Reforming the International Financial System as New Debt Crisis Looms

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1. In Rio, in June 2012, sovereign states agreed on Para 262 in the document entitled “The Future We Want” (A/RES/66/288): “We recognize that greater coherence and coordination among the various funding mechanisms and initiatives related to sustainable development are crucial. We reiterate the importance of ensuring that developing countries have steady and predictable access to adequate financing from all sources to promote sustainable development.”

2. Para 262 of the Rio+20 Outcome Document is found in Chapter VI under Means of Implementation. Without steady and predictable access to adequate financing sustainable development is unattainable.

3. When this paragraph was agreed in June 2012 and until the present time, the global economy was (is) engulfed in the deepest, still ongoing and unresolved, global crisis, centred in the financial sectors of the developed countries. Will the current crisis provide an opportunity to achieve necessary but long-delayed changes. Will the UN post-2015 discussions provide the occasion for the needed systemic reforms at the international level? This is a challenge to the developing countries after a decade of pronouncements about the rise of the South.

4. As in previous episodes of global financial instability – 1982, 1994, 1997 - developing countries face the prospect as Paragraph 263 of the Rio+20 outcome

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recognizes “... that ongoing serious global financial and economic challenges carry the possibility of undoing years of hard work and gains.” As in 1982, 1994, 1997 characterized by sudden stops in global financing and upsurges in interest rates, the looming tapering of QE3 (quantitative easing) by the US Federal Reserve threatens to provoke widespread capital flow reversals and debt crises in the developing world. The irony is that the faster the US economy recovers, the greater the scale of an upsurge in interest rates, the faster the reversal capital flows, and the greater the impending development damage. (I refer you to the paper by South Centre chief economist Yilmaz Akyuz entitled “Waving or Drowning: Developing Countries after the Financial Crisis.”) Moreover, if the Eurozone collapses, or even if its economy stays in the doldrums for the next five years, key export markets will continue shrinking even further, after decades during which developing countries have striven to become export-oriented.

5. There was previously a problem in the opposite direction and this demonstrates that the problem is not one of wrong policies but of a wrong international system. Before the current US Federal Reserve tapering predicament, in March 29, 2012, Leaders of the BRICS countries (in their Delhi Declaration) highlighted the opposite problem too much global liquidity (Paragraph 6):

   a. “We believe that it is critical for advanced economies to adopt responsible macroeconomic and financial policies, avoid creating excessive global liquidity and undertake structural reforms to lift growth that create jobs. We draw attention to the risks of large and volatile cross-border capital flows being faced by the emerging economies. We call for further international financial regulatory oversight and reform, strengthening policy coordination and financial regulation and supervision cooperation, and promoting the sound development of global financial markets and banking systems.”

6. Since the breakdown of the Bretton Woods system in 1971, reserve issuing currency countries, such as the US, the Eurozone (Germany earlier), and Japan, have not been subject to international disciplines. This deficiency fuels global imbalances and
exposes developing countries to unsteady, volatile mood swings of international private portfolio players, making bets toward high returns in developing countries during the booms and stampeding back to safe havens during busts.

7. There is critical need to repair and overhaul the international financial and payments system if it is to provide steady, predictable and adequate access to finance (as called for in paragraph 262 in the Rio+20 outcome).
   a. In particular, progress must be made in the commitment made as long ago as March 2002 in Paragraph 52 of the Monterrey Consensus, in the chapter on Systemic Issues, to address the “urgent need to enhance coherence, governance, and consistency of the international monetary, financial and trading systems”.
   b. Paragraph 55 of the Monterrey Consensus stipulated that: “The multilateral financial institutions, in particular the International Monetary Fund, need to continue to give high priority to the identification and prevention of potential crises and to strengthening the underpinnings of international financial stability.” The IMF did not do anything about this mandate.

8. Systemic reform is required to create enabling global environment for sustainable development and this must be a key lesson from the ongoing financial crisis. This view contrasts sharply from that incorporated in the Secretary-General’s High Level Panel of Eminent Persons report which in effect argues that because the financial crisis has severely reduced public resources for development, we should rely even more on private finance.

9. The problem with this view is that – in order for the private sector be a reliable development partner - the financial bubble which was root of the global economic crisis would have to be reincarnated if the private sector can be compelled into taking risk and restarting investment in the developing countries. Despite the enormous quantitive easing, the private financial companies have only taken positions in financial markets (including portfolio lending to emerging economies of mostly short-term tenor) and
private nonfinancial companies have concentrated on buying back their stock. There has been no restart in real investment and employment creation except in small companies.

10. Instead, it is important to insist that global systemic reform will unlock and mobilize both public and private financing, but first international rules must channel risk-taking and finance towards sustainable development projects. (Instead of taxpayer resources in Europe having been devoted to capital injections to unconditional rescues of financial companies – thereby causing a surge in public debt – they could have been used for domestic spending, to substitute for the collapse of private demand. Banks that have received capital injections have not restored their lending levels.)

11. What are the key elements of an enabling global environment for sustainable development? The list could be very long, many of whose elements are interdependent, but here let me mention only five.

12. First, domestic austerity should not be the main framework for access to international markets and finance. The phrase “maintaining an enabling business environment” has become a standard item in IMF country programs, such as in recent IMF programs for the Arab countries. Since IMF programs concerns themselves with external payments, an “enabling business environment” is in effect a code for a country’s commitment to maintain unregulated capital accounts, which becomes in turn the basis of austerity policies in externally indebted countries. (Here I refer you to a South Centre IPD paper by Isabel Ortiz and Matthew Cummins entitled “The Age of Austerity.”)

13. Open capital accounts and unstable international private capital flows are the main culprit behind the emphasis on national austerity – both in the short-term and the long-term. One could call this: Goodbye financial repression, hello wage suppression (using a parallel to well-known Carlos Diaz-Alejandro 1985 piece).

14. Because of the IMF view that countries must be ready to adjust their exchange rate, fiscal and monetary policies in response to the ups and downs of international private capital flows, domestic austerity becomes a stance to set aside resources like an insurance policy (whose beneficiaries are short-term portfolio investors). But long-term
austerity is inimical to adequate, predictable and steady domestic private and public investment and thus to achieving sustainable development.

15. Thus, our view is that capital account regulations should be normal practice in developing countries, a daily part of the macroeconomic toolkit, not, as the IMF staff institutional view insists, a last resort policy.

16. Second, restoring policy space to developing countries over their capital account needs to be a key element of global systemic reform in order to mobilize domestic investment for sustainable development and to privilege long-term investment from external sources. Capital account regulation will restore the effectiveness of developing countries’ fiscal and monetary policy tools and permit countries to aim for less volatile exchange rate trends. Previous fora and studies have called for upgrading international cooperation in regulating global capital flows for which authorities supervising international financial centres must bear a greater burden of responsibility.

17. Third, a global enabling environment should increase the capability of developing countries in domestic resource mobilization. Developing countries require international tax cooperation and indeed international cooperation in capital flow and financial regulation to enhance their domestic resource mobilization.

18. Fourth, international disciplines on reserve issuing countries have to be restored. Many ambitious proposals have been discussed, including transitioning away from the over-dependence of the international payments system on one national currency – the dollar and replacing it with a truly global currency. But any increased discipline and accountability would be better than the current one. G20 deliberations have proven to be indecisive. Here, many observers believe that making progress in updating voting weights in key institutions to reflect the global economy’s structure would be crucial.

19. Fifth, a non-arbitrary, non-case-by-case, predictable, equitable, comprehensive sovereign debt resolution mechanism for must be established.

20. The South Centre has undertaken some background thinking in connection with the global effort toward a sustainable development process at the United Nations. (I refer you to last month’s issue of the South Bulletin which is a compendium of our recent work.)
21. Three things need to be mentioned:
   a. First, we believe that sustainable development is more than the elimination of extreme poverty, even though that can be an outcome of sustainable development.
   b. Second, we believe a truly global sustainable development agenda must pay attention as much to means as it is about ends (which the present MDGs did very well). There are two kinds of means – (1) a global enabling environment and (2) flows of finance and technology transfers.
   c. Third, restoring the capacity of the international economy to invest in increasing access to modern clean energy, more efficient equipment and buildings and less wasteful lifestyles is the key to sustainable development. But this will require that developed countries take up their share of the global responsibility for a more stable global investment regime that facilitates long-term finance to developing countries.

22. Here is a short list of systemic issues:
   a. Expanded and secure policy space for developing countries
   b. Orderly and equitable international financial and sovereign debt crisis resolution mechanisms.
   c. Greater stability of exchange rates of reserve currencies. This will require reintroduction of international disciplines on reserve-issuing countries and eventual elimination of the dependence on the dollar for the international payments and reserve system.
   d. International disciplines to reduce the negative spillovers from developed country policies. The most egregious of this are agricultural subsidies. But monetary policies and immigration policies are also important.
   e. Stability and predictability of foreign exchange earnings from commodity exports, including strengthening compensatory finance for commodities-dependent developing countries;
f. Effective international monitoring and coordination mechanisms to reduce the probability and size of international financial crises. This will involve the regulation of systemically important finance companies and financial centres.

g. Modernized governance in international institutions to reflect the changed global structure and to rebalance their responsiveness to their main users.

h. Appropriate public reporting requirements and social accountability of transnational corporations. A legally binding multilateral code of conduct for TNCs to monitor and achieve accountability and prevent restrictive business practices. This will also include re-designing mechanisms of investor protection such as those contained in BITs. It will also require enhanced tax cooperation among countries.

23. The current discussions over the post-2015 development agenda provide an important opportunity for the South to call for systemic reforms and the building of a enabling global economic environment. As in previous global crises, developing countries have not been consulted on the negative policy spillovers of US tapering policies and Europe’s continued deflationary policies.

24. Developing country members of the G20 can consider bringing this matter to the G20 discussions. They can also make sure to bring systemic reform front and center in discussions towards the Rio+20 follow-up, including the discussions on the sustainable development goals.
References


