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UNCTAD Board Debates Financial Architecture

The Trade and Development Board (TDB) of the United Nations Conference on Trade and Development (UNCTAD), meeting in Geneva from 1-12 October 2001, discussed prospects for meaningful reform of the international financial architecture (IFA), in relation to preparations for the International Conference on Financing for Development (FFD) to be held in March 2002 in Monterrey (Mexico, see *NGLS Roundup* 83, 78, 71 and 65). The debate was informed by the UNCTAD secretariat's analyses of systemic financial instability and the views of a panel of financial experts from East Asia and Latin America. The main background documents were UNCTAD's *Trade and Development Report, 2001 (TDR)*, which focuses on international financial architecture reform (see inside pages), and an update prepared by the secretariat.

This *NGLS Roundup* highlights some of the main issues and proposals voiced during the TDB informal meetings under its annual agenda item on interdependence. These do not represent consensus views or agreed conclusions by the TDB.

INTERNATIONAL FINANCIAL ARCHITECTURE REFORM

In the immediate aftermath of the 1997-98 East Asian financial crisis, which soon spread to Russia and Latin America, fundamental reform of the IFA was high on the political agenda of the major industrialized countries. It would appear today that interest in IFA reform has waned, and according to a number of speakers at the TDB, nothing much has happened since 1998 in terms of addressing the global systemic nature of financial crises. This "complacency" on the part of major industrialized countries was attributed to the fact that their economies were not negatively affected by the 1997-98 crisis, and may have even benefited from it indirectly, notably through the resulting fall in world commodity prices.

Although one speaker noted that the Executive Board of the International Monetary Fund (IMF) agreed to work on prudential measures in both creditor and debtor countries, others argued that most of the substantial changes have taken place in relation to reforming debtor countries' domestic financial systems. This includes the adoption of stricter financial standards, improving transparency and carrying large amounts of hard currency reserves.

However, according to the UNCTAD secretariat, this overlooks the systemic nature and global reach of recent currency

and financial crises in developing countries. The *TDR, 2001* notes that almost all major crises in emerging markets have been connected with frequent gyrations and misalignments of the currencies of major industrialized countries (United States, countries of the European Union and Japan) and large swings of unstable international capital movements, all of which are beyond the control of developing country governments. In other words, the current global financial regime of *laissez-faire* is likely to remain prone to systemic instability and crises, with the devastating social and economic consequences that lie in their wake. It was suggested that the 11 September terrorist attacks on the United States may further slow down progress on IFA reform, *unless* it is perceived by major industrialized country governments that future crises due to systemic financial instability will hit developed country economies as well.

TEMPORARY STANDSTILL AND ORDERLY DEBT WORKOUT

If little progress can be expected on establishing effective global mechanisms to prevent financial crises, a number of speakers suggested that one may expect more progress on developing an international debt standstill mechanism, which would in effect "bail in" private creditors when crises have already erupted. In recent years, the way financial crises were managed by the international community through the IMF have essentially bailed out international private lenders when their highly lucrative speculative ventures failed. In essence, this is now widely recognized as a breach of basic market principles, whereby creditors, enjoying easily up to 40% returns, are exempt from bearing the consequences of the risks they choose to take. The burden is shifted to the borrowing governments, and in effect to their citizens, even though they were not at the origin of the crisis.

The idea of replicating the United States' Chapter 11 bankruptcy laws at the international level was first proposed in the *TDR, 1986* and developed in *TDR, 1998* and *TDR, 2001*. A "temporary standstill" for countries under financial attack would stop "asset-grabbing" and pave the way for an orderly and equitable debt workout. In order to ensure private sector involvement in crisis management, such an arrangement would imply strict limits on access to financing by the IMF and an amendment to IMF Articles of Agreement to provide statutory protection from creditor litigation against debtors imposing temporary standstills. It would also require the

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TDR 2001: FOCUS ON INTERNATIONAL FINANCIAL ARCHITECTURE REFORM

Under the current regime of laissez-faire, the global financial system is likely to remain prone to systemic instability and crises such as the one triggered in East Asia in 1997, according to the Trade and Development Report, 2001 produced by the United Nations Conference on Trade and Development (UNCTAD). The mainstream debate has mainly focused on “disciplining” developing country debtors, the report says, even though the main causes of systemic instability lie in the major industrialized countries.

The report says failure to achieve greater progress in international financial architecture (IFA) reform has been to a considerable extent due to political rather than technical reasons, because proposals that would address global systemic instability and risk have often run counter to the interests of creditors. Thus the focus has been on measures to “discipline” debtor countries, including the adoption of strict financial standards at the national level, improving transparency, adopting appropriate exchange rate regimes, carrying large amounts of reserves, and making voluntary arrangements with private creditors to involve them in crisis resolution. The report acknowledges that some of these reforms have their merits. However, it notes that many of the recommended “self-defense mechanisms”—such as carrying large amounts of reserves to counter speculative currency attacks—can be very costly in social and economic terms. Moreover, they presume that the cause of crises rests primarily with policy and institutional weaknesses in debtor countries, and thus the burden of responsibility for reform is placed firmly on their shoulders.

Systemic Nature and Global Reach of Crises

In sharp contrast to the above, the report emphasizes that “the virulence of the economic forces unleashed after the collapse of the Thai baht in July 1997, and among countries with track records of good governance and macro-economic discipline, seemed to confirm the systemic nature and global reach of currency and financial crises.” It says that almost all major crises in emerging markets have been connected with frequent gyrations and misalignments of the currencies of major industrialized countries (United States, countries of the European Union and Japan) and large swings of extremely unstable international capital movements—all of which are beyond the control of recipient countries. However, the report says, these factors are not taken into account in the mainstream debate and the official advice to developing countries related to the choice between floating exchange rate regimes or locking into a reserve currency through currency boards or dollarization (the so-called hard pegs). “Much of this is a false debate,” the report asserts, since crises are likely to occur under either system.

The report suggests that the root of the problem lies in failure to establish a stable international system of exchange rates after the breakdown of the Bretton Woods arrangements in the 1970s. Yet the need to establish a global system of exchange rates, it notes, is not even on the agenda for reform of the IFA. It therefore recommends that serious consideration be given to:

- introduction of adjustable target zones for the three major reserve currencies (the Dollar, Euro and Yen), together with a commitment by nations to defend these target zones through coordinated intervention and macro-economic policy action;
- establishment of effective multilateral surveillance over macro-economic policies of major industrial countries, especially in terms of their impact on poorer countries; and
- regional arrangements that, in the absence of progress at the global level, could provide collective defence mechanisms for developing countries against systemic failures and instability, but that would probably require the participation of a large reserve-currency country.

Temporary Standstill and Orderly Debt Workout

In the absence of an effective global mechanism to prevent financial crises, it is essential to determine how best to limit their damage, says the report. It notes that large bailout packages have been the preferred option, but are becoming increasingly problematic. They create “moral hazard” for lenders, which do not bear the consequences when their investments fail—a breach of the basic principles of market discipline. The packages also shift the burden of the crisis onto taxpayers in debtor countries. Because debtor country governments are often forced to assume responsibility for private debt, their taxpayers have had to foot the bill of most of the US\$60 billion total cumulative losses that international banks incurred in emerging markets since 1997. Over the same period the same banks have collected more than US\$20 billion per annum as risk premium on loans to these countries. Moreover, bailouts are facing increasing political opposition in creditor countries, as crises become more frequent and extensive, and required funds get larger. The report notes that “while the international community has come to recognize that market discipline will only work if creditors bear the consequences of the risks they take, it has been unable to reach agreement on how to bring this about.”

The report proposes a temporary standstill for countries under financial attack in order to stop “asset-grabbing” and pave the way for an orderly and equitable debt workout. In order to ensure private sector involvement in crisis management (“bailing in” the private sector), this would have to be combined with strict limits on access to financing by the International Monetary Fund (IMF). Such a strategy would require amending the IMF’s Articles of Agreement to provide statutory protection from creditor litigation against debtors imposing temporary standstills.

The report notes that despite support for such a framework by many industrialized countries, there is “strong opposition from some major powers, and from participants in the private markets, to mandatory mechanisms for ‘binding in’ and ‘bailing in’ the private sector.” However, it says that without statutory protection of debtors, negotiations with creditors for restructuring loans would be voluntary in nature and could not be expected to result in equitable burden sharing. Recent examples of negotiated settlements show that creditors did not bear the consequences of risks they had taken. Instead, they forced developing country governments to assume responsibility for private debt and accept a simple maturity extension at penalty rates.

Such standstills should be sanctioned through an established independent panel, insists the report, because as a creditor itself the IMF cannot be expected to play this role. The IMF should also refocus its conditionalities on core macro-economic objectives, as recent bailouts in Turkey and Argentina suggest that the practice of attaching wide-ranging policy conditions to loan packages persists, despite official pronouncements to the contrary.

The report also recommends that developing countries do not succumb to pressure from some developed countries within the IMF to take on international legal commitments to liberalize their capital account regimes. If countries were to lock themselves into such legal obligations, this would remove the policy autonomy they may require to regulate capital flows, including the imposition of capital controls to tame excessive inflows and stave off "panic exits" of short-term speculative capital.

Reform of Governance of International Financial System

The report emphasizes that much of the policy reform proposals discussed above would imply significant changes in the mandate and policies of the IMF; these cannot be discussed in isolation from reforming the way decisions are made in the IMF. "Reform of the international financial architecture," says the report, "presupposes a reform of the IMF."

Any system of control and intervention at the international level would need to be reconciled with national sovereignty and accommodate diversity among nations. Moreover, the report warns, a rules-based international financial system raises concerns for developing countries. "Under the current distribution of power and governance of global institutions," says the report, "such a system would be likely to reflect the interests of larger and richer countries rather than to redress the imbalances between international debtors and creditors." Such biases already exist in the rules-based trading system it notes, "although relations here are more symmetrical than in the financial domain." Whereas developed countries account for only 17% of voting strength in the United Nations, 24% in the World Trade Organization (WTO) and 34% in the International Fund for Agricultural Development (IFAD), they account for over 61% in the Bretton Woods Institutions. "And a single country [the United States] holds virtual veto power over important decisions," adds the report. It cites a study undertaken for the Group of 24 (G-24) middle-income developing countries which argues that "the allocation of quotas and the correlate membership rights in both institutions [the IMF and World Bank] no longer reflect relative economic and political power, and the principle of equal representation....Furthermore, decision-making practices have not adapted to the changed mandates of both institutions, whose work now takes them further and further into influencing domestic policy choices in developing countries."

In addition, says the report "it is now agreed in many quarters that the procedures for selection of the Managing Director of the IMF and the President of the World Bank should give greater weight to the views of developing and transition economies, since the *raison-d'être* of these institutions is now to be found mainly in their mandates and operations with respect to these economies."

"More fundamentally," the report continues, "crucial decisions on global issues are often taken outside the appropriate multilateral forums in various groupings such as the G-7 or G-10, where there is no developing country representation or participation." It cites a paper prepared for the June 2000 World Bank/Commonwealth secretariat conference on Developing Countries and Global Financial Architecture. The paper says that "nothing consequential happens in the formally constituted organizations that do have operational capabilities—the IMF, the World Bank, the Bank of International Settlements—without the prior consent, and usually the active endorsement, of the 'Gs' (here used as a short form for all the deliberative groups and committees dominated by the major industrial countries)." The Trade and Development Report welcomes the inclusion of developing countries in the newly created G-20, which discusses financial architecture reform outside the Bretton Woods Institutions. However, it notes that so far the focus of this forum's work "has not substantially deviated from the G-7 reform agenda" and has no representation from the poorest and smallest developing countries.

"If reforms to the existing financial structures are to be credible," stresses the report, "they must provide for greater collective influence from developing countries and embody a genuine spirit of cooperation among all countries....No less than a fundamental reform of the governance of multilateral institutions is therefore necessary." Progress in these areas will depend on the willingness of major industrial countries to extend the reform agenda and process so that they also address the concerns of the developing countries. But progress will depend equally on positions taken by developing countries; so far, there is no consensus among them on a number of key issues. "At times of crisis," the report says, "many countries seem unwilling to impose temporary standstills, preferring official bailouts, even though they complain that their terms and conditions deepen the crisis, put an unfair share of the burden of adjustment on the debtors and allow the creditors to get away scot-free."

However, there appears to be greater convergence of views and interests among developing countries regarding measures for crisis prevention and governance of international financial institutions, observes the report. These include more balanced and symmetrical treatment of debtors and creditors, more stable exchange rates among the major reserve currencies and effective IMF surveillance of the policies of the major industrial countries, especially with respect to their effect on capital flows, exchange rates and trade flows of developing countries. There is also convergence on the need for less intrusive conditionality and "above all, more democratic and participatory multilateral institutions and processes."

In his foreword to the report, UN Secretary-General Kofi Annan notes that the many "challenging recommendations" it offers are related to issues that will be discussed at next year's International Conference on Financing for Development to be held in Monterrey (Mexico) from 18-22 March 2002, and expresses his hope that it will make a useful contribution to those discussions.

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establishment of an independent panel entrusted to sanction such standstills, because the IMF, as a creditor itself, cannot be expected to play this role.

Although there is likely to be considerable private and public sector resistance to establishing such a standstill mechanism, political opposition to conventional bailout operations is fast growing in creditor countries, not least because of the increasingly large sums involved, as well as the speed and velocity with which such operations have failed in recent times.

The TDB noted the recent testimony of United States Secretary of Treasury, Paul O'Neill, to the Senate Banking Committee: "We need an agreement on international bankruptcy law so that we can work with governments that, in effect, need to go through Chapter 11 reorganization instead of socializing the costs of bad decisions."

However, speakers at the TDB noted that a likely consequence of the application of an international standstill mechanism would be a reduction in capital flows to developing countries, as lenders' perceptions of risk will increase. It was suggested that this may require rethinking basic development models away from excessive reliance on global financial capital, and towards models of "self-reliance" (see below).

PROSPECTS OF REGIONAL "SELF-DEFENCE" MONETARY ARRANGEMENTS

In the absence of progress on developing preventative mechanisms at the global level, the TDB discussed the prospects of regional arrangements that could provide collective defence mechanisms for developing countries against systemic failures and instability. These were discussed in relation to Asia and Latin America. In this context, the so-called "Chiang Mai Initiative"—launched in May 2000 by the 10 member countries of the Association of South-East Asian Nations (ASEAN) plus China, Japan and the Republic of Korea—was seen as a promising regional framework for financial cooperation. At the core of the Initiative is a financing arrangement among the 13 countries that would strengthen intra-regional support against currency runs. A key strength of this initiative is the participation of one large reserve currency country (Japan)—which is viewed as an indispensable component of any viable regional framework.

However, a number of speakers noted that a successful regional arrangement in Asia may require a significant amount of time in order to build trust among the region's nations, which some said are still affected by rivalries that have marked their recent history.

According to some speakers the prospects for regional monetary arrangements in Latin America are not too promising, at least not in the near future. None of the countries in the region is a major reserve currency country. Among other factors, there are sharp differences in the macro-economic and exchange rate regimes in the region (e.g. dollarization, or currency boards versus managed floating regimes), which would preclude meaningful financial cooperation, unless some countries were willing

and able to radically re-orient their basic macro-economic framework away from excessive liberalization.

ALTERNATIVE MODELS OF DEVELOPMENT BASED ON SELF-RELIANCE

The limited short-term prospects of regional arrangements led to discussions on what some panellists described as "Do-it-yourself" self-defence mechanisms at the national level. In this context, it was stressed that rapid and imprudent liberalization of the capital account was "highly risky business." According to a number of speakers, the basic problem is that measures that would be most likely to prevent financial crises go against the conventional wisdom of orthodox policy advice and could generate political opposition domestically and internationally, and may lead to "punitive" actions by international financial markets.

Such measures would include a combination of heavily managed floating exchange rates backed by tough preventive capital controls, including restricting capital remittances abroad and, where it has become common practice, phasing out the use of hard currencies for domestic transactions. However, such measures, it was said, would have to be managed by highly competent State administrations.

One speaker described the difficulties of rectifying the mistakes of indiscriminate financial liberalization with a metaphor borrowed from US-based economist Jagdish Bhagwati: "The best way for a country to exit imprudent financial liberalization is not to have undertaken such reforms in the first place [e.g. India and China]; for those that have already gone down that path, it is probably as difficult to exit from financial liberalization as it is to resign from the Mafia."

Yet a number of speakers insisted that, while difficult, it is not impossible to "put the genie back in the bottle." It was suggested that the Financing for Development Conference could serve as a forum for developing countries to exchange experiences of strategic national responses to the excesses of financial markets, and help build a quorum of opinion in favour of experimenting with such "unorthodox" policies.

At this stage, few countries were said to be willing or able to pursue such policies. In this regard, the representative of one major industrialized country argued that proposals of this type are favoured neither by capital source countries nor by major recipient developing countries. "We are surprised," he added, "at a time of global economic slowdown, however temporary, to see measures advocated that would be likely to further reduce flows of capital to developing countries." In contrast, other speakers argued that the short-term costs of such measures (in terms of potentially reduced capital inflows) are infinitely less than the price society has to pay in the end when crisis strikes.

In this context, it was suggested that the FFD process could also be an opportunity to rethink basic development models away from excessive dependence on external capital and towards the harnessing of domestic or regional resources and capacities for more sustainable and self-reliant forms of development.

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