth of local currency bond markets, has only been slow, as countries have remained preoccupied with addressing issues of harmonization of rules and regulations and there has been a lack of transparency in its investment targets and fund performance.

One priority target for alternative uses of excess official foreign-exchange reserves, both for domestic development and for increasing regional integration, would be the massive unmet infrastructure funding needs across Asia and the Pacific (United Nations, Economic and Social Commission for Asia and the Pacific, 2006). It is estimated that the region, with an annual shortfall of more than \$200 billion, needs an annual investment of more than \$600 billion in transport, energy, water and telecommunications. One option for countries in the region would be to allocate a part of their reserves to a trust fund set up to guarantee bond issues for infrastructure financing. In May 2010, for example, countries members of the Association of Southeast Asian Nations, joined by China, the Republic of Korea and Japan (“ASEAN+3”), set up a \$700 million bond fund backed by \$130 million dollars from the Asian Development Bank and a total of \$570 million from member countries. The trust fund will provide guarantees for long-term local currency-denominated bonds. Progress in the creation of these kinds of trust funds has been limited so far, however, because of a lack of agreement on the allocation of voting rights in such funds.

A financial architecture within the Asia and Pacific region could grow out of successful regional experiences in establishing and operating such funds. These funds would provide a more effective intermediation between the region's growing savings and foreign-exchange reserves and its established investment requirements than is currently being achieved through the recycling of reserves to finance developed-country deficits at substantial opportunity cost.

¹⁴ The Economic and Social Commission for Asia and the Pacific (United Nations, Economic and Social Commission for Asia and the Pacific, 2010) examines the challenges that have beset the Chiang Mai Initiative which is being converted from a set of bilateral agreements into a regional foreign reserve pool totalling \$120 billion.

There are important complementarities between world and regional mechanisms. Regional institutions could “play a useful role in setting norms, in the adaptation of international norms to regional conditions (given different regulatory traditions), and in reducing learning costs and sharing experience with institutional development” and could “also establish mechanisms to ensure surveillance of their regulatory systems and, eventually, regional currencies” (Ocampo, 2001, p. 21). Regional institutions have the potential to provide programmes that are better tailored to the regional situation and the situation of small countries, inasmuch as global institutions tend to be more responsive to systemic players. Finally, regional mechanisms can use the fact that they offer their participants a greater voice to help aggregate commitment to and coordination with global mechanisms.

Conclusions

The agenda encompassing the reform challenges set out in this chapter is an enormous one. Furthermore, it entails urgent political requirements. As discussed above, the set of reforms must be seen as a whole whose parts must be mutually reinforcing. Fiscal policy and monetary policy should not operate at cross-purposes domestically and both must sustain investment. Both types of policy must in turn be coherent with international arrangements (and vice versa), most particularly the controls exerted over international private asset flows, which are part of prudential regulation. What political resources the international community can count and draw on in order to address these challenges is a question examined in chapter VI.