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Reforming the International Financial System

Against the backdrop of the present crisis this Forum is dedicated to the discussion of measures to prevent future breakdowns of the global economy. Daniel Gros, Ulrich Klüh and Beatrice Weder di Mauro regard as the biggest flaw in the existing structures the lack of an institution that has the information, expertise and impartiality that would enable it to swiftly identify and frankly communicate emerging risks to the global financial system and the world economy. They present a proposal that aims at placing the IMF in a position to play this part. The paper by Philip Lane focuses on how reforms in the governance of the global financial system may alter the incentives facing those emerging market economies that have opted to run large – and globally inefficient – current account surpluses as insurance against the risks of disruptions in capital flows to these economies.

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Reforming Global Governance: How to Make the IMF More Independent

Expectations were high when the G20 countries first met to design better rules for the conduct of finance, provide a new international financial architecture and reform global governance. On the eve of their second meeting, the G20 proposals now appear disappointing in at least one crucial area: they are playing down the need for a bolder reform of the institutional landscape for international cooperation in economic and financial issues. In part, this is the result of the fact that in an ongoing crisis, pressures to address immediate concerns of crisis management abound and medium to long-term issues take a back seat. At the same time, however, there is a more fundamental problem: while being more representative than the G7, the G20 does not explicitly include an institution through which the multilateral perspective is brought to the table. The G20 thus shares at least one of the deficiencies of the system that it is expected to improve: a lack of impartial input into the discussion of global economic policy problems. The IMF provides much needed input to the discussions, but it does so effectively under the orders of the same governments that also sit in the G20.

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Key Issues in Global Governance Reforms

There is no shortage of proposals as to how the global institutional set-up should be changed to prevent the occurrence of another systemic crisis. But there is a substantial degree of overlap among the many proposals that currently circulate. For instance, most observers agree that the International Monetary Fund (IMF) needs additional financial resources to deal with the current crisis, let alone potential future crises, that emerging and developing countries need to be assigned a more substantive role and that the Fund's and the World Bank's managing directors should be chosen more transparently and without any preference for their nationality.

Though most proposals share common elements, they differ in the degree to which they emphasise alternative problem dimensions:

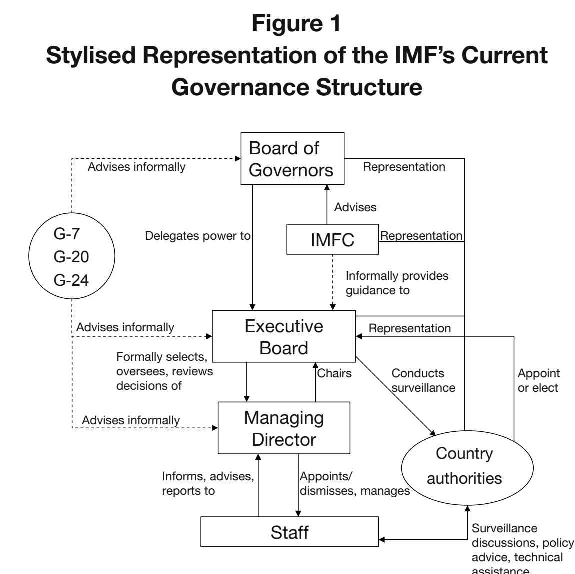
- One set of proposals concentrates on the *ability of the Fund to expand its lending activities* sufficiently to rebuild confidence amongst emerging market investors now and prevent an excessive build-up of reserves in the years to come. The problem here is not merely one of providing additional resources, but also one of putting in place the right lending facilities. Consequently, proposals include boosting the allocation of SDRs, allowing the Fund to borrow directly from financial markets, easing Fund conditionality

and reviving the so-called Conditional Finance Facility.[1] There exists now, at least at the political level, a general agreement that the resources of the Fund should be greatly increased, probably doubled. This should allow the IMF to play a much stronger role in addressing the current emergency situation because the larger emerging market economies have rather strong balance sheets.

- Another set of proposals centres on the *lack of a forum for continuous and binding policy coordination* involving senior government officials from all relevant countries. To make such coordination effective, the right balance has to be struck between a sufficiently broad coverage of all major countries, the need to make the forum small enough to be effective, and the desire to have more *legitimacy* than is currently the case. In this respect, the current round of G20 meetings is at best seen as makeshift. To build a more coherent framework for the future, proposed changes range from the establishment of a completely new institution, for example at the UN, to an overhaul of the International Monetary and Financial Committee (IMFC).[2]
- A further concern is *complexity*.[3] The institutional architecture for global financial governance in general and international financial supervision in particular is characterised by a proliferation of formal and informal groups and organisations, with overlapping and often competing agendas and mandates. A brief look at a stylised view of IMF governance (Figure 1) says more than many words. Now consider that there are at least half a dozen other multilateral institutions in which the same member countries or subgroups of countries discuss the same or similar issues of economic and financial stability. For instance, the Financial Stability Forum shares many mandates of the IMF to identify risks in financial markets and institutions. The envisioned inclusion of large emerging market countries in the FSF does not address this problem of shared responsibilities.

More resources, greater continuity of coordination at all levels, better representation, as well as clearer and leaner structures are indeed important. However, addressing these concerns would not resolve what in our view has been the biggest flaw of existing global structures: the lack of an institution that has the information, expertise and impartiality that would enable it to swiftly identify and frankly communicate emerging risks to the global financial system and the world economy. Without such an institution, none of the other short and long-term issues can be resolved satisfactorily. First and foremost, any forum of high-level decision-makers will need to be informed by an independent body that is not restricted in its capacity to create awareness for emerging risks. Second, expanding the Fund's lending capacity will necessarily increase the inclination of individual countries to be part of day-to-day decision-making, and thus has to be complemented by a structure that ensures that problem identification remains impartial and unaffected by individual countries' interests. Finally, reducing complexity necessarily will start from a strengthening of the institutional core.

Figure 1
Stylised Representation of the IMF's Current Governance Structure



Source: www.imf.org.

What explains the apparent lack of an independent institutional core for the oversight of the global monetary system? After all, the IMF in principle has the mandate to act as a watchdog over its member countries. However, when it comes to problems in large member countries, the IMF is severely limited in what it can achieve. For example, over the last 7 years the USA has refused to submit to a financial sector assessment programme (FSAP). Partly as a consequence of large countries' influence, those within the IMF that had warned of the emergence of substantial vulnerabilities through financial innovation relatively early did not have the means to follow up on their risk assessment.[4] The

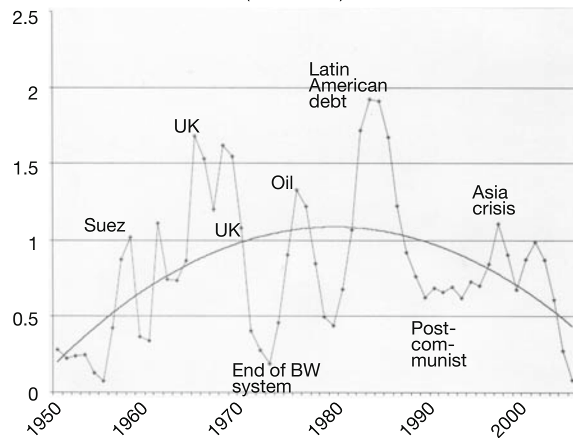
[1] Cf. for example Dani Rodrik: Why Don't We Hear More About SDRs?, 4 February 2009, www.voxEU.org; John Williamson: Reforming the IMF, 14 February 2009, www.voxEU.org; and Morris Goldstein: Dig into the IMF's Tool Box to Tackle the Crisis, 2008, www.iie.org.

[2] As recently proposed by R. Rajan on the discussion platform of the London summit's webpage http://comment.fco.gov.uk/roller2/debate/entry/usa_academics_debate_raghuram_rajan.

[3] Cf. e.g. Luigi Spaventa: Reforms of the world financial system: Can the G20 deliver?, http://www.voxeu.org/index.php?q=node/2894, 28 January 2009.

[4] For one of these early assessments, cf. Raghuram Rajan: Has financial development made the world riskier?, in: NBER Working Paper, No. W11728, 2005, available at SSRN: http://ssrn.com/abstract=842464.

Figure 2
IMF Drawings as a Proportion of World Exports
(1948-2006)



Source: Michael Bordo, Harold James: The Past and Future of IMF Reform: A proposal, in: Building an International Monetary and Financial System for the 21st Century: Agenda for Reform, eBook published by the Reinventing Bretton Woods Committee, Proceedings of the conference organized by the committee in New York City, 24-25 November 2008.

degree to which the IMF was considered an institution which should focus on emerging markets became clear in the last two years, when the IMF underwent a large-scale reduction in staff because its key shareholders thought that fewer crises in the past meant that the institution was no longer needed (Figure 2).

This, at least, has now changed radically. There is now general agreement that the global monetary system needs a body that looks after its overall systemic stability. And most experts would agree that the IMF is the right platform around which to build a structure of more effective policy coordination. While much has to be done to improve its expertise in linking different aspects of global financial and economic fragility, the IMF is the only institution that has most of the basic building blocks: it knows bilateral surveillance and has multilateral units to combine insights from individual member countries. Similarly, it has a staff with expertise in monetary, financial, regulatory, real economy, and fiscal issues, and a lot of experience in emerging markets, and thus the regions that are likely to increasingly define global economic fragilities. Finally, the Fund's global membership enables it to identify inter-regional links between national imbalances and risks and to incorporate the views of those economies that for the foreseeable future will not be at the centre of the multilateral policy dialogue.

How to Make the IMF a More Effective Watchdog

To make better use of the Fund, two main problems have to be addressed. First, the informational and analytic content of surveillance has been inadequate. The Fund has simply not had access to the relevant information to detect early warning signals effectively. In particular it has to be granted access to data on individual systemic institutions and markets from all systemic countries. Second, there has been a lack of independence and impartiality.

To address these problems and to make the IMF a more effective watchdog, a two-pronged strategy is required:

- the IMF needs to be equipped with a stronger mandate, adequate resources and better access to information to improve its *capabilities to identify risks*;
- more importantly, the IMF needs a much higher degree of *independence and impartiality* from its main shareholders that ensures that problems are not only properly identified but also effectively addressed.

The necessary steps have to be carried out against the backdrop of an ongoing crisis. This means, in particular, that the new Fund has to have a governance structure consistent with potentially large new lending engagements.

Improving IMF Early-warning Capacities

To beef up the IMF's capacity to provide a more forward-looking assessment of emerging global economic risks, progress on various fronts is necessary. The natural starting-point for any reform would be to expand the Fund's mandate under Article IV of its Articles of Agreement. The current focus on exchange-rate regimes implies a tendency to over-emphasise risks from emerging markets and to downplay problems in developed countries. Only an explicit recognition to the effect that the Fund is expected to identify and communicate threats to financial and economic stability more generally would provide it with the leverage it will need to address the delicate issues that are likely to define its new role.

Another more substantive step that we believe is absolutely essential is to provide the IMF with access to all relevant information to create a comprehensive "risk map" that can be used to regularly stress test the global financial system. In its communiqué of November 2008, the G20 pledged to "ensure that all financial markets, products and participants are regulated or subject to oversight". This can only be achieved when the supervisory gaps and blind spots that have characterised the previous financial cycle are addressed forcefully. Since these gaps were to a large extent caused by an incongruence of global finance and local oversight, an international watchdog has to be equipped with all relevant macro *and* micro-prudential data on systemic institutions and markets, a right to request any information

that it deems necessary to fulfil its task, and the mandate to conduct regular assessments of global financial players as well as individual financial systems and their public infrastructure.

With respect to the internal organisation of surveillance activities, the focus should be on making better use of bilateral surveillance as an input to multilateral activities and improving macro-financial analysis. One option to better consolidate available information and organise effectively the production of new analytical outputs would be to create a new Global Surveillance Department (GSD) that ensures that the information from the risk map and from bilateral surveillance is integrated into a frank assessment of emerging macro-financial risks. The creation of such a GSD was already contemplated during the last restructuring exercise that the Fund undertook in 2007 and 2008. Apart from allowing the Fund to make better use of available information and to refocus its analytical outputs on issues of systemic relevance, such a structure would have an important institutional advantage: it would clearly demarcate those areas in which the Fund should be granted a maximum degree of autonomy and independence.

Increasing IMF Independence

Increasing early warning capacities alone will not change anything if identified risks remain within the confines of the IMF. Greater independence of Fund surveillance is needed to ensure that national interests and veto rights do not prevent the actions that would follow from a thorough analysis of global vulnerabilities. Though we support many of the detailed prescriptions with respect to improving Fund governance (such as a single seat for the European Union, a transparent mechanism for choosing the Managing Director, and less micro-management by the Executive Board) we believe that existing proposals fail to make an important distinction.

Specifically, we think that one cannot and should not create the same decision-making procedures for traditional IMF balance-of-payment support on the one hand and surveillance and early-warning activities on the other. The IMF is supposed to fulfil a range of activities, and for some of these a different mode of governance is entirely appropriate:

- Granting balance of payments support has important fiscal implications and it is natural that for this function there should be continuing close oversight by those who in the end provide the capital, namely the fiscal authorities of the Fund's member states.
- Overseeing the global financial system, including the assessment of global macro imbalances are analytical functions for which there is no need for close oversight. On the contrary, in the exercise of these functions independence and professional expertise should be decisive.

The decision rule of the Fund should thus distinguish between financial measures (granting balance of payments assistance) and the analytical function of the IMF, especially macro surveillance and, potentially, as the main organisation to look out for sources of risk in the global financial system.

At present the daily business of the IMF is run by its Executive Board that consists only of representatives of member countries and makes decisions that are all weighted by the shares of each member country. The IMF's 24-member Executive Board discusses everything from the IMF staff's annual health checks of member countries' economies to economic policy issues germane to the global economy.[5] The IMF's Executive Board is deeply involved in the day-to-day business of the IMF, meets almost permanently and constitutes essentially a very large extended Management Board, which delegates only the execution of its decisions to the Managing Director and the staff.

This needs to change in order to give the IMF the independence it needs to become a credible impartial judge of balance of payments disequilibria and sources of risk to global financial markets. The IMF staff needs to be independent in these functions, which should no longer be micro-managed by the Executive Board.

The required independence of the IMF staff can be achieved simply by stipulating that the Board of the IMF only *oversees* the work of the IMF on its analytical functions and, even more importantly, that its decision-making mode (and composition) is different in its oversight of these areas. This could be achieved with two simple decisions:

1. The Executive Board should be enlarged by a number (possibly 3) of *independent directors* (as in the private sector) and the voting principle should be one man, one vote. The independent board members would constitute only a small minority. But their presence and professional expertise would give them a disproportionate weight and they would have a disciplining effect since they are to represent the general interest and would be free to go public with their views, for example through the right to publish any dissenting vote or opinion.
2. Management would also be free to take positions on all issues not involving the use of fund resources unless it is explicitly overruled by the expand-

[5] Cf. www.imf.org.

Proposed Changes to the IMF's Statutes (Articles of Agreement)

Section 3. Governing (instead of Executive) Board

(a) The Governing Board shall be responsible for supervising (instead of conducting) the business of the Fund, and for this purpose shall exercise all the powers delegated to it by the Board of Governors.

New paragraph:

Section 3.xx The Governing Board

The Governing Board shall consist of the Executive Board, the Managing Director, two Deputy Managing Directors and three independent members selected for their professional expertise in international financial matters. Each member of the Governing Board has one vote. The Managing Director shall be chairman of the Executive Board and shall have the casting vote in case of an equal division. In matters involving the use of the financial resources of the IMF only the members of the Executive Board shall vote and their votes shall be weighted by the shares of the constituencies they represent.

Section 4. Managing Director and staff

(a) The Board of Governors (instead of Executive Board) shall select a Managing Director (and two deputy MDs) who shall not be a Governor or an Executive Director. The Managing Director shall be chairman of the Executive Board, but shall have no vote except a deciding vote in case of an equal division. He may participate in meetings of the Board of Governors, but shall not vote at such meetings. The Managing Director shall cease to hold office when the Executive Board so decides.

(b) The Managing Director shall be chief of the operating staff of the Fund and shall conduct, under the direction of the Executive Board, the ordinary business of the Fund. Subject to the general control of the Governing Board, he shall be responsible for the organisation, appointment, and dismissal of the staff of the Fund.

ed board. This would give management de facto considerable independence since under the one man, one vote principle the larger member countries could no longer block issues just because they are inconvenient from a domestic political point of view.

For all decisions involving the resources of the Fund (lending to member countries or the size of quotas etc.) the existing decision-making procedure could remain unchanged. All financial issue decisions would thus continue to be taken by the existing Executive Board with weighted voting reflecting the financial contribution of member countries to the IMF.

The ECB (or rather the Eurosystem, as it likes to call itself) provides an interesting analogy because it has two voting procedures depending on the issue at hand:[6] the Governing Council of the ECB comprises the six members of the Executive Board plus the governors/presidents of the national central banks of the countries in the euro area (at present 16). The Governing Council takes the really important decisions on monetary policy based on the "one man, one vote" principle. When the Maastricht Treaty was negotiated this was considered a major concession by the Germans, but it is really indispensable if the ECB is to be really independent and if one expects that all members of the Governing Board, including particularly the governors of national central banks, base their decisions only on the interests of the entire euro area (and not of their home country). However, on financial matters (in particular the distribution of profits and losses) the voting rules are different: the Executive Board does not participate and the votes of the national central bank presidents in the Governing Council are weighted by their respective capital shares (Article 10.3 of the Statutes of the ECB).

Conclusion

It is by now generally acknowledged that there is a need for an institution that looks after global financial macroeconomic stability. It is also generally agreed that the IMF should play this role (in addition to its standard role of lender of last resort for countries with balance of payments difficulties). However, the IMF as presently organised cannot fulfil this analytical function because it operates under the close scrutiny of a resident Board which represents the interests of individual member countries. We argue that the IMF can become an effective watchdog for international financial stability only if its governance is changed. The management and staff of the IMF need to have a high degree of independence in order to be able to critisise, if neccessary, even its largest member states. This can be achieved by putting independent directors on the Board and changing its voting arrangements.

[6] The ECB also has two decision-making bodies but the second one, the General Council, which also comprises the governors of the central banks of the EU countries which do not (yet) participate in the euro area, has no important function.

Philip R. Lane*

Global Imbalances and Global Governance

The scale and multi-faceted nature of the international financial crisis has temporarily shifted attention away from the global imbalances debate. However, there are several reasons to remain concerned about the scale of global imbalances. First, global imbalances were surely a contributory factor to the origin of the global crisis.[1] While there remains considerable disagreement about the appropriate weighting that should be attached to global imbalances in developing a comprehensive explanation for the current crisis, it is important to further improve our analytical understanding of the sources of global imbalances. Second, the ongoing persistence of global imbalances (in the current account and in the net foreign asset position) continues to be a major risk factor for the world economy. Most obviously, the risk of a disruptive dollar depreciation remains current, such that there is a clear policy interest in continuing to focus on global imbalances.

Since it is commonly accepted that large and persistent global imbalances are rooted in structural fragilities in the operation of international markets, the G20 reform agenda accords high priority to structural reforms that can strengthen the global financial and economic system. I focus in this article on how reforms in the governance of the global financial system may alter the incentives facing those emerging market economies that have opted to run large current account surpluses over the last decade. These surpluses have been accumulated in order to self-insure against the risks of disruptions in capital flows to these economies.

Although the emerging markets have not been the only source of current account surpluses, we focus on this group of countries since these surpluses may be interpreted as globally inefficient. The group of emerging Asian economies (led by China but also including other major economies such as Korea and Indonesia) has run sizeable surpluses in recent years, while the scale of current account deficits has contracted for many other emerging market economies in other regions. In contrast, the large surpluses run by oil exporters in recent years conform to neoclassical predictions of optimising behaviour in response to a terms of trade windfall. Similarly, the chronic current account surpluses of Japan and Germany can be largely attributed to demographic patterns and the declining share of these economies in global GDP. While efficient current account surpluses may still pose problems for the global system, the inefficient surpluses run by emerging market economies are arguably a more natural target for institutional reform.

Although the epicenter of the global financial crisis has clearly been in the financial systems of the advanced economies, the emerging markets have been substantially affected by the crisis. The latest indicators suggest a major slowdown in output and trade volumes and a reversal in capital inflows to these economies. The decline in fundamentals is also reflected in major shifts in asset prices, with a substantial depreciation of the currencies of most emerging market economies, a decline in stock market values and an increase in foreign-currency bond spreads. These negative developments illustrate that the self-insurance model has not enabled emerging market economies to remain immune from negative global developments and reinforce the urgency of developing a new institutional framework to support a more stable pattern of capital flows to emerging market economies.

The External Balance Sheets of Emerging Market Economies

The external risk profile of emerging market economies has undergone a radical shift since the mid 1990s. The level of international financial integration is much higher in terms of gross positions than was the case during previous crisis episodes in the 1980s and 1990s. The scale of gross positions grew rapidly over the last five years, which was mainly generated by an acceleration in gross capital flows. In addition, rising global asset values increased the scale of balance sheets relative to GDP. Accordingly, in terms of gross cross-border positions, the emerging market economies were much more integrated into the global financial system at the onset of the current global crisis.

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[1] Richard Portes: Global Imbalances, in: Mathias Dewatripoint, Xavier Freixas, Richard Portes (eds.): Macroeconomic Stability and Financial Regulation: Key Issues for the G20, VOX e-book, March 2009.

In addition, the composition of the international investment position of emerging market economies underwent a major shift. Most obviously, there has been rapid growth in foreign-exchange reserves, which have increased for the emerging market group from 5 per cent of aggregate GDP in the 1980s to over 25 per cent by 2007. Another major trend has been the growing importance of FDI and portfolio equity as a source of finance. This has been a positive development in terms of risk profile, since the foreign investor absorbs the risk of state-contingent returns on these positions. However, it also means that emerging markets form a larger proportion of the portfolios of investors from the advanced economies and are thereby more exposed in terms of the transmission of financial shocks.

Taken together, these trends have led to a striking shift in the international configuration of portfolios for the major emerging market economies, which have shifted from a position in 1995 in which these countries were both net debtors and net recipients of equity investments to a profile in which a much larger negative net equity position is nearly matched by a very large long position in foreign debt holdings. The mirror-image trend is evident for the major advanced economies, which increased their long position in foreign equity while also taking on a larger short position in foreign debt.

The transformation of the external financial profile of emerging market economies also included a major reduction in net foreign liabilities. This was achieved by a sustained period of running current account surpluses. While the long-term allocative efficiency of capital running uphill may be open to question, it should have reduced the vulnerability of emerging market economies to capital flow reversals, since the net external position has been a historical predictor of the incidence of crises.

The impact of these shifts in external capital structure has been to transform the aggregate foreign-currency position of emerging market economies. As is shown by Lane and Shambaugh,[2] many emerging market economies are now long in foreign currencies, such that domestic currency depreciation actually has a positive balance sheet impact, in sharp contrast to the experience during the 1990s.

At one level, this general reconfiguration may be viewed as involving a major risk transfer from the emerging markets to investors in the advanced economies. In turn, this should be welfare improving to the extent that investors in the higher-income economies with more developed financial systems should be better equipped to manage risk. However, the build up in large two-way gross positions also meant that failures in risk management and illiquidity problems in the advanced economies may be transmitted quickly to counterparts in the emerging market economies.

However, while these steps have reduced the vulnerability to financial crises, each involves significant inefficiencies. In particular, this strategy has been costly in terms of foregone domestic absorption opportunities and in the potential for superior international risk sharing arrangements. Moreover, it exerts substantial spillover effects on the reserve-issuing countries, through the impact of persistent trade surpluses and the official-sector demand for liquid securities. Finally, the adverse impact of the current crisis on emerging market economies demonstrates that vulnerabilities remain, such that the self-insurance approach has not provided complete insulation.

Reforming the Institutional Framework for Capital Flows between Advanced and Developing Economies

In relation to the medium-term goal of improving the structural foundations of the international financial system, the overriding principle is to reduce the risks faced by emerging market economies in engaging with the international financial system.[3] In addition, in managing the residual risk, the goal is to develop mechanisms that reduce the cost of insuring against such risks.

In general, the appropriate framework for thinking about medium-term reform is to recognise that the emerging market economies suffer from an incomplete level of international financial integration. Unlike very low income countries, these economies are sufficiently integrated into the global financial system to be exposed to severe financial shocks. However, at the same time, these countries are treated differently by the global system in comparison to the financial environment that faces the most advanced economies. Key differentiating factors include the level of domestic financial development, the quality of institutions and governance, macroeconomic policy discipline and trade integration: those countries that score better along these dimensions are also those countries that are better equipped to prosper under international financial integration. Accordingly, reaping the gains from financial globalisation involves the same types of reforms that are also generally beneficial for domestic economic performance.

In relation to the domestic reform efforts of the emerging market economies, the recent increase in the

[2] Philip R. Lane, Jay Shambaugh: Financial Exchange Rates and International Currency Exposures, in: American Economic Review, forthcoming.

[3] Martin Wolf: Fixing Global Finance, Yale University Press 2009.

cost of external capital should induce an intensification of efforts to develop the domestic financial system. Domestic financial development is important for two reasons. First, the improved domestic mobilisation of domestic savings reduces the importance of external capital as a funding source. Second, a deeper financial system increases the span of investable opportunities that are available to foreign investors. Financial development should be broadly interpreted to encompass improvements in corporate governance and the quality of the regulatory system. In particular, the current crisis has highlighted that volume-based indices of financial development (such as the stock of outstanding securities) are not good measures if the financial system is distorted by a poor regulatory environment.

It is also important to take into account that the empirical evidence indicates that financial reform policies only promote financial development in environments in which private property rights are secure from arbitrary political interference. Moreover, while the full impact of domestic financial reform only unfolds over the medium term, the credible announcement of a programme of financial reforms should be helpful even in the short term. While the major emerging market economies have made major progress in financial reform, a considerable gap remains for several countries relative to a fully liberalised domestic financial system.

It should also be understood that domestic risk management extends beyond the financial system to include social insurance programmes. In advanced economies, risk management is provided by a combination of public and private systems. However, the degree of social insurance for major personal risks (illness, unemployment) is much less adequate in a number of emerging market economies, leading to a high degree of precautionary saving by households. Accordingly, part of the reform agenda is to improve the adequacy of social insurance, via welfare systems and the public funding of relevant goods and services. In similar fashion, institutional reform extends beyond the regulation of the financial system. For instance, the ambiguous ownership status of many enterprises in China generates an extraordinarily high level of corporate savings, due to lack of clarity over the appropriate distribution of dividend payments.

In relation to domestic reforms that directly affect the nature of international capital flows, one key element is the development of local-currency debt markets. So far, local-currency debt markets have been dominated by locally resident investors, with relatively little participation by foreign investors. While participation by domestic residents is a major achievement in itself, it is also desirable to enable effective cross-border capital flows in local currency. To this end, it is important that the development of local-currency debt markets is complemented by the development of the currency derivatives market, in order to allow investors to separately trade currency risk and credit risk.

In addition to the promotion of local-currency debt markets, there is also considerable scope to improve risk sharing via other types of state-contingent instruments. For instance, the idea of GDP-indexed bonds has received considerable attention. Other types of state-contingent instruments may also be envisaged. On the liabilities side, a commodities exporter might issue debt with a coupon that is indexed to global commodity prices. More broadly, emerging markets might tie yields to the high-risk spread in the US corporate debt market. The virtue of these types of instrument is that the contingent element in the return is a function of external conditions, such that it cannot be manipulated by the issuer. This feature eliminates the moral hazard problem that generically affects state-contingent contracts. There is also scope for greater use of state-contingent instruments on the asset side of the international balance sheet, since many of the risk sharing benefits of state-contingent liabilities can be replicated by an appropriate portfolio of assets. However, the limitation of an asset-based approach is that, all else equal, it involves the leveraging of the international balance sheet.

A second key element is to further promote international equity financing. As indicated earlier, the share of equity in the foreign liabilities of emerging markets has grown strongly over the last decade. However, corporate governance and regulatory problems limit the attractiveness of emerging-market stockmarkets for many investors.

The importance of domestic institutional development extends beyond the financial sector. In particular, a fundamental goal for emerging market economies is to copperfasten stability in macroeconomic policies. In relation to fiscal procyclicality, institutional reforms can do much to improve the cyclical behaviour of fiscal policy. While there remains considerable variation across countries, the capacity of countries such as Chile to develop fiscal processes that help to insulate the budget from the curse of procyclicality has been impressive.

Regional Financial Integration

So far, we have discussed domestic reforms. An extension of this is to further promote regional financial integration. The empirical evidence is that gravity factors such as distance and cultural linkages are influential in international asset trade. In addition, there is

a strongly positive correlation between trade in goods and services and trade in assets. Accordingly, there is much scope for regional levels of financial integration. In particular, regional capital flows may be more stable in character, in view of the underlying linkages between neighbouring economies and the lower level of bilateral exchange rate volatility. Accordingly, it is desirable that regional groups intensify efforts to cooperate in the design of common institutional standards for financial market development and work to lift barriers to cross-border asset trade.

Turning to the international dimension of reform, there is considerable scope for the international community to support a more stable system of international finance for emerging market economies. The international financial institutions have a clear role to play in terms of the provision of technical advice in the development of domestic financial systems.

The IFIs could possibly do more in terms of issuing securities in the currencies of the emerging market economies. Such issues have the potential to help to expand the depth and liquidity of the domestic-currency bond markets, as well as allowing the international financial institutions to make local-currency loans to clients in those markets. Such issuance could be in specific currencies, such as the RMB-denominated bond issues by the Asian Development Bank and the International Finance Corporation (the so-called Panda Bonds). In addition, securities could be issued that are indexed to a basket of emerging market currencies.[4] More generally, in view of the free riding problem and other externalities that inhibit the creation of new securities markets, the IFIs potentially have a central role in helping to develop the types of state-contingent securities that may improve the risk profile of the external liabilities of emerging markets.

What Does It Mean for the Current Crisis?

The current crisis has vividly illustrated how public sources of funding must be available in the event of the breakdown of financial trade among private-sector counterparties. In this respect, two major innovations stand out in terms of the expansion of public funding for cross-border transactions. First, there has been the establishment of currency swap arrangements among the world's major central banks and also vis-à-vis selected emerging market economies. Second, the IMF created the new Short-Term Liquidity Facility (SLF) that is available to those member countries that have previously demonstrated strong fundamentals in terms of sound policies, access to capital markets and sustainable debt burdens. Since it relies on the track record of the applicant, the funds can be disbursed quickly and without conditionality, such that the SLF has the potential to be helpful in tackling short-term liquidity difficulties. Accordingly, the SLF represents a potentially useful expansion in the range of instruments available to the IMF in dealing with liquidity problems. However, as with any public liquidity facility, the SLF faces the stigma problem, by which a country may be reluctant to tap these funds in fear of the negative signal that such a move would send to the markets.

More generally, the disruption in private capital flows reinforces the need for an expansion of the funding base for the IMF, in order to address both liquidity problems and the traditional "debtor-in-possession" financing for those countries that require a period of reform in order to re-establish access to financial markets. In tandem with a redistribution of quotas, it is appropriate that the largest emerging market economies join the advanced economies in becoming substantial underwriters of the IMF's balance sheet. A better-financed IMF that stood ready to provide liquidity support would enable these economies to shed some of their excess foreign-currency reserves and would be collectively more efficient. Accordingly, the principle of major IMF renewal should be a key governance target.

However, major IMF reform can only be negotiated over time. The recent agreement to reallocate quotas in a limited fashion took a considerable period to be negotiated and has not yet been ratified by all member countries. A major shift in the distribution of voting power at the IMF requires leadership by those regions that are currently over-represented, with the obvious potential for the consolidation of representation by member countries of the European Union.

The expansion of IMF resources need not wait for the completion of governance reform. In February 2009, a bilateral $100 billion loan from Japan to the IMF was finalised, while the USA has proposed a major expansion in IMF funding via the New Arrangements to Borrow facility, which could be expanded to include more of the major surplus economies.

These tensions are reflected in the 15 March 2009 agreement among the G20 finance ministers on IMF reform. A doubling in the IMF balance sheet from $250 billion to $500 billion was approved but the funding mechanism was left open between bilateral loans, new arrangements to borrow and quota reforms. In addition, progress was made on IMF governance, with the agreement of open competition in appointing the heads of the IFIs and a shifting forward of the next IMF quota review from 2013 to 2011.

[4] See also the discussion in Martin Wolf, op.cit.

How to Deal with the Risks Embedded in Financial Balance Sheets

The current crisis has also revealed a major analytical failure in under-estimating the risks embedded in the rapid increase in financial balance sheets over 2002-2007. It is important that the appropriate lessons from this episode be drawn and the IMF is best positioned to conduct the research that analyses the sources of the crisis from a global perspective. In relation to the emerging market economies, a key priority is to better understand the liquidity risks generated by gross exposures in the international balance sheet, rather than just focusing on net external positions.

In turn, the IMF has a role to play in developing new analytical frameworks to better understand international financial linkages and in establishing a common level of understanding across the member countries. While such initiatives do not immediately translate into coordinated policy decisions, the central role of national governments in policy delivery means that a new framework for global financial governance must build linkages between national governments and the IMF, in addition to the functions that can be addressed through supra-national institutions and purely intergovernmental cooperation.

In addition to reform of the global financial institutions, there is also room for a greater range of regional initiatives. The limits to the potential resources of the IMF and the heterogeneity of IMF membership means that there is scope for additional resource pooling at the regional level. Most obviously, the bilateral swap arrangements among ASEAN+3 countries under the Chiang Mai Initiative demonstrate the viability of securing liquidity insurance that is additional to IMF resources. Moreover, the current crisis has also shown a regional capability to quickly respond to the shift in international financial conditions. For example, major increases in the scale of the agreed bilateral swaps between China and Korea and between Japan and Korea were announced in December 2008. There is also room for the regional development banks to provide additional financing in those cases where private-sector credit markets have broken down.

Regional groupings may also be better placed in terms of continuous surveillance of member country policies and in designing multi-dimensional forms of policy coordination, by which regional integration in trade and factor mobility reinforces the incentives to cooperate in terms of financial support. The European experience also suggests that there may be scope for regional cooperation in the development of processes that help in ensuring the sustainability of the public finances.[5] While the scope for political integration clearly varies across regions and limits the transferability of institutional models across regions, the general principle is to obtain those benefits from regional integration that are feasible in each particular setting.

Finally, it is important to appreciate that a broad reform programme at the domestic and international levels could lead to a major re-configuration of the distribution of global imbalances. In particular, the growing share of global GDP that is generated by emerging market economies in combination with successful domestic financial development and appropriate international financial reforms may lead to this group of countries seeking to be a major net absorber of global capital flows. If this scenario plays out, other potential borrowers will receive smaller net capital inflows and/or the level of global interest rates will climb. For advanced economies seeking to save due to population ageing, this should be a welcome development.

Conclusions

The self-insurance strategy adopted by many emerging market economies over the last decade has been only partially successful in reducing exposure to international financial shocks. However, the limited role of domestic-currency debt in the funding of external liabilities means that the nature of international financial integration for the emerging market economies remains quite different relative to the experience of the advanced economies. Moreover, the self-insurance approach is collectively inefficient in terms of the allocation of resources within the emerging market economies and between the emerging markets and the advanced economies. Crucially, the expansion in the gross scale of international balance sheets means that the linkages between the emerging market economies and the advanced economies have grown tighter, in terms of the exposure to breakdowns in the normal operation of financial markets.

Accordingly, structural reforms are required at the domestic, regional and global levels in order to develop a financial system that improves the stability of external financing for emerging market economies. The reforms that will benefit the emerging markets are also the reforms that should improve global economic performance and global financial stability, through the promotion of local-currency debt and improved backstop liquidity provision through the international financial institutions. Accordingly, improving the institutional framework that underpins international capital flows should be a priority for global reform efforts.

[5] Philip R. Lane: The Macroeconomics of Financial Integration: A European Perspective, IIIS Discussion Paper No. 265, Dublin 2008.