NEW GLOBAL FINANCIAL ARCHITECTURE: APPROACHES AND ISSUES

( Y. Venugopal Reddy )

Chairman Narasimham garu, Professor Lord Nicholas Stern, Dr. S K Rao, Dr. Ruth Kattumuri and distinguished friends.

I am honoured by the kind invitation to deliver the 4th I.G. Patel Lecture. I am thankful to LSE-India Observatory and, in particular to the Director of LSE, Mr. Howard Davies for this opportunity. I have had the privilege of knowing Dr. Patel for over thirty years, personally and professionally. He was Governor of Reserve Bank of India when I was working in World Bank; and I saw the leaders of global economic policy-making treating him with awe and respect. In later years, we worked together in several Committees and Boards, where his sagacity and wisdom were all pervading. Not many are aware of his leadership of one of the most leading academic institutions of the world, London School of Economic and Political Science (LSE), the school that produced the largest number of heads of governments in the world. Both Mr. Narasimham and Lord Nicholas Stern had long and close association with Dr. Patel and that adds to my pleasure of being here.

*4th I.G. Patel Lecture, organised by the London School of Economics and Political Science, in association with the Administrative Staff College of India, delivered at the Jubilee Hall, Public Gardens, Hyderabad, on 25 October 2010. Dr Reddy is Honorary Fellow at LSE.
Dr. I.G. Patel had many links with Hyderabad. He was an ardent admirer of Ms. Vanaja Iyengar and Mr. Mohit Sen of Hyderabad, his contemporaries in Cambridge University; and his write-up remembering them is eloquent and touching. Mrs. Alaknanda Patel still often visits her several friends here, and was keen to be with us today; but could not make it, unfortunately.

In view of Dr. Patel’s interest in global economy and the current global financial crisis, I have chosen to speak on the issue of Global Financial Architecture (GFA). I will briefly recall what appear to be the pillars of GFA and then explain the current context. I will mention the proposals and initiatives in the past and then detail the current approaches and proposals. I will narrate the new initiatives on GFA and conclude by listing some relevant issues.

Globalisation is a process that involves reducing the barriers to movement of people, goods, services, capital etc. between countries. The process of globalisation in recent years has given immense benefits but there have been costs. The recent financial crisis has brought out huge risks involved in globalisation of finance. GFA refers to the institutional and policy arrangements aimed at enhancing benefits and minimising risks of globalised finance.
**Pillars of GFA**

The IMF and World Bank group constitute the most important pillars of the GFA. The two institutions are inter-governmental organisations generally referred to as Bretton Woods institutions. They have, as members, the governments of almost all the countries. They are cooperative institutions, but the members have unequal voting strength within the two organisations. Representation on the Board of Directors that manages day-to-day affairs is skewed in favour of advanced economies, in particular Europe. Major decisions require special majorities, and this bestows virtual veto on important matters to the US, the single largest shareholder.

The IMF’s main functions are, monitoring global economy, surveillance over exchange rate and related policies of individual countries, and providing liquidity support to countries to overcome temporary problems of balance of payments. The IMF also provides technical assistance to some member countries to improve their macroeconomic management. The members of the IMF have to observe some obligations such as avoiding dual exchange rate, subjecting themselves to surveillance, and enabling full convertibility of their currency on current account. The IMF’s core competence and responsibility relate to global financial system, in
particular balance of payments, exchange rate and related macroeconomic policies. The IMF derives its resources mainly from the contributions of member countries, which are supplemented, as necessary, by borrowings from member countries.

The World Bank consists of two entities, namely the International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA). The World Bank is also an intergovernmental organisation with governance arrangements similar to the IMF. The World Bank provides resources and advice to developing countries for economic development. The World Bank group includes private sector affiliate, like the International Finance Corporation and others. The IBRD operates with capital provided by the members and by borrowings from financial markets. The IDA draws its resources from member governments, the IBRD, and repayments and retained earnings.

The WTO, as a third pillar, deals with the subject of international trade and is designed to bring down barriers to trade. The WTO covers, apart from trade in goods, subjects like trade in services and minimum standards for intellectual property protection. The General Agreement in Trade and Services (GATS) of the WTO is designed to establish a multilateral framework of rules for trade in services with a view to ensure expansions of such trade under
conditions of transparency and progressive liberalisation. One of the services covered by GATS is financial services. Financial services cover a wide range of insurance, reinsurance and other insurance-related services as well as a host of banking and other financial services. The WTO is unique as far as its decision-making methodology is concerned since each member has same weight in voting. The WTO continues the practice of decision-making by consensus, which is defined as absence of formal objection. Since voting is seldom resorted to in practice, in a sense, every WTO member enjoys veto power.

Recently, the G-20 (a group of twenty systemically important countries) has been described as a fourth pillar of the GFA. The Group of Twenty (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialised and developing economies to discuss key issues in the global economy. From 1999 till 2008, G-20 was essentially a discussion forum which ended in the issue of a communiqué. The financial crisis of 2008 came as a rude shock to the global community, in particular to the advanced economies. First, the centre (G-7 / G-8) became the origin of the crisis. Second, the periphery (developing countries) became innocent victims, but was less affected. Third, the financial crisis was spilling over into serious economic and, possibly, a social crisis. It was clear that the
crisis in 2008 was essentially global in nature, and the policy responses had to be globally coordinated. These events led to the initiation of Summit Meetings of the G-20 in November 2008 in Washington D.C., with the USA and UK taking a lead in the process. Since then, there have been Summit Meetings at the level of heads of states or of governments. In the context of the management of the crisis and creating a post-crisis world that would be more secure and stable than before, G-20 evolved as the most important economic policy forum in the world.

The Bank for International Settlements (BIS) is an international organisation with some (not all) central banks as members. The BIS fosters international monetary and financial cooperation and serves as a bank for central banks. It acts as a forum to promote discussion and policy among central banks and the international financial community. Its customers are only central banks and international organisations. The BIS plays a critical role in enabling the evolution of standards of capital adequacy for the banking system, and was instrumental in developing Basel standards. The operating arm for this work is the Basel Committee on Banking Supervision (BCBS), which is hosted by the BIS.

There are a host of other international organizations who are also part of the GFA but may not be described as pillars. These are the
Financial Stability Forum (replaced by the Financial Stability Board after the global crisis); the Financial Action Task Force (FATF); the International Organization of Securities Commission (IOSCO); the International Association of Insurance Supervisors (IAIS); the Joint Forum of national regulators in banking, securities and insurance; and the International Accounting Standards Board (IASB). Credit rating agencies which are for profit organisations, are also considered by some to be one of the pillars of the GFA.

**Context for the New GFA**

The global financial crisis has several dimensions but there is a consensus that the GFA was one of the relevant factors in not preventing the crisis. First, macroeconomic imbalances developed, which were a source of financial instability. Second, the surveillance of systemic risk for the global economy was obviously less than adequate. Third, financial markets have been globalised and financial institutions have been operating cross-border finance without adequate global coordination of regulations. In other words, the cross-border arrangements for financial regulation were non-existent or inappropriate. Fourth, the institutional arrangements for the provision of liquidity support to countries that suddenly faced serious difficulties, and to smoothen the necessary adjustments against shocks were not available. Fifth, infrastructural
arrangements such as credit ratings and international accounting standards proved to be pro-cyclical and hence sources of instability. Broadly speaking, the inadequacies relate to macro-economic policies, financial sector regulations and institutional set up to deal with globalised financial markets. In regard to macroeconomic policy in particular, it was felt that the international monetary system and the exchange rate arrangements were responsible for the generation of macroeconomic imbalance and their perpetuation without necessary correctives.

The gross inadequacies of the GFA were brought into focus as a result of the crisis. In regard to the IMF, there is a recognition that surveillance by the IMF was not sufficiently objective, in the sense that too much faith was placed in a particular ideological position that trusted unfettered markets. It was also felt that the surveillance failed to take account of systemic risks that were building up, in particular the risk to financial stability. Moreover, the IMF has not been even handed in its surveillance in so far as it has not brought out clearly some of the weaknesses in major advanced economies. When the crisis occurred, it was noticed that lendable resources available with the IMF were inadequate to meet the requirements of a number of developing economies. Many of these developing economies had been impacted by the financial crisis mainly because of global circumstances, and not their own
weaknesses. Finally, the IMF was not in a position to command adequate legitimacy and trust in view of its reputation built on past experiences. The ownership rights, the design of governance and the composition of the Board were responsible for the infirmities in governance of the IMF, and in any case, did not reflect the changed global economic realities.

In respect of the World Bank, according to many, its contribution in realising the objectives of development, have not been cognisable, though its contribution to thinking on developmental issues is arguably significant. In terms of flow of resources for development, it was playing smaller role in relation to private capital flows. When the crisis occurred, the resources available with the World Bank were less than adequate to meet the demands of developing countries. Above all, the governance structure of the World Bank suffered from weaknesses similar to the IMF. In regard to the WTO, many members have undertaken commitments for liberalising the financial services sector. The push for such liberalisation through the WTO could have been one of the contributory factors to the global crisis.

Within the BIS, which has restricted membership, there is a domination of North America, Europe and the UK, and their ideological preferences. The regulatory standards evolved under the
aegis of the BIS described as Basel II could not prevent the financial crisis, in particular, the banks’ balance sheets. The Financial Stability Forum (FSF) constituted after Asian crisis in 1998, which was the watchdog of the Global Financial Stability had not anticipated the crisis and had not taken any steps to mitigate the impact. Similarly, the G-20 which was also brought into existence in 1999 after the Asian crisis has failed to appropriately anticipate the forces that led to the crisis. These realisations have led to a serious reconsideration of the GFA.

**Past Proposals**

It is necessary to recognise that the inadequacies in the Global Financial Architecture are not entirely new. There was a realisation that inadequacies existed. The first and foremost effort to set up a Global Financial Architecture was undertaken after the Second World War. This initiative led to the creation of Bretton Woods Institutions. When US Dollar’s link with gold was broken in 1971, there were discussions on the International Monetary System. However, no significant change took place. The major review of the GFA took place consequent upon the Asian crisis. There were several proposals, particularly within academic circles. The first proposal related to lender of last resort. It was noted that during the 1990s, the G-7 group of industrialised countries, i.e. the US,
Japan, Germany, France, UK, Italy and Canada acting in close coordination with the IMF and World Bank, had performed the functions of the global lender of last resort. It was, however, observed that the resources available for the lender of last resort were grossly inadequate. First, it was felt that a larger fund for the IMF as a lender of last resort may encourage banks in industrialised countries to take more risks and, at the same time, encourage developing countries also to take on huge external liabilities. No significant progress was made in increasing resources for the IMF. Second, an international financial manager was proposed. The crisis manager may not necessarily need large resources, but should be in a position to provide comfort to the international community. The issue was whether functions of the crisis manager and lender of last resort can be separated.

A third proposal was to set up an International Bankruptcy Court in order to adjudicate debt issues between sovereign debtors and their creditors. This was expected to be similar to Chapters 9 and 11 of the US Bankruptcy Law. There is, however, a difference in the sense that in regard to a domestic bankruptcy, fixed assets can be seized and action can be taken against the Board of Directors of the company. No such options are available in regard to a country. However, there was a major difference, viz., countries have a sense of continuity and, therefore, there were strong incentives to honour
their debt obligations so that they continue to be credit worthy. The International Bankruptcy Court, however, may help in coordinating expectations about a good international sovereign borrower and a good international sovereign lender. An international authority to insure institutional investors against debt defaults was proposed. The authority would insure loans in advance when they are floated, and the G-7 would deny bailouts of loans that were not insured. There was a view that there should be no lender of last resort at all in global finance so that both lenders and borrowers are prudent.

Some proposals related to a global financial regulatory authority to be run by investment professionals to oversee both banks and non-bank financial intermediaries. It was felt that this would help harmonise standards of global regulation. Increasing transparency and improving financial regulation in developing countries was a more acceptable proposal. An international deposit insurance corporation to insure sovereign debt issues with floating rates was another suggestion.

A world monetary authority akin to the ECB but on a global scale, was also proposed. The world monetary authority would have the ability to issue currency to address global liquidity flows. In addition, proposals to impose controls on capital flows were also propagated. This will control capital inflows or capital outflows, or
both. Build-up of higher level of foreign reserves was considered as yet another option. Finally, opening up more to foreign banks was suggested to reduce the costs of any bail out after the crisis. Yet another suggestion was that there should be a correction to the bias in favour of debt-financing. There is a bias towards debt-finance since there is no risk sharing, and international debt contracts are often enforced through creditor country codes and G-7 institutions.

**Past Initiatives**

It is interesting that almost none of the above proposals or improvements in the GFA were considered seriously among policy circles. The problem at that time was considered to be essentially one of the debt of developing countries, and one of inadequate development of financial markets and weak regulation of the financial sector. The problem was also thought to be one relating to currency markets and relating to the banking sector of developing countries. In brief, the problem was essentially local and marginally of global significance. Accordingly, three changes were brought about in the GFA. The FSF, a forum of select advanced economies and important financial centres, was brought into existence to monitor financial stability. This was working mainly under the aegis of the BIS. The G-20 was constituted consisting of both developed and developing countries. The objective was to bring together
systemically important industrialised and developing economies to discuss key issues relevant for global economic stability. This had both, finances ministers and governors of various countries. The BIS, IMF and World Bank took initiatives to have a set of internationally acceptable standards and codes in regard to the financial sector. The Financial Sector Assessment Programs (FSAPs) were initiated in respect of most countries. A very modest beginning was made to change the composition of voting strength in the IMF and World Bank to reflect changing global realities in economies and trade.

**Current Approaches**

As a result of the current global financial crisis, some of the proposals which were originally mooted soon after the Asian crisis are, in a way, being revisited more seriously than before. There is better appreciation of the problem as being global in nature, though in reality the problem was in advanced economies but was transmitted through contagion to many developing economies. It is interesting that the role of two new institutions in the GFA (G-20 and FSF, constituted in 1999) which were created consequent upon the Asian crisis, and which failed to address the issue of financial stability has now been expanded and strengthened.
It is also necessary to note that during the period between Asian crisis and the current crisis the role of the IMF in handling the Asian crisis had come in for severe criticism. The stigma attached to obtaining resources from the IMF was intensified on account of its role in Asia. Subsequent to the Asian crisis, there have been crises in developing economies, in particular, in Latin America, which required support from the IMF. However, as the global economy picked up considerable growth momentum, the demand for support from the IMF waned. Operational income for the IMF reached a stage when was difficult to maintain itself. There was a feeling in some circles that the IMF has become somewhat irrelevant while many felt that it was necessary to have a global institution conducting economic surveillance over countries and over the global economy.

Asian economies in the light of experiences from the crisis of 1997 improved their performance in a dramatic manner, and they built significant reserves as a deliberate policy of self-insurance. The World Bank was, in the meantime, not in a position to significantly increase its net transfer of resources. The BIS expanded its membership to include some central banks of developing countries. In brief, the GFA almost went out of active agenda in the consideration of the global economy in the events leading to the current crisis. The crisis brought the GFA back into sharp focus.
There are two possible approaches to the design of the new GFA under discussion, viz., to create new institutions to replace or supplement the existing global institutions. These include institutional framework for a new global reserve system including establishment of a global central bank, a global economic coordination council, an international debt restructuring court, and above all a new Bretton Woods conference to consider a new GFA. Those who advocate in favour of new institutions argue that the existing architecture cannot be improved through marginal changes, in view of the inherent structural weaknesses in the institutions, their lack of credibility, their poor track-record and above all their resistance to divert, in the substance and style, from the entrenched interests in existing institutions. They also argue that such a process of designing a new GFA should not be difficult since the world is far more conducive to global cooperation now than before. On the earlier occasion, discussions took place soon after the Second World War and it was possible to come to an agreement through intellectual exercise backed by political considerations. The current crisis is of such magnitudes that a fundamental change in the institutional structures is called for, and hence a new GFA is required.
An alternative approach is to proceed on the assumption that creating new institutions would be an extremely complex process and hence it would take time. It would also divert attention from the immediate tasks. More important, the existing institutions are repositories of talent, skill and experience which could be built upon. Hence, it is also argued that since there is a clear recognition of the problems arising out of the crisis, it is possible to effect improvements to the existing institutional structures and their way of functioning, with a proper mandate and direction. On balance, the consensus appears to be in favour of reforming the existing institutions. In other words, the current approach is that a new GFA should be through reforming existing institutions rather than building new institutional structures.

The fundamental weaknesses of the International Monetary System which is closely related to but not exactly a part of the GFA, have been placed on the table as an issue. It has been recognised by most analysts that it is an issue which has to be addressed, but it is not easy to find technical solutions that would be politically feasible, and in any case, the transition would be complex. However, in view of the urgency as well as the necessity to explore improvements in the International Monetary System, ways are being explored by which SDR or SDR like mechanisms can be strengthened and utilised, with the IMF playing a critical role. Such a critical role could
be through sub-structures of the IMF. This is an issue on which considerable debate should be expected in the near future.

**New Initiatives**

Several initiatives have been taken by the IMF for internal reform, under the overall direction of the G-20. First, the IMF has initiated a process of reappraisal of its policies as evidenced from several research documents. It is not very clear whether the open mind and objective approach, as found in the research documents, is being reflected in the IMF operations.

Second, in regard to surveillance, the coverage of the financial sector has been increased and its assessment is being integrated into surveillance mechanisms. There is greater effort to address systemic issues in the surveillance while ensuring even handedness. In fact, in September 2010, the IMF made it mandatory for twenty-five jurisdictions with systemically important financial sectors to undergo financial stability assessments under the FSAP every five years. Selection of countries for mandatory assessments has been based on the size and interconnectedness of their financial sectors,
and will be reviewed periodically to make sure it reflects developments in the global financial system.

Third, lendable resources have been enhanced through several channels in particular through additional borrowings under the IMF’s New Arrangements to Borrow.

Fourth, global safety nets are being put in place. For countries which have strong policies and fundaments, there is an option of an assured resource by opting for flexible credit line. For countries which have policy strengths in most areas, they may opt for precautionary credit line which will make resources available but with ex-post (after disbursement) conditionality. The IMF is also examining the possibility of global stabilisation mechanisms as part of the global safety nets. It is not clear whether the possibility of collateral lending to supplement conditionality is being explored. Above all, effort is being made to erase stigma associated with approaching the IMF.

Fifth, with its program of lending to Greece in association with the ECB, the attitude of the IMF to link with regional bodies is under reappraisal.
Finally, in regard to governance, agreement has since been reached in G20 on October 23rd, 2010 for a shift in quota shares in favour of dynamic EMEs and under represented countries of over six per cent while protecting the voting share of the poorest. India’s quota share will improve from 2.44 per cent to 2.75 per cent. Europe will give up two of its seats on the Board.

In 1978, the Articles of Agreement of the Fund were amended to allow the setting up of a Ministerial Council of the IMF. Unlike the IMFC which is an advisory body, the Council would be a decision-making body with voting based on the current vote shares in the IMF. The composition of the Council is similar to the Executive Board. The Council will also have powers delegated to it by the Board of Governors. The activation of the Council requires a majority of 85 per cent of the voting power of the Board of Governors. The activation of the Ministerial Council has been recommended by the Independent Evaluation Office of the IMF and an Expert Group chaired by Trevor Manuel, the former Finance Minister of South Africa. However, there is no indication of action on this part.

In regard to the World Bank, lendable resources have been enhanced. The voting shares of developing and transition countries are being increased by 3.13 percentage points (from 44.06 per cent
to 47.19 per cent). Authorised capital of the bank is also being raised. For multilateral development banks as a whole, the capital base is being increased by 85 per cent. During the crisis, the World Bank had extended assistance to several developing countries and there has been front loading of IDA disbursements. There is however, resentment among several less developed countries that several countries like China and India continue to draw resources from the IBRD and IDA on a significant scale.

As regards the WTO, there has been no significant debate on the implications of the financial crisis. In its functioning and commitment of the members, the FSF has been expanded to include several developing countries virtually mirroring the composition of the G-20. The FSB has been functioning as the operating arm of the G-20 in regard to the financial sector. This includes monitoring of standards and codes, and setting up regulatory standards. The recently released BCBS guidelines on Basel III focuses on five aspects of financial sector regulation, viz., micro-prudential regulation specially for capital adequacy; macro-prudential regulation in terms of countercyclical measures; addressing liquidity issues; improving trade practices in regard to financial markets; and special provision for systemically important institutions.
The G-20 has been holding meetings regularly and considering coordination of various issues. These include issues relating to the global financial architecture. However, the decisions of the G-20 are made operational through the existing global institutions and actions by respective national governments in their relationship with existing institutions that comprise the GFA.

**Some Relevant Issues**

There are several issues that would determine the outcomes of the new GFA. First, the changes that have been brought about so far are addressing the infirmities observed in the existing institutions and their functioning. There is no evidence of a fundamental review of the ideological base of the global economy and global finance.

Second, the actions taken so far relate to operational aspects within the existing institutions with some indication of a possible shift in governance. As per all indications, the shift is likely to be very marginal. In other words, the new GFA is new only in operational terms but not in strategic terms.

Third, the approach so far is proceeding with only two layers, viz., national and global. However, the three layer approach involving regional arrangements such as in the Euro-Area and in Asia, may be
more appropriate. In particular, safety nets should be considered at national, regional and global levels, taking into account the circumstances of different countries and regions.

Fourth, the link between the financial and real sectors has not been explored adequately. There is still an assumption that real activity will have to necessarily adjust to financial markets.

Fifth, the trade-offs between growth, stability and regulation, have not been sufficiently explored in the design of improvements to the GFA. In particular, the design seems to aim to address stability issues of advanced economies rather than structural and developmental issues of developing economies. The missing element in regulation is the inter-connected and cross-border financial processes especially in the activities of international banks. Highly leveraged private institutions operating in cross-border markets remain somewhat unregulated.

Sixth, while the G-20 has flagged the issue of tax havens and tax secrecy, the importance of global fiscal coordination has not been adequately addressed. There is a review of progress in Tax Information Exchange Agreements but they only refer to quantitative aspects. Quality of agreements signed, relevant partners, domestic regulation of tax-haven jurisdiction, etc. are not
addressed. The GFA is incomplete without binding institutional structures for coordinating tax regimes since tax regimes and regulatory regimes of financial sector impinge on each other closely.

Seventh, no serious effort has been made to revisit the financial services commitments undertaken with the WTO. It can be argued that the commitments already undertaken with the WTO need to be reviewed to ensure the integrity and stability of the financial system and that since the problem is not relatable to a single member or a group of members only, it is desirable to adopt a ministerial declaration enabling the members to revise their schedule. In fact, the preamble to the GATS recognises the right of members to regulate and to introduce new regulations on the supply of services to meet national policy objectives. Members may have to roll back some of their commitments in the financial services sectors under GATS on the way forward to prevent recurrence of global financial and economic crisis.

The question that remains unanswered so far is how new will the new GFA be? Much will depend on the functioning of a revived IMF and a rediscovered G-20 which happen to be the cognisable new elements of the new GFA. There are three distinct challenges for both IMF and G20. First, how to manage the asymmetry in the extent of global integration of
labour, capital and financial regulation? Second, how to design global governance that is equitable to people at large with unequal nations, unequal in terms of economic strength? Third, how to reconcile the public policy autonomy needed for national governments essential for their accountability, and the arrangements for governance at global level? In addressing these issues, it is essential to recognise that developments in technology have a tendency to favour globlisation in general.

India has an important role to play in the evolution of new GFA. India is unique among major economies is not causing the macro imbalances and not contributing to financial crisis. India adopted pragmatic policies successfully and hence India can be objective and impartial in the deliberation of GFA. This has been recognised by the global community and our Prime Minister has emerged as a global economic statesman. There is every reason to be cautiously optimistic about a desirable and acceptable new GFA.