



Briefing Note

Policy Responses to Unfettered Finance and the Reshaping of the Global Economy

This brief draws on highlights from the first workshop of the Policy Responses to Unfettered Finance (PRUF) project, made possible by the generous support of the Ford Foundation and in partnership with our New York hosts Initiative for Policy Dialogue (IPD). While the discussion over the course of the two-day event, February 12th -13th, 2009, was expansive, this brief is divided thematically into two sections: diagnoses of the crisis and response to the crisis; and reform proposals and policy alternatives.

(DRAFT VERSION, FOR COMMENT)

Key Messages

- ❖ **Address the Global Governance Deficit:** the existing international financial governance institutional and policy framework is inadequate in responding to complex crises. The financial industry is one of the most globalized of all, yet global financial governance is miles behind.
- ❖ **Keep the Social Context Front and Center:** policymakers need to keep the social context and particularly the impact of the crisis on the poorest and most vulnerable groups, as well as commitments made to the poorest countries, front and centre when crafting policy responses. Well before the financial crisis hit, recall that food and fuel price crises were already causing havoc for the poorest peoples and these were largely ignored.
- ❖ **IMF Reform:** is a crucial as well as multifaceted issue. Four aspects deserve greater attention: trade-offs associated with increasing the Fund's financial resources, genuine reform and increased representation of emerging and developing countries on the Fund's Executive Board, limitation and clarification of the Fund's mandate, and easing conditionalities in a time of global crisis.
- ❖ **Strengthen the UN's Coordinating Function:** with the widest possible representation of countries and broad responsibility for setting normative frameworks, the UN is the ideal venue to debate and respond to the crisis in an inclusive and comprehensive manner. To this end, proposals for a representative economic council or formal forum, accountable to the UN General Assembly, should be advanced.
- ❖ **Countercyclical Sources of Development Finance:** there is an urgent need to think about how to stimulate demand in the poorest countries that lack fiscal capacity. A large one-time Special Drawing Rights (SDR) allocation, greater utilization and capitalization of regional development banks could act as countercyclical sources of development financing.
- ❖ **Prudential Capital Controls:** in a time of crisis emerging, developing and least developed countries need policy space to respond to sudden starts, stops and volatile reversals of capital flows that could cause deeper macroeconomic crises. Global policy responses must provide space for countries to consider marginal charges on capital flows.
- ❖ **Fresh Thinking on a Stable Global Reserve Currency System:** the crisis presents a window of opportunity for fresh thinking on a stable global currency system, one that is not predicated on a single national currency. The SDR could be the centerpiece of a genuinely global currency system.
- ❖ **Comprehensive Coverage:** the guiding principle for a new regulatory blueprint should be comprehensive coverage. There should be a 'zero-tolerance' policy as far as transparency and secrecy in the financial sector, be it the regulated sector or the 'shadow system', is concerned.
- ❖ **Control Leverage:** regulation, on capital adequacy, must lean against the wind in good times and mandate build up of provisions that can be called on during downturns. Countercyclical capital charges can help counter boom-bust cycles.

Diagnoses of the crisis and responses to the crisis

The workshop provided a rare platform for exchange of ideas across groups that do not always engage one another. This unique event brought together members from four distinct communities of interest – policymakers, academics, civil society representatives and members from the private financial sector – in order to discuss implications of the crisis and recommend policy responses that emphasize developmental priorities.¹

The two-day discussion began with a focus on diagnoses of the sources of the crisis from various viewpoints. We would highlight at the outset that economic crises hit in waves. Advanced economies are at the center of this crisis. Emerging markets (EM) and large developing countries (DC) that are more plugged into the global economy are more directly hit by crisis contagion. From our perspective it is important to emphasize that the wave to hit other developing (DC) and least developed countries (LDC) has not fully crashed ashore yet and the outlook could worsen considerably unless decisive development friendly responses are treated as first-order priorities.

The proximate sources of the crisis lie in financial sector practices and macroeconomic policies in advanced economies. Foremost among these include excess leverage in the financial sector of the US and other advanced economies, rapid financial innovation and proliferation of opaque credit derivatives and the failure of both active regulation as well as the self-regulation model. Underlying these developments, major conflicts of interest within the financial sector (particularly credit-ratings agencies and large investment banks), the sharp growth in segments of financial markets entirely beyond the regulatory and surveillance purview (so called ‘shadow system’) as well as the ad-hoc nature of responses to the crisis (evident in Lehman failure), contributed to what is now a chronic confidence crisis in the global economy.

However, the above mentioned are only the proximate sources. This crisis has been years in the making. Deeper sources of the crisis include persistent macroeconomic imbalances between surplus saving and deficit economies which contributed to prolonged low interest rates and helped feed the housing market bubble. At the national level in key economies the unwillingness to recognize the housing boom as a boom (as opposed to a secular shift in trends) as well as persistent chronic fiscal deficits played an important role in the lackluster regulatory stance and unpreparedness once the bubble was well on its way to bursting. Furthermore the crisis highlights the fact that yet deeper issues are at stake which stem primarily from a widely acknowledged global financial governance deficit.

While the international financial governance architecture may not have directly ‘contributed’ to the crisis, it is clear that the existing institutional and policy framework is inadequate in responding to the challenges posed as a result of the crisis. Global financial governance in general lacks teeth and is at best partially enforceable (i.e. while the major financial governance institutions clearly have a great deal of influence on poor countries, the same is not the case when it comes to advanced economies). This is not merely a ‘cosmetic issue’ of representation – as one participant noted, even if China had three times its current voting share at the IMF this would not have prevented the crisis – but a deeper issue regarding the effectiveness and mandate of individual institutions, as well as the lack of influence key institutions such as the IMF seem to have on the largest economies. These are major structural issues that relate to wider geopolitics and asymmetry amongst ‘systemically significant’ (and insignificant) economies. The G20 in this context is best seen as a response to deeper structural issues and reservations both rich and poor nations alike share about ‘compromising on sovereignty’, that the present global financial governance architecture seems ill-suited to deal with.

The major gaps are at the level of global financial governance. The financial industry is perhaps the most globalized of all and has facilitated globalization of other sectors. And yet financial

¹ Please see list of attendees and meeting agenda at the project website

governance at the global level seems miles behind. Addressing this deficit through both fundamental reforms to existing institutions as well as openness to new institutions should be a priority if future crises are to be avoided.

The discussion surrounding global responses to the crisis centered primarily on preliminary assessments of the G20 process. The G20 is welcomed as an improvement on the G8, but with cautious optimism. The G20 is still an exclusive club comprising 'systemically significant' economies, and thus by definition cannot adequately reflect the priorities of the poorest countries. The limited nature of the grouping raises serious questions regarding the credibility and legitimacy of proposed responses. This crisis is uniquely global in scope and scale and thus effective responses require a wide base of support and legitimacy in order to address the deep confidence crisis at the center of the economic crisis. The last thing policymakers should want is to give the impression of a business-as-usual behind closed doors approach. In this regard we welcome wider representation of developing countries at the upcoming London Summit in April via participation of the New Partnership for Africa's Development (NEPAD), the African Union (AU) and the Association of Southeast Asian Nations (ASEAN).

The United Nations (UN), with the widest possible representation of countries and broad responsibility for setting normative frameworks the UN is the 'ideal' venue to debate and respond to the crisis in an inclusive and comprehensive manner. The UN is uniquely placed to play a coordinating role in addressing systemic issues to provide both political legitimacy and accountability for decisions reached in more specialized and limited membership bodies (e.g. FSF and standards setting bodies). The UN is also particularly useful as a venue to address developmental issues and needs of the poorest and smallest economies that are left out of more exclusive groupings.

The convening authority of the UN can be of particularly useful as the UN can call upon more specialized institutions and their regulatory expertise (such as the FSF, BIS and also the standard setting bodies) as required on systemic issues, and still provide an inclusive platform for debate. What is required in order for the UN to be able to play a more comprehensive role on systemic issues on a consistent basis is a 'bridging structure' between the UN, the international financial institutions (IMF, the Bank, BIS, FSF) as well as the standards setting bodies (IASB, IOSCO). The expected Conference at the Highest Level should also be utilized to move forward on systemic reform and policies for the medium and long-term which are unlikely to be adequately addressed by the G20. The conference will benefit from recommendations of the Commission of Experts on Reforms of the International Monetary and Financial System established by the President of the UN General Assembly and chaired by Prof. Joseph Stiglitz. Initiatives to strengthen the UN's coordinating function are urgently required. To this end, proposals for a representative economic council or formal forum, accountable to the UN General Assembly, should be advanced.

As far as the G20 process is concerned a key deficit is the lack of an accountability framework. It is unclear to citizens, academics, civil society, as well as private sector members exactly how and where the G20 can be held accountable for the comprehensive set of actions they have proposed to take. Putting in place a strong accountability framework would go a long way in building legitimacy around the G20, not to mention enhance the effectiveness and credibility of proposed actions. We would also point out that while the G20 Washington Declaration (November, 2008) was a comprehensive menu of near-term as well as medium-term actions, a majority of the proposed actions have been long-standing issues of debate and on the reform agenda of international financial institutions for years (if not decades).² For its part the G20 would have to

² Reforming accounting standards and best-practices as they relate to hedge funds and other private pools of capital have been subjects of debate for some time at the standard setting bodies (e.g. IASB, IOSCO) and at the FSF. Reform of the FSF and IMFC for instance is also a long-standing issue. Addressing

demonstrate its utility, in part, by laying out a more comprehensive analytical as well as accountability framework than the loose 'Working Group' structure currently in place.

From our perspective, there is a gaping deficit in the locus of the debate and the crisis response measures to date. Civil society representatives have repeatedly pointed out that policymakers have not paid due attention to the impact of the crisis on the poorest countries. There is a profound disconnect between the dominant technical and regulatory discourse surrounding near term priorities (getting the credit system functioning and ensuring that the global economy does not enter a prolonged 'L-shaped' recession) and the plight of poorest.

Developing and least developed countries, especially in Sub Saharan Africa, benefited greatly from the recent period of steady global growth backed by stable and low inflation. While the majority of these countries would still have fallen short of developmental targets (such as MDGs, by 2015) without the crisis, the worsening global economic outlook risks erosion of recent gains and threatens to pull millions more into poverty. The backlash to globalization and protectionist undertone evident in the crisis response (despite hollow assurances to the contrary by the G20) poses a major threat to the prospects of the poorest, who depend directly and indirectly on a return to growth in the major economies.³ In this context, we welcome initiatives such as the World Bank's proposed Vulnerability Fund that calls on advanced economies to set aside 0.7percent of their planned stimulus expenditures to finance similar measures in LDCs that lack fiscal space to undertake the same.⁴ In a time of crisis as financial flows including aid, remittances, FDI, export earnings, and portfolio flows to DC/LDC and Emerging Markets reverse dramatically, policymakers should work to prevent a sense of double standards – Keynesian stimulus for the North continued austerity for the South – from gaining a foothold. For this reason we call for much greater and more serious attention to be paid to a 'development friendly' set of reform proposals and policy alternatives.

Reform proposals and policy alternatives

Keep the Social Context Front & Center

If there is one overarching principle that encapsulates each of the reform proposals and alternatives outlined below, it is that policymakers need to keep the social context, as well as commitments made to the poorest countries front and centre when they craft global policy responses. Recall that well before the financial crisis which began in the US turned into a global economic crisis affecting virtually every country, the poorest regions were already reeling under the pressure of a dual food and fuel price crisis that was largely ignored.

IMF reforms: Capitalization, Representation, Mandate and Conditionality

The seeds of this crisis were sown partly in the late 1990s East Asian crisis. Reserve accumulation in East Asia (and major oil producing states) has contributed greatly to global imbalances. Reserve accumulation is an expensive form of self-insurance, both against macroeconomic crises (volatile capital flows and currency runs) but also from reliance on the IMF

macroeconomic imbalances (exchange rates and reserve accumulation) has been debated for years at the IMF (with little success) as well as at BIS

³ Protectionist, anti-globalization undercurrents include but are not limited to the Buy America provision in the US stimulus (even if softened), the 'fire foreign workers first' rhetoric, restrictions on H1B visa hires, and British Jobs for British Workers in the UK

⁴ We also welcome other initiatives proposed by the Bank including fast-track IDA lending and increasing available IBRD funds. In the same vein we welcome the IMF's Exogenous Shock Facility, but again with cautious optimism (more on this below)

for emergency assistance which tends to be attached to onerous policy conditionalities. Therefore IMF reform is both crucial as well as a multifaceted issue. We highlight four aspects in particular:

The IMF needs to be well capitalized in order to deal with crises of this magnitude; in this regard Japan's recent \$100bn loan to the Fund is welcome. However it must be stressed that increased capitalization must be commensurate with IMF representation reforms including reducing the Euro-zone stake in the institution and increasing not only emerging economy but more importantly DC and LDC representation on the Executive Board. As was noted, the IMF has little influence over rich countries; it is the developing and poor countries that are most influenced by the Fund. For this precise reason their representation in the institution needs to increase commensurately so that IMF recommendations are consistent with the developmental needs and priorities of recipient countries. It is important to underscore that 'rule-making' and 'rule-application' interact with each other. Only once IMF rules become applicable to rich countries as well will the rule-making change and increased developing and emerging country representation have substantive meaning. The bottom line is that IMF reform is not merely a cosmetic issue of representation for the sake of inclusivity but central to the credibility of the Fund, especially among new and emerging actors such as China, India, Brazil, and South Africa amongst others.

There is considerable debate regarding the limits of the IMF's mandate and use of policy conditionality. On mandate, over the years there has been significant mission creep at the Fund. For instance the Fund was never intended to deal with poverty reduction but has played a major role in shaping policy and debate in this area. In the present context we emphasize that regulatory issues are beyond the IMF's mandate and are best left to other institutions (including BIS, FSF, IOSCO, IASB and better coordination among national regulators). The issue of policy conditionality goes to the heart of the Fund's effectiveness and credibility. There are good arguments both for and against conditionality, but in a time of crisis policy conditionality on emergency lending should be held in abeyance.

Countercyclical Sources of Development Finance

There is urgent need to think about how to stimulate the poorest economies that lack fiscal capacity to finance their own stimulus and will be further squeezed out of global credit markets as advanced economies look to finance their measures. A large upfront SDR allocation by the IMF is an accessible policy tool before policymakers. Such an initiative would lend credibility to the otherwise hollow high-sounding talk of globally coordinated stimulus measures, and may also help address the defensive or self-insurance needs which led emerging and developing countries to accumulate large foreign reserves.⁵

The regional development banks (RDBs) could play the role of countercyclical sources of development financing. However the capital adequacy of RDBs needs to be looked at seriously. The IADB, ADB and AfDB could play an important countercyclical role, to address contraction of trade finance for instance, but they would need to be 'pump-primed'. It is noteworthy that while only a handful of countries have looked to the IMF for emergency financing (and reluctantly so); the number of countries turning to the RDBs as well as the World Bank and IFC are much greater. We emphasize, multilateral development banks could play a much greater role in supplying 'smart finance' given they possess the requisite infrastructure and experience not only in extending credit but also in helping tap private sources. Financial resources required to prime their concessional lending pumps must ultimately come from donors. Here a mechanism that coordinates the Vulnerability Fund proposed by the Bank and the RDBs (as a disbursement channel) could help address the needs of the poorest. Investing in the recovery of the developing world is in the self-interest of advanced economies as doing so ultimately stimulates global recovery.

⁵ We should also emphasize that the low interest rate (presently 0.6percent) on SDR credit further adds to its desirability from the perspective of DC and LDCs

Prudential Capital Controls

We emphasise the word 'prudential'. Particularly in a time of crisis emerging markets, DC and LDCs need policy space to respond to sudden starts, stops and volatile reversals of capita flows that could cause deeper macroeconomic crises. The debate over policy responses must provide space for these countries to consider marginal charges on capital flows, along the lines for instance of the former Chilean *encaje*, a reserve requirement on short-term inflows.

Fresh Thinking on a Stable Global Reserve Currency System

The crisis presents a window of opportunity to think about the global reserve currency issue. Important emerging actors such as China have a huge stake in this issue and may be very willing to consider new ideas, especially as China in particular has been chided on its exchange rate policy. This crisis presents the political opportunity to push the SDR to play its intended role as the centerpiece of a genuinely global reserve currency system. Any system principally based on a single national currency as the primary global reserve currency is fraught with instability (not to mention an exorbitant privilege for the issuing country). The unexpectedly high demand for the US dollar could itself sow the seeds of a wider currency crisis if the dollar unwinds in a disorderly manner. This further reinforces the need for fresh thinking on a global reserve system and the SDR could play a key role in this regard.

Comprehensive Coverage and Zero-Tolerance of Lack of Transparency, Secrecy

Countless examples of fraud, secrecy and lack of transparency related to this crisis have shaken confidence in markets. We call for a zero-tolerance approach. The key guiding principle for a new regulatory blueprint should be comprehensive coverage. Foremost here is extending regulatory and surveillance coverage to the 'shadow financial system' comprising off-balance sheet entities, structured investment vehicles, hedge funds, private equity and other private pools of capital. It also includes bringing off-shore tax havens into the regulatory perimeter. In the credit derivatives market, the process of moving key instruments from over-the-counter markets to exchanges (as with CDSs) has already begun. However, we emphasize that one of the key deficits in financial governance is that regulators simply lack the necessary information to respond to complex crises. It is widely accepted that opaque derivatives and other instruments are often (though by no means exclusively) used to avoid taxes, increase leverage, overcome transparency requirements and gain exposure to restricted areas. Without position and leverage data from the largest institutions (including hedge funds and investment banks) regulators are ill-equipped to deal with complex correlations as experienced over the course of this crisis. While there is a lot of talk about a 'systemic risk' regulator, we would argue the first step is to get the necessary data.⁶

We welcome the fact that proposals along these lines are now beginning to receive greater attention from lawmakers. Noteworthy here is the idea of a Financial Products Safety Commission (FPSC) that would do for financial products what the FDA does for pharmaceuticals in the US.⁷

Controlling Leverage

Excess leverage in the financial system in advanced economies was a major source of this crisis. There are several ideas on the table that address financial system leverage, among these we highlight proposals calling for dynamic provisions such as countercyclical capital charges or

⁶ We elaborate on these ideas further in a short proposal, see: Bookstaber R. and Bhushan A., *New Ideas to Improve Risk Management: Mapping the Market Genome*

⁷ See: *US Lawmakers Propose Financial Products Watchdog*, <http://www.reuters.com/article/gc06/idUSTRE5295DC20090310>

reserve requirements, and maximum limits on gross leverage ratios. The main principle underlying these proposals is the need to counter boom-bust cycles by leaning against the wind in good times and creating reserves that can be used to counter downturns. The pro-cyclical tendency of the Basel II capital adequacy framework is now widely acknowledged; however questions remain regarding how to introduce 'macro-prudential regulation' into the existing regulatory frameworks. Bank of Spain's experience with dynamic provisioning offers interesting lessons in this regard. Countercyclical requirements could be placed on the asset side (could be risk weighted) and could also be worked out in a more nuanced manner that takes into account both asset and liability sides, over different maturities.⁸

References

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⁸ For more, see the trigger paper contributed to the workshop by Avinash Persaud et. al., *Fundamental Principles of Financial Regulation*

Annex

What is the central project question?

What “development friendly” reforms to global financial governance are required in order to ensure that the needs and priorities of developing countries are reflected in the response to the financial crisis?

What are the key dates, expected outcomes and follow-up opportunities?

Launch Event: Ottawa, December 11th, 2008⁹

Briefing Events: Department of Foreign Affairs, Ottawa (Jan 2009); UN, New York (Feb 2009)

First Workshop: New York, February 12th and 13th, 2009

Briefing Event: Ottawa, March 2009

Second Workshop: Geneva, June 8th and 9th, 2009

Third Workshop: New Delhi, (TBC) November, 2009

Briefing event (proposed): Ottawa, Q1/2010, as input into Canada G8

NSI prepared an Analytical Paper to stimulate discussion at workshops and lay the groundwork for the project. In addition NSI researchers have compiled presentations on specific issue areas (e.g. financial innovation, emergence of BRICs, and role of civil society).¹⁰

Individual project members have also presented on other platforms. Informal briefings provide an opportunity to follow up on the project, discuss findings and share intermediate outputs for comment. Another follow-up and dissemination channel is the project blog, which can be accessed at: <http://prufproject.wordpress.com/>

Intermediate outputs include workshop reports, short working briefs, related op-end pieces and trigger papers. The expected final output is a publication that will draw on the NSI Background Paper, trigger papers, consultations and briefings, and the workshops themselves.

The expected outcome of the project is a coherent documentation of a set of ‘development friendly’ reforms of the global financial governance architecture. The project will also assess global responses, including G20 initiatives and commitments in particular, from the perspective of the impact on DC and LDCs. The project will compile policy alternatives aimed less at short-term responses to the crisis (e.g. specific regulatory issues, national and international fiscal stimulus coordination), but more at longer-term foundational issues such as governance reforms, persistent macroeconomic imbalances, sustainable global reserve currency system and responses to boom-bust cycles. Our priority, consistent with the mandate of The North-South Institute, is to produce high-quality, technically feasible and politically practical strategies aimed at returning poor, developing and emerging economies (that were not responsible for this crisis) to a path of sustainable growth and poverty reduction.

⁹ Documents relating to the launch can be found at: <http://www.nsi-ins.ca/english/research/progress/61.asp>

¹⁰ These are available at the link above and also at the project blog: <http://prufproject.wordpress.com/>



Policy Response to Unfettered Finance Workshop
February 12/13, 2009, New York
List of Confirmed Participants

- ♦ Barbara Adams, *Global Policy Forum*
 - ♦ Mark Allen, *International Monetary Fund*
 - ♦ Emily Altman, *Former Managing Director, JPMorgan Chase & Co.*
 - ♦ Amar Bhattacharya, *G24*
 - ♦ Mario Blejer, *(private consultant)*
 - ♦ Richard Bookstaber, *formerly Bridgewater Associates*
 - ♦ Uwe Bott, *Cross-Border Finance Inc.*
 - ♦ Ariel Buirá, *The North-South Institute, Board of Directors*
 - ♦ Sarah Burke, *FES*
 - ♦ Leonardo Burlamaqui, *Ford Foundation*
 - ♦ Stephany Griffith-Jones, *Initiative for Policy Dialogue, Columbia University*
 - ♦ Jo-Marie Griesgraber, *New Rules for Global Finance Coalition*
 - ♦ Eric Helleiner, *Centre for International Governance Innovation and University of Waterloo*
 - ♦ Barry Herman, *The New School*
 - ♦ Jens Martens, *Global Policy Forum*
 - ♦ Manuel (Butch) Montes, *UN DESA FfD*
 - ♦ Jose Antonio Ocampo, *Initiative for Policy Dialogue, Columbia University*
 - ♦ Iara Pietricovsky, *Institute of Social and Economics Studies (INESC)*
 - ♦ Vitoria Saadi, *Roubini Global Economics*
 - ♦ John Sewell, *Wilson Center*
 - ♦ Jan Joost Teunissen, *The Forum on Debt and Development*
- Observers
 Wolfgang Obenland, *Global Policy Forum*
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