Dialogue Forums 2010

Global Financial Stability:
A Dialogue on Regulation and Cooperation

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On behalf of

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Global Financial Stability:
A Dialogue on Regulation and Cooperation

Selected Expert Papers from the Dialogue Forums 2010
Editor: Dr. Martina Metzger

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Foreword

The global financial crisis constitutes a watershed in both crisis perception by the global community and the way global financial governance is organized. The financial crisis left a deep mark in global collective consciousness that no country whichever development level has been reached is immune to financial crisis. Moreover, economic and financial de-coupling of countries or regions is rendered impossible by the globalisation in finance and trade.

The international community responded accordingly to this basic shift. Global financial governance became more representative by broadening the membership of existing institutions towards stakeholders from emerging markets. In addition, G20 members agreed upon an unprecedented level of macroeconomic coordination to counteract direct impacts of the global financial crisis and to prevent the world economy from being stalled. And third, G20 members together with international financial institutions envisaged far-reaching reforms of the financial sector regulation in order to reduce regulatory arbitrage within and between jurisdictions and to prevent another risk accumulation.

For years already and long before the outbreak of the global financial crisis the Federal Ministry for Economic Cooperation and Development has collaborated with its partners in developing countries and emerging market economies on financial sector development issues. A major topic ever since has been financial market regulation, in particular banking regulation. Banks as the core segment of the domestic financial market in many countries are due to provide companies with investment finance and present attractive opportunities for household savings thereby transforming maturities and risks. However, only banking regulation, including prudential regulations and macro-prudential surveillance, ensure liquidity and solvency of individual banks as well as provide for systemic financial market stability.

Another prominent focus of our cooperation is regional financial integration. Mature regional financial markets are considered a stable source of funding for companies, banks and public entities in the region; at the same time they offer options of wealth accumulation to individual households and institutional investors. It is also hoped that deeper regional financial markets are characterized by higher competition with lower costs for customers and less concentration of risks and market power. Moreover, integrated regional financial markets are expected to reduce currency and maturity mismatches which played a significant

role in the outbreak of financial market crisis in developing countries and emerging markets.

Financially sound and well capitalised financial institutions and regional financial integration are cornerstones of financial sector development; they require sophisticated regulation and surveillance both domestically and regionally and consensus on closer cooperation regarding financial sector reforms.

In the last two and a half years policy makers, central bankers and supervisory authorities have made strong endeavours to cooperate closer in international bodies, in particular the Financial Stability Board and the G20. Meanwhile agreements on financial sector reforms have been concluded of which Basel III with its improvement in quantity and quality of capital together with a liquidity ratio is the most far-reaching and the most prominent. However, there is still a need to evolve regulation in other crucial areas, e.g. the shadow banking system in order to cover all financial institutions by supervision and the adoption of early warning exercise and reliable stress test methods for systemically important financial institutions. Moreover, consent how to address strategic issues like global imbalances or the development agenda is marginal.

While at the beginning of the global financial crisis the G20 and the Financial Stability Board initiated financial sector reforms vigorously and after only a short discussion, reform dynamics seem to dwindle in the course of the crisis. There are indications that national interests might increasingly impede agreements to enhance the global public good financial market stability; the risk of a resurgence of unilateral strategies in contrast to a multilateral handling of financial market issues with a global impact is gaining momentum. Against this background, it is all the more important to continue the dialogue between all stakeholders. In that sense the Dialogue Forums on Financial Stability Issues from which the expert papers of this volume originate assume an essential task.

Jürgen Zattler

Head of Directorate
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Federal Ministry for Economic Cooperation and Development (BMZ)

Introduction

Last year, InWEnt welcomed over two hundred finance sector experts to dialogue forums organised together with our partners in Germany and abroad and held in Berlin, Beijing, Mumbai and Mexico City. At these events, current challenges to global financial market stability were debated and constructive cooperation promoted through joint deliberations on policy formulation.

The dialogue forums in 2010 focused on the challenge facing the international community of reacting with an enhanced regulatory framework to the shortfalls in national and international bank regulation and supervision that had led to the serious crisis in financial markets in and after 2007. The topics addressed concentrated on the efforts initiated by the G20, by the Basel Committee on Banking Supervision and the Financial Stability Board to set new international rules within the Basel III framework. To effectively strengthen the banking sector's robustness, the Basel III final rules text ratified in December 2010 needs to be implemented in every major financial centre worldwide. Implementing 'soft law' assumes the constructive involvement of all G20 Member States in the efforts to harmonise global standards on regulating banks.

The discussions within the dialogue forums illustrated the willingness of all those involved to play a constructive part in shaping this process, although the banking systems, still 'immature' at least in some sections, and the limited institutional capacities to implement worldwide uniform standards will require an aligned implementation strategy in the emerging market countries. The majority of participants expressed their readiness to support global efforts and recognise and implement uniform standards.

A further strand of the discussion, addressed in all dialogue forums since 2008, explored the possibilities of more intensive regional financial market cooperation. This process has to be accompanied by an active political process such as, for example, that taking place within the framework of the Association of Southeast Asian Nations (ASEAN) and its cooperation partners of China, Japan und South Korea since the 1997/1998 Asian crisis. In this case, after a phase of economic integration, attention has been increasingly focused on monetary cooperation. Successfully testing the internationalisation of the renminbi as a unit of account in international commercial transactions and as a transfer unit in currency swaps by the Chinese central bank indicate that there are the beginnings of a potential

here to restructure the international monetary system beyond the present framework.

In the light of recent events, the European experience brought into the dialogue forums primarily referred to those risks that might be connected with regional monetary integration processes across economies of differing strengths. These were dramatically underlined by the rescue operation for Greece and Ireland in 2010 in the Euro zone which, for many years, had itself been regarded as an unqualified success. The European monetary and budgetary policies have led to emerging market countries being confronted with strongly fluctuating foreign capital inflows and outflows, making it extremely difficult to combat inflation. Under these circumstances, the call by governments of emerging market countries for improving the global coordination of economic, budgetary, financial and monetary policies is understandable.

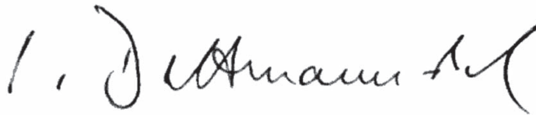
The debates, conducted with robust commitment and great openness, confirm the relevance of the opportunity created by the dialogue forums for meeting personally, promoting approaches of informal cooperation between the central banks involved, ministries of finance, and bank supervision and regulatory authorities as well as economic advisory agencies. An external programme evaluation carried out in the second half of 2010 with considerable support from our expert partners within Germany and abroad confirmed that the thematic debates initiated in the dialogue forums were also continued by the participants within their organisations and taken into account when drafting own policy recommendations.

This has encouraged us, as a unit within the newly created *Gesellschaft für Internationale Zusammenarbeit* (GIZ), to prepare, in close cooperation with our partners and closely coordinated with the BMZ, dialogue forums in 2011 as well. As part of Germany's contributions to the G20's development policy agenda, these forums will serve in particular to draw attention to the themes and interests in emerging market and developing countries.

This programme would not have been possible without the continous support of the Federal Ministry for Economic Development and Cooperation (BMZ). The high quality of these forums was facilitated by the professional expertise of representatives from the Indian central bank (Reserve Bank of India), Indian Ministry of Finance (MoF India), Indian Council for Research on International Economic Relations (ICRIER), Chinese Central University for Finance and Economics (CUFE), Mexican Ministry of Finance (SHCP), South African Reserve

Bank (SARB), South African Institute for International Affairs (SAIIA), Federal Ministry of Finance (BMF), Deutsche Bundesbank and the Federal Financial Supervisory Authority (BaFin). The quality of these dialogue forums is not only underlined by the expert contributions collected in this volume but also by the comprehensive forum reports posted on ***www.inwent.org/dialogues***.

Last but not least, it is a particular pleasure to thank Dr. Peter Wolff and Dr. Ulrich Volz from the German Development Institute (DIE) and Dr. Martina Metzger for their involvement and their knowledgeable expertise which, in 2010 as well, helped to shape the dialogue forums.



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Chapter 1

Global Financial Regulation

Frontier Issues on the Global Agenda: Need for Global Cooperation

Duvvuri Subbarao *

1 Introduction

First of all, my thanks to the organizers of this conference – ICRIER, the German Development Institute (DIE) and InWEnt – for inviting me to inaugurate this conference on: "Policies for Growth and Financial Stability Beyond the Crisis – the Scope for Global Cooperation". Having just returned from a meeting of G 20 Finance Ministers and Central Bank Governors in the Republic of Korea over this weekend, I am deeply sensitive to the value of generating a wider debate on issues that the world has to grapple with as we emerge out of the crisis.

The focus of this conference on global cooperation is particularly relevant. Everyone now has her/his list of lessons of the crisis, and one item common on almost every list is the lesson that today's macroeconomic problems cannot be resolved without global cooperation. The crisis has taught us that no country can be an island and that economic and financial disruptions anywhere cause ripples, if not waves, everywhere. The crisis also taught us that, given the deepening integration of countries into the global economic and financial system, uncoordinated responses will lead to worse outcomes for everyone.

When the history of this crisis is written, the London G 20 Summit in April 2009 will be seen as a clear turning point when the leaders of the world showed extraordinary determination and unity of purpose in combating the deepest economic crisis of our generation. Sure there were differences, but they were debated and discussed and compromises were made without eroding the end goal – that is to end the crisis.

The priority task today is to calibrate the exit from the crisis driven accommodative policies and put the world on a sustainable growth path. Global cooperation is as vital for managing this recovery as it was for managing the crisis. There is a growing apprehension though that the vaunted unity that the G 20 had shown during the crisis is dissipating and that its resolve to foster globally optimal solutions

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* Inaugural Address by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India at the ICRIER/InWEnt/DIE Conference on "Policies for Growth and Financial Stability Beyond the Crisis – The Scope for Global Cooperation" in Mumbai on October 27, 2010.

is weakening. When all the details are distilled out, two main worries emerge: first, that countries are not able to resolve their conflicts of interest, and second that at the world level we are bogged down by the tyranny of the present and are not able to resolve the balance between medium term sustainability and short term compulsions.

These concerns are valid, but the judgement on G 20 is perhaps harsh. The global problems we are facing today are complex and not amenable to easy solutions. Many of them require significant and often painful adjustments at the national level, and in a world divided by nation-states, there is no natural constituency for the global economy. At the same time, the global crisis has shown that the global economy as an entity is more important than ever. We cannot afford a situation where decisions essential for global prosperity become hostage to domestic concerns.

Against this background, and keeping in view the vast sweep of this conference theme, what I propose to do in this inaugural address is to highlight the frontier issues on the present day global agenda and emphasize how we cannot resolve them without global cooperation.

2 Multi-speed recovery

By all accounts, the world has recovered from the financial meltdown and the follow on recession much sooner than we had feared at the depth of the crisis. In its latest World Economic Outlook (WEO – October 2010), the IMF projected global growth for 2010 of 4.8 per cent; this marks a surprising upward revision from its earlier projection of 4.6 per cent. This remarkable turnaround in outlook masks some significant geographical variations in the recovery process. Emerging market economies (EMEs), contributing nearly half of this growth, have clearly been the engine of this recovery. World trade, which shrank by 11 per cent in 2009, is projected to expand by 11.4 per cent in 2010, again powered by import demand of EMEs which is rising twice as fast as that of advanced economies.

On the other hand, in advanced economies, there are growing concerns about the slowing momentum of recovery, stubbornly high rates of unemployment and persistent output gaps. Although specifics vary, the G 3 – America, Europe and Japan – are caught in fierce policy debates on stimulus and exit strategies. At the heart of this debate are two issues that pit the short-term against the medium term: first, whether additional fiscal stimulus at this stage will jeopardize medium term fiscal sustainability; and second, whether continued expansionary monetary stance – QE2 in popular jargon – will be an adequate substitute for the waning fiscal stimulus, and what impli-

cations the ultra loose monetary policy may have for medium term inflation trends. A question often asked is whether EMEs will be able to sustain global growth even if advanced economies continue to languish. People who put this question, I believe, are doing so as a rhetoric – to encourage analytical thinking rather than to solicit an affirmative answer. Sure, multiple growth poles are a safety-net for the whole world, but to expect EMEs, by themselves, to lift global growth will be unrealistic. Note that emerging and developing countries account for less than half of world GDP even when measured at PPP valuations, and only about a third of the world trade in goods and services. Notably, the much hyped 'decoupling' does not stand to strict scrutiny. On the contrary, there is evidence of powerful coupling. Recent research within IMF shows that the detrended aggregate output growth of EMEs has strong association with the aggregate output growth of advanced economies and this 'association' has in fact increased over time, evidencing not only that the coupling is strong but that it is getting stronger. Sure, in recent years EMEs have been less affected by recessions in advanced economies owing to improved policy framework and more effective macroeconomic management. But over an entire cycle, the economic prospects of EMEs remain firmly coupled with those of advanced economies.

3 Global adjustments – Short term and medium term

All members of the G20 are deeply conscious that purely national solutions do not solve global problems and that they each need to make an adjustment to the post-crisis global realities. It is in calibrating the exit in the short-term and sequencing the structural reforms in the medium term that the differences arise, and that is where global cooperation is most vital.

The post-crisis global scenario has thrown up three interrelated issues. The first is the need for rebalancing across and within economies. In as much as global imbalances – no matter whether they were caused by 'a consumption binge' in advanced economies or a 'savings glut' in EMEs – were one of the root causes of the crisis, reducing imbalances is a necessary condition for global financial stability. A second issue is the role of exchange rates in redressing external imbalances. A third set of questions relates to capital flows into EMEs raising the familiar challenge of managing the impossible trinity. Let me turn to these one by one.

The first issue, rebalancing, is the focus of the latest (October 2010) World Economic Outlook of the IMF. I can do no better than to quote from the foreword to the Report.

> "Achieving a 'strong, balanced and sustained world recovery' – to quote from the goal set in Pittsburgh by the G20 – was never going to be easy. .... It requires two fundamental and difficult economic rebalancing acts. First, internal rebalancing: When private demand collapsed, fiscal stimulus helped alleviate the fall in output. But fiscal stimulus has to eventually give way to fiscal consolidation, and private demand must be strong enough to take the lead and sustain growth.
>
> Second, external rebalancing: Many advanced economies, most notably the United States, which relied excessively on domestic demand, must now rely more on net exports. Many emerging market economies, most notably China, which relied excessively on net exports, must now rely more on domestic demand. These two rebalancing acts are taking place too slowly."

A prime lever for redressal of external imbalances is exchange rate flexibility, the second issue that I listed. Rebalancing will require deficit economies to save more and consume less. They need to depend for growth more on external demand which calls for a real depreciation of their currencies. The surplus economies will need to mirror these efforts – save less and spend more, and shift from external to domestic demand. They need to let their currencies appreciate. Managing currency tensions will require a shared understanding on keeping exchange rates aligned to economic fundamentals, and an agreement that currency interventions should be resorted to not as an instrument of trade policy but only to manage disruptions to macroeconomic stability.

That brings me to the third issue that I listed, return of lumpy and volatile capital flows. Since capital flows have become such an emotive topic around the world in recent months, it is important perhaps to recall a few realities. First, that emerging and developing economies do need capital flows to augment their investable resources, but such flows should meet two criteria: they should be stable and be roughly equal to the economy's absorptive capacity. The second reality that we must remember is that capital flows are triggered by both pull and push factors. The pull factors are the promising growth prospects of EMEs, their declining trend rates of inflation, capital account liberalization and improved governance. The push factors are the easy monetary policies of advanced economies which create the capital that flows into the EMEs. What this says is that international capital flows comprise a structural component and a cyclical component. It is the cyclical component that typically causes all the adjustment problems for EMEs.

That said, the multi-speed recovery around the world and the consequent differential exit from accommodative monetary policy has triggered speculative capital flows into EMEs. The biggest problem thrown up by capital flows is currency appreciation which erodes export competitiveness. Intervention in the forex market to prevent appreciation entails costs. If the resultant liquidity is left unsterilized, it fuels inflationary pressures. If the resultant liquidity is sterilized, it puts upward pressure on interest rates which, apart from hurting competitiveness, also encourages further flows.

Currency appreciation is not the only problem arising from the ultra loose monetary policy of advanced economies. Speculative flows on the lookout for quick returns can potentially lead to asset price build up. The assurance of advanced economies to keep interest rates 'exceptionally low' for 'an extended period' has also possibly triggered financialization of commodities leading to a paradoxical situation of hardening of commodity prices even as advanced economies continue to face demand recession. Hardening of commodity prices has affected those EMEs which are net importers of commodities.

Managing capital flows should not be treated as an exclusive problem of EMEs. In as much as lumpy and volatile flows are a spill-over from policy choices of advanced economies, the burden of adjustment has to be shared. How this burden has to be measured and shared raises both intellectual and practical policy challenges. The intellectual challenge is that we do not have a good theory that explains the role of capital flows in the determination of exchange rates. We, of course, have an established theory of current account management and the role of exchange rate as a variable in that. What we now need is a theory that encompasses both current and capital accounts and one that gives a better understanding of what capital controls work and in what situations. That is the intellectual challenge. What is the practical challenge? The practical challenge is that once we have such a theory, we need to reach a shared understanding on two specific aspects: first, to what extent are advanced economies responsible for the cross border spill over impact of their domestic policies, and second, what is the framework of rules that should govern currency interventions in the face of volatile capital flows.

4 Protectionism

In the post-crisis world, there may not actually be 'deglobalization' but the earlier orthodoxy that globalization is an unmixed blessing is being increasingly

challenged. The rationale behind globalization was, and hopefully is, that even as advanced countries may see some low end jobs being outsourced, they will still benefit from globalization because for every low end job gone, another high end job – that is more skill intensive, more productive – will be created. If this does not happen rapidly enough or visibly enough, protectionist pressures will arise, and rapidly become vociferous and politically compelling. The efforts of several countries around the world to resist currency appreciation are a manifestation of protectionist pressures.

There is concern in some quarters that while open protectionism has been resisted relatively well during the current crisis, opaque protectionism has been on the rise. Opaque protectionism takes the form of resorting to measures such as anti-dumping actions, safeguards, preferential treatment of domestic firms in bailout packages and discriminatory procurement practices. Experience shows that countries resort to restrictive trade practices in areas not covered by multilateral rules or by exploiting the lack of specificity in certain rules. To strengthen multilateral trade discipline, the need for a quick conclusion of the Doha Round can hardly be overemphasized. In a world with growing worries about the debt-creating stimulus packages, a Doha Round agreement should be welcomed as a non-debt-creating stimulus to the global economy.

5 International monetary system

The global crisis has revived the familiar concerns about the robustness of the international monetary system. The system we now have is that the US dollar is the world's reserve currency by virtue of the dominant size of the US economy, its share in global trade, the preponderant use of dollar in foreign trade and foreign exchange transactions and a host of other intangible factors. The US has met the obligation of an issuer of reserve currency by running fiscal and external deficits while enjoying the comfort of not having to make the necessary adjustment to bridge the deficits. Such persistent deficits of a dominant economy can potentially create imbalances at the global level as indeed happened in the build up to the crisis. While the US took care of the supply side of the reserves, the demand side impetus comes from several factors including the accumulation of reserve assets by EMEs as a measure of self-insurance against external shocks.

The problem with the world having only a single reserve currency came to the fore during the crisis as many countries faced dollar liquidity problems as a consequence of swift deleveraging by foreign creditors and foreign investors.

Paradoxically, even as the US economy was in a downturn, the dollar strengthened as a result of flight to safety.

Based on the experience of the crisis, several reform proposals have been put forward to address the problems arising from a single reserve currency. One is to have a menu of alternative reserve currencies. But this cannot happen by fiat. An alternative currency or currencies will take root as reserve currency/currencies only if those currencies are fully convertible and acquire a dominant share in world trade. A second option is to develop the SDR as a reserve currency. This does not seem to be a feasible option. For the SDR to be a genuine reserve currency, it has to fulfil several conditions: the SDR has to be accepted as a liability of the IMF, has to be automatically acceptable as a medium of payment in cross-border transactions, be freely tradable and its price has to be determined by forces of demand and supply. A third suggested solution aims at reducing the need for self-insurance and thereby the dependence on a reserve currency by supporting a multilateral option of a pre-arranged line of credit that can be easily and quickly accessed. Such a multilateral option is necessary as a complement to self-insurance but it cannot be a substitute; some measure of self-insurance will continue to be the first line of defence.

None of the above solutions as you can see fully addresses the problems arising from a single global reserve currency. What this underscores is that at the global level we need to explore these and other options for protecting ourselves from the vulnerabilities that we confront as a consequence of a single reserve currency.

6 Governance of Bretton Woods institutions

The global crisis has underscored the importance of reforming the governance structures of Bretton Woods institutions – the IMF and the World Bank, so as to give representation to EMEs commensurate with their growing share in the global economy. These reforms are central to the legitimacy and effectiveness of these global institutions. There has been significant progress in respect of World Bank capital and voice reforms. Quota reform in the IMF is also expected to be completed soon. Countries which have not been traditional creditors, including India, have entered into sizeable credit arrangements with the Fund. This strengthens the case for quota shifts in their favour as a group, and in particular to dynamic EMDCs, to better reflect current global economic realities. These shifts need to be followed up by continuing the dynamic process aimed at enhancing the voice and representation of the poorest through a comprehensive review of the quota formula by July 2013. Here the need for cooperation among countries will be crucial.

7 Financial sector reforms

In September 2010, the Basel Committee on Banking Supervision (BCBS) put out a comprehensive paper indicating the broad agreement reached on the Basel III proposals. Broadly, these reforms will require banks to hold more and better quality capital and to carry more liquid assets, will limit their leverage and mandate them to build up capital buffers in good times that can be drawn down in periods of stress. The Basel III process is not yet complete. Some aspects of Basel III, such as common equity and tier I capital have been firmed up; others such as the new global liquidity standards and the leverage ratio have yet to be precisely specified. This will be done after a further assessment of the reasonableness of these measures and their impact on banks' balance sheets as well as the national economies. Though this would allow time for further calibration and refinement, it could on the other hand contribute to regulatory uncertainty. Moreover, there are several issues such as capital conservation buffer and countercyclical buffer which are fraught with severe definitional and implementation complexities and challenges.

Another crisis driven initiative has been to expand the erstwhile Financial Stability Forum into a Financial Stability Board (FSB) by giving representation to EMEs. The FSB has been working on a number of initiatives including managing the moral hazard associated with systemically important financial institutions (SIFIs) through more stringent regulatory and supervisory norms, principles to guide compensation of bank managements, a single set of accounting standards and regulation of OTC derivatives, credit rating agencies and hedge funds. There are also several areas where substantial work needs to be done including in improving resolution regimes for cross-border banks and systemically important non-bank financial companies, addressing the procyclicality of the financial system, and macro-prudential surveillance. More work also needs to be done to extend the prudential norms on the lines of Basel III to the shadow financial system which lay at the heart of the recent financial crisis.

Within a common set of agreed-upon global standards, each jurisdiction may have to tailor some of its rules and supervisory practices to national conditions and preferences. The big challenge going forward will be to implement global standards with national differentiation but without giving any scope for the market to interpret national deviations from the standards as regulatory looseness.

8 Conclusion

Let me now summarize. In my remarks today, I covered what I believe are the frontier issues on the present day global agenda. In particular, I gave a picture of the multi-speed recovery and its implications for global adjustments in the short term and in the medium term. These adjustments need to cover three inter-related issues: redressing imbalances, exchange rate flexibility and management of capital flows. I emphasized how global cooperation is vital to reach a shared understanding on all the three issues. I then raised the possibility of a post crisis world which will be less welcoming of globalization and how this may trigger protectionist pressures. I moved on to emphasize how global cooperation is vital for reforming the international monetary system and the need for a comprehensive quota and representation reform in the Bretton Woods Institutions commensurate with the growing contribution of EMEs to global growth and global trade. Finally, I gave a brief status of the reforms in the financial sector, and how again restoring financial stability at the national and international levels requires global cooperation.

The common thread running through all the issues that I raised is the need for global cooperation in solving our most pressing problems of today. Given the strength and pace of globalization, purely national solutions are not only inadequate but may indeed be counterproductive.

I realise I have raised several issues without providing complete solutions. I believe that is the privilege of the inaugural speaker. The burden of identifying solutions and debating their pros and cons belongs to the conference proper.

The global crisis has taken a devastating toll on global growth and welfare. In their painstakingly researched book, '*This Time is Different: Eight Centuries of Financial Folly*', Kenneth Rogoff and Carmen Reinhart show how over eight hundred years, all financial crises can be traced to the same fundamental causes as if we learnt nothing from one crisis to the next. Each time, experts have chimed that 'this time is different' claiming that the old rules do not apply and the new situation is dissimilar to the previous one. It will be too costly for the world not to heed this lesson. We should cooperate not only to firmly exit from the crisis, but also to ensure that in resolving this crisis, we do not sow the seeds of the next crisis.

Building a Global Monetary System

Heiner Flassbeck[*]

1 A new path to global economic governance

For a smooth flow of trade and capital and the prevention of unsustainable imbalances among countries with flexible national currencies an effective and prompt adjustment of currency movements to the fundamentals in terms of prices or unit labor costs is crucial.

The outbreak of the financial crisis in 2008 – and its global ramifications since – propelled the group of 20 developed and developing countries to centre stage to lead a coordinated international response. G20 finance ministers highlighted the need to assess the persistently large global imbalances and the prerequisites for rebalancing. Concern is increasingly being focused on addressing internal structural balances, fiscal policy and currency alignment, within a common policy package to weather the next stage of the crisis. This welcome dose of inclusive multilateralism and new thinking on interdependence, a foundational principle of UNCTAD, has come at the right time, as exchange rate management seizes the foreground of the policy debate.

This debate opens new paths to improve global economic governance. It acknowledges that the mantra of "leaving currencies to the market" has lost its persuasive power. The contradiction between expecting market forces to do their job, and hoping for a realignment of currencies according to fundamental determinants of competitiveness, has become glaringly obvious. This was revealed yet again in recent weeks as a major deficit developing country, Brazil, was faced with having to fend off the huge capital inflows that caused an unsustainable appreciation of its currency.

This should not come as a surprise – the world has been in a similar situation before. In 1985, the market's inability to resolve long-standing trade imbalances between Japan and the United States was finally resolved by the historic Plaza Accord. After all other approaches had failed, coordinated intervention between G5 members achieved a 50 per cent devaluation of the United States dollar.

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* Director, Division on Globalisation and Development Strategies, United Nations Conference on Trade and Development (UNCTAD), Geneva. The paper was presented at the International Dialogue Forum on "Strengthening Cooperation to Foster Global Growth and Sustainable Development" in Berlin, 5–6 July, 2010.

Today the need for coordination is greater, but achieving it is more difficult. Globalization means that virtually all of the world's economies are affected, rather than just the leading few. Also, by comparison, the magnitude of the trade and capital flows involved is immense.

2 Current account imbalances: fallacies and flaws

In order to monitor global trade imbalances and progress towards external sustainability as part of a mutual assessment process, the G20 will consider technical guidelines to indicate when the overall scale of imbalances is moving away from sustainable positions. One suggestion has been to focus on the size of a country's current account deficit or surplus, as a percentage of gross domestic product (GDP). Other viewpoints favor looking at a range of indicators that contribute to imbalances and to inconsistent fiscal, monetary and exchange rate policies.

This renewed impetus for multilateral cooperation to resolve long-standing imbalances, and tabling of concrete proposals for mechanisms to reduce global monetary and financial volatility, is timely. But it would be a mistake to use the current account as the indicator of choice when measuring the "sustainability" of large imbalances.

To do so would be to focus on a symptom of global imbalances rather than on its cause. As described in the Trade and Development Report 2006, this focus on the current account stems from a widely held view that current account surpluses or deficits are mainly the result of an excess of savings in the surplus country and a lack of savings in the deficit country. This view is based on the simple national accounting identity between savings on the one hand, and investment and the current account balance on the other. But this is just an identity, not an explanation: it says nothing about the causality of changes in these macroeconomic variables. For example, misalignment of the real exchange rate distorts the international competitiveness of countries, with the ensuing capital flows ("foreign savings") from surplus to deficit countries being the apparent result.

Focusing on current account imbalances alone is also flawed, owing to the difficulty of quantifying appropriate bands outside which imbalances are truly unsustainable – not to mention all the circumstances under which exceptions might be tolerated. There are many good reasons why a current account may be in deficit or surplus at any given point in time. One reason is that the domestic economy may be growing faster than that of its trade partners, causing imports

to rise more than exports (e.g. the United States). Another is that a country may be a major importer of a commodity whose price tends to rise again and again, increasing the import bill without there being any compensation through higher levels of export (e.g. the group of "low-income, food deficit countries"). Still another reason is that a country may serve as a hub for foreign firms to produce manufactures on a large scale, but may not yet have enough high-income members of the population to consume the level of imports that would equilibrate exports (e.g. China).

In all such cases, the short-term buffer of net capital inflows or outflows is needed to allow for a smooth functioning of the international trading system. In other words, imbalances in the current account are not in themselves indicative of a systemic problem that needs coordinated intervention. Moreover, what is important is not so much the current account position of any one country – some commodity exporters can rely on maintaining their surpluses indefinitely (e.g. Saudi Arabia). What does matter is a loss of competitiveness in aggregate that may be at the origin of a current account deficit.

The only current account imbalances that are clearly unsustainable are those originating from a loss of competitiveness of the economy as a whole. A general overvaluation of a country's currency means that the nominal exchange rate of its currency has appreciated against other currencies more than is warranted in terms of the difference between the domestic price level and that in comparator economies.

The fact that exchange rates play a pivotal role is supported by empirical evidence analyzing the factors influencing current account reversals. UNCTAD's Trade and Development Report 2008 showed that rather than being driven by the autonomous savings and investment decisions of domestic and foreign agents, current account reversals tend to be driven by external shocks emerging from both goods markets and financial markets. In particular, improvements in the current account were usually accompanied either by positive terms-of-trade shocks, by a real exchange rate depreciation, or by panic in the international capital markets followed by sudden stops in capital flows.

3 Multilateral currency coordination is the key to resolving global imbalances

Exchange rate management must be at the centre of the package to avoid unsustainable imbalances, notwithstanding other policy measures that will be needed. To sum up, the right approach to the twin problems of global trade imbalances and destabilizing short-term capital flows is straightforward: it entails adjustment of the nominal exchange rate in line with the constant real exchange rate rule (CRER – see the Trade and Development Report 2009 and UNCTAD Policy Brief 12). This rule would firstly be enforceable by multilateral agreement on the pattern of optimal or reasonable exchange rates. Secondly, concerted central bank action would maintain this pattern and would also help to remove the incentive for short-term currency speculation that has so aggravated global imbalances.

As important as the trade distortion effect of real exchange rate changes is the impact that a large deviation of nominal exchange rates from the inflation difference has on the volatility of capital flows and on the ability of countries to pursue a growth-oriented countercyclical monetary policy. Large short-term interest rate differences between countries attract speculative capital flows (currency carry trade) that are normally associated with inflation differentials of a similar size because central banks determine the level of the short-term interest rate in line with its (implicit or explicit) inflation target. The nominal short-term interest rate in countries with rather high inflation rates will incorporate this inflation rate plus a premium set by the central bank to achieve a positive short-term real interest rate. In this way, the real interest rates in countries with open capital accounts will deviate much less than the nominal interest rates or even be equal.

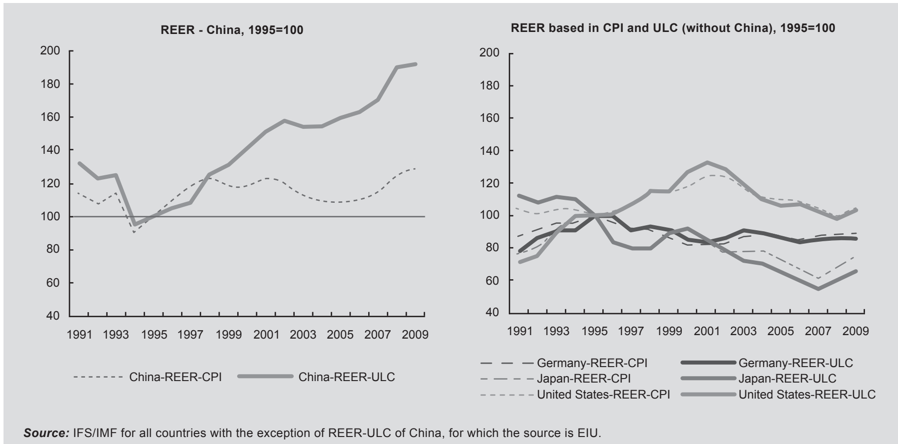
As interest rate arbitrage of the carry trade type exploits the differentials of short-term nominal interest rates (the speculator is not interested in buying goods in the country he invests in), a rule to adjust exchange rates along the lines of PPP takes away most of the incentive to invest short-term in countries with relatively high inflation and high interest rates. Moreover, as huge amounts of short-term capital following carry trade operations tend to drive the exchange rate in systems of free floating in the wrong direction (which means appreciation of the currency of high-inflation countries) and to add a currency profit to the interest profit, the enforcement of the PPP rule yields a second and important dividend. Indeed, such a rule is the only way to reduce large-scale speculation short to closing the capital account and to avoid financial crises triggered by misaligned currencies.

Financial market participants would quickly understand that challenging such a multilateral policy framework would be impossible. This is because the stabilization of the system would call for the active participation of the central banks – not only those of countries whose currencies have a tendency to depreciate (and thus require the sale of foreign exchange reserves for their stabilization). Also, the central banks of countries whose currencies are under pressure to appreciate beyond the generally accepted rule would have to stand ready to stem the speculative tide by intervening through sales of their own currency. Their reach is always greater than that of the market, because they can print all the currency they need.

4 The technical problems

At least two important technical problems need to be addressed in order to implement such a scheme. A central problem is the determination of the level and range of nominal exchange rates as a starting point of this mechanism. Determining the appropriate "original equilibrium exchange rate", will require a detailed investigation into the absolute purchasing power of all currencies.

The second technical problem is the choice of the right basis for the calculation of the REER. The charts on page 32 show that there can be significant differences in the measurement of the real exchange rate, depending on whether it is calculated on the traditional basis of changes in the consumer price index (CPI) or on changes in unit labour costs (ULC). The charts depict these two indicators for the four biggest countries in terms of economic power as measured by GDP, using 1995 (a year with low trade imbalances among the G20) as the base year. On both counts, the real exchange rates of Japan and Germany indicate a significant gain of competitiveness compared to the base year. Despite the persistent surpluses of these two economies and the recent nominal appreciation of the Japanese Yen, their real exchange rates did not significantly appreciate in the subsequent years. On the other hand, the US dollar appreciated sharply in real terms between 1995 and 2001, together with high and further rising current account deficits. Although the United States has been on a path to recover its competitiveness since then, the level of 1995 has only again been reached in 2008. For these three countries the two measures move more or less in tandem, indicating that urgent policy action is required to reduce imbalances by realigning nominal exchange rates to the domestic cost level.



Source: IFS/IMF for all countries with the exception of REER-ULC of China, for which the source is EIU.

For China, however, the situation is different. China experienced a widening deviation between the two measures for the reasons explained below. The CPI-based REER rose less than the ULC-based REER and has remained reasonably constant since the end of the 1990s, interrupted by a phase of depreciation in the mid-1990s. To some extent this trend may have been influenced by the different weights used to calculate the Chinese CPI, which some observers believe require updating. By contrast, however, the ULC-based REER appreciated sharply since 1994. It rose consistently and strongly between 2000 and 2010, indicating an overall loss of competitiveness of some 40 percent in these years. While the data used for this exercise does not cover the whole of the Chinese labour force, there are strong indications from several sources that wages in the Chinese economy have risen quickly in recent years. An important gauge of this trend is booming private consumption, which would not have been possible without strongly rising nominal and real wages.

5 FDI is the key to understanding the real appreciation of the Chinese currency

The divergence between the two indicators has to be fully understood before China can be accused of unfair competition and an "undervaluation". Based on the ULC-REER China is the only country among the four specifically identified in this brief where the rising surplus on the current account coincides with the expected loss of competitiveness. This discrepancy is less surprising when the particularities of China's economic development over the past two decades are

considered. China is the only country among this group where activities based on foreign direct investment (FDI) dominate export and import behaviour. More than 60 per cent of all Chinese exports emanate from affiliates of foreign firms. Most of them use China as a host location because production there allows technology incorporating high labour productivity to be combined with low absolute wages. This combination warrants extraordinarily high profit margins and allows companies using this production hub to conquer global markets by means of lower costs and prices. Even if nominal and real wages and the ULC rise strongly, as they did in China during the last ten years, there is a significantly larger margin for foreign producers in China to keep prices low to gain market shares than for producers using the same technology located in developed economies.

A huge amount of so-called greenfield-investment in fixed capital is searching for cheap factors of production, and in particular cheap labour. This kind of FDI moves technologies with a high capital intensity, or at least a capital intensity much higher than hitherto applied in the low-wage countries. If labour in these countries is mobile or wages are set centrally and are following the domestic productivity trend, the overall level of wages in the country of destination is influenced by the import of this kind of FDI slowly, namely to the extent of the impact that an individual investment has on the overall level of productivity.

In this case, unit labour costs for a single production unit applying the new imported technology will normally drop remarkably. For example, an average industrial production site in Germany has a productivity (value added per hour) of 40 Euros per hour and average hourly wages (including all sorts of labour taxes) of 27 Euros. The unit labour costs are 0.67 (27 divided by 40). Moving such a production to a low cost location like China or India may cut the average wage to be paid by the foreign investor to a twentieth of the German level, i.e., 1.35 Euros per hour. Even if the productivity of the imported plant is not as high as in Germany, due to losses incurred by less skilled workers or lack of efficient logistics in the developing country location, the new level of unit labour costs realized will be much lower than in Germany. This implies that products can be either sold on the world market at very low prices or at "normal" prices, realized with high profit margins. If more and more intermediate products are relocated to the low wage country the overall cost level will drop significantly to reach its maximum once the whole production chain is relocated.

As unit labour costs are the most important determinant of competitiveness between countries and regions with less mobile labour, the monopoly rents or the

gains in market shares that the foreign investor is able to realize by cutting prices up to the full extent of the possible cost reduction are extraordinary. In China, the overall economy booms and FDI is an important contributor to the visibly huge jumps in productivity in the overall economy, which induces sharply rising nominal and real wages. However, even in such cases the monopoly position of the foreign investor recedes only slowly as the process of catching-up takes many years or even decades, given the low original level of wages and the low domestic capital stock compared to the most advanced economies.

The absolute competitive advantage enjoyed by foreign investors who are able to combine high technology with low wages in a low-wage environment is an advantage vis-à-vis those competitors with the same level of capital equipment in advanced economies and vis-à-vis those competitors enjoying low prices of labour in developing economies but having no access to high level technology. Consequently, the strategy of some early catching-up developing countries in Asia (Japan and Republic of Korea) and of China to combine the advantage of having a well-educated but low-paid labour force with imported high technology (in China mainly driven by FDI, in the other countries by industrial policy) is without parallel. Undervaluation is not a necessary complement for the success of such a strategy.

Accusations against China as a violator of trade rules, as raised by Fred Bergsten (FT, 29.11.2010) and many other prominent economists, based on the mere fact that the nominal exchange rate is fixed, are baseless. Real effective exchange rate changes are the most reliable measure to estimate the impact of domestic costs on trade flows and imbalances. Even if some uncertainty concerning the validity of the data is taken into account, China has undoubtedly experienced a significant, real appreciation in recent years. Nominal wages and real wages have been rising much faster in relation to productivity than in other big countries. Given the special circumstances of China as a hub of manufacturing production employing the highest technology globally available, the ULC-based REER provides the most reliable information on the country's competitiveness. If, as occurred in China, labour costs increase sharply in relation to productivity, the effect will show up in either a loss of market share or a loss of profitability compared to the past. On both accounts, competitiveness is reduced in relation to producers in other countries with a lower increase in labour costs. If the REER based on a price index remains unchanged, the economic situation of producers who choose to accept falling profit margins to maintain their trade volumes deteriorates.

To "find a mechanism to facilitate timely identification of large imbalances that require preventive and corrective action" is crucial for the future of world trade. Trade cannot be made an effective tool to foster growth and reduce poverty if the global community fails to find such a mechanism, which must be based on sober theory and thoughtful analysis.

6 The solution

The currency crises of the past have shown that for countries facing sudden reversals of hot money flows the policy options are very limited. Countries can try to defend their exchange rates from falling too rapidly by foreign exchange market interventions, which means to sell foreign exchange reserves and to buy the domestic currency. However, foreign reserves are always limited and the defending countries cannot convincingly hope to defeat the "market" with its huge amounts of speculative money. Raising interest rates and cutting budget deficits may be part of the defence package but these measures come with huge adverse effects on the real economy because they usually force a decline in domestic demand and economic activity in general including the number of jobs.

IMF assistance – at times combined with swap agreements or direct financial assistance from the EU or, recently, even the United States – has helped ease the immediate pressure on the currencies and banking systems of the troubled countries. But the origin of the problem – speculation of the carry trade type – raises doubts about the adequacy of the traditional IMF approach for tackling such a crisis. Raising interest rates to avoid further devaluation is like the tail wagging the dog. Traditional assistance packages or swap agreements, combined with restrictive policy prescriptions – or at least an expectation by donors that the spirit of such belt-tightening exercises will be applied by beneficiary countries – have proved to be counterproductive. Countries that have been exposed to carry trade speculation need a real devaluation in order to restore their international competitiveness and they need assistance to avoid a downward overshooting of the exchange rate, which would hamper their ability to check inflation and unnecessarily increase the burden of debt denominated in foreign currency. But they do not need belt-tightening. Rising interest rates and falling government expenditure will only re-invite speculation and worsen matters in the real economy. In such situations, countries need expansionary fiscal and monetary policies to compensate for the fall in domestic demand, as long as the expansionary effects of devaluation have failed to materialize.

To stop an overshooting devaluation – which is the rule and not the exception – is very costly if done unilaterally, but very inexpensive if countries under pressure to devalue join forces with countries facing revaluation. Countries that are struggling to stem the tide of devaluation are in a weak position, as they have to intervene with foreign currency, which is available only in limited amounts. If the countries with appreciating currencies engage in a symmetrical intervention to stop the "undershooting", international speculation would not even attempt to challenge the intervention, because the appreciating currency is available in unlimited amounts: It can be printed.

Unless there is a fundamental rethinking of the exchange rate mechanism and the cost involved in the traditional "solution" of assistance packages without symmetrical intervention, the negative spill-over of currency crises into the real economy will be much higher than needed. In addition, "undershooting" of exchange rates will change trade structures and trade flows much more profoundly than is justified, given the losses of overall competitiveness experienced during the build-up of speculative positions.

Multilateral or even global exchange rate arrangements are clearly necessary to achieve and maintain global monetary and financial stability and to combine such stability efficiently with an open trading system. The idea of a cooperative global financial and monetary system would be to ensure, on a multilateral basis, the same rules of the game for all parties, just as multilateral trade rules apply to all trading partners. The main idea behind the creation of the International Monetary Fund was precisely to avoid destructive competitive devaluations. In a well-designed global monetary system, the advantages of currency depreciation in one country would have to be balanced against the disadvantages in another. Since changes in the exchange rate that deviate from purchasing power parity affect international trade in a very similar way to changes in tariffs and export duties, such changes should be governed by multilateral regulations. A multilateral regime would, among other things, require countries to specify the reasons for real devaluations and the dimension of the necessary changes. If such rules were applied strictly, the real exchange rate of all parties would tend to remain more or less constant, since the creation of competitive advantages for specific countries or groups of countries would not likely be accepted.

G20 After the Crisis: An Indian Perspective

Subir Gokarn*

1 Introduction

I would like to thank the organizers of this event for inviting me to deliver this keynote address. While the title of the session is "What India expects from the G20", I think it would be extremely presumptuous of me to speak on behalf of the country as a whole. I have, of course, been involved with the G20 process as the Central Bank deputy and, in that capacity have had the opportunity to contribute to the shaping of the Indian position on various issues. So, rather than assert a national position, I would prefer to share some of the thinking that underlies the stance that is taken at various G20 forums. With this in mind, my presentation is divided into three broad segments. First, I look at what the G20 did to avert a potentially severe crisis a couple of years ago, which essentially provides the context to whatever role it may play in more 'normal' circumstances. Second, I explore the inherent differences within the group, which will naturally impose limits on what it can realistically hope to achieve by way of global co-ordination on structural issues. Third, I build on these two foundations to try and articulate a general "emerging market economy" position, which, I think, would be reflective of the Indian stance on a range of issues.

2 The context of crisis

The G20 had its origins in a previous crisis that also began in the financial sector and which threatened to spill over from one country to the next. This was the East Asian crisis of 1997–98, the roots of which lay in the increasing presence of foreign capital in economies that perhaps didn't quite have the capabilities to handle it. The fact that one of the factors underlying the crisis – foreign capital – linked the advanced and emerging economies provided the basis for countries from both groups coming together to look for ways to minimize the vulnerability

* Keynote Address by Dr. Subir Gokarn, Deputy Governor, Reserve Bank of India at the ICRIER/InWEnt/DIE Conference "Policies for Growth and Financial Stability Beyond the Crisis – The Scope for Global Cooperation" at Mumbai on October 27, 2010.

of emerging economies on the one hand and global financial institutions domiciled in advanced economies on the other.

Of course, the East Asian crisis wound down, with the affected countries showing strong resilience in the years following. The need for collective solutions, such as those which might have been provided by the G20 was felt less and less as emerging economies, both those most impacted by the crisis and those which escaped it, found their own, individual buffers against the next crisis. Since the crisis had had no significant macroeconomic impact on the advanced economies, they also had no particular interest in pursuing any collective strategy for structural change, which might have helped to stabilize the global economy and make it less vulnerable to a crisis. Of course, one important outcome of keeping the group going despite the absence of a particularly significant agenda was that the institutional representatives from the member countries got to know each other, making communication during the most recent crisis when the group really came into its own perhaps a little easier and more effective than otherwise.

In effect, then, a group that was born in the wake of one crisis really got the opportunity to demonstrate its effectiveness when another one precipitated. This crisis also had its genesis in the financial sector, which helped retain the relevance of the group's structure, with its core constituencies being finance ministries and central banks. This time round, however, the origins of the crisis lay squarely in the financial sectors of the advanced economies, a factor that has created some special challenges for the group's attempts to deal with post-crisis structural issues, a point that I shall return to later.

My essential point is that the origins and structure of the group made it an appropriate and, eventually, effective mechanism to deal with a crisis that threatened to spiral into a deep global recession. There have been many questions raised about what exactly the group did that contributed to mitigating the impact of the crisis. Some have argued that the measures that each country took to deal with the crisis would have essentially been the same even without the coming together of the G20. That may well be the case, but I would argue that it was precisely the show of strength and collective resolve of the group that helped reinforce the confidence of global stakeholders that the crisis would indeed be averted. Individual, uncoordinated responses, to my mind, would not have had the same impact on global perceptions that the G20 solidarity did, even if the policy measures in each country had been exactly the same.

Beginning with the Washington Summit in November 2008 and through 2009, the visible focus of the group on both the proximate aspects of the crisis and the more fundamental causes was, I believe, a major reason for the restoration of global confidence. The economic recovery has been slow and somewhat choppy, but potential disruptions have also been met with collective responses, which have, in turn, reinforced the belief that the recovery can be sustained. Further, the prominence that the group gave to structural reforms of various kinds sent the signal that it was committed not just to dealing with the immediate crisis but to putting in place measures that would significantly reduce the probability of recurrence. As we know from our own experience with structural reform, crisis always presents a window of opportunity to obtain a consensus on reform measures that would just not be possible under normal circumstances. It is for the leadership to grasp this and to push through reforms that meet the needs of changing global circumstances. The group's focus on structural issues was itself an important reason for the credibility it gained for its efforts to manage the crisis.

In short, I think that it is a reasonable assessment that the global economy would have been in somewhat different shape today if the G 20, or any collective process involving the world's largest economies, had not taken place. The group can certainly draw strength from this as it now shifts focus from dealing with the crisis to dealing with the structural issues that are perceived to have caused it. But, it is precisely at this stage in the process that the challenges to change management arise. As the crisis abates, the common threat perception and collective responsibility inevitably begins to dissipate and the consensus that was visible in the crisis management phase gives way to more individualistic priorities and agendas. How are these manifesting in the G 20?

3 Dividing lines

A number of factors have contributed to the emergence of differences within the group. This should not be surprising in and of itself, given the fact that this is an enormously disparate set of countries. The 20 countries in the group can be classified into categories based on a large number of parameters, each of which implies different policy priorities and, consequently, different approaches to deal with domestic and global conditions. Large or small, more or less affluent, net importers or exporters, commodities producers or manufacturers, aging or young populations – whichever way one looks at it, the composition of the group should not inspire much confidence that it can agree on common approaches to the structural issues that confront the global economy. Let me explore a few of these dividing lines and their implications for the group.

At this juncture, the variability of the recovery across the members of the group is a critical difference. In fact, with some economies having consolidated their domestic recoveries while others struggle to do so, there are legitimate concerns about whether the crisis has actually abated; in other words, whether the primary objective of the group has actually been achieved. Perceptions about the robustness of the global recovery have oscillated quite widely during the past several months and the outlook today is somewhat more negative than it was at the beginning of 2010. But, within this overall shift, while the outlook for several economies has deteriorated, it has remained constant or improved for others. This has immediate implications for the domestic policy priorities of each country. In a group that is ostensibly committed to doing no harm to each other, these differences may pose a challenge.

The most visible dilemma is on the issue of continued quantitative easing by advanced economies whose recoveries are showing some signs of stalling. As the capacity for further fiscal stimulus abates, more so as countries attempt to pull back from huge fiscal overhangs, more liquidity being pumped in appears to be the only avenue remaining for stimulating the economy. From the viewpoint of individual countries, there is not much choice; not using the instrument significantly increases the risks of the recovery reversing course. Apart from the domestic impact of this, given the relative size of the economies involved, this could clearly have global implications as well. So, it may well be that individual and collective interests are aligned on this issue.

But, while there may be alignment over a somewhat longer time horizon, in the immediate future, there are signs of misalignment. More liquidity, even the prospect of it, in some advanced economies, is spilling over into fast-recovering emerging economies, introducing several complications into their domestic policy environment. Some are worried about currency appreciation and the impact that this might have on their recovery as domestic producers lose competitiveness. Others are worried about the short-term nature of the inflows and the disruption that might be caused if there is a sudden exit in response to a global shock or new developments in the source countries. There are widespread concerns among energy and commodity importers that global liquidity is flowing into commodities and driving up prices, with consequent inflationary implications. In short, the immediate impact of quantitative easing may represent a dividing line within the group, even if, over time, it may be in the collective interest.

Financial safety nets represent another potential dividing line, not necessarily on principle, but on the different approaches that groups of countries have used to develop them. Self-insurance by way of reserve accumulation may be the safest way to protect oneself from global shocks from the viewpoint of individual countries. But, beyond some threshold levels of magnitude, it begins to generate externalities. To return to a point that was made earlier in the context of the East Asian crisis of the late 1990s, the effective choice made by countries affected or threatened by that crisis to build up self insurance capacity was both a response to perceived inadequacies in the collective safety nets available at the time and a contributory factor to some of the imbalances that have been associated with the global transmission of the recent crisis.

The analytical debate on this issue will go on, but the practical implicationfor many countries is to decide on their acceptable mix of insurance options within the overall consideration of doing no harm to other countries. Even while collective options, such as those that have recently been introduced by the International Monetary Fund become more accommodating of individual country requirements, the benefits of self-insurance that many countries experienced first-hand during the recent crisis are difficult to deny. Meanwhile, the perceived link between the building up of individual safety nets and global imbalances makes this issue a dividing line within the group.

Another example of a dividing line is financial regulation. It is now generally accepted that a significant contributory factor to the recent crisis was the opportunity that the existing regulatory and supervision framework in some advanced economies provided for highly risky investments to be made. However, even as this was happening, there are several countries in the group whose regulatory frameworks did not provide such opportunities and whose financial systems emerged from the crisis relatively unscathed. Notably, there seems to be a significant correlation across countries between the degree of damage that domestic financial systems suffered and the speed and robustness of their recoveries.

However, there is little question that there is a strong and inexorable process of global financial integration, which, with all the risks it entails, does have large potential benefits for all countries concerned. One important requirement for realizing these benefits is a set of common regulatory principles, standards and practices across countries. These are necessary to ensure that capital flows across the world based on genuine consideration of fundamental returns and risks and not on arbitrage between different regulatory environments. Certainly in theory,

this should not be the cause of any division; there is a clear common and shared interest in the outcome. In practice, however, divisions could arise on what exactly these standards and practices should be; whether they are driven by the specific conditions prevailing in the worst hit financial systems and, therefore, inappropriate and burdensome for the relatively healthy ones; and, the knowledge and human capital requirements to implement them effectively across a diverse set of countries.

I have tried to provide some examples of potential dividing lines, drawing on my experience and observations of the process in the finance track. Let me conclude this segment of the presentation by reiterating the point on which it began. This is an extremely differentiated and heterogeneous set of countries, whose conditions and priorities differ both in the short term and over the long run. It would be extremely naive to expect that such a group would be able to reach agreement on anything beyond the immediate crisis at hand, despite their ambition to tackle structural issues. From this perspective, any consensus on any issue is an achievement. It reflects the recognition that, notwithstanding differences between countries, global integration is a process that can be chaotic and disruptive if not handled in a collective and coordinated way. What is true for crisis management is also valid for the range of structural issues that the G20 as well as those which other multilateral processes are dealing with.

4 An emerging market economy/Indian perspective

Against this backdrop, let me now attempt to articulate what I would call an "Emerging Market Economy" perspective, but which also reflects my characterization of the Indian perspective. An important premise in this perspective is the point I concluded the last segment with. The process of globalization has enormous potential benefits for EMEs in all its forms. But, it also brings with it significant risks, such as the vulnerability to shocks which emanate outside their sphere of control. The best way to optimize on the "risk-return" tradeoff from globalization is to adhere to a common set of standards and rules, which, as I said earlier, forces the process to be driven by fundamental factors rather than by regulatory arbitrage, broadly speaking. On the basis of this argument, EMEs will see a clear benefit from engaging in any process that can develop and enforce such common standards and practices. The G20 is one such process, with the distinct advantage that, being a relatively small group, reaching consensus where it can be found is not too difficult a task.

However, EMEs have significant domestic objectives and challenges and these must take priority in their policy decisions. Many are dealing with the critical challenge of providing a large proportion of their population access to the most basic necessities, let alone education, health and financial services. An integrated and balanced development strategy makes several demands of the financial system. This, in turn requires a careful balancing between rapid expansion in capacity and the kinds of products and services offered on the one hand and safety and prudence on the other. This balancing act, at one level common to EMEs, but at another, differentiated by the vastly different conditions within the EMEs themselves may not be amenable to a reasonable set of common standards, except at a lowest common denominator level, which is then unlikely to serve the purpose of achieving a safe and secure global financial system.

The financial safety nets issue is also one on which a distinct EME perspective may emerge. The difference in concerns between advanced and emerging economies is heightened in the current environment in which increasing liquidity in some advanced economies is driving possibly short term capital flows into emerging economies. In such a situation, self-insurance needs to be given due consideration. When economic fundamentals are sound, would reserves not constitute the most effective way of dealing with reversals in short-term capital flows? If self-insurance were done away with, reliance on external insurance mechanisms might conceivably have two negative implications. One, procedure and due diligence might take time, thereby diluting the effectiveness of the safety net. Two, global investors may suspect that something is fundamentally wrong, aggravating the pressure of exit.

I have used the issues of financial regulation and safety nets to illustrate my point about the balancing act that EMEs need to perform between addressing domestic priorities and aligning with a meaningful set of global standards or mechanisms. However, this can be taken as a more general issue for EMEs as they engage in global forums on a whole range of issues on which the benefits of integration have to be viewed in conjunction with the pursuit of domestic policy objectives.

Essentially, from the emerging market perspective, the value of the G 20 process lies in how effectively it is able to accommodate this need for balance. As I have tried to argue through this presentation, both on short-term and long-term issues, the differences and divergences between countries in the group are wide and, perhaps, inevitable. This puts the group at an immediate disadvantage when it comes to addressing issues, because, given the differences, even agreeing on a common objective, let alone a common approach may be a difficult, if not impossible task.

However, it is reassuring that, in the face of these inherent handicaps, the group seems to have made significant achievements, which go beyond the immediate compulsions of crisis management and address some of the key structural issues. The underpinning for this progress, as I have alluded to earlier in the presentation, is the recognition by all parties involved that the process of globalization has potential benefits for everybody as long as it is controlled in some way. The basis of control is, as the G20 demonstrates, common principles, on which are based common, or at least compatible standards for both conduct and enforcement. But, control does not mean homogenization. As long as common standards can be reconciled with differences in practices and institutions, which allow individual countries to effectively address their domestic priorities, the arrangement is eminently workable.

Just as each country needs to maintain a balance between acceptance and adherence to global standards, the group needs to accommodate a possibly thin and blurred line between conformity and autonomy. Its effectiveness on all the issues that it seeks to address, but particularly on the structural ones, will depend heavily on this accommodation. Every member of the group must feel that there are some tangible benefits from continuing to associate and in turn, that perception depends on the space that is available to pursue legitimate domestic priorities, which do not impinge on the interests of the other members of the group.

By this benchmark, the group has done quite well. In the midst of significant differences, some of which I have pointed out, meaningful consensus on, for example, safety nets, financial regulation and reform of the International Monetary Fund suggest that it has found a way to accommodate the balance on a number of significant issues. The nature of this consensus has been widely reported on and debated in the wake of the recent Finance Ministers and Central Bank Governors' meeting in Gyeongju, Republic of Korea, so I do not want to go into the details here. The point I want to emphasize, though, is that the common feature of both the process of arriving at consensus and the agreements themselves was precisely the acceptance of common principles and standards, which do not come in the way of allowing each country to organize its internal systems in ways that it thinks is best.

This is not to say that there are no disagreements or unresolved issues within the group. It would be naive to expect that there would not be. However, as in the case of all collective activity, the presence of disagreements, even intractable ones, does not in any way undermine the legitimacy of the process. It should be judged by what it is able to achieve, not by what it is not.

5 Concluding remarks

At the very least, the G 20 provides a compact forum for knowledge and experience sharing between the largest economies in a structured way. The network that it creates certainly facilitates co-ordination on policy actions, should an occasion for this arise. In this respect, it is certainly a useful and effective crisis management mechanism.

But, from an emerging market perspective, its utility can and has gone beyond crisis management. These countries do recognize that the benefits of globalization will not be fully realized and the risks will be heightened in the absence of some meaningful collective activity. The effectiveness of this collective activity is, in turn, enhanced by its emphasis on common principles and standards, its recognition of national autonomy in deciding on policy priorities and strategies and, very importantly, its insistence on the principle of "do no harm". A realistic assessment of the performance of the group over the past two years would suggest that, while it may not have had equal success on all fronts, its achievements are significant and, in many ways, a vindication of its approach.

I would like to thank the organizers once again for inviting me and thank you all for listening.

The Art of Supervision by Emerging Markets: Impacts on the Global Financial Governance Agenda

Martina Metzger and Günther Taube *

1 Background

The course of the global financial crisis displayed widespread flaws in regulation and supervisory failure. Many advanced countries' financial sector was at risk to collapse requiring unprecedented monetary and fiscal intervention by policy authorities to stabilize it. Advanced countries financial sectors piled up systemic risk comprising almost all financial institutions; high cross-border exposure between the financial institutions resulted in a core meltdown when the bubble burst in 2008. Many debates and reform initiatives, notably by the G 20 and the Basel Committee on Banking Supervision, have been started since then; meanwhile, there is a consensus that financial market architecture both domestically and globally needs to be revisited. Against this backdrop, we discuss special features of the financial market architecture of those countries which were least affected: emerging markets.

Financial markets of emerging market economies have also come under pressure in the second half of 2008 resulting in steep stock market corrections, and a strong volatility of prices, in particular exchange rates. However, there was no bail-out of financial institutions and in 2009 financial markets of these countries strongly recovered. On average, first round effects or direct impacts of the financial meltdown in advanced countries on many emerging market economies were relatively low as exposure of their domestic financial institutions to toxic assets

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had been small (InWEnt 2009, 2010). However, there had been considerable second-round effects via the financial sector and more importantly the trade sector as main transmission channels. In contrast to advanced countries in emerging market economies, there was contagion from the real sector through a slump in exports and a decline in industrial production.

Despite reported differences in the magnitude and severity of the transmission channels, policy responses by fiscal and monetary authorities of emerging market economies were quite similar. In a first step central banks increased liquidity by cutting policy rates; in a second step central banks reduced reserve requirements and compulsory deposits to provide additional liquidity to credit institutions; a third measure covered companies and banks which were affected by the restricted access to international and domestic finance, in particular trade finance; and additional to the monetary policy measures fiscal policy initiated a package of measures with discretionary counter-cyclical instruments to dampen negative impacts of the global financial crisis on domestic growth and employment. Compared to previous crises, this time is different insofar as central banks and governments of emerging markets disposed adequate policy space to use multiple instruments, including non-conventional monetary measures and counter-cyclical fiscal measures.

In the next section, we discuss special features of the domestic financial market architecture of selected emerging market economies. The countries under consideration here are Brazil, India and South Africa; besides being a heavy weight both in their respective region and continent, the financial sector of these three countries showed a remarkable resilience to the global financial turmoil. We will argue that the art of supervision already developed and applied by Brazil, India and South Africa before the outbreak of the global financial crisis explains both the low vulnerability of their financial sectors *and* the policy scope to initiate counter-cyclical measures to moderate repercussions. The paper identifies a combination of a reduction of foreign debt exposure, a macro-prudential approach in supervision and a rule-based approach in regulation complemented by a variety of country-specific rules applied by these countries as the main features of their success. Finally, the paper elaborates on the implications of the success in terms of macroeconomic and financial stability by emerging markets for the current and upcoming debate on a globally co-ordinated financial regulation and global policy coordination.

2 Features explaining the financial sector resilience of Brazil, India and South Africa

Conventional wisdom suggests that the capacity to manage a crisis mainly depends on what policy has realized during good times, e.g. the creation of sound financial institutions, the improvement of regulatory and institutional capacities, the deepening and broadening of domestic financial markets and the design of an adequate monetary and fiscal framework which allows the involved institutions to work out a consistent response to a crisis in a coordinated way. Still, the low impact of the financial meltdown in advanced countries on the financial sector of raises the question whether and to what extent specific characteristics and features of their financial market architecture and their regulatory approach can explain the high resilience. In the following, four factors will be presented which stand out and might claim to have insulated the financial sector of emerging market economies from the worst woes of the global financial crisis.

2.1 Crisis heritage

Each of the three countries experienced a financial sector nemesis in the past and this experience decisively determined speed and extent of financial sector reforms and financial sector regulation in the three countries. Although they were subject to different modes of crises economic, financial and social costs of resolving them were high. These past crises were partly caused by domestic politics; hence, each of the three countries embarked on a policy stance to improve their macroeconomic fundamentals. However, good macroeconomic fundamentals might not be sufficient to protect countries from adverse effects as was impressively shown during the East Asian crisis. With rising openness and integration of domestic financial markets into the global economy the risk of spill-over and contagion from shocks is also increasing. Accordingly, Brazil, India and South Africa applied a gradual approach to capital account liberalization. They initiated financial market reforms in order to enhance the capacity of the domestic financial system to cope with capital flows and to increase the soundness of their financial institutions, in particular the banking system, which had been heavily affected by the past crises. “A key consideration in the choice of pace and sequencing has been the management of volatility in financial markets and implications for the conduct of monetary operations” (Mohan 2007: 21).

As basis of their supervisory practice the three countries adopted regulations recommended by international standard setters, e.g. core principles of bank

supervision, concepts of risk management and control systems. In addition, they consider other countries experience – either successful or failed – for the design of their regulatory framework: "(…) we believe that what is new in a market is not necessarily new in other markets. Therefore, when we think that a new financial instrument needs to be introduced in our market, we try to verify if this particular instrument has been regulated in any other market" (Gomes 2009: 3). This applies particularly to the approval of more sophisticated financial products which entail higher risk and are less transparent in nature; the more sophisticated financial products are and the more actors participate in financial market activities the easier might risk be spread throughout institutions and spill-over to the real sector. Thus, Brazil, India and South Africa have only gradually introduced innovative financial products and thereby they also benefited from other countries' experience. "An advantage for emerging-market countries in pursuing financial innovation and adopting synthetic or structured financial products is that they can learn from the mistakes of others and in that way shorten the learning curve" (Mminele 2008: 6).

One key problem of the past crises had been the high foreign indebtedness and the thereof derived currency and maturity mismatches which entail the risk of balance sheet effects. These balance sheet effects were a major factor which exposed developing countries and emerging market economies most to hazard with regard to macroeconomic stability and development as they put domestic borrowers with foreign debt under severe pressure in case of exchange rate devaluations. This 'fear of floating' (Calvo and Reinhart 2002) together with volatile capital flows strongly limited emerging markets room for manoeuvre and in some cases enforced harsh financial and economic adjustments. Hence, after two decades of crises experience emerging market economies switched to a policy which comprises the reduction of foreign debt exposure and the accumulation of foreign exchange reserves (Hausmann and Panizza 2010); though systemic instabilities would not be abolished by such a policy stance, it could diminish vulnerabilities to external shocks, dampen repercussions on individual countries and re-store policy space.

This holds true also for Brazil, India and South Africa which reduced their outstanding foreign debt to levels of 16 to 19 per cent of gross national income (World Bank 2010). The ratios of short-term external debt to total external debt and to total reserves respectively are particularly comfortable for Brazil and India, although India displays a strong increase of short-term maturities in recent years with which it financed its rising oil and food bill. From the turn of the millen-

nium the countries also succeeded to increase their foreign exchange reserves supported by a favourable world economic environment. At the start of the global financial crisis India could have still repaid its total external debt simply by using its foreign exchange reserves; Brazil's and South Africa's reserves covered nonetheless 80 per cent of its total external debt (World Bank 2010). Joining South Africa, Brazil became a net creditor country in 2008, an "unprecedented fact in our economic history" (BCdB 2008: 3) which was highly appreciated by Brazil's central bank. At large, the encouraging improvement of the foreign debt position provided Brazil, India and South Africa with the necessary policy scope to respond to the global financial crisis without delay and has effectively helped to mitigate its impact. "Thus, it is important to highlight that the risk management decision of the government to increase international reserves and to reduce short foreign exchange rate exposure from 2004 to 2008 made it possible for the Central Bank of Brazil to manage the financial turmoil of 2008 without a dramatic increase in the interest rate" (Silva 2010: 11).

2.2 Macro-prudential approach

The macro-prudential approach which is applied by the central banks of Brazil, India and South Africa is another distinguishing mark of their financial architecture. As their experience has shown that financial sector related crises are an important feature of market economies, their central bank policy takes into account financial stability considerations – a task which many central banks in advanced countries rejected due to a perceived conflict of interest with the objective of price stability. Although Brazil (since 1999) and South Africa (since 2000) follow an inflation targeting framework, their central banks regard the promotion of financial market stability by any means consistent with price stability. "The global financial crisis has shown that central banks have a vested interest in financial stability, and that the financial stability objective is a necessary corollary to the price stability objective. Else, monetary policy execution can be too easily thwarted by financial system disturbances. Whether responsible for supervision of banks or not, central banks need to expand their mandates and resources to assess and foster broader financial stability" (Bezuidenhout 2009: 6-7).

A macro-prudential approach implies that simple compliance with rules and regulations by financial market institutions does not necessarily prevent financial instability. Single institutions might even be sound; however, due to the interconnectedness and the inherent pro-cyclicality of financial sector activities systemic risk might be built up. "It is necessary that we alter the central banks inspection

philosophy. Today, this activity concentrates more on verifying formal compliance with specific norms set down in regulations than it does on analyzing the equity situation of these institutions" (BCdB 1995: 4). Thus, the establishment of system-wide surveillance to detect structural vulnerabilities and exposure in the financial system was a crucial measure within the design of the financial sector framework by Brazil, India and South Africa (Mohan 2009; Reddy 2008; Selialia 2009, 2010; Tombini 2006). For years now all three central banks regularly publish a thorough financial stability report or review; they conduct stress tests to analyse systemic risks including liquidity risks, asset price bubbles or the interconnectedness between financial and macroeconomic factors with credit risk. Based on their macro-prudential supervision monetary authorities have developed policies to mitigate systemic risks and to adjust prudential regulation.

2.3 Strict prudential regulation

Though Brazil, India and South Africa have adopted international standards, their prudential regulation is often stricter than envisaged by international standard setters. The minimum regulatory capital for bank lending, for example, is considered to be a cornerstone of international banking regulation and set by 8 per cent of risk-weighted assets. In all three countries authorities requested higher capital requirements already before the outbreak of the global financial crisis, e.g. Brazil 11, India 9 and South Africa 9.5 (Tesoro Nacional 2009; RBI 2009; SARB 2009). Similarly, the launch of a new financial product or service is linked to strict and sometimes higher requirements than commonly applied in other countries. "One additional thought I would like to share with you is that when a new financial instrument is introduced in the market normally regulators don't know exactly how it will work in practice. We are in the beginning of the learning curve. So there is a strong incentive for the regulator to set up more strict and detailed rules in order to make itself more comfortable with the new product in the market" (Gomes 2009: 4).

Moreover, central banks of the three countries tighten prudential requirements in a forward-looking and pre-emptive manner when deemed necessary. For instance Brazil increased capital requirements for foreign exposure for cross-border positions within international banking groups already in 2007 (Tesouro Nacional 2009). On the other hand, India increased provisioning requirements and risk weights for loan exposures to the real estate sector and consumers to dampen a domestic asset price bubble. "This 'dynamic provisioning' approach has facilitated adequate buffers within the banking system" (Mohan 2009: 13). South Africa

introduced deposits for some kind of loans and temporarily increased minimum capital requirements “to take into account financial stability considerations” (SARB 2009: 33).

Another aspect in the financial market regulation shared by the three countries is the rule-based rather than principle-based approach. While a principle-based approach which was followed by the two countries of origin of the global financial crisis, US and UK, provides regulators and market agents with more operational flexibility and is conducive to innovations, it is much more complex and entails less predictability of legal decisions. In addition, the influence of the financial service industry tends to increase, and due to the complex rules the response time of regulators on anomalies and irregularities are longer. In contrast, a rule-based approach with universal standards entails less forbearance and enables less regulatory arbitrage; supervisors’ decision are based on transparent and reliable indicators, e.g. equity capital, non-performing loans or credit ratios. Hence, regulation based on a rule-based approach is easier to impose and decisions can be taken quicker which is backing pre-emptive surveillance. “The key is to keep it simple and return to basics. Perhaps a modification of Warren Buffet’s investment rules should be considered: *Make regulations that are simple to understand and comply with, and enforce them. Never allow any activity that you cannot understand yourself and whose risks cannot be defined in terms of simple regulations*”(Bezuidenhout 2009: 8, emphasize in the original).

2.4 Country-specific rules and regulations

Brazil, India and South Africa as well exhibit country-specific features in a narrow sense which contributed to the resilience of their financial systems; rules and regulations have evolved over time according to the specific history and circumstances and, therefore are unique to the respective individual country. With regard to Brazil, it is worth mentioning that supervision covers all financial institutions, including hedge funds and OTC derivative markets. “Differently from other countries, there are no important players outside the Central Bank supervision” (Tesouro Nacional 2009: 12). The OTC derivative market regulation was formerly introduced for tax reasons, but also proved to be of value for mitigating systemic risk. Already back in 1998, Brazilian regulation required from investment banks to erect a so-called Chinese wall in order to separate their trust activities from their commercial bank activities (BCdB 2002). Another particularity is the so-called Public Hearing Process for regulatory proposals concerning securities in which interested parties can participate and give an opinion within

a pre-determined time frame. Later on the Brazilian securities commission has to deliver a report arguing which of the submissions will be taken into consideration and which will not be followed and why they will not be followed. "Public Hearing is almost mandatory under the Brazilian securities act, through the public hearing process we can address at least one of "the conflicting demands" faced by a regulator that we mentioned before that is: *Be responsive and not be captured by the industry*" (Gomes 2009: 3, emphasize in the original).

India actively manages its capital account. Hence, it has still exchange controls which restrict domestic banks' investment in off-shore financial instruments (RBI 2009). Complex structures like synthetic securitisation have been banned outright (Mohan 2009). Securitisation guidelines are applied for both banks and non-bank financial companies; they cover a broad range of aspects, e.g. liquidity and capital adequacy provisions for special purpose vehicles, resulting in a conservative treatment of securitisation exposures (Reddy 2008). In addition, the Reserve Bank of India instructed banks to base their investment decision not only on the recommendations of external rating agencies, but to apply the usual criteria of credit checks as in the case of direct lending. Furthermore, banks have to make provisions for a counter-cyclical Investment Fluctuation Reserve (Reddy 2008), which bears some resemblance to the currently debated liquidity buffers by the Financial Stability Board. India also developed a special framework for non-banking financial companies (NBFCs) with an explicit treatment and deliberate prudential norms of those entities. "The overarching principle is that banks should not use an NBFC as a delivery vehicle for seeking regulatory arbitrage opportunities or to circumvent bank regulation(s) and that the activities of NBFCs do not undermine banking regulations" (Mohan 2008: 2003).

Though South Africa has no specific regulatory framework on hedge funds, they are covered by the regulation on collective investment schemes. The regulation comprises a ban of using leverage and short selling strategies; in addition, provisions require collective investment schemes to hold enough liquidity to continue to operate a scheme at least for three months in case of winding up (Hadebe 2008). The Financial Services Board supervises the non-bank financial services industry, including collective investment schemes; its Enforcement Committee which was established in 2001 is endowed with extensive competences and pursues violations against existing legislation and regulation. In case of an (alleged) contravention of legislation administered by the Financial Services Board, a process similar to a law suit is set in with a panel appointed for each specific case. "The Committee may impose unlimited penalties, compensation orders and cost

orders. Such orders are enforceable as if it was a judgment of the Supreme Court of South Africa" (FSB South Africa 2001). Accordingly, decisions are published on the FSB's website. Furthermore, with the National Credit Act (NCA 2006) South Africa developed a broad spectrum of instruments to protect consumers' rights when borrowing by credit providers, credit bureaux and debt counsellors; all of them have to be registered to operate legally and follow a standardized manner of credit granting supervised by the National Credit Regulator (NCR 2007). In case of complaints by consumers and disputes with credit providers, including banks, the National Consumer Tribunal enforces a hearing process at which end it can completely suspend the credit agreement to the disadvantage of the credit provider when proved reckless. "The adoption of the NCA has, therefore, reined in reckless lending practices and improved consumer protection while at the same time indirectly saving South Africa from the fate of the global financial crisis" (Selialia 2010: 5).

Taking into account the art of supervision in Brazil, India and South Africa which is based on a macro-prudential approach and strict prudential regulation complemented by a variety of country-specific rules and legislation, it comes to no surprise that banks in the three countries are on average sound and banking behaviour has adapted to legal restrictions and norms; they even hold reserves and liquidity in excess of regulatory requirements which was considered to be inefficient and non-innovative before the crisis. More importantly, at the time of writing banks in Brazil, India and South Africa have not been infected by the notorious originate-and-distribute virus of granting loans which was a major driver of the credit and securitization bubble which finally resulted in the global financial crisis; instead they still execute the original banking model with a buy-and-hold strategy based on thorough credit assessment and borrower supervision.

In sum, the high resilience of the financial sectors of Brazil, India and South Africa is a result of continuously strengthening financial sector institutions and adjusting the regulatory framework to their country's needs and vulnerabilities. This is an on-going process which started already two decades ago. Thereby, crisis heritage has constituted a major motivation for macroeconomic and financial sector improvements while at the same time Brazil, India and South Africa constructively turned the drastic experience into a cautious and thorough handling of financial-sector related issues. In the hostile environment of a global financial crisis the specific art of supervision performed by Brazil, India and South Africa was put to test – and impressively passed it.

3 Constituting new roles in the global financial governance

Meanwhile, there is no doubt that emerging market economies have gone through the global financial turmoil not only better in terms of financial and macroeconomic stability than expected taking into account their former crises performances, but also better than G7 countries. Against this backdrop, the question arises whether the high stability and resilience of their financial markets will constitute just a passing moment of contemporary economic history or whether it will have implications for the current and upcoming debate on a globally co-ordinated financial regulation. The view advanced here is that it has already changed policy coordination between advanced countries and emerging markets and will continue to do so both in terms of voice and content.

The evolution of global macroeconomic coordination and international financial regulation follows a crisis-cycle and can be considered to be a learning-by-doing process. The international capital accord Basel I, which was adopted in 1988, was a response to the alarming meltdown of banks' capital in particular in the US as a result of the international debt crisis in the first half of the 1980s (Metzger 2006). In 1996, an amendment to Basel I was adopted which required considering market risk in the banks' capital reserves in particular for foreign exchange risk of debt securities and equities; the main impetus for this amendment was the Mexican crisis 1994/95 during which the Mexican peso strongly depreciated and put in foreign currency indebted Mexican banks and companies at risk of default with negative impacts for creditor banks' balance sheets in advanced countries, including write-offs and debt rescheduling.

In 2004, Basel II was adopted which replaced Basel I; it was the East Asian crisis which gave the major impulse to revise the old capital accord; already in 1999 the Basel Committee launched the initiative with the objective of redesigning international banking rules in order to prevent bad banking by introducing more risk-sensitive standards for internationally operating banks which were accused to have excessively expanded credit to East Asian debtors (Metzger 2006). At the time of writing, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (Basel Committee) lead-managed by the G20 currently discuss a broad regulatory agenda, e.g. increase of quality and quantity of banks' capital, the introduction of counter-cyclical liquidity buffers and leverage ratios as well as measures dealing with systemically important financial institutions and derivative markets (Rhee 2010). In the near future, there will be definitely changes and adjustments in form of a new capital accord Basel III (Basel Committee 2010).

Similarly, global macroeconomic coordination proceeded, albeit until the global financial crisis with less impetus and covering only few topics. After signing the Smithsonian Agreement in 1971 with which G10 countries agreed upon to move on to flexible exchange rates, it took almost 15 years to come to the Plaza Agreement (1985) and the Louvre Agreement (1987) with which the US, (West) Germany and Japan arranged to intervene in the foreign exchange market, the former limiting the US dollar's appreciation and the latter restricting its depreciation against other key currencies.

Institutions – be it formal or informal – are required to come to an agreement and mutual commitments between several stakeholders. Thus, the evolution of macroeconomic and financial policy coordination groups follows the needs of coordination arising from the respective challenges in each particular period. Only if a crisis is considered to be of global nature and sufficiently dramatic, will policy coordination groups emerge which adequately reflect voice and participation. The current crisis was the first crisis after WWII which was perceived as global by the G7 and more importantly, it was their countries in which the crisis originated and it was their policy, though involuntarily, which brought about the crisis. This explains why the G7 was prepared to open the exclusive club and invite emerging markets to join the table which meanwhile spans over 80 per cent of world population and world output.

Thus, over the last two years a remarkable shift of power has taking place within global economic and financial governance structures which broadened their membership and hence increased policy outreach. In 2009, the G7 which until then constituted the unchallenged major international policy coordination group on global macroeconomic and financial issues gave way to the G20, a group which had displayed a rather dozy performance most of the years since coming into existence. Parallel to that, both the Financial Stability Forum, which was renamed into FSB, and the Basel Committee invited emerging markets as new members. Meanwhile, the FSB can be considered as the central coordination forum on financial market topics between the various institutions and organisations dealing with these matters under the auspices of the G20. On the other hand, the Basel Committee, which is the most comprehensive forum with regard to member countries, disposes over the most focused mandate of banking supervision.

The perception of a crisis as being of global nature is only a necessary, however not sufficient condition. The transition to flexible exchange rates in the 1970s, the debt crisis in the 1980s and the currency crises in the 1990s all constituted

state of affairs with global impact and harsh economic and social repercussions; nonetheless from the point of view of developing countries and emerging markets economies agreements and stipulations were all drafted behind closed doors. This time G7 countries considered the situation to be different and this has much, if not solely to do with the strong economic and financial standing of emerging market economies. Already before the global financial crisis they consolidated and subsequently strengthened their position by reducing their foreign exchange exposures and increasing foreign exchange reserves. Ironically, this policy move was induced by a lack of an accepted multilateral policy framework for crisis resolution; financial support by the IMF for crisis-afflicted countries during the 1980s and 1990s was criticised as too low, too late and too lopsided. In the course of the current crisis emerging market economies could additionally strengthen their reputation due to the high resilience of their financial markets and their successful policy response.

Not only membership of global financial governance structures, but also content has already been broadened. There is a big overlap of topics, which are of interest for both emerging market economies and developing countries of which some have already entered the G20 agenda, e.g. financial inclusion and trade finance, but also energy.

Whether the gain in influence by emerging markets will permanently provide an opportunity to strengthen the voice of those developing countries which are not sitting at the table yet and will not in the foreseeable future, either, will depend on whether emerging market economies apply a bottom-up or rather a top-down attitude towards them. A potential avenue might consist in furthering the regional dimension and thereby increase outreach; some of the emerging market economies are heavy weights in their region and play an important role in the already existing regional monetary and financial cooperation frameworks, e.g. in South-East Asia or Southern Africa (Metzger 2008a, 2008b). However, in other regions regional cooperation in terms of monetary and financial issues is just at its outset; hence, it remains to be seen whether the modification in global governance structures towards emerging market economies can give fresh impetus to these regional schemes.

However, the crucial contribution of emerging markets participation in the global financial governance might come to the fore only in future debates on global economic policy and can be condensed in the message: There is an alternative, tested and scrutinised by financial markets. The art of supervision processed and

performed by emerging market economies represents an approach alternative to orthodox economic policy predominant in the run-up to the global financial crisis. Since the beginning of the 1990s, the notion of market supremacy became the hegemonic yardstick for economic policy, inducing widespread liberalisation and deregulation. There was one model that served as a rule and it was commonly practiced by international financial institutions condensed in the credo 'one size fits all'.

In contrast, the remarkable resilience of emerging markets' financial market architecture backs an alternative approach towards economic policy, not necessarily conflicting with the orthodox approach by any means, however more balanced and less bound. Though this alternative approach has existed all those years, it could emerge on the international arena as a serious mindset and challenge the oversimplified orthodox approach only due to the good macroeconomic performance by emerging market economies. This alternative approach may be supportive in several respects. It helps to resist advanced countries' requests vis-à-vis emerging markets and developing countries to harmonize international standards and to give up country-specific rules and regulation which had been essential to maintain financial stability. It may also help emerging markets to develop a collective vision vis-à-vis issues of financial markets or financial stability and embark on a mutually approved strategy in international governance structures. And finally, the alternative approach may stimulate future debates on financial market reforms and earnest global macroeconomic coordination in order to design a globally accepted framework of economic and financial crisis prevention with a coherent and aligned crisis resolution mechanism. That way the global financial crisis could eventually be beneficial even for advanced countries.

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East Asia in the Global Governance of Finance

Thomas Kalinowski *

1 Introduction

The global financial and economic crisis since 2008 has demonstrated the importance of East Asia for global economic governance. Global problems like volatile financial markets, erratic exchange rates and global economic imbalances cannot be solved without the region that produces huge trade surpluses, accumulates the largest amount of foreign exchange reserves and accounts for an increasing share of international financial flows. East Asia is needed, but how does it respond to calls for global economic cooperation and more specifically to reregulate global finance?

Since the 1997/98 Asian financial crisis, East Asian countries have gradually received a stronger voice in international financial institutions (IFIs) like IMF and World Bank. The establishment of the leaders G 20 in 2008 puts four East Asian countries, China, Indonesia, Japan and the Republic of Korea (henceforth Korea) at the table of the "premier forum for international economic cooperation" (G 20 2009) (section 2). How does is formal integration affect the G 20 agenda to reregulate global finance since the beginning of the global financial and economic crisis in 2008? In important discussions in the G 20 like improved international banking standards ("Basel III"), East Asian countries showed little interest and remained sceptical bystanders or reluctant followers (section 3). On the other hand, global solutions that are in the strong interest of East Asian countries like curbing volatile global financial flows and exchange rates have not been seriously discussed by the G 20. Instead of proactive actions, the G 20 focused on incremental improvements in reactive crisis management like increasing IMF quotas and the strengthening of "global financial safety nets" (section 4). Finally, the most serious conflict involving East Asia in the G 20, the issue of global economic imbalances and exchange rate management ("manipulation") of East Asian countries is far from being solved (section 5). In short, despite its importance for the solution of global economic problems, East Asia remains strangely out of sync with the agenda of the G 20.

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As we will see throughout this short essay, instead of seeking global solutions for problems of economic crisis, volatile financial growth and exchange rate instability, East Asian countries in the G 20 are concentrating on national self-help strategies like accumulating foreign currency reserves and implementing unilateral capital controls. What is important to note is that this bias against global cooperation is not primarily the result of an "anti-Western" political strategy or a "Hobbesian" world view (Katzenstein 1996), but can be more persuasively explained by structural constraints originating in the East Asian political economy.[1] I identify four major reasons for East Asia's reluctance to take on global responsibility. First, East Asia has been hit by the crisis since 2008 in a distinct way. The problems in East Asia were not flaws in the regulation of financial actors but its dependence on exports and exposure to the volatility of international financial flows. Secondly, so far, East Asian countries have been very successful in implementing national(ist) development strategies that aim at exploiting the global economic system – not challenging it. Thirdly, a successful export oriented development model in which the government's major objective is to increase "national competitiveness" has created an export oriented path dependency that is difficult to abandon. Fourthly, a "corporatism without labour" or in the case of China a "socialism without labour" in which governments are dominated by business interests and have a strong bias against demand side policies and the introduction of social safety nets that would be needed for more balanced growth.

2 A gradual shift of power to East Asia in the G 20 and the IFIs

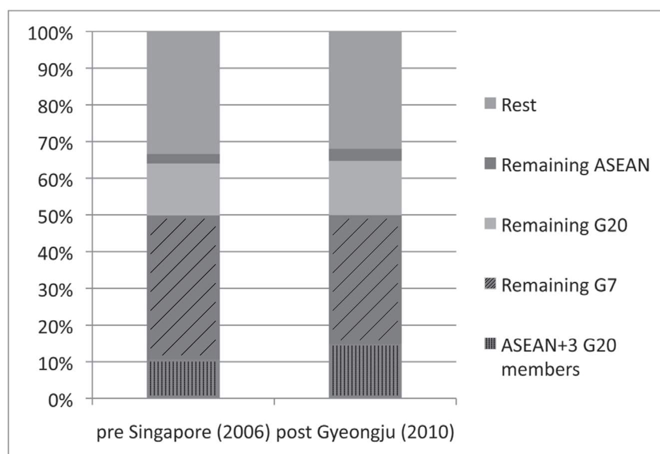
The inclusion of four East Asian countries into the leaders G 20 in 2008 has elevated the role of the East Asian region in global economic institutions and global economic governance. In the previous G 7 framework, Japan was the only East Asian representative that enjoyed the benefit to discuss issues of economic cooperation with the most important global leaders. Understandably, the most important goal of the "new", non-G 7 members is to consolidate the role of the G 20

1 It might seem presumptuous to lump together all East Asian G 20 members, given their obvious and significant differences. Nonetheless, I believe that East Asian countries share many similarities in their development paths. The "flying geese pattern," whereby Japan leads and is followed by Korea, Taiwan with China and South East Asia behind might be an oversimplification. However, there are strong similarities in economic structure (dependence on large conglomerates), integration into the world market (export orientation, capital export), the role of finance (low level of financialization), the role of the state (authoritarian pro-business corporatism) and ideology (strong nationalism). I believe that this kind of regional view can complement (but of course not replace) country-specific case studies, because it can help us to think outside the box of nation states and national idiosyncrasies, rather guiding our view to the underlying political-economic dynamics of the East Asian region.

to permanently replace the G 7 as the "premier forum for international economic cooperation", which was in principle agreed upon at the Pittsburgh meeting of the G 20 in September 2009 (G 20 2009). The French proposal to create of a permanent G 20 secretariat also finds strong support among the new East Asian G 20 members although Japan remains cautious to replace the informal setting with a more formal organization.

An important benefit for East Asian G 20 members is that they can use their position in the G 20 to lobby for an expansion of their power in related international organizations like the IMF and World Bank. At the G 20 finance ministers' meeting in Gyeongju in October 2010, an agreement was reached to reform the voting shares in the IFIs. If we compare the now-reformed voting shares with those in place before the first round of very limited reforms at the IMF annual meeting in Singapore in 2006, there are three important points to note. First, the reforms are slow and incremental. G 7 countries only lost 4 percentage points of their voting share in the IMF, which still leaves them with 41 percent. Second, the East Asian G 20 members (except Indonesia) are the biggest winners of the reform, as they gained 4.1 percentage points and now control 14.9 percent of the votes. Third, most of the changes are taking place within the G 20, though some non-G 20 IMF members also lose voting shares – particularly if we look at those countries outside the East Asian (ASEAN) region (chart 1). The reform of the IFIs does not substantially change the balance of power within the IFIs, but is a very limited shift in voting shares from the G 7 (and oil exporting countries) to emerging Asia, and to a lesser extent, to other emerging economies such as Mexico, Brazil and Turkey.

Chart 1: IMF voting share reform proposal at G 20 finance ministers' 2010 meeting in Gyeongju



Source: Own calculations from IMF (2010d).

The influence of East Asian countries within the G 20 and the IFIs is growing only slowly and in the IMF, the four East Asian G 20 members still have fewer votes than the US alone. It is thus not surprising that the role of East Asia in shaping the reform of the global governance of finance remains limited as we will see in the following to sections.

3 East Asia's as a bystander and reluctant supporter of Basel III

Weak regulation and supervision of banks and other financial firms was one of the major reasons of the global financial crisis. Consequently, a reform of the Basel II framework that sets international standards for bank regulation was a major concern of the leaders G 20 from the beginning. The so called Basel III framework was passed in September 2010 despite scepticism from East Asian governments. This is mostly, because banks in the region were far less affected by the global financial crisis than banks in the US or Europe. When the global financial crisis began in September 2008, some smaller East Asian countries such as Korea were hit hard owing to capital flight to safe havens in Japan and the US. However, throughout the entire period, banks in the region remained remarkably stable. One reason for the resilience of East Asian banks is the relatively recent shock of the Asian financial crisis in 1997/98 and the long malaise of the Japanese banks since the collapse of the real estate bubble in the early 1990s. Having experienced those crises, East Asian banks had ever since been undergoing a process of deleveraging and asset bubbles had little chance to become big enough to cause any major problems for banks. Even though there is arguably a real estate bubble in Korea and some parts of China today, it remains limited to some regions and is far less debt-financed than was the case in the US. After the Asian financial crisis, Asian governments also implemented stricter rules for banks, rules that they perceive as superior to those in the West. In Korea, for example, the government limited real estate loans to 50 percent of purchase values – a regulation that would have prevented the US subprime mortgage crisis. In China, capital controls and strict government control and guarantees also immunized against any banking crisis contagion.

Another reason for the resilience of East Asian banks is the relative "underdevelopment" of East Asian financial markets that limits the exposure to complex and risky assets. In the East Asian development model, banks are not profit-seeking businesses, but tools of governments and big corporations for financing industrialization and economic development. In stark contrast to the US-style financial-market-driven economy, banks in East Asia have always been subordinated to the

real economy and accordingly have functioned as providers of financial services. Banks only slowly abandon this traditional role. Financial firms remain focused on non-complex and "unsophisticated" financial products such as stocks, bonds and futures for the domestic market, while limiting their exposure to complex financial products (e.g. collateralized debt obligations and credit default swaps).

The low level of financialization also explains the second reason why East Asian governments have been hesitant to agree to stricter capital requirement rules within the Basel III framework. Part of the new guideline is to increase common equity requirements from 2 to 4.5 percent of (risk weighted) assets until 2015 and Tier 1 capital requirements from 4 percent to 6 percent, with an additional capital buffer that has to be built up by 2019 (BIS 2010). While these incremental changes in capital requirement rules are not posing serious problems for East Asian banks, they put them at some competitive disadvantage and might limit their ability to expand assets. Stock markets in East Asia are relatively shallow and banks in the region are mostly controlled by a majority shareholder, which makes it more difficult for them to increase their capital base by issuing common stocks.[2] Even though Basel III favours banks based in financialized countries like the US and Britain, East Asian governments have done little to prevent the new standards or offer alternatives. For example, a Basel III that would have put more emphasis on limiting the accumulation of highly risky and complex assets would probably have suited East Asian banks much better.

The scepticism about international standards for bank regulation has other reasons as well. East Asian governments are far from content with their relatively resilient but unsophisticated financial systems. They are planning to take advantage of the crisis of "Western finance" and establish financial centres in East Asia that can become serious competitors of New York's Wall Street and London's "The City." Reversing the tradition of strict government control over banks, East Asian governments are trying to establish or strengthen "financial hubs" within their jurisdictions. In Hong Kong for example, employment in the financial sector increased from 146,000 in 2003 to 196,000 in 2010 (Wassener 2010). The Chinese government is also trying to promote Shanghai as a new financial centre, while Korea has passed the Korean Financial Hub Act (2008) in an attempt to boost Korea as a financial centre and attract financial firms to the country. Japanese banks have launched a new initiative to become global players after failing to

2 This applies to the private banking sector in Japan and Korea, while Chinese banks are owned and backed by the state.

establish themselves in the 1980s and 1990s. For example, the Japanese brokerage firm Nomura bought the international operations of bankrupt Lehman Brothers and is planning further acquisitions in the US (Financial Times 7 November 2010).

East Asian governments are reluctant to agree to international standards for banking regulation but rather are looking to gain advantage from the strengthening of bank regulations in Europe and the US. It is likely that competition between the US and Britain about who offers the lightest regulation, which has fuelled financial globalization and crisis since the 1970s (Helleiner 1994; Abdelal 2007), is now being supplemented by competition between Western and East Asian financial centres. If this scenario in fact emerges, the intensifying trilateral competition will make the necessary, stricter and globally coordinated financial regulation even more difficult to achieve.

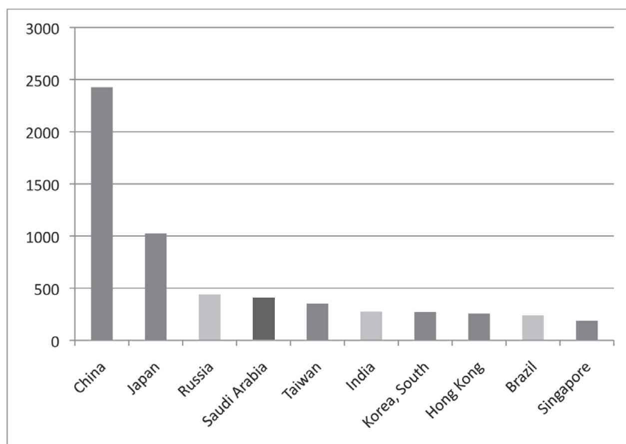
4 East Asia's unilateral regulation of financial flows and currencies

Unlike improving bank regulations, curbing volatile global financial flows and erratic currency swings are major concerns of East Asian countries. All East Asian countries are highly affected by volatile in and outflow of private capital, for smaller economies like Korea and Indonesia this is a major problem. The trauma of the 1997/98 Asian financial crisis and the humiliation of depending on the IMF to prevent a default are still vivid in the collective memory of East Asia. In 2008/09 many feared that history would repeat itself when massive capital outflow from the region destabilized currencies and exhausted foreign currency reserves.

Instead of looking for global solutions to regulate global financial markets and currencies, East Asian countries relied on national strategies to protect themselves against the volatility of global financial markets. The most important measure was to accumulate huge amounts of foreign currency reserves as a defence against sudden outflow or inflow of capital. Among the top ten foreign exchange-rich countries are six East Asia representatives that, together, have accumulated US$4.5 trillion of currency reserves (chart 2). Foreign currency reserves not only provide insurance against a sudden withdrawal of capital but also allow central banks to manage exchange rates. Since 2010, not capital flight but inflow of capital has become a serious problem for the East Asian region. Low interest rates in Japan, the US and Europe have created a carry trade of cheap "hot money" to emerging markets in East Asia that recovered relatively fast from the global financial crisis. This inflow of capital puts upward pressure on currencies in the region and

threatens to undermine international competitiveness. By accumulating foreign currency reserves and, thus, selling their own currency, East Asian central banks prevent a rapid appreciation of their currencies that would undermine exports as the main contributor to economic growth.

Chart 2: Top ten holders of foreign currency reserves in billion USD (2009)



Source: CIA Factbook (2010).

Unfortunately, buying insurance against financial crisis and managing exchange rates through reserve accumulation is quite costly, because it requires the purchase of US Treasury Bonds that carry very little interest. The dependence on the US dollar as a reserve asset is also risky, as it puts the value of foreign currency reserves at the mercy of US monetary policies and the value of the US dollar. East Asian governments are fully aware of these risks. China's Premier Wen Jiabao has voiced concerns about the future of the dollar as a global reserve currency and the Governor of the People's Bank of China, Zhou Xiaochuan even proposed that the IMF's special drawing rights (SDR) should take over the role as the global reserve currency. While both remarks were widely published and created a stir on global financial markets, they had almost no impact on the discussion within the G20 and the IMF.

A more real but less published challenge to Western ideological hegemony was East Asia's readiness to abandon capital account liberalization, which was an almost sacred principle of US dominated globalization under the "Washington Consensus". Since 2010, many East Asian countries suffered from massive inflows of short-term capital, because the region recovered fast and interest rates

in Europe and the US remained low. This "carry trade" created the danger of asset bubbles and put currencies in the region under additional pressure to appreciate, which further threatened to undermine the export oriented economic recovery. To defend themselves against the inflow of this "hot money", many East Asian countries, including Korea and Indonesia, have newly introduced capital controls on the inflow of capital (e.g. a tax on bond holdings by foreigners) while China has always maintained a relatively high level of control on international financial flows (Singh 2010). Implementing these capital controls has drawn criticism from developed G20 members, but East Asian countries get support from an unsuspected side. In a recently published IMF staff paper, the authors signalled support of the introduction of capital controls under certain circumstances (Ostry et al. 2010), and the G20 leader's communiqué from the meeting in Seoul in November 2010 can be interpreted as approving capital controls.[3] Another question is the effectiveness of such unilateral capital controls, which might limit the inflow of capital into the region but do not solve the underlying problem of volatile financial flows as such.

Considering the destabilizing effects of erratic global financial and currency market on East Asian countries, the high cost and the doubtful effectiveness of national self-help measures, it is surprising that East Asian governments have shown little interest in global initiatives like the financial transaction tax (FTT) proposed by France and Germany or a new global currency system ("New Bretton Woods") that was put on the agenda by France for the G20 summit in 2011 (The Economist 2010a). A FTT could curb volatile financial flows "on both ends" and a new Bretton Woods System could create stable exchange rates through international cooperation without the need to accumulate huge amounts of currency reserves that bear little interest. One reason for the scepticism about such global solutions is the East Asian experience with the failure of international institutions and particularly the IMF during the Asian financial crisis in 1997/98 (Veneroso and Wade 1998; Kalinowski 2005). The scepticism about Western dominated international institutions even led to the creation of a regional financial safety net. Already in 1997 Japan proposed the formation of an Asian Monetary Fund (AMF), a proposal that was rejected by China and the US. Later this proposal let to the creation of the Chiang Mai Initiative (CMI) consisting of a system of bilateral and multilateral currency swap agreements between East Asian countries

3 The communiqué states that "…in circumstances where countries are facing undue burden of adjustment, policy responses in emerging market economies with adequate reserves and increasingly overvalued flexible exchange rates may also include carefully designed macro-prudential measures" (G 20 2010).

(Park and Wang 2005). In the current global financial crisis, however, East Asian countries have not just shunned IMF lending (with the exemption of Mongolia) but have also demurred from activating the CMI. Instead, in 2008, countries such as Korea directly asked the US Fed to provide support through bilateral swap agreements.

The failure of the CMI to become a viable alternative to the IMF in the region has shifted attention back to the global level and the strengthening of "global financial safety nets". East Asian countries not only increased their voting share in the IMF but supported the largest quota increase in the IMF's history. In November 2010, member countries approved a doubling of its quota from SDR 238.4 billion to SDR 476.8 billion (about US$755.7 billion) in November 2010 (IMF 2010a). East Asian countries not just provided the IMF with substantially more money but also continued their attempts to change the way it lends. Particularly, East Asian governments were interested in reducing ex-post conditionality of IMF lending that was perceived as particularly intrusive and humiliating during the Asian financial crisis. Consequently, the IMF established two new credit lines with no or limited ex-post conditionality and fast access to funds: the flexible credit line (FCL) and the precautionary credit line (PCL). The FCL and the PCL come with no (FCL) or "focused" (PCL) ex-post-conditionality, but instead require ex-ante conditionality and provide money only to countries with a proven record of "sound economic policies" (IMF 2010b, 2010c). Both credit lines are tailored to successful emerging economies in East Asia with good economic records like Korea and Indonesia but also other new G20 members such as Brazil, Turkey and Mexico. East Asian G20 members and some of the more developed ASEAN members that are part of the CMI would qualify for "light touch conditionality" lending by the IMF, while most poorer developing countries still depend on support through "traditional" IMF Standby Arrangements that come with heavier conditionality.

5 Global rebalancing and East Asian export-orientation

So far we have looked at East Asia's approach to the institutional and technical reforms of the global governance of finance that have been implemented or discussed since 2008. However, we can only understand East Asia's role in this reform process, if we take a broader look at the East Asian political economy and its role in the global economy. It is East Asia's mercantilist, export-oriented development strategy that enabled countries to follow costly national self-help strategies and limits the ability of governments to actively participate in finding

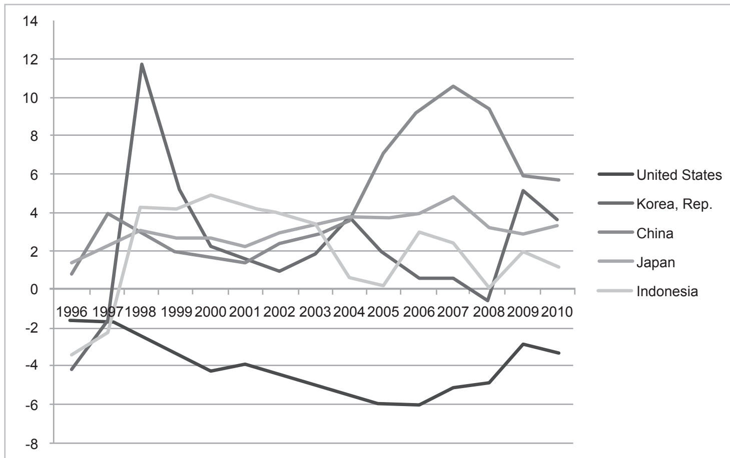
global solutions. In other words, we have to understand the political economy of the global economic imbalances that have been a root cause for the global financial and economic crisis since 2008.

In the past four decades, East Asia emerged as the "factory of the world" that produces everything from raw materials and labour-intensive consumer products (China, Indonesia) to capital- and technology-intensive consumer products and transportation equipment (Korea) and high-tech consumer and capital goods (Japan). In this flying geese pattern, Japan leads, followed by Korea and China, creating a sophisticated regional division of labour and economic trade that previously only existed in Europe and North America. Until the 1980s, this export-oriented strategy largely worked without trade surpluses, because East Asian countries had huge demands for Western technology and capital goods. Since then, however, many East Asian countries, with the notable exemption of China, have reached or are about to reach a stage of economic development in which investment opportunities are declining.[4] Trade surpluses became chronic since the Asian financial crisis because East Asian countries needed them to create growth, repay their foreign debt and accumulate foreign exchange as a way to insure themselves against future external financial shocks.

The global economy is a system of communicating tubes in which surpluses in one group of countries depend on deficits in other countries and deficits in the trade of goods and services require corresponding inflows of capital and vice versa. Most of the East Asian current account surpluses since the Asian financial crisis have been absorbed by the US (chart 3). The resulting accumulation of foreign currency reserves that were recycled as US treasury bonds (see section 4) led to the low interest rates in the US that fuelled the US credit and real estate bubble and led to even more consumption of East Asian products. This "symbiotic relationship" between the US and East Asia has contributed to the economic recovery of East Asia and the rise of China, but at the same time has created the global imbalances that contributed to the severity and reach of the current global financial and economic crisis.

4 Gross capital formation in Japan accounted for an average 29 percent of GDP in the 1990s and 23 percent in the 2000s, in Korea the respective figures were 35 and 29 percent and in Indonesia 28 and 25 percent. Only in China, investment rates were higher in the 2000s at 41 percent compared to 39 percent in the 1990s (ADB 2010).

Chart 3: Current accounts of East Asian G 20 members and of US (% of GDP)



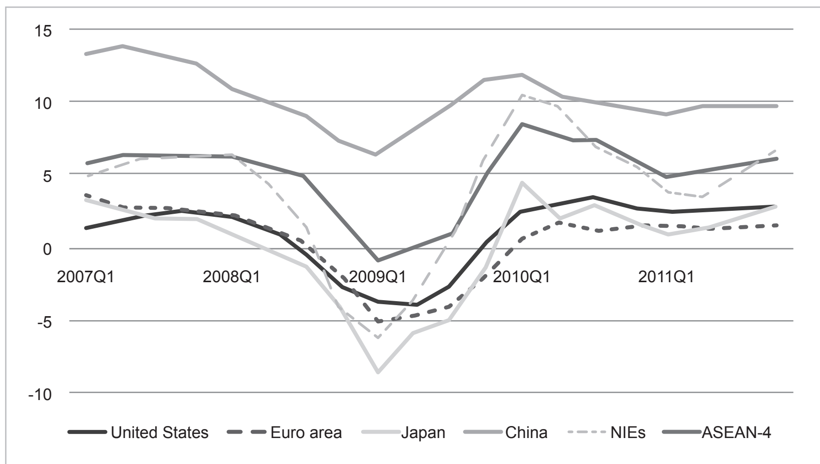
Source: World Bank, World Development Indicator Database (2010).
The data for 2010 (in the case of China, for 2009 and 2010) are estimates from *The Economist*, Weekly Indicators (2010c).

When the financial crisis in the US spread to the global real economy in the fourth quarter of 2008 and growth rates around the world collapsed, countries in East Asia were heavily affected due to their export dependency. Growth rates in Japan and East Asian NIEs initially declined even more than the US or Europe, while growth rates in the remaining ASEAN and China declined a bit less dramatically (chart 4). Since the Pittsburgh summit in 2009, the leader's G 20 put the goal of achieving "sustained and balanced growth" at the centre of its agenda. Initially the focus was on coordinating and implementing fiscal stimulus packages that could restart the stalled economic and financial engine. Since then, all G 20 members have implemented massive stimulus packages, but while European and US governments have rediscovered Keynesian support for consumption or profited from automatic stabilizers in their welfare systems, East Asian countries have engaged in more business friendly, supply-side oriented stimuli.[5] These "corporatist" fiscal policies had first been explored by Japan as it entered its low-growth period in the early 1990s. Unlike Western countries that provided tax breaks or subsidies

5 For example, in Japan supply side effects of the fiscal stimulus from 2008–10 were 2.9 percent of GDP (tax reduction for business + transfer to businesses + government investment) and demand side effects were 1.2 percent (tax reductions for households and consumption + social transfers + government consumption + transfer to households. In Korea, it was 3.3 and 2.2 percent respectively. In comparison in the cases of more demand side oriented stimulus packages the figures were 1.1 and 3.6 percent for the US, 0.6 and 1.3 percent for the UK and 1.4 and 1.6 percent for Germany (OECD 2010).

for new car purchases ("cash for clunkers") that benefited global demand for cars (including Japanese and Korean cars), East Asian governments in the current crisis have focused on infrastructure investments or subsidies to businesses that benefitted almost exclusively domestic businesses. These measures include investment in housing, airports, high-speed trains and R&D in China and the "four river restoration project" and support for "green growth" industries in Korea (Hur et al. 2010).[6] Instead of reducing global imbalances, these investments will further increase the global competitiveness of East Asian businesses and will probably create even larger trade surpluses in the future.

Chart 4: Quarterly real GDP growth over previous years (in percentages)



Notes: Estimates for 4th quarter 2010 and for 2011;
NIEs: Hong Kong SAR, Republic of Korea, Singapore and Taiwan, Province of China
Source: IMF (2010e), World Economic Outlook October 2010, Figure 1.13

Export-oriented East Asia was hit severely by the crisis, but it also recovered faster, partly due to the massive stimulus packages and partly due to revived exports. While the US current account deficit shrunk, global imbalances remain a prob-lem as East Asian exports to the US were replaced with exports to Europe and the developing world. When it became clear that fiscal stimulus packages alone would not reduce global imbalances and that East Asia might run even stronger surpluses after the crisis, the G20 switched from coordinating fiscal pa-

6 Only Indonesia's much smaller fiscal stimulus, a substantial share of which was tax incentives, can be called "consumption friendly."

ckages to discussing more structural reforms. First, the US criticized East Asia and particularly China for "currency manipulation," that is, strategically undervaluing their currencies to gain export competitiveness. In Korea, exports profited from currency devaluation due to the outflow of foreign capital. Since the beginning of the recovery process in the second half of 2009, Korea joined the Chinese strategy to limit the appreciation of their currency through exchange rate management. Because exchange rate management was targeted to limit appreciation against the devaluating dollar, East Asian currencies (except the Japanese Yen) devaluated massively against free floating currencies like the euro and currencies from emerging economies without currency management like Brazil[7]. Whereas it is difficult to determine relative currency values, The Economist's October 2010 "Big Mac Index" (like other indexes) suggests that with the exemption of Japan, all East Asian currencies remain substantially undervalued, ranging from about 20 percent for Korea to roughly 40 percent for China (The Economist 2010b).

East Asian countries in turn accuse the US of using monetary policies of quantitative easing to devalue the dollar and flood East Asia with cheap money that is drives up currencies and creates asset bubbles in the region. During the G20 meeting in Seoul, US President Obama changed course, instead of demanding an exchange rate adjustment, he proposed to limit current account surpluses (and deficits) to 4 percent of GDP. This proposal was immediately dismissed by East Asian surplus countries with the support of Germany, which dislikes undervalued East Asian currencies but is even more concerned about losing the economic stimulus from its own massive trade surplus.

In short, all attempts to limit East Asia's export orientation have been unsuccessful, and governments in the region have shown little interest in finding global solutions for the global economic imbalances. East Asian countries follow a path dependency of corporatist "developmental states" (Johnson 1982, 1995; Woo-Cumings 1999; Evans 1995; Kalinowski 2008) that have successfully utilized industrial policies and mercantilist strategies to develop. The export oriented strategy and the corporatist goal of "national competitiveness" are so deeply engraved in the East Asian economic structure and political-economic institutions that they will be very hard to remove – just as the US would find it hard to abandon financial-market-oriented capitalism. The export orientation has prevailed in East Asia since the 1960s (Japan), with Korea joining in the 70s and China in the 80s.

7 It is, thus, not a surprise that it was the Brazilian Finance Minister Guido Mantega who warned of a "currency war".

Particularly remarkable has been the successful export-oriented crisis recovery strategy as was exemplified by Korea after its debt crisis of the 1980s, the Asian financial crisis (Indonesia, Korea) and the current crisis (chart 3).

Recommendations for reforms made by international organizations or the US to reduce East Asian export dependency by appreciating exchange rates, increasing domestic consumption or strengthening social safety nets neglect that unique political economy of East Asian countries. Industries in the region that manufacture consumer products like electronic and IT equipment, transport vehicles like cars and ships or intermediate products like semiconductors are so heavily dependent on exports that domestic demand can hardly ever match supply. These corporate engines of development have over the decades formed an export lobby that certainly will push their governments to further increase export competitiveness and prevent or at least limit exchange rate appreciation. Problems associated with undervalued currencies are mitigated through alternative policies like capital controls to prevent inflow of volatile capital and government led “resource diplomacy” to limit the increase of prices for natural resources and agricultural products.

On the political level, the path dependency of pro-business corporatism is a formidable obstacle to global rebalancing. Already in the 1970s Pempel and Tsunekawa have characterized the Japanese developmental state as a “corporatism without labour” (Pempel and Tsunekawa 1979), a term that can be used for Korea and to some extend for the “socialism without labour” in China. In such a political constellation, demand side oriented policies are difficult to implement because they are seen as costs that undermine the competitiveness of the export sector. The creation of a comprehensive welfare state that would reduce the necessity to save for retirement and illness and, thereby, free up resources for consumption is equally unrealistic. Japan and Korea are both spending far less on welfare than other developed countries, and China has just abolished its “iron rice bowl” welfare system upon joining the WTO in 2001.

East Asia seems to defy Western modernization theory that would expect the region to enter a new “stage of economic growth” (Rostow 1990) based on domestic consumption. On the contrary, the past decade in East Asia has been characterized by a massive increase of social inequality in terms of income distribution and the ability to consume (ADB 2007). A minority of East Asians has succeeded in entering the middle class and become consume oriented while a majority is kept in precarious working conditions that create neither the income nor the social security necessary needed for an increase of consumption that would match

economic output. Inflated real estate prices in the region and the necessity to accumulate private savings for retirement and health care tie up income and require high saving rates that further limit the availability of income for consumption.

A balanced, domestic-consumption-driven economy does not emerge spontaneously, through international negotiations or government strategy, but needs domestic social actors that supports such a transformation. Unfortunately, due to the long tradition of authoritarian corporatism, labour unions and demand-side-oriented political forces in the region are too weak to gain wage increases high enough to shift the economies onto a domestic-consumption-oriented trajectory. Where strong labour unions exist like in Japan or Korea, their organization on the company level (as opposed to the industry level) facilitates collusion with business at the expense of those in the massive low-wage sector that are not able to increase their consumption expenditure. The cooptation of a small group of privileged workers that are well paid and receive corporate welfare benefits has depoliticized labour unions. They focus on bread and butter issues and do not develop an alternative to the supply-side-oriented corporatism. This further weakens progressive political forces that represent demand-side policies and could facilitate the transformation to a balanced, less export-dependent economy.

6 Conclusion

East Asia is needed to reregulate international finance and rebalance the global economy, tasks that are on the agenda of international institutions like the G20 since the beginning of the global financial and economic crisis in 2008. We have seen that the G20 agenda does not reflect East Asian interests and so far governments in the region fail to offer serious alternatives to Western initiatives. While there is broad agreement in the G20 for a more important East Asian role in the IMF and an expansion of global financial safety nets, the proactive reregulation of global finance remains heavily contested. East Asian governments care little about international banking standards, because they want to establish their own financial centres as competitors to Western financial centres where financial regulation is strengthened. Issues that are an important concern of East Asian countries like volatile international financial markets and exchange rates are not seriously discussed in the G20. This lack of responsiveness forces East Asian countries to follow national self-help strategies like the accumulation of foreign currency reserves, exchange rate management and unilateral capital controls.

Finally, without reducing the global economic imbalances, technical reforms of improving the regulation of banks, financial flows and even a global currency regime ("New Bretton Woods") would not be effective. A stable global financial system can only rest on a balanced real economy. Unfortunately, solving the global economic imbalances would require deep changes of the East Asian political economy. The global economic imbalances are nothing else than the East Asian trade surplus with the rest of the word. This trade surplus is the result of an export oriented development regime that is deeply engraved in the East Asian political economy. There is little indication that East Asia is abandoning the path dependency of export orientation and is turning on a more balanced, domestic-consumption-oriented road to economic development.

It is important to note that East Asia's reluctance to seek global solutions and the conflicts in the G 20 about global economic imbalance and exchange rate management are not the result of an "East Asian challenge" to Western dominated international institutions. Trade surpluses and accumulation of foreign exchange reserves are not the means of an "economic attack on the West" but the consequences of the limits of the East Asian export-oriented development model. In order to understand East Asia's dilemma and to avoid misinterpretations about the rise of East Asia, we need more careful studies of the East Asian political economy. Only if we carefully analyze path dependency and change in the region, we can understand the dynamic of East Asia's role in global economic governance.

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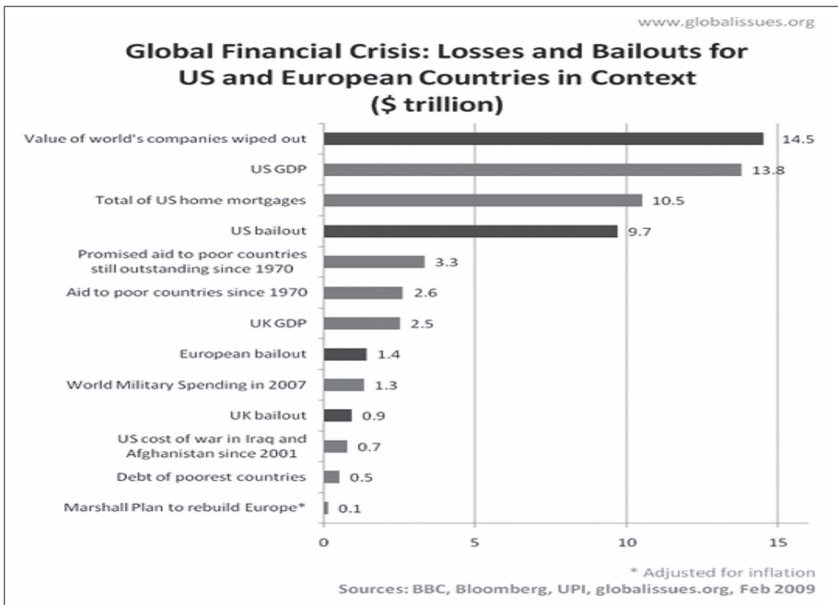
Regulation of the Financial System Two Years after Lehman – An Indian Perspective

K.P. Krishnan*

1 Background

The scale and scope of the US subprime mortgage crisis has been such as to have shaken the fundamental philosophy of financial regulation in the developed countries. The magnitude of the crisis can be gauged from the extent of losses following the crisis and the bailout packages doled out by major countries (chart 1).

Chart 1



* Secretary, Economic Advisory Council to the Prime Minister of India, New Delhi. The paper was presented at the ICRIER/InWEnt/DIE Conference „Policies for Growth and Financial Stability Beyond the Crisis – The Scope for Global Cooperation" in Mumbai, 27-28 October 2010.

As the next section will attempt to explain, the crisis had multiple and complex causes. However, in a limited financial markets sense, the seeds of the crisis were sown around the year 2002, when loan originators started packaging mortgages as securitized instruments and marketing them as Collateralized Debt Obligations (CDOs) on the secondary mortgage market. These credit vehicles encouraged banks and other financial firms to take on riskier loans than they should have; helped increase leverage in the global financial system; and exposed a much wider array of financial firms to the risk of default. This was the trigger for what followed to be a chain of events leading up to the global financial crisis.

The fundamental role of financial regulation is to manage risks attached to financial promises. While in some other areas safety regulation aims to eliminate risk almost entirely, this is not an appropriate aim for most areas of the financial system, where the aim is to manage, allocate and price risk. In other words, the aim is to ensure provision of finance to the economy at least cost while ensuring stability of the system as a whole. Instability in any part of the financial markets weakens the financial system, making it vulnerable to negative shocks and also spreading negative externalities. Increasing volumes of transactions, complexity of new instruments, costly crisis in national financial systems and several high profile misfortunes at individual institutions have led to the containing of financial instability becoming a top priority for public policy. To appreciate this better, it will be useful to see these numbers:

- the Argentinean banking sector crisis of 1980-82 was estimated to have led to loss of 55 per cent of its GDP;
- the Mexican crisis in 1995 cost the economy 12-15 per cent of its GDP and
- the Japanese banking crisis during the 1990s has led to a 10 per cent fall in its GDP.

Following the sub-prime crisis, the importance of maintaining financial stability has once been reinforced. The financial crisis that engulfed the world financial order in September, 2008 can, in retrospect, be said to have been caused by the contagion effect of one institution's failure spreading to the others as a result of a general breakdown of trust of investors in the ability of financial institutions to meet their liabilities, which is the cornerstone of a "stable" financial system. Further, it is quite obvious that these institutions responsible for the contagion effect were institutions that were of systemic importance to the financial system as a whole.

There has been an outpouring of academic literature and official reports analyzing the causes of the global financial crisis and suggesting steps to reform financial architecture.

What emerges from these reports is that there seems to be strong consensus and emphasis on the global financial markets reform agenda as the following:

a Regulation of OTC markets;
b. Regulation of credit rating agencies;
c. Reforming compensation practices;
d. Checking excessive leverage in the system;
e. Regulation of large, complex financial institutions.

Some of the above issues would require coordinated action among nations, such as resolution of multinational financial firms. Action on most other fronts however would lie with the domestic regulators/governments. It is these issues that will be the focus of the rest of the paper.

2 The Indian context

2.1 Indian financial system: The basic structure

The financial system and infrastructure of a country, at a given point in time, is the result of its own peculiar historical evolution. This evolution is shaped by the continuous interaction between all the players in the system and public policy interventions over time. These policy interventions are also a reflection of the thinking of regulators and governments of the time as to the acceptable and desirable balance between innovation and stability, the role of state and markets.

The evolution of Indian financial markets and the regulatory system has also been along a similar path. The philosophy and practice of financial sector regulation in India can be said to have evolved in response to India's unique contexts and necessities over time. Today, most financial service providers and their regulatory agencies are in place. The role of regulators has evolved over time from that of an instrument for planned development in the initial stages to that of a referee of a relatively more modern and complex financial sector at present. The regulatory framework of the Indian financial system can be best described as "arm's length, market-based, Anglo-Saxon system". It is characterized by dominance of banks with banking institutions accounting for nearly 70 per cent of the total assets of all financial institutions. The focus on regulators has been on regulation of deposit

taking institutions and systematically important non-deposit taking institutions. The regulations have always recognized the vulnerabilities originating in the external sector and adjusted policy response accordingly to maintain financial stability.

2.2 Impact of the global financial crisis on Indian economy

India can be said to have only been indirectly affected by the global financial crisis largely because Indian banking system had no exposure to tainted assets or institutions in distress and due to that fact that India's growth was mostly driven by domestic demand and investment and that its exports are less than 15 per cent of GDP. However, the indirect effect of the crisis was felt as India is now more closely integrated with the global economy and financial integration is as deep as trade integration. In 2008-09, the export plus import to GDP was 41 per cent and two way flows of capital (on capital+ current account) to GDP ratio was 112 per cent.

While in the initial phase of September, 2007 to January, 2008, foreign investment inflows increased with India offering better returns, they turned negative later as foreign investors attempted to book profits to offset their losses in other markets. Net foreign investments (net of foreign investments and loan operations by Indians abroad) rose from USD 14.75 billion in 2006-07 to USD 43.33 billion in 2007-08 and then fell drastically to USD 3.47 billion in 2008-09.

Stock market indices fell and current account was adversely affected through a slowdown in exports. Current account deficit (CAD) increased in 2008-09 to 2.6 per cent of GDP from 1.5 per cent of GDP in 2007-08. This was the highest level of CAD since 1990-91. Also, capital account surplus dropped from 9.3 per cent of GDP in 2007-08 to 0.9 per cent of GDP in 2008-09, the lowest level of surplus since 1981-82 (table 1). The economic growth of the country clocked 6.7 per cent in 2008-09, a decline from 9.2 per cent in 2007-08 and 9.7 per cent in 2006-07.

Table 1 India's Balance of Payments (in USD billion)

	2006-07	2007-08	2008-09	2009-10 (Apr-Sept)*
Imports	190.67	257.63	307.65	139.36
Exports	128.89	257.63	189.00	81.39
Trade Balance	-61.78	-91.47	-118.65	-58.22
Net invisibles	52.20	75.73	89.92	39.59
Current account (net)	-9.57	-15.74	-28.73	-18.62
Total Capital account	46.17	107.90	8.65	28.15
Overall Balance	36.61	92.16	-20.08	9.53

* Preliminary estimates
Source: Economic Survey 2009-10, Government of India, Ministry of Finance, Department of Economic Affairs

2.3 How India weathered the crisis

Various quick measures were taken by the Government and the Central Bank to maintain a stable financial environment in the midst of the global financial developments. Government provided two fiscal stimulus packages in December 2008 and January 2009, together amounting to about 3 per cent of GDP. The stimulus was in the form of additional capital spending; government-guaranteed infrastructure spending; cuts in indirect taxes, expanded guarantee cover for micro and small enterprises and additional support to exports.

The Reserve Bank of India's (RBI) monetary policy response through the crisis was guided by the objectives of ensuring ample rupee liquidity; maintaining comfortable foreign exchange liquidity and guaranteeing credit flow to productive sectors of the economy. The measures taken by the RBI in the light of these objectives included reduction in policy rates; reduction in cash reserve ratio; relaxation of norms for external borrowings and increase in interest rate ceilings on nonresident Indian deposits. The repo rate was cut in stages from 9 per cent in October 2008 to 4.75 per cent and the reverse repo rate was brought down from 6 per cent to 3.25 per cent in April, 2009. The cash reserve ratio which was 9 per cent in October 2008 has been brought down to 5 per cent in January, 2009. The statutory liquidity ratio requiring banks to keep 25 per cent of their liabilities in government securities was reduced to 24 per cent in November, 2008.

Some unconventional measures were also taken by the Central Bank, which included extension of Rupee-dollar swap facility for Indian banks to help them manage their short-term foreign funding requirements; provision of an exclusive refinance window and a special purpose vehicle for supporting non-banking financial companies, and expansion of lendable resources available to apex finance institutions for refinancing credit extended to small industries, housing and exports.

3 Evolution of Indian regulatory changes and future agenda

As noted in section 3, the international declarations inter alia include commitments to strong measures to improve transparency, regulation and supervision of hedge funds, credit rating agencies, OTC derivatives and in compensation practices in an internationally consistent and non-discriminatory way.

Even before the global financial crisis forced the developed countries to consider overhauling their financial regulatory framework, India had been working on the next set of reform agenda for its financial markets realizing that in a growing and increasingly

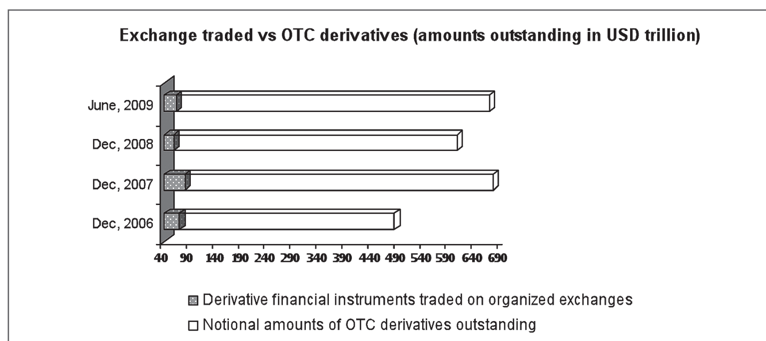
complex market-oriented economy such as India's, with increasing integration with global trade and finance, a competitive yet sound and stable financial system would be an important element in the country's future growth trajectory. Further steps were, hence, required to make the financial markets deeper, more efficient and well-regulated. In this direction, two recent important Government Committees, the High Powered Expert Committee on Making Mumbai an International Financial Centre (HPEC on MIFC) and High Level Committee on Financial Sector Reforms (CFSR) charted out the road ahead for India's financial system to prepare it for the challenges of the future. Despite differences in their scope and terms of reference, the two reports had a common underlying term of reference, viz. to recommend next generation financial sector reforms for India. The two reports emphasized that recognizing the deep linkages among different reforms, including broader reforms to monetary and fiscal policies were essential to achieve real progress.

Some of the important recommendations of the two reports included more rapid progress towards capital account convertibility; moving to a streamlined financial regulatory architecture; restructuring the banking industry; ensuring the bond-currency-derivatives markets linkages through lifting of bans on certain markets and introducing certain missing markets etc. We discuss below a few of the recommendations which are relevant in the aftermath of the financial crisis, focusing on where India stands on these counts in the context of global intellectual thinking.

3.1. Moving OTC trades to CCP framework

To appreciate why taming the OTC markets is important, it will be useful to look at chart 2 presenting the derivative transactions on organized exchanges vis-à-vis those happening in the OTC markets.

Chart 2



Source: BIS Quarterly Review, various issues.

As in June 2009, 90 per cent of all derivatives trades were being executed OTC. Though OTC transactions have benefits of flexibility and innovation, they face problems of inefficient price discovery and large counterparty risk as they are privately negotiated, devoid of novation which a clearing corporation offers. An IMF working paper[1] of November 2008 attempts to quantify counterparty risk that may stem from the OTC derivatives markets. It measures risk as losses that may result via the OTC derivative contracts to the financial system from the default or failure of one or more banks or broker dealers. It finds that considering that the notional value of all categories of the OTC contracts reached almost $600 trillion at the end of December 2007, the failure of a single major financial institution could result in losses to the OTC derivatives market of $300-$400 billion. The paper argues that since such a failure would likely cause cascading failures of other institutions, the total global financial system losses could exceed $1,500 billion.

Prior to the subprime crisis, OTC markets had proven to be fairly robust despite rapid growth of trading activity. However, the crisis exposed weaknesses in the system. While central counterparties (CCPs) worldwide functioned relatively well, where such CCPs were not involved, there were difficulties in unwinding derivatives contracts. Bilateral clearing resulted in a proliferation of redundant overlapping contracts, exacerbating counterparty risk and enhancing the complexity and opacity of the interconnections in the financial system.

At the time of the crisis in December, 2008, the global OTC derivatives market stood at $547 trillion. Lack of transparency in the massive OTC markets intensified systemic fears during the crisis about interrelated derivatives exposures from counterparty risk. With no requirements for margin or capital, OTC derivatives increased leverage in the financial system enabling traders to take large speculative positions on a relatively small capital base. Counterparty credit exposure in the derivatives market was seen as a major source of systemic risk during the failures of Bear Stearns, Lehman Brothers and AIG.

There is now a move in most countries towards mandating a transparent trading framework for these products and more regulatory oversight.

Economic entities in India currently have a menu of OTC products. In respect of forex derivatives involving rupee, residents have access to foreign exchange forward contracts, foreign currency-rupee swap instruments and currency options –

1 Miguel A. Segoviano and Manmohan Singh, Counterparty Risk in the Over-The-Counter Derivatives Market, IMF Working paper No. 08/258, November 2008.

both cross currency as well as foreign currency-rupee. For derivatives involving only foreign currency, a range of products such as interest rates swaps (IRS) and forward rate agreements (FRA) are allowed. The rupee interest rate derivatives presently permissible are FRA, IRS and Interest Rate Futures (IRF).
Table 2 indicates the activity in the OTC markets in India.

Table 2: OTC derivatives turnover in April 2007 (Daily averages, in mn of USD)

OTC foreign exchange derivatives	Outward forwards	6,299
	Foreign exchange swaps	13,437
	Currency swaps	479,000
	Options	3,800
OTC single currency interest rate derivatives	Forward rate agreements	...
	Swaps	3,395
	Options	...
	Total	**27,410**

Source: BIS Triennial Central Bank Survey of foreign exchange and derivatives markets activity, 2007

The corresponding activity on the derivatives segment of the largest derivatives exchange, the National Stock Exchange, in the month of April 2007 was Rs 30,8143 milion (or USD 7463 million[2]) of average daily turnover. Thus, in line with international trend, the OTC derivatives markets in India are far larger than the exchange traded market for derivatives.

However, it is important to note that Indian regulators have always been cautious on the use of OTC derivatives and have put in place appropriate guidelines for banks dealing in these products and also a trade reporting platform. The Central Clearing Corporation of India (CCIL), has been developed as a reporting platform to capture the transactions in OTC interest rate derivatives, e.g. IRS and FRA, since August 2007. Since one of the counterparty in an OTC transaction has to be an RBI regulated entity and has to report to it on a regular basis, the Indian model for regulation of OTC markets provides an automatic surveillance on OTC expos-

2 Converted at the 2007 calendar year annual average exchange rate, published by the RBI, of IUSD=Rs 41.29.

ure of all banks in India. Additionally, the use of CCIL as a reporting platform on a real-time basis helps the RBI keep a real-time watch on systemic risk. Depending on RBI-stipulated capital requirements, the CCP guarantee would reduce capital requirements for banks up to 80 per cent by eliminating the counterparty risk.

The RBI, in 2009, directed that, with a view to accessing complete information on this segment of the market, the scheduled commercial banks and primary dealers to report the IRS transactions entered into with their clients on a weekly basis. Further, RBI requires all trading parties "to submit counter party and contract wisemarked to market (MTM) values of derivative (viz., forwards, swaps, FRA, futures, options, credit derivatives, etc.) contracts on gross basis in equivalent US dollars with details of currency of settlement, country of the counter party, country and sector of ultimate risk, to their respective head/principal offices" [3].

A general view emerging after the recent financial crisis is that OTC derivatives trading should be moved to an exchange platform or an exchange like environment. The proponents of this view hope that this would increase liquidity and reduce significantly the opacity of the market. However, it needs to be noted that OTC and exchange-traded products cater to completely different needs of different types of market participants. While exchanges cater to retail as well as wholesale customers, OTC markets are totally wholesale and used by institutional investors. Also, the Indian OTC forward market is primarily used by hedgers with physical exposure whereas the futures market is apparently used mostly for arbitrage and speculation purposes. Further, while exchanges specialize in highly standardized products, many of the products currently traded OTC are highly customized so that it is difficult to trade them on the exchanges. Thus, the two markets serve different purposes and are complementary to each other.

In conclusion, the Indian OTC derivatives market did not contribute, directly or indirectly, to the global financial crisis. Unlike the new regulatory initiatives in the United States and European Union towards more regulation of the OTC derivatives markets, Indian OTC markets are reasonably well regulated and there seems to be no need for new moves to tighten the regulatory framework. Instead, what we need is a concerted effort towards deepening the markets for derivatives along with increased disclosure, more transparency and more standardization.

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3 RBI notification "Reporting of OTC interest rate derivatives-client level transactions", dated 5th October, 2009.

3.2 Need for a stability regulator or improvement in the existing system of inter-regulatory structure and functioning

The recent global economic crisis has generated a lot of discussion on the existing system of financial sector regulation all over the world. In India, too, there has been enormous debate on the structure and functioning of the existing regulators. At present, the Indian financial markets are regulated by the following autonomous institutions:

- Reserve Bank of India: Banks and NBFCs
- Securities and Exchange Board of India (SEBI): Securities markets
- Insurance Regulatory and Development Authority (IRDA): Insurance sector
- Pension Fund Regulatory and Development Authority (PFRDA): Pension funds

The forum for inter-regulatory interface is the High Level Coordination Committee on Financial Markets (HLCCFM) constituted in 1992 with the RBI Governor as its Chairman. Its other members include Chairmen of SEBI, IRDA and PFRDA. The Government is represented in the said forum by 3 persons from the Ministry of Finance namely the Secretaries of the Department of Economic Affairs and the Department of Financial Services as well as the Chief Economic Advisor.

Since the details of the functioning of the HLCCFM, the minutes of its meetings etc. are not in the public domain, an objective evaluation of its working is difficult. However the view of the present author, based on five years of close association with these issues is that the HLCCFM was a good mechanism when it was set up. However, to keep pace with subsequent developments, it needs to change and keep up with the times in order to be more effective because the markets that are regulated by members of the HLCCFM have dramatically changed since 1992. It is generally agreed that, over time, markets have become more complex and converged and are becoming increasingly integrated. In the light of these developments, if the regulators do not take an integrated and holistic view, outcomes will be sub-optimal.

The Budget 2010-11 has recognized the importance of better inter-regulatory coordination especially in the light of the need to maintain a stable financial system as well as promoting its growth and development. The Finance Minister, in his Budget speech, announced the setting up of an apex-level Financial Stability and Development Council (FSDC) to strengthen and institutionalize the mechanism for maintaining financial stability. The Council will, without prejudice to the autonomy of regulators, monitor macro prudential supervision of the economy, including the

functioning of large financial conglomerates, and address inter-regulatory coordination issues. It will also focus on financial literacy and financial inclusion. The Government is in the process of implementing this Budget announcement.

FSDC would need to objectively define "financial stability" for the Indian context as there is no internationally accepted definition. One definition is that a "financially stable" system can be said to be one which is robust to macroeconomic disturbances and thus able to withstand unforeseen shocks relying on its stable "key institutions" so that there is high degree of confidence that they would continue to meet their contractual obligations on their own. Financial stability means not only an absence of actual financial crisis, but also ability of the financial system to limit and manage imbalances before they assume a magnitude that threatens itself or economic processes.

However, this definition is incomplete as it does not define "key institutions or SIFIs", which are fundamental for maintenance of financial stability of the system. There is a huge debate on what institutions in a financial system are most important for ensuring financial stability and the criteria of choosing one over the other. When the US Government went out to bail out the AIG and not Lehman Brothers many questions on this line were asked and debated. What kind of financial institutions are "too big to fail" or are SIFIs for the financial system and most importantly to what extent and in what manner public authorities should intervene to maintain financial stability of the system and how to deal with moral hazard issues arising out of this intervention?

Financial stability is the key to sound functioning of the financial markets and the economy itself. By definition, this cuts across regulatory domain and is multidisciplinary and multi-agency in nature. At present, there is no regulatory agency in India that is formally entrusted with the task of maintaining financial stability though there is clear understanding and unanimity that like elsewhere the central bank will have a major role in whatever mechanism is designed to handle financial stability. There is a felt need for such an agency which can be assigned the task of assessing macroeconomic risks with an aim to prevent financial crisis by ensuring adoption of policies that mitigate systemic risks, thereby contributing to financial stability and sustained economic growth.

Financial stability is about achieving a condition where the financial system is fully performing its function of allocating resources and modifying the risk structure of the economy, so as to enable and foster the highest GDP growth.

Importantly and as noted earlier, financial stability is not synonymous with the complete absence of any type of financial crisis. As an extreme example, it is easy to rule out crises by eliminating financial markets, products and firms. This does not yield the desired state of financial stability. Financial stability is only achieved when finance is fully playing its desired and appropriate role in enabling a well-functioning market economy.

Micro-prudential supervision is necessary but not sufficient. The traditional focus of financial supervision was upon one firm at a time. While this 'micro-prudential' engagement by regulatory and supervisory agencies is necessary, it is not sufficient for assuring financial stability. When individual firms are properly supervised, it does not add up to a robust financial system.

A 'macro-prudential' approach is additionally required: one which sees the financial system as a whole, across all markets and across all financial firms. A fresh focus on financial stability does not invalidate the traditional wisdom on micro-prudential regulation. It requires additional effort to look at financial markets and the financial system as a whole, with a different kind of system thinking.

There are two dimensions in which financial stability thinking in India differs from the mainstream discussion worldwide:

- The resilience of financial markets in emerging markets is generally less than that seen in advanced countries. While deep and liquid markets are a given in many advanced countries, they are the ultimate and as yet not fully achieved objective in India. While the sharp decline of liquidity on the money market in London in the crisis of 2008 was an unprecedented event by historical standards, difficulties in liquidity of the money market in Mumbai are not so unusual. The resilience of liquidity of these markets, where many impediments continue to exist, cannot be taken for granted. While 'liquidity black holes' are an exotic phenomenon that could rarely occur in advanced countries, they are potentially a greater risk in India.

- India's system of financial governance features a large number of agencies, each operating in a specified area, often with a set of financial firms where all activities are supervised by one agency. India is different in the placement of regulation of organised financial trading across three different agencies; in all OECD countries but one, this function is performed by one agency.

The other important task of the FSDC would perhaps be to identify SIFIs in the Indian economy. Issues that would need to be debated are should banks be treated is the same league as non-banks in the context of financial stability and possible bailouts; is failure of a big bank same as that of a small bank and should the central bank be concerned about volatility in asset prices which may lead to instability among financial institutions? Then it would be essential to draw out a supervision framework for SIFIs recognizing that the same ought to be such as to remove the advantages they derive from becoming systemically important and to create time-consistent incentives for them. Also, there may be certain financial markets of more importance than others in ensuring stability of the system as a whole. Which are these and how to differently regulate them?

It would also be important to assess the ways in which financial instability interacts with the real economy to either amplify or moderate the effects of initial shock. Thus, it is important that regulators responsible for oversight of different financial institutions interact and cooperate closely among themselves and with those responsible for stability of prices and the real economy. The FSDC could be the forum for such interactions.

The recent global financial crisis has drawn a lot of attention to the role of regulatory bodies. The G20 countries have increasingly been discussing the need for greater coordination not only between regulatory bodies but between member countries and jurisdictions as well. India has recently become a member of the Financial Stability Board (FSB) and the Financial Action Task Force (FATF). Response to these international bodies has to be timely and often requires inputs from regulators at very short notice. At present, the Ministry of Finance via an "informal" arrangement collects the required information and sends a unified stand from India to the international bodies. However, with time, expansion of work in this direction would require streamlining of procedures and effective regulatory coordination to produce a timely and "unified view from India". As India moves in the direction of carrying out a financial sector assessment programme (FSAP) as per the criteria specified by international standard setting bodies, it is in the interest of all concerned that the present arrangements are fortified to cater to the upcoming requirements.

The Council also is likely to be a repository of views on the entire financial sector in India and the level of compliance of a system as a whole (and not just its individual parts) with internationally acceptable standards. For example, if Sector A of the financial system in India is compliant with international standards and

Sector B is not, then what is the international ranking of India's compliance relative to the rest of the world. Currently, there is no body in India that looks at the financial system in its entirety. FSDC is likely to be that institution that will take views on the entire financial system after consultation with all the regulators. It is visualized as a council that will seek to bring better synergies among regulators across sectors, which would help in better implementation of policies.

There have been debates after the collapse of the Lehman Brothers about further liberalizing and opening up India's financial sector. The Prime Minister in his speech at the World Economic Forum November 7, 2009 articulated India's views in the matter to the global community. He mentioned that his Government was "better placed than any time" to push through reforms in the financial sector. A roadmap for next generation of financial sector reforms has been charted out by various Government appointed committees. This agenda needs to be driven in a coordinated manner to achieve results. There is need for an institutional mechanism that can coordinate and oversee the reform and development agenda for the financial markets as a whole. Reforms require multi-disciplinary work; regulatory coordination has to become effective. The forum of HLCC (which is the present system of regulatory coordination) has not been as effective as required given the ever changing global scenario." The creation of FSDC is an important step to further India's reform agenda.

There will be no operational change in the role of any regulator. The FSDC will not be a super-regulator. It will achieve its mandate without undermining the autonomy of the regulators.

3.3 Regulatory framework for credit rating agencies (CRAs)

The first point to be noted as regards CRAs is that credit rating and CRAs have been "regulated" in India for a long time. In 1992 when the SEBI Act was passed by the parliament, SEBI was conferred with powers to regulate credit rating. It is generally perceived to have done a good job of this since then. More over in recent times, even before the world thought of regulating CRAs after the global crisis, India's efforts in the direction of strengthening this had started way back in January 2008. India's High Level Committee for Inter-regulatory coordination (the HLCCFM) in its meeting held in January 2008, inter alia decided that "the legal and policy framework for regulating the activities of CRAs should be revisited in order to take a larger view of the entire policy with respect to banking, insurance and securities market. Accordingly, a committee was formed by the

Ministry of Finance. The committee submitted its report (http://finmin.nic.in/the_ministry/dept_eco_affairs/capital_market_div/Report_CCRCRA.pdf) in December, 2009. The recommendations of this committee that have already been implemented include:

- Mandating half yearly internal audit for CRAs covering all aspects of CRA operations and procedures including investor grievance redressal and compliance with securities laws;
- Making it mandatory for a CRA to obtain prior approval of SEBI for change in status or constitution including amalgamation, demerger, consolidation or any other kind of corporate restructuring;
- Mandating various transparency and disclosure requirements for CRAs. These include maintaining record of rating process, publication of default studies, formulating policies and internal codes for dealing with conflict of interest, disclosing whether rating is solicited or unsolicited, disclosing credit rating history and defaults in prescribed format etc.

3.4 Compensation packages

The international discussion on this subject is dominated by the need to restructure practices primarily in the banking sector to contain the incentives of bank managements to take undue risks (with the associated higher incomes) so as to gain on the upside and be insulated from the downsides which are borne entirely by the equity holders, depositors and in the worst case scenario by the tax payers. It was felt that the practices pre-crisis were such as to enable the managers to reap private gains arising out of high risk-high reward activities and socialize the losses arising out of these. The FSB recommendations on the subject are as under:

On the other hand, in India, the issue is if anything not only different but perhaps the exact opposite. With public sector banks accounting for nearly 70 per cent of the banking activities in the system, and their salaries pegged to relatively non-competitive civil service salaries, public sector banks are bereft of the kind of talent and human resources required to handle the complex tasks involved in the provision of modern banking and financial market services. In fact, the Governor of the RBI has publicly drawn attention to this recently and argued for higher salaries for public sector bankers. On the other hand, for the few private sector banks, the RBI has in place a system of approving the terms and conditions of appointment of senior management of its regulated entities. However, at present, this works more like an incomes policy in terms of controlling the quantum of payment rather than focusing on whether these are structured in a manner of

increasing risky behavior. There is therefore a need to improve these practices but on the whole this is not a major issue for India at present.

3.5 Principal based versus rules based regulation

There is an ongoing debate amongst Indian policy makers on the need to revisit the financial regulation framework in the country which is "rule-based" and over prescriptive, writing down every minute detail into the basic legislation and detailed subordinated rules and regulations. The suggestion here is to move towards more principles-based regulation to promote financial innovation and avoid the mistake of over-regulation. However, even if the regulatory system continues to be "rules-based", then, given the pace of financial innovation that a country that is growing as fast as India requires, there should definitely be a constant revisiting of the rules that are in place. Else, we get stuck in an old set of rules that work to restrict the pace of growth in the country. Regulatory impact assessment could serve as an important tool for evaluating the cost-benefit of various aspects of the regulatory architecture and implementation to guard against the error of over-regulation.

4 Conclusion

Has the global financial crisis necessitated a change in India's approach and commitment to financial sector development on the lines of recommendations of certain recent Government Committees? I am of the opinion that it has not. The Indian approach to development of financial markets has focused on gradual, phased and calibrated opening of the domestic financial and external sectors, taking into cognizance reforms in the other sectors of the economy. This continues to be the overall stand on reforms even after the global crisis, though noting that on some aspects there is need to move faster while being cautious regarding financial stability. However, given that a lot of the agenda of financial sector reforms in India consists of creation of banned or non-existent financial markets, strengthening regulation, plugging regulatory gaps and strengthening regulatory coordination, recent global developments in no way have diluted this agenda.

The right lessons that we can draw from the crisis, inter-alia are:

- Innovation in financial markets should not be strangled. However, it should be ensured that the complexities of new products are understood, especially if they are traded off exchanges, as over-the-counter products. Widely distributed, poorly understood, such products are dangerous to systemic stability.
- Too much risk aversion on part of regulator can impede growth and development.
- There is no perfect regulatory architecture, but institutional design needs to be in tune with markets and requirements.

Inclusion, growth and stability are the three objectives of any reform process and these objectives are not in contradiction. With the right reforms, the financial sector can be an enormous source of job creation both directly, and indirectly through the enterprise and consumption it can support with financing. Without reforms, however, the financial sector could become an increasing source of risk, as the mismatches between the capacity and needs of the real economy and the capabilities of the financial sector widen. India has been a case study of how financial sector reforms can play a supporting role to the growth of an emerging market economy. The challenge is how to bootstrap from these past successes to escalate to the next level of financial sector development, so that it can continue to support the growth that India faces going forward.

India's Expectations from G20

Parthasarathi Shome
and
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1 Introduction

Over the past few decades, the balance of economic power has tended to become far more dispersed than was the case when the Bretton Woods system was established. The dominance of the triad, the United States, Japan and Europe that had long dominated the world economy, has been challenged by the emergence of the newly industrialising developing countries, which have exploited the opportunities offered by increased trade in goods and services and in financial flows to dramatically accelerate their growth rates. However, institutions of global governance such as the UN Security Council, the International Monetary Fund (IMF) and the World Bank, set up when the triad of the US, Europe and Japan dominated the world economy, still reflect the old world order and need to be reformed to reflect the political and economic realities of today.

For long, the G7 grouping had an inordinate influence over global governance issues and provided the forum for co-operation in managing the global economy, ensuring economic growth and keeping global peace. The group was later expanded to eight countries with the inclusion of Russia. Emerging economies had little say on matters of global governance. It was only after the Asian Financial Crisis of 1997 that the need to bring advanced and emerging economies in a larger grouping for co-ordinated action to stabilise the global financial market was felt.

The formation of the G20 reflected the emergence of multi-polarity. Initially convened "to establish an informal mechanism for dialogue among systemically important countries within the framework of the Bretton Woods institutional system"[1], the grouping's primary role today is seen to be one of global co-ordination, an upshot of the 2008-09 crisis, which pushed the world to the brink of the worst ever recession. The global financial crisis of 2008-09 called for swift and

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1 Canada (1999) "New G20 Forum: Backgrounder", Canada, Department of Finance.

intensified international co-operation to ensure greater policy coherence and, more importantly, credible commitments to implement the outcomes of global dialogues.

The summit of the heads of governments of the G20 countries on 'Financial Markets and the World Economy' in 2008 at Washington was a watershed. It was more inclusive and brought in leaders whose commitments would carry a lot more credibility than the representatives of developed countries alone would. The prominent role of the G20 in brokering a co-ordinated recovery from the crisis also marked a change in the role of emerging nations in global governance and marked a new beginning in the global dialogue.

India, one of the fastest growing developing countries, which is fairly well-integrated with the rest of the world through both trade and capital flows, has a high stake in global recovery in the short run and global governance in the long-run. This paper discusses what India's immediate and long-term concerns are and how they have been addressed in various G20 summit declarations. We also explore what needs to done in the medium term for more inclusive global development.

2 Evolution of the G20 agenda

Since 1975, the G7 and later the G8 summit was the platform for leaders from member countries to discuss complex economic issues such as co-ordinating macroeconomic management, fostering freer international trade and development aid. Discussions also covered other recurring, albeit not core, themes that included issues relating to the environment, energy, food security and terrorism. Thus, it helped in setting the agenda for more stable and sustainable global economic development.

In 2007, the outreach programme of the G8, which established regular, structured and institutionalised co-operation between G8 and the O5 – China, India, Brazil, Mexico and South Africa – was initiated. However, despite the development agenda being an integral part of G8 and its attempts to reach the outreach countries, it fell short of accommodating the agenda of emerging nations. The particularly contentious issues were the reform of multilateral financial and development institutions such as the IMF and the World Bank to provide representation and voting rights on the basis of current economic realities and equal say for emerging nations in setting the agenda. The reservations of emerging economies were voiced most clearly by India's Prime Minister, Manmohan Singh, who said "[B]odies such as the G7 are no longer sufficient to meet the demands of the day. We need to ensure that any new architecture we design is genuinely multilateral

with adequate representation from countries reflecting changes in economic realities".[2] Elsewhere, he summed up his views on the effectiveness of the out-reach programme as follows: "[T]he expanded group (G 8 + China, India, Brazil, Mexico and South Africa) is not cohesive since the countries included for purposes of outreach do not participate fully in the proceedings, or the preparations, and the expanded group therefore does not have a composite identity. Second, these groupings do not have any special legitimacy within the UN System."[3]

The G 20, on the other hand, has attempted to incorporate the agenda of emerging nations. The Pittsburgh Summit included in its agenda the initiation of work on issues such as modernising global financial institutions to reflect the relative strength of emerging nations in today's global economy.[4] Further, the G 20 committed to reforming the mandate, mission, and governance of the IMF and other development banks to meet the needs of a more interconnected world and an open global economy. More recently, the Korean Summit of the G 20 explicitly included a development agenda, something that emerging nations such as Brazil, China, India, Mexico and South Africa have been pushing for.[5]

2.1 What emerging nations want

These countries have also been demanding an equal say in agenda setting. The pre-crisis agenda of emerging nations included global governance, trade, transfer of technology, energy and food security, migration, climate change and South-South co-operation. Their main concerns are articulated in a joint paper presented at the G 8 Summit in Heiligendamm, Germany in June 2007.[6]
The joint paper emphasised three issues:

1. Reforming the decision-making bodies of global multilateral institutions, particularly the United Nations' Security Council and the Bretton Woods Institutions, to increase the participation of developing countries

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2 Manmohan Singh's statement at the Summit of Heads of State or Governments of the G 20 countries on Financial Markets and the World Economy, November 15, 2008, Washington.

3 Manmohan Singh "PM's vision of how the world is governed in the 21st century" July 7, 2009, New Delhi.

4 G 20 Leaders' Statement, Pittsburgh, September 25, 2009.

5 G 20 Leaders' Declaration, Seoul, November 12, 2010.

6 Joint Position Paper of Brazil, China, India, Mexico and South Africa participating in the G 8 Summit, June 8, 2007, Heiligendamm, Germany.

2. Reforming trade, successfully concluding the Doha Development Agenda and facilitating financial flows to developing countries and
3. Tackling climate change issues based on "common but differentiated responsibility and respective capability".[7]

Trade reforms, especially negotiations in the agricultural sector, such as eliminating trade distortions and providing more access to developed countries markets, occupied a prominent place because it was seen as an instrument to channel the benefits of globalisation to the poorest countries.

In the wake of the global crisis in 2008-09, emerging nations have faced a whole set of new problems. These include weak export demand, the choking of export credit, reduced capital flows (particularly foreign direct investment flows) and an elevated risk perception. The crisis has also brought the debate on whether or not developing countries were insulated against the risk of crisis contagion from advanced countries (also called the 'decoupling" hypothesis) back to the fore. The hypothesis that emerging nations would remain relatively unaffected by developed country business cycles was based on their relatively strong growth performance and reserves position. However, contrary to what the hypothesis would have led one to expect, the crisis spread to these countries through the trade, finance and confidence channels.

Consequently, the immediate priorities for emerging nations in the G20 discussions were the following:

1. Ensure special initiatives to counter the shrinkage in trade finance and other capital flows to developing countries
2 Replenish IMF's and other development banks' resources to provide more credit lines and fund development projects, which would restore confidence about emerging markets
3. Support infrastructural investment in developing countries as a counter-cyclical measure, which was expected to stimulate demand immediately and pave the way for growth in the medium term
4. Initiate strong measures to curb any protectionist tendency and
5. Ensure a more rule-based international economic environment for growth-inducing technology transfers and capacity building.

While short-term priorities such as a financial sector bail out and a reduction in global imbalances are issues of immediate concern for everyone, emerging coun-

7 Ibid.

tries have demanded two important medium term changes. These are first, an explicit development agenda for more sustainable and balanced growth and second, a greater say for developing countries on global governance issues by increasing their representation in the World Bank, the IMF and the UN Security Council.

2.2 India's role in G 20 process

Over the past two decades, India has become increasingly integrated with the global economy through both the current and capital accounts. Through its cautious capital account management process, India has managed the 2008-09 global crisis better than many other countries have. As the process of integration with the rest of the world gathers pace, India's stake in orderly global governance, the creation of a better environment for trade and investment flows and sustainable development will increase. In the words of Manmohan Singh, "[I]t is necessary for India to engage in the management of the world economy because we have a lot at stake, and a lot to contribute"[8].

India's interest in the G 20 process is to secure a voice to espouse its interests in international fora. Prime Minister Manmohan Singh has articulated India's stand:

> "India, as the largest democracy in the world and an emerging economy that has achieved the ability to grow rapidly, remains deeply committed to multilateralism. It has been an active member in global institutions – the United Nations, Bretton Woods Institutions, World Trade Organization, International Atomic Energy Agency and so on... India will seek its due place, play its destined role and share its assigned responsibility … guided by the principle of common but differentiated responsibility and respective capability"[9].

India's concerns, as voiced repeatedly by the Indian Prime Minister, the central bank governor and the Sherpa[10], include the following:

1. Rebalancing global governance by reforming global financial institutions
2. Reforming the global financial and monetary systems to provide better financial safety nets

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8 Manmohan Singh's statement prior to his departure for Pittsburgh, USA for the G 20 Summit", September 23, 2009, New Delhi.

9 Manmohan Singh "PM's vision of how the world is governed in the 21st century" July 7, 2009, New Delhi.

10 Indian Planning Commission deputy chairman Montek Singh Ahluwalia is Indian Sherpa to the G 20.

3. Checking global macro imbalances
4. Ensuring lines of credit and export finance to developing countries
5. Checking any protectionist measures and
6. Widening the current agenda to include developmental issues

3 Reforming institutions of global governance

One of the recurring themes of global governance in the recent past has been that global governance institutions such as the World Bank and IMF do not represent the current political and economic realities of the world. Better representation of emerging nations would increase the credibility of these institutions in even-handedly assessing the macroeconomic policies of member countries in the context of a multi-polar world. The 'outreach 5' (O5) countries, especially India, has advocated quota reforms strongly. As Manmohan Singh states, "[A]n important element of longer term reform is to restructure the representation in the governance levels of the Fund to reflect the current and prospective economic realities. Quota reform is the normal way to effect a change in voting power but it has been contentious and incremental, and what has been achieved thus far has fallen far short of what is needed. The Board of Governors of the IMF should be explicitly charged with exploring alternative modalities to achieve a more legitimate representation."[11]

A second issue in global governance is the need for a revamp of the IMF's mandate to take account of the much higher degree of integration of the world economy. In a highly interconnected world, where the macroeconomic policies of one country affect other countries, a credible system of multilateral surveillance and a system of mutual assessment are needed to ensure better policy co-ordination and global macroeconomic management. Manmohan Singh captures the issue vividly:

> "[T]he International Monetary Fund is the logical body to perform the task of multilateral surveillance of macro-economic imbalances and their relationship to financial stability. However, it is relevant to ask whether its systems and procedures are adequate to the task. Over the years, the Fund has become marginal to the task of policy analysis and consultations on macroeconomic imbalances and related policies in the major countries… we need a comprehensive review of the procedures of the IMF leading to recommendations

11 Manmohan Singh's statement at the Summit of Heads of State or Governments of the G20 countries on Financial Markets and the World Economy, November 15, 2008, Washington.

> on governance reform which would enable the Fund to perform the role of macroeconomic policy co-ordination."[12]

The role of international financial institutions in ensuring that developing countries have access to adequate credit when required is another issue that has been brought to the fore in the current crisis. The experience of many of the developing countries during the Asian financial crisis prompted them to maintain large foreign exchange reserves to finance current account deficits and to hedge against a reversal of capital flows. While this stood them in good stead during the 2008-09 crisis when they were faced with shrinking export markets and a drying up of capital flows, it also led to the imbalances that exacerbated the crisis. If international financial institutions are able to extend assured lines of credit to emerging market economies when required, the need to build up huge foreign exchange reserves will be reduced to a considerable extent.

Although India does not need IMF funding, the demand that international financial institutions step up their credit to developing countries has been most strongly advocated by Prime Minister Singh, who points out that this would not only help developing countries that need assistance but would also serve to restore confidence about emerging markets. He also suggests that resources available to the IMF could be enhanced through "bilateral arrangements, an expansion of the NAB[13] and other borrowings by the Fund" and also through "the sale of a part of the Fund's gold to support concessional lending to low-income countries through the Fund's concessional windows".[14] Further, a relaxation of the conditionalities associated with loans in the case of countries that have strong economic fundamentals but are vulnerable due to the external environment is also imperative. India has suggested, "[I]n addition to increasing resources with the IMF, we should also signal that the conditions associated with the use of Fund resources are made more appropriate and flexible. Unless this is done, countries will prefer to build foreign exchange reserves which would be counter-productive in current circumstances".[15]

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12 Ibid.

13 New Arrangements to Borrow (NAB) and General Arrangements to Borrow (GAB) are the arrangements of IMF with member countries and financial institutions for supplementing its resources.

14 Manmohan Singh's remarks at the official dinner hosted by Prime Minister Gordon Brown on the occasion of the G 20 meeting, April 1, 2009, London.

15 Ibid.

4 Reforming the global financial system

One of the weaknesses, exposed by the 2008-09 crisis, was associated with financial sector regulatory policies at the national level. The crisis underlined the need to set up global standards for regulation and ensure that national standards are consistent with them. The G20 summit at London paved the way for this.[16] The erstwhile Financial Stability Forum was revamped to include all G20 countries, renamed the Financial Stability Board (FSB) and was mandated to serve as a premier global standard setting body for global financial transactions. The Washington summit called on the FSB to deliver a robust framework that would ensure the maintenance of adequate bank capital and liquidity and address the moral hazard associated with systemically important institutions.

The FSB, along with the Basel Committee on Banking Supervision, has proposed Basel III norms for banking supervision. This is expected to "substantially raise the quality, quantity and international consistency of bank capital and liquidity, constrain the build up of leverage and maturity mismatches and introduce capital buffers above the minimum requirements that can be drawn upon in bad times".[17] Second, the FSB has proposed a framework to regulate systemically important financial institutions (SIFIs) beyond the requirements of Basel III to check the risk they pose to the global financial system.

India, a member of both the Financial Stability Board and the Basle Committee on Banking Supervision, has called for broadening representation of under-represented countries in these bodies to achieve better co-ordination on regulatory issues.

Apart from Basel III norms for banking regulation, India has sought international co-operation to

1. "Expand the perimeter of regulation to cover the non-banking sector… redefine capital requirements to avoid pro-cyclicality... avoid a build-up of excessive leverage and... subject systemically important institutions to supervision by a college of supervisors
2. Endorse sharing information and bringing tax havens and non-cooperating jurisdictions under closer scrutiny
3. Develop an effective early warning system which can spot a buildup

16 G20 Action Plan for Recovery and Reform, London Summit, April 1–2, 2009.

17 FSB (2010) "Progress of Financial Regulatory Reforms", 9 November 2010.

of risks which would threaten global financial stability. This task must be assigned to the IMF in consultation with the expanded FSF".[18]

5 Checking macro imbalances

As stated earlier, macroeconomic imbalances, reflected in unsustainable deficits in some parts of the world with excessive savings elsewhere, was one of the factors that aggravated, if not caused, the 2008-09 global crisis. India has always contended that correcting macroeconomic imbalances is the responsibility of both surplus and deficit countries.

The IMF has advocated that developed deficit countries that resorted to unprecedented fiscal stimulus when demand collapsed should ensure fiscal consolidation and debt sustainability while leaving economic growth to private demand in the medium term (World Economic Outlook, 2010). It also recommends that deficit countries that rely on external finance should turn to structural adjustments that increase efficiency and competitiveness, and encourage exports.

However, India has reservations about pushing for a global policy,[19] given its concern relating to the "individual circumstances" of different countries such as differing stages of economic growth and global share of imbalance. It has, instead, called for surplus countries to encourage domestic demand. Manmohan Singh suggests that this could be "best done through increased investment directed to infrastructure. This will sustain growth in the short run by offsetting the contractionary effect of lower exports. It will also increase growth potential in the medium term, by addressing the supply side constraints."[20]

Despite differences in the mechanics of how it is to be achieved, there is no gainsaying the fact that countries need to focus on structural reform, particularly reform of the product and labour markets and of taxation, to restore macroeconomic balance in the global economy. The process is unlikely to be smooth but needs to begin now.

There are a few necessary conditions proposed for the rebalancing to be credible (IMF, World Economic Outlook, 2010; Manmohan Singh, 2010). These are the following:

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18 Manmohan Singh's remarks at the official dinner hosted by Prime Minister Gordon Brown on the occasion of the G 20 meeting, April 1, 2009, London.

19 Manmohan Singh's remarks at the Plenary Session of the G 20 Summit, November 12, 2010, Seoul, Republic of Korea.

20 Manmohan Singh's remarks at the Toronto G 20 Summit, June 27, 2010, Toronto.

1. The global financial system should be conducive to finance higher current account deficits of developing countries that restructure through multilateral and private capital flows.
2. Any kind of protectionism, particularly competitive devaluation to boost exports, should be avoided collectively. One way to ensure this is to move to exchange rate flexibility, which would help achieve a sustainable current account position.

6 Strengthened global financial safety nets and monetary system

The 2008-09 crisis has raised questions regarding the current international monetary system, particularly on the continuation of the dollar as the reserve currency. Neither the supply of nor the demand for the reserve currency is based on the fundamentals of the issuing economy; several other factors play a role. One reason the US has run up large fiscal and current account deficits is the fact that it is the reserve currency issuing country and the deficit was necessary to sustain the dollar as a reserve currency. However, its persistent deficit is one of the factors that led to the current crisis. Demand for the dollar was driven mainly by the official reserves maintained by emerging nations as self-insurance rather than the use of the dollar as a medium for foreign transactions.

Though there are questions about the dollar's strength, reserve currencies in general enjoy a kind of positive network externality, especially in invoicing foreign trade and foreign debt. Thus, the dollar did not lose much ground to the competitors. However, the demand for dollar as a reserve by emerging nations might change as the network externalities are not very strong and diversification of reserves would hedge against large capital losses. This process could be supported by developing the SDR as a reserve currency that could be accepted as a medium of payment in cross-border transactions. Simultaneously, the need for self-insurance and overdependence on foreign reserves could be tamed through financial safety nets such as prearranged lines of credit. Indian policy makers have indicated that India is open to exploring various options such as extending lines of credit by the IMF and its relaxing conditionalities on loans to protect the global economy from the vulnerabilities of having a single reserve currency.[21]

The volatility in capital flows and the resultant disruption of economic growth is a growing concern for many developing countries. The G20 finance ministers'

21 See the contribution of Duvvuri Subbarao in this book.

meeting at Gyeongju, Republic of Korea, called for an IMF initiative to expand global safety nets for countries that are vulnerable to external shocks but otherwise have strong fundamentals. The IMF responded by relaxing the preconditions for flexible and precautionary credit lines that it extends to developing countries.

7 Protectionism and trade finance

7.1 Doha Development Round of multilateral trade negotiations

Given the magnitude of the current crisis, high unemployment and persisting sluggishness in demand in advanced countries, concerns that there could be strengthening of protectionist tendencies[22] have been raised. Global trade plays an important role in promoting broad-based growth in developing countries. Trade distortions, particularly in the agricultural sector, hinder the growth prospects of these countries. Emerging nations have strongly demanded the elimination of trade distortions, "especially those derived from the limited access to the developed countries markets as well as from the substantial and effective reductions in trade-distorting domestic support and other forms of internal support instrumented by the developed countries".[23] Manmohan Singh points out, "[T]he only way to ensure that protectionism does not gain the upper hand is to restore momentum to the trade talks. I hope the G 20 will lend their weight to this objective."[24]

7.2 Trade finance

Trade finance was another major casualty of the 2008-09 crisis. Though global exports have picked up in recent times, trade finance remains a worry, particularly for the countries that are off the grand trade routes.[25] Past G 20 summits have substantially increased the resources to development banks to ensure lines of credit and other trade finance tools to developing countries. Despite these efforts, the cost of traditional trade finance instruments remain higher than that in the pre-crisis period, mainly due to greater counterparty risk and increased capital constraints. One of the factors that raise the cost of financing is the capital

22 Evenett, Simon (2010) "The State of Protectionism on the Eve of the Seoul G 20 Summit" Voxeu.org, 8 November.

23 Joint Position Paper of Brazil, China, India, Mexico and South Africa participating in the G 8 Summit, June 8, 2007, Heiligendamm, Germany.

24 Manmohan Singh's remarks at the Plenary Session of the G 20 Summit, November 12, 2010, Seoul, Republic of Korea.

25 International Chamber of Commerce (2010) "Global 2010 Trade Finance Survey".

adequacy regime under Basel II rules, which clubs easily collateralised, low-risk trade finance instruments with higher risk, off-balance sheet items.

8 Development policy

Questions regarding the appropriateness of the export-led growth strategy followed by some countries have also been raised in the past summits. As we mentioned earlier, macroeconomic imbalances in the global economy, characterised by excessive savings in some countries and excessive consumption in others, is widely believed to have amplified the magnitude of the crisis, even if it did not trigger it. The low domestic demand in many emerging market economies that follow an export-led growth model has resulted in suggestions that they may need to reconsider this growth strategy and look to stimulate domestic demand for further growth. If persistent savings of some countries could be channelled to emerging nations for infrastructure investments, it would help to "not only address the immediate demand imbalance, it will also help to address developmental imbalances".[26] It would serve as a counter-cyclical measure in the short run by stimulating domestic demand and pave the platform for faster growth in the medium term. More importantly, since infrastructure investments are typically more import intensive vis-à-vis investment in export capacity, there will be a demand spill over to the world economy as well.

Infrastructure investment in emerging countries could be financed through multilateral and private capital flows. In the wake of the global crisis, private capital flows to emerging nations have shrunk considerably. In times of distress such as this, multilateral development banks such as the IBRD and regional development banks can play an important role in injecting more resources to emerging nations. Manmohan Singh has suggested that the resources of these banks have to be enhanced and conditionalities, such as those on single borrower limits and debt to capital ratio, should be relaxed.[27]

9 G 20 achievements

The G 20, one of the few fora that allow equal say to developing countries, has passed a number of resolutions to accommodate the needs of developing countries. The G 20 has achieved the following:

26 Manmohan Singh's remarks at the Plenary Session of the G 20 Summit, November 12, 2010, Seoul, Republic of Korea.

27 Manmohan Singh's remarks at the official dinner hosted by Prime Minister Gordon Brown on the occasion of the G 20 meeting, April 1, 2009, London.

1. The grouping has established itself as the foremost forum for global discussion.[28]
2. It has orchestrated co-ordinated fiscal and monetary policies worth $5 trillion to rescue the world economy from severe recession.
3. It has ensured adequate resources to the IMF, World Bank, and other multilateral development banks to extend credit to emerging nations in times of distress and for infrastructure investment. IMF resources have been increased in two tranches of $750 billion and $250 billion to ensure greater liquidity in the international financial system. There has also been agreement on an increase in the capital base of multilateral development banks such as the Asian Development Bank (ADB) for more trade finance.
4. Flexible credit lines (FCL) and precautionary credit lines (PCL) extended by the IMF to countries that have strong fundamentals have been enhanced and initiatives to collaborate with other regional financing arrangements (RFAs) have been launched.
5. At the Pittsburgh Summit, it was agreed that at least five per cent of voting rights in the IMF and three per cent of voting rights in the World Bank would be transferred to under-represented, emerging nations to reflect the changing world economy. In Seoul, G 20 leaders "agreed to a shift in quota shares of six per cent to emerging market countries and the composition of [the IMF] Board is being changed to reduce the European representation."[29]
6. FSB and Basel Committee on Banking Supervision (BCBS) have been reformed to better represent all the G 20 member countries. Further, the FSB, along with the IMF, was entrusted with the task of international standard setting and surveillance for better financial stability.
7. A high-level panel was constituted at the Seoul Summit to recommend measures to mobilise resources for infrastructure investment in developing countries.
8. A commitment was also made to successfully complete the Doha round though the timeline was not mentioned.
9. The G 20 agreed to a consultative mutual assessment process (MAP) for mutual assessment, monitoring and implementing commitments made in the summits.

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28 Lee, Myung-bak (2010) "Seoul G 20 Summit: Priorities and Challenges" Davos Forum Special Address, 28th January.

29 Manmohan Singh's remarks at the Plenary Session of the G 20 Summit, November 12, 2010, Seoul, Republic of Korea.

The Seoul G 20 Summit, 2010, moved forward a few steps to commit to "resolve the most significant bottlenecks to inclusive, sustainable and resilient growth in developing countries, low-income countries (LICs) in particular: infrastructure, human resources development, trade, private investment and job creation, food security, growth with resilience, financial inclusion, domestic resource mobilisation and knowledge sharing".[30]

10 Future agenda

The G 20, true to what was expected of it, managed to forge co-ordinated counter-cyclical fiscal and monetary policies in the wake of the crisis. However, a number of structural issues such as persistent deficits/surpluses, loopholes in financial sector regulation, growing trade and financial protectionism and consequent disagreements that undermined the willingness to co-operate further threaten the very existence of the group. The G 20 has to address the following issues in future summits to stay relevant.

1. As discussed above, the G 20 has shown willingness to indulge in large-scale restructuring to ensure financial stability and order in the global economy while lending a helping hand to poor countries to grow faster and reduce poverty. The immediate challenge is to implement what has already been committed in the previous summits. Though the Korean Summit explicitly mentioned the need to implement the commitments of previous summits, the recent G 20 Toronto Summit Final Compliance Report prepared by the G 20 Research Group shows that the commitment to implement what has been agreed upon is in general weak and needs considerable attention. In particular, compliance by the non-G 8 members, including India, is weak. Incidentally, India has achieved the least compliance score.

2. Eichengreen (2009) points out that the fundamental difference between the advanced and emerging economies in the G 20 arises from the insistence of advanced countries that emerging markets should stimulate demand to rebalance while emerging markets insist on building up foreign reserves as an insurance against volatility in capital flows.[31] This holds true even today. Though the G 20 has made considerable progress in persuading the IMF to provide a line of credit and relax conditionalities, developing countries still

30 Framework for Strong, Sustainable and Balanced Growth, G 20 Seoul Summit, 11–12 November 2010.

31 Eichengreen, Barry (2009) "The G 20 and the crisis" Voxeu.org, 2 March.

rely on their own reserves rather than on institutional funding. It is imperative for the G 20 to convince emerging nations of its commitment to provide global safety nets.

3. The threat that more and more advanced countries will resort to quantitative easing as fiscal measures are exhausted is beginning to gain greater credibility. However, the G 20 should collectively resist quantitative easing as it is unlikely to be a solution to the problem and may, indeed, prove harmful. First, it would not help boost demand in the advanced countries as there is already enough liquidity available in many of these countries. Second, cheap money would flood the emerging nations where maintaining the exchange rate, export competitiveness and independence of monetary policy in general would become increasingly difficult. Instead, advanced countries should be encouraged to take advantage of lower interest rates in the long-term bond market to finance public investment that have a high multiplier effect and to concentrate on structural reforms, such as labour and tax reforms, that improve their growth in the medium term and productivity in the long run.

4. India's concern on Basel III is that though it brings stability to the banking sector across the world, the stringent capital buffers proposed would be detrimental to the interests of developing countries. In particular, many developing countries that are fast catching up with the advanced countries would require more bank credit at a cheaper rate. High buffer requirements as a counter-cyclical measure would translate into higher lending costs and thus would hurt economic growth. The Indian banking sector as a whole has a capital adequacy ratio which is on par with what is proposed in Basel III, though there are a few banks that do not meet the requirement. Reserve Bank Governor Subbarao has warned that "counter-cyclical buffers require judgments to be made on the trajectory of the business cycle and on identification of the inflexion point. Wrong judgments can entail huge costs in terms of foregone growth."[32] Further, one of the fundamental reasons for the failure of Basel II norms to check the global crisis is attributed to the dominance of the G 10[33] in Basel committee and in agenda setting and the influence of large

32 Remarks by Duvvuri Subbarao, Governor, Reserve Bank of India at a panel discussion on "Role of Emerging Economies Going Forward and Key Policy Challenges" at the IMF, Washington DC on October 9, 2010.

33 G 10 refers to the group consisting of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States.

international banks over the sub-committee.[34] Basel III, which has a larger representation, could overcome these shortcomings by making the decision making process more transparent by encouraging public discussion on the process.

5. The latest Global Trade Alert report cautions that protectionist measures implemented in 2009 have not been removed and that new measures have been introduced. The report states, "G20 countries account for 101 of the 141 protectionist measures that have harmed the commercial interests of the most vulnerable nations, namely, the least developed countries. Most of that harm is done by the developing country members of the G20." The immediate concern is "to cut the rate at which protectionist measures are implemented before the current accelerated rate becomes the new norm".[35] From the developing countries' perspective, one of the significant obstacles to global co-operation in the medium term is that a successful completion of the Doha development round, particularly negotiations pertaining to the agricultural sector, is nowhere in sight. Checking new protectionist measures while completing the Doha round would enhance world trade, help reduce current macro imbalances and check growth imbalances in the long run.

6. The other important issue relevant to the sustainability of the G20 grouping as a global policy making forum is the membership selection process. At present, it is ad hoc and does not enjoy much support outside the G20 nations, particularly among the non-member European countries. Though increasing membership would add to the difficulty in arriving at meaningful decisions within a reasonable time, expanding the membership base to accommodate the changing dynamics of the world economy is imperative. The G20 might consider institutionalising new membership by having rule-based inclusion in a stipulated periodical revision. Simultaneously, the G20 has enjoyed more legitimacy by including the World Bank and IMF in its meetings, thus making them an integral part of global governance reforms. Expanding this to include regional blocs such as the ASEAN and other regional bodies in the G20 meetings in the line of EU would increase the credibility of the G20 process.

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34 Lall, Ranjit (2009) "Why Basel II Failed and Why Any Basel III is Doomed", WP 2009/52, GEG Working Paper series, University College, Oxford.

35 Evenett, Simon (2010) "Tensions Contained... For Now: The 8th GTA Report" Global Trade Alert.

7. The other important administrative reform required is to institutionalise the G 20 agenda setting process. At present, the presidency is responsible for setting the agenda. Unlike other global governing bodies, the G 20 does not have a permanent secretariat for the reason that it functions as an informal forum to build up consensus. However, having a Troika secretariat, i.e., having the past and future presidency also contribute human resources to the secretariat, would ensure some kind of institutional continuity.

8. In course of time, the G 20 should also consider how to assist in the reform of the structures and mandate of other global institutions of governance dealing with trade, political and security issues and effect better commitment and co-ordination through more democratic participation.

11 Conclusion

The G 20 initiative is indeed at a crossroads. When global recovery is at an uneven pace across countries and some parts of the world see unable to get out of the possibility of double dip recession, the G 20 needs to segregate immediate concerns from long term goals. A co-ordinated fiscal and monetary policy for advanced countries where recovery is weak should ensure that loose monetary policy in these countries (particularly in the United States which is the reserve currency country) does not lead to huge capital inflows to emerging markets, creating problems in exchange rate management and export competitiveness. In the medium term, the longevity of the G 20 would be based on its ability to devise a framework for more inclusive global growth and on its ability to constructively move towards it.

Challenges for Globally Co-ordinated Financial Regulation: A Perspective Based on the Experience of South Africa

Francis Selialia*

1 Introduction

The effectiveness of financial regulation has been called into question in the wake of the 2007–2009 global financial crisis. In some cases, fundamental discussions are taking place while in others significant reforms to financial regulation are being proposed. These developments are taking place both within countries and internationally.

One of the challenges facing policy-makers in the aftermath of the global financial crisis is, therefore, the design and creation of globally co-ordinated financial regulation. The advantages of establishing such an entity include avoidance of regulatory arbitrage between countries and financial centres. By pooling and sharing their resources internationally, regulators can increase their joint control over the global financial markets. This can help make costly financial crises less likely in the future. In the aftermath of the global financial crisis, economists, financial analysts and policy-makers universally agree that a repetition of the type of crisis that started in 2007 must be avoided at all costs and that there is a need to search for a lasting solution to prevent future financial and economic crises. Many lessons have been learnt, and there is much to digest in terms of proposed new regulation and policy instruments aimed at maintaining both price and financial stability (Mnyande 2010).

This paper discusses the challenges for globally co-ordinated financial regulation in the aftermath of the global financial crisis and draws from the experience of South Africa. A brief overview of the experience of sub-Saharan Africa is given to set a scene. Some of the questions to be answered are: Can the G20 agree on a comprehensive regulatory agenda? Where are the obstacles for implementation? How can international co-operation, including technical assistance, help to

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overcome these obstacles? What is the prospect that the G20 member countries disseminate and promote the standards that were agreed upon within the G20 and Financial Stability Board to neighbouring countries?

2 Arguments for and against a globally co-ordinated financial regulation: A brief overview

Proponents of globally co-ordinated financial regulation argue that, so far, international prudential regulation has developed in a relatively fragmented and weak institutional context. Their view is that there is a mismatch between the financial services industry and the international regulatory structure (see Commonwealth 2009 for example). They argue that while the international community has taken important and valuable steps towards globally co-ordinated regulation (e.g., the creation of the Financial Stability Forum and recently its transformation into the Financial Stability Board – FSB), their efforts are insufficient given the speed and depth of globalisation of private finance and its often negative spillover effects on other countries.

Another argument for globally co-ordinated financial regulation is to ensure that the financial sector serves the real economy and thus the needs of the household and corporate sectors to consume, save and invest, that is, taking a macroprudential approach to regulation. Innovations and new financial instruments should, therefore, support growth and development in a sustainable way. Globally co-ordinated financial regulation is therefore expected to help avoid systemic risks that can also be disruptive to the real economy globally.

Proponents of this approach maintain that, to date, the implementation of financial regulation and supervision has been mainly located at the national level, with most international financial regulatory arrangements taking forms of best practice standards and principles that are not legally binding. Developing countries have been following these standards either because they are part of international financial institutions such as the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) or because they have been indirectly forced by financial markets to adhere to the international best practice and standards.

Critics of the globally co-ordinated financial regulation approach, however, have been arguing that some of the causes of the instability in the international financial system may be linked to the injustice on which it is built, that is, excluding other major players such as emerging-market economies and developing countries in the decision-making processes. They, therefore, recommend that in

outlining the reforms necessary to stabilise the international economy, the views and interests of more actors should be considered and, in particular, the voices of emerging and developing countries should be taken into account. There is a broad consensus among emerging and developing economies that no fundamental and global reforms can be implemented if such reforms do not arise from a process that is inclusive of both industrialised and developing countries (Friedrich Ebert Stiftung and Shanghai Institutes for International Studies 2009).

Another criticism has been that although it is generally accepted that as financial markets are becoming increasingly integrated across borders, global institutions that provide international standards and rules for the world are becoming increasingly important. However, these institutions have been criticised as being undemocratic and unrepresentative (see Commonwealth 2009 for example). Developing countries have, therefore, voiced their wish to be represented in the bodies that design regulatory standards.

3 The experience of the sub-Saharan Africa: An overview

Low-income countries in sub-Saharan Africa generally suffered a less severe slowdown in the growth rates of their economies during the global financial crisis. The brevity of the slowdown owes much to the relatively favourable economic conditions going into the crisis. International reserves were high, both in terms of share of GDP and months of imports coverage, debt burden had been falling and inflation was declining by the end of 2008. These conditions gave many African governments a margin to manoeuvre. Governments were able to provide much-needed fiscal stimulus by maintaining expenditure in the face of falling revenues. Thus, many African countries had strong policy buffers in place prior to the onset of the crisis. As noted by the IMF, "If the global financial crisis was a "stress test" of macro policy framework in Africa, most countries would have come through in reasonably good shape, if a little bruised. African economies have a new resilience, and the challenge will be to maintain this resilience" (Nord 2010).

Based on the experience of sub-Saharan Africa (and that of South Africa in particular), it is important to build and improve on the policies that worked. In formulating the mandate of a globally co-ordinated financial regulator, it should be recognised that the policies that worked for Africa should be taken into account and improved on as opposed to coming up with only new policies. The resilience of the African economies also highlights the importance of building buffers during good times. Thus, the global financial crisis has proven the importance of strong

fundamentals and solid buffers against shocks. It should also be noted that the establishment of a global regulator is a complicated and technical issue and may take some time. It might, therefore, be easier to reinforce existing international regulatory bodies such as the FSB and to expand their mandates.

4 The experience of South Africa

South Africa did not suffer the full might of the recent global financial crisis as was the case with some economically advanced countries. South Africa's banking industry and the broader financial sector escaped the most recent global financial crisis relatively unscathed. This was partly because of historical, circumstantial and fundamental factors including country-specific aspects of financial regulation. The reasons include: modest leverage ratios, relatively limited securitisation activities, low foreign currency exposure and low foreign funding reliance. A lesson that can be learned from South Africa's experience is that the importance of country-specific aspects of financial regulation cannot be ignored. However, the second-round effects were felt mostly in the real sector of the economy as evidenced by the extensive job shedding in some of the sectors of the economy and the slowdown in the real economic activity (see Table 1).

Table 1: Selected indicators of real economic activity[1]

Annual percentage change unless indicated otherwise

Activity indicators	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08
Building plans passed	−15,0	−7,3	−24,9	−20,2	−32,6
Buildings completed	−14,5	9,2	−6,1	5,3	2,1
Retail sales	−0,5	−1,3	−0,4	−4,7	0,5
Wholesale trade sales	2,3	10,5	6,4	2,6	4,1
New vehicle sales	−20,0	−11,0	−21,7	−24,6	−30,8
New passenger car sales	−19,0	−22,9	−25,2	−21,5	−24,7
Electric current generated	3,7	−2,1	−3,2	−0,5	−10,4
Utilisation of production capacity[2]	87,2	84,8	84,8	85,0	83,0

1 At constant 2000 prices and seasonally adjusted, unless indicated otherwise
2 Utilisation of production capacity by large enterprises in the manufacturing industry. The data in the table are for November 2007 to November 2008

Source: South African Reserve Bank (2009).

4.1 Sound macroeconomic policies

When the storm hit, South Africa had been sitting on relatively strong fundamentals and was emerging from a protracted period of economic expansion. It had enjoyed high gross domestic product (GDP) growth rate and maintenance of macroeconomic stability. For instance, annual GDP growth averaged 5,1 per cent over 2004–2007, up from 3,6 per cent over 2000–2003. This growth was driven by household consumption and private and public fixed investment on the demand side. On the supply side, it was driven by financial and business services, construction and wholesale and retail trade. However, the indirect impact of the crisis was felt in the real economy as mentioned above. House prices and vehicle sales had been declining, manufacturing production had slowed, the mining sector was shrinking and retrenchments were on the rise. This adverse impact was somewhat ameliorated by the sound fiscal position which cushioned the economic slowdown. Prudent macroeconomic management resulted in a budget surplus in 2006, low public debt, high revenue collection and single digit inflation. The deep, well-regulated and liquid financial sector, which borrows largely in domestic currency, also played a major role.

4.2 Macroprudential policy approach

The South African Reserve Bank has always recognised its role in promoting and partly contributing to financial stability in the country. It has had a dedicated Financial Stability Department since 2001 that serves to enhance the surveillance capacity of the macroprudential or systemic integrity of the domestic financial system and prevailing international trends; to identify systemic risks in both the domestic and international environments; to assess the robustness of the regulatory environment; and to review and test contingency plans to handle crises in the financial sector going forward (Mnyande 2010).

In an effort to cushion the economy from the impact of the recent and future financial crises, the South African Reserve Bank is in the process of intensifying its pursuit of a conscious macroprudential policy framework. It is envisaged that the proposed framework will include the adoption of countercyclical policies that can foster discipline during the phases (upwards or downwards) of the business cycle and identification and monitoring of excessive domestic credit extension that could result in self-feeding asset-price bubbles in line with international guidelines. This is in line with the two key principles of comprehensiveness and counter-cyclicality, which have a backing of most leading international and national reports on regulatory reform and the leaders of the G20 (see Commonwealth 2009 for example).

4.3 Market conduct and consumer protection regulation

The introduction and implementation of the National Credit Act (NCA) in 2006 curbed the irresponsible borrowing of the vast majority of South Africans and prevented the reckless lending practices of some credit providers. The adoption of the NCA has, therefore, reined in reckless lending practices and improved consumer protection while at the same time indirectly saving South Africa from the fate of the global financial crisis. This was a manifestation of the complementary role of market conduct regulation to prudential regulation. While the NCA was primarily enacted to protect consumers and to ensure good market conduct, it played a major role in curbing the over-indebtedness of the household sector which has a potential of causing financial instability in South Africa. Table 2 summarises the key prudential and market conduct regulators in the South African financial system.

Table 2: Key players in the South African financial regulation

Regulatory and supervisory institution	Regulated and supervised entities
South African Reserve Bank[1]	Commercial banks: the Banks Act and the Mutual Banks Act assign powers to the registrar of banks; the registrar is appointed by the Bank subject to the approval of the minister of finance; the registrar has direct reporting line to the minister.
Financial Services Board[2]	Insurance companies (both long-term and short-term insurers), pension funds and intermediaries and capital markets: operates under various sectoral pieces of legislation; is governed by the Board of Directors which is accountable to the minister and parliament.
National Credit Regulator	All credit providers to consumers (banks and non-banks): operates under the National Credit Act (NCA) and is answerable to the minister of the Department of Trade and Industry.

1. Also plays an oversight role of the national payment system
2. Also responsible for the market conduct and consumer protection regulation of non-bank financial institutions

Source: constructed with information from IMF (2008).

4.4 Relationships with international financial and regulatory institutions

In South Africa, as is the case in many other developing and emerging-market economies, financial regulation and supervision has been mainly located at the national level, with most international financial regulatory agreements simply taking the forms of best practice standards and principles that are not legally binding. Such standards have been adopted as a result of South Africa being a member of standard-setting bodies such as the BIS or because financial market participants have been dictating such adoption.

South Africa has been (and still is) part of the global village and has been playing an active role in the international arena. It is a member of international bodies such as the IMF and the BIS. The latest joint IMF–World Bank Financial Sector Assessment Program (FSAP) was in May 2008 and confirmed that financial regulation in South Africa is sound. The FSAP mission also compared the progress made since the FSAP conducted in 2000. The main conclusions of the 2008 FSAP mission were that: (i) South Africa's financial system is sophisticated and fundamentally sound and had weathered the global financial market turmoil without major pressures. Banks and insurance companies have enjoyed good profitability, capitalisation and reserves. (ii) The financial sector regulatory framework was assessed as generally modern and effective and the framework for securities regulation had been enhanced. (iii) Stress tests results suggested that capital and reserve cushions at banks and insurance companies were sufficient to absorb large shocks.

Areas that were identified as needing some attention were: (i) exposure to credit risk as was reflected in high levels of household indebtedness and mounting debt service burden and deteriorating asset quality. (ii) A need to strengthen supervision of conglomerates with a focus on risks that span more than one sector and to further promote co-operation, consistency, and effectiveness among regulators. (iii) A need to strengthen surveillance of over-the-counter (OTC) markets and for improved monitoring of listed company disclosure. Of note was the fact that the 2008 FSAP mission reported that the South African regulatory authorities had addressed all the recommendations that were made during the 2000 FSAP visit (IMF 2008). The South African regulatory authorities, have, therefore, been observing the international best practice and standards.[1]

1 The 2000 FSAP mission had assessed the South African regulatory framework as robust and transparent with the supervisory practices broadly in line with international standards. The recommendations made included: strengthening of onsite inspections of financial institutions; ensuring that supervision and capital adequacy requirements took better account of cross shareholding of financial conglomerates; and improving the procedures for resolution of problem banks.

The regulatory framework for banks has been reinforced with the implementation of Basel II in 2008. The South African Reserve Bank has offered both the standardised and the internal ratings-based (IRB) approaches. Banks representing over 80 per cent of total assets are implementing the IRB approach to credit risk. South Africa also participated in an IMF and World Bank pilot project on Basel II implementation. The regulatory authorities in South Africa are, therefore, committed to meeting global best practice and standards in their supervisory regimes.

5 Concluding remarks

In conclusion, key messages can be emphasised. The experiences of the sub-Saharan African countries and that of South Africa, in particular, suggest that it is important to have sound macroeconomic policies. Low-income countries in sub-Saharan Africa generally suffered a less severe slowdown because they had relatively favourable economic conditions going into the crisis. For South Africa, when the storm hit, the country had been sitting on relatively strong fundamentals and was emerging from a protracted period of economic expansion.

Of equal importance is to build buffers during good times. Many African countries had strong policy buffers in place prior to the ons of the crisis. The resilience of the African economies highlighted the importance of building buffers during good times. Thus, the global financial crisis has confirmed the importance of having strong fundamentals and solid buffers against shocks.

It is also important to strike the right balance between international best practice and standards and country-specific aspects of financial regulation. South Africa is part of the global village and has been observing international best practice and standards, which should have played a role in enhancing its resilience to the global financial crisis. The resilience was, however, partly ascribed to historical, circumstantial and fundamental factors – country-specific factors. For example, while the NCA was primarily enacted with the primary intension of protecting the consumers and ensuring good market conduct, it played a major role in curbing the over-indebtedness of the household sector which has a potential of causing financial instability in South Africa.

For the proposed globally co-ordinated regulator to succeed along the lines proposed by the G20, the working policies of the countries that survived the worst side of the crisis should be consolidated and improved upon. The process should

be more consultative and inclusive of all key players. Another important factor is the political will of the countries to co-operate.

The success of the globally co-ordinated financial regulation will depend on the manner in which it is implemented. For instance, the one-size-fits-all approach should be avoided. Global financial regulation can be applied to those financial institutions that transact internationally and such international regulators should work very closely with national regulators. While on the one hand disparate national regulatory policies can be potential drivers of international systemic risk, on the other, country-specific regulatory policies can enhance financial stability as was the case in South Africa. The experience of South Africa shows that while it is important to adhere to international best practice and standards, it is equally important to pursue country-specific financial regulation policies.

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Chapter 2

Regional Monetary and Financial Cooperation

Regional Financial Cooperation in East Asia: Recent Developments and Prospects

Liqing Zhang and Jie Li*

1 Introduction

The financial or monetary cooperation in East Asia[1] has been debated for long as the success of EU and Euro gains Europe a growing international status either politically or financially. But the actual progress in East Asia was relatively little until recently. The recent global financial crisis has revealed greater risks for East Asian economies. Capital inflows in East Asia may be subject to "sudden stop". Export may be plummeting with shrinking demand in the US and EU markets. The valuation of huge foreign reserves assets denominated in the US dollar may go down with the weaker green back and massive export revenue invoiced in the US dollar may be exposed under greater volatility with the volatile dollar valuation.

Facing those difficulties, regional financial cooperation in East Asia has been called up to reduce impacts from global crises and reliance on the dollar. How to better deal with crises and reconstruct international financial infrastructure with less reliance on the US dollar have become two primary driving forces for regional financial cooperation in East Asia.

The internationalization of RMB has been entangled with regional cooperation in East Asia. Pushing for more uses of RMB in international bond markets and as invoice currency in international trade has put China as the main player in regional cooperation.

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1 "East Asia" is referred to ASEAN +3 in this paper.

In this article, we will briefly review the progress of regional financial cooperation in East Asia and analyze the underlying driving forces. In particular, we will investigate the role of China in this process, from the perspective of RMB internationalization. Then, we will discuss the challenges of further cooperation followed by our prospects of regional financial cooperation in East Asia. The final section concludes the paper.

2 The rationales of Asian monetary and financial cooperation

The current revived Bretton Woods System has been featured by the dominant role of the center country's currency, the US dollar[2]. The fundamental problem of the US dollar serving as both sovereign and international currency, known as the "Triffin Dilemma", makes the value of the US dollar unstable in the medium run. How to reform the current international financial architecture has been a heated topic. From an Asian point of view, Asian monetary and financial cooperation could be an important vehicle for pushing forward such reforms. In addition, Asian countries do have incentives to do so.

Preventing financial crisis is the primary incentive for East Asian countries to co-operate. Before 1997 Asian financial crisis, the regional cooperation in this region was sporadic and often interrupted by various political obstacles. The prospect for further EU-type integration was very pessimistic. However, during the turmoil of the crisis in 1997, Asian countries got to know about the destructive power of the crisis and started to design cooperative mechanisms to reduce crisis impacts and lower the probability of future crises. One of the most important lessons drawn from the Asian financial crisis is the inadequate international reserves levels in defending home currencies. Thus, a reserve pool was started after the crisis to increase usable liquidity during potential crises. Another lesson from the crisis is that the "original sin" problem of emerging countries makes the foreign debt burden unbearable with home currency crash.[3] Therefore, Asian bond market with issuance of foreign debt denominated in local currencies is initiated. In addition, the current global financial crisis has no doubt speeded up the further East Asia financial cooperation featured by the multilateralization of "Chiang Mai Initiative".

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2 Dooley, Folkerts-Landau and Garber, 2004.

3 "Original sin" refers to currency mismatch of assets and liability in developing or emerging markets. Less developed countries are not able to issue bonds in local currencies. But their assets are denominated in local currencies. Therefore, their foreign debt may skyrocket with a sudden depreciation of local currencies.

Reducing reliance on the US dollar provides another incentive for East Asian countries to pursue regional financial cooperation. The dollar system has caused the long-term interest rate fluctuations (McKinnon, 2006), which in turn, provides a source of instability. The unconstrained dollar liquidity floods the international financial markets, fueling asset bubbles. The real purchasing power of international reserves holdings of East Asian countries is declining with the depreciating dollar. Heavy reliance on the US dollar to conduct international trade, accumulate international reserves, and peg exchange rates has become a common problem of East Asian countries. Therefore, regional financial cooperation is desirable in terms of increasing the interdependence of East Asian countries and reducing dependence on the US dollar.

Deepening trade integration in East Asia requires a further development of regional financial cooperation. Starting from 2010, the free trade agreements (FTAs) between ASEAN and China as well as between Taiwan (Province of China) and China have taken effect. East Asian countries have been intensively engaging in FTA negotiations. Lots of new FTAs have been signed. Intra-region international trade is encouraged to be invoiced by local currencies, aiming at avoiding exchange rate risks.

3 Recent developments of regional financial cooperation in East Asia

3.1 From Chiang Mai Initiative (CMI) to Chiang Mai Initiative Multilateralisation (CMIM)

The primary feature of regional financial cooperation in East Asia is that the cooperation is a crisis-driven process. Among the very few cooperation moves before the Asian financial crisis, the setup of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP)[4] in 1996 is a noticeable event.

In response to the outbreak of the Asian financial crisis, different kinds of proposals featuring regional cooperation were put forward. In September 1997, Japan proposed an "Asian Monetary Fund" to assist crisis-hit countries, mending the flawed IMF rescue package. However, this proposal did not get much positive response from the rest of the world, even within the East Asia region. In Novem-

4 It is a cooperative organization of central banks and monetary authorities in the East Asia and Pacific region. It comprises the central banks of eleven countries and regions: Reserve Bank of Australia, People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, the Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, and Bank of Thailand.

ber 1997, 14 Asia-Pacific economies[5] created the “Manila Framework Group” to enhance financial stability. The ASEAN Surveillance Process (ASP) was created in October, 1998, to coordinate and strengthen policy making process and improve macroeconomic and financial surveillance. Before long, the ASP was evolved into ASEAN-Plus-Three Surveillance Process with China, Japan and Korea added. In October 1999, Malaysian former premiere, Mahathir, suggested an “East Asian Monetary Fund”, proposing a multilateral agreement in East Asian economies.

In May 2000, for better preventing financial crisis in the future, finance ministries of ASEAN-Plus-Three countries signed a bilateral currency swap agreement at the 33rd annual conference of the Asian Development Bank (ADB), which was dubbed “Chiang Mai Initiative” (CMI). Under this agreement, ASEAN-Plus-Three countries may get short term liquidity support from each other on a bilateral base when suffering from temporary balance of payments problem.

CMI is probably the most important outcome of the Asian financial cooperation. Since its establishment, the amount of currency swaps under CMI keeps increasing. In December 2003, the total amount of bilateral currency swaps reached 44 billion US dollars[6], jumping from its original amount of 1 billion US dollars. During Hyderabad meeting of ASEAN-Plus-Three in May 2006, it reached 75 billion US dollars. In 2007, it came to 80 billion US dollars, confirmed at the Kyoto meeting (Table 1, Figure 1). On May 5, 2008, as an important development of the CMI, ASEAN-Plus-Three decided to set up a reserve pool at 80 billion US dollars, which was considered as an upgrading of CMI. Through this arrangement, CMI has become a multilateral one which is known as “Chiang Mai Initiative Multilateralisation” (CMIM). Under CMIM, The resource was expanded to 120 billion US dollars on February 22, 2009 (see Table 2, Figure 2).

Although the resource of CMI has increased steadily over the past decade, particularly after 2009 when the CMI was upgraded into CMIM, it has not evolved into a practical one yet. Since its establishment, CMI has never been really used. For instance, when Republic of Korea got into balance of payment problem in 2009, it did not resort to CMI and instead asked for help from Fed in the United States. One of the main reasons for the inactive status of CMI is its IMF linked

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5 The 14 members are Australia, Brunei Darussalam, Canada, China, Hong Kong SAR, Indonesia, Japan, Republic of Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand and the US.

6 http://doctor-cafe.com/detail1.asp?id=3115&tid=2.

conditionality. For a long time, 90 percent of the credit support arrangement under CMI would comply with IMF's strict conditionality.

CMIM could be a new vehicle for facilitating Asian financial cooperation. However, it still faces some problems. First, although the capacity of credit has increased a lot compared with the situation in the past, it is still not enough. The largest ASEAN members of the CMIM can access roughly US$11 billion via the CMIM, yet these same countries required between US$40 – $60 billion during the Asian Financial Crisis in 1997-1998. Second, though the share of CMI unconditional credit has increased from 10 percent to 20 percent, it is still too small. Given the lack of efficient surveillance, it is still not clear how far the CMIM will de-link from the IMF conditionality. Notably, the Economic Review and Policy Dialog of ASEAN-Plus-Three finance ministers (ERPD) is being integrated with CMI to build a more independent surveillance system. However, unless ERPD is proved to be sufficiently effective, loaner countries with CMIM may not be willing to have it de-link so much with IMF. Third, the rivalry in getting a leading role among the main economies may hinder the progress significantly. In October 2010, as a very important step of CMIM institutional construction, the deputy finance minister meeting attended by the CMIM member countries decided to set up a secretary in Singapore, named "ASEAN Plus Three Macroeconomic Research Office" (AMRO). However, due to the divarication between Japan and China, the meeting did not reach any agreement in the leadership of this institution.

3.2 Asian Bond Market Initiative and Asian Bond Fund

Under the current "dollar system" or "revived Bretton-Woods system", the huge current account surplus of East Asian countries has to be invested in the US dollar assets. The real purchasing power of those reserves assets may shrink with the depreciation of the US dollar in the medium run. Currency mismatch of assets and liability may also cause the problem of "original sin". Therefore, diversifying foreign reserves portfolio has become a very important incentive for East Asia to develop regional financial cooperation. In particular, the creation of Asian Bond Fund (ABF) aims directly at issuing bonds in domestic currencies, getting rid of the problem of "original sin".

In November 2002, Republic of Korea initiated the idea of Asian Bond Market. At the Tokyo meeting of ASEAN-Plus-Three Ministries of Finance, Asian Bond Market Initiative (ABMI) was proposed to push for issuance of Asian Basket Currency bonds participated by East Asian governments and private enterprises.

In June, 2002, EMEAP started Asian Bond Fund (ABF1) at the size of the US dollar 1 billion. The source of the fund is foreign reserves in member countries. This fund is targeting the sovereign and quasi-sovereign bonds of EMEAP members, increasing the liquidity of these bonds.[7]

Even though ABF1 is started in the US dollar term, ABF2 is clearly aiming at the investment of bonds denominated in local currencies. ABF2, at the size of the US dollar 2 billion, comprises the ABF Pan Asia Bond Index Fund (PAIF) and eight Single-Market Funds. The PAIF is a single bond fund investing in sovereign and quasi-sovereign local currency-denominated bonds issued in eight EMEAP markets. The eight Single-Market Funds will each invest in sovereign and quasi-sovereign local currency-denominated bonds issued in the respective EMEAP markets. Even though dwarfed by the domestic bond market size in the eight EMEAP countries, the launch of ABF2 at 2005 provided learning by doing experience by EMEAP central banks through actually setting up bond funds investing in local-currency bond markets.[8] ABF2 has accelerated the Asian bond market development, making Asian local-currency bond an important asset class in investor's portfolio. After successful operation of the first US dollar 2 billion funds, the nine ABF2 funds are ready to be opened up to other investors. As by the end of 2005, four funds have been listed on exchanges.[9]

ABF3 is now under negotiation. Differently from the first two, ABF3 focuses at securitization of bank assets in order to reduce the reliance on financial assistance from international financial institutes. ABF3 helps the issuance of non-sovereign bonds in East Asia, increasing the liquidity of Asian bond market issued by private sectors (Li, 2010).

3.3 Monetary cooperation: Asian Currency Unit and Asian Monetary Unit

Even though there is very few virtual regional monetary or exchange rate cooperation, the proposals of Asian Currency Unit (ACU)[10] and Asian Monetary

7 The eight investment destination countries are China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand.

8 Guonan Ma (2005).

9 Both the Hong Kong Index Fund and the Pan Asia Index Fund are listed in Hong Kong Stock Exchange while the Malaysia Index Fund and the Singapore Index Fund are listed in Kuala Lumpur and Singapore respectively.

10 Kuroda and Kawai (2002) and Kawai (2009a, 2009b).

Unit (AMU)[11] were singled out as significant ones. Masahiro Kawai announced a portfolio of ASEAN-Plus-Three's currencies, taking weighted average as ACU. Unfortunately, the weighting scheme did not get much recognition from other main economies in the area. Eiji Ogawa suggested Asian Monetary unit and its deviation indicators in 2006. The components of AMU are still ASEAN-Plus-Three currencies with a weighting scheme similar to that of ECU. The weights are determined by the relative shares of trade volume and real purchasing power GDP.

According to its advocates, the ACU index can be used as an important indicator in measuring joint movements and divergences of East Asian currencies. It may not be acceptable by current financial markets, but its use in real market transactions in the future should be encouraged. Eichengreen (2006) proposed the "parallel currency" approach. This approach involves issuance of an ACU as a parallel legal tender together with national currencies, issuance of ACU-denominated bonds, and the establishment of a clearing and settlement system for ACU transactions. In the longer term, as the volume of ACU transactions increases, the ACU could develop into the sole legal tender within the region. Without strong political will to adopt a common currency in the near term, the "parallel currency" may serve well as the temporary move toward a deeper monetary cooperation.

Ogawa (2010) specifies the roadmap to ACU through surveillance path and private-sector transaction path. ACU for surveillance on exchange rate policy will be an appropriate tool in identifying misalignment and excess volatility of intra-regional exchange rates. He recommends that the monetary authorities should define a certain kind of ACU for surveillance, announce the ACU value every day, and monitor an ACU Deviation Indicators in Economic Review and Policy Dialogue (ERPD) of ASEAN-Plus-Three. Along private-sector transaction path, the official support and encouragement are indispensable for the sustainable development of financial products denominated in ACU.

Whether China should play an important role in the Asian monetary cooperation is an interesting issue. In Xiao et al. (2010), they investigate the possibility of "China factor" in determining exchange rate regimes in ASEAN countries. In the traditional "dollar system", the US dollar usually serves the pegged currency of small open economies in ASEAN. However, as the influence of China on ASEAN economies grows, the change of RMB exchange rates may also be taken into account when ASEAN countries set their exchange rates. For example, a

11 Ogawa and Shimizu (2005).

small open economy at ASEAN seems more likely to devalue if China devalues its RMB. China, on the other hand, may not respond to ASEAN country's devaluation. This asymmetry in exchange rate responses is called "China factor". Their analysis suggests that the relative size of domestic market with respect to foreign market is the crucial determinant of existence of "China factor". Even though the "China factor" is not a cooperative move among East Asian countries, it is more market determined and may provide an incentive for East Asian countries to collaborate more on the exchange rate issues. With the existence of "China factor", the level of the US dollar is pegged and the changes of RMB are also considered. "China factor" shows the co-movement of RMB and other currencies, which pave the way for their further cooperative move.

4 RMB internationalization

In order to play a more important role in the Asian financial cooperation, China has become active in expanding the international usage of its currency or so-called RMB internationalization since the outbreak of the sub-crime crisis, by having currency swaps between China and other countries. Since 2008, China has signed eight such agreements, among which six are with Asian countries and two are with other countries. The total amount of RMB swapped has reached 803.5 billion[12]. The currency swaps facilitate foreign enterprises' operation and their financial needs in China, help settle bilateral trade, and make RMB as a reserve currency. These market-driven as well as government-driven practices have provided China and other Asian countries valuable experience in monetary cooperation.

In addition to crisis-fighting currency swap arrangements or crisis-rescuing fund mechanism, a proposal by Fan et al. (2010) calls for intra-regional cross-holding of reserve currencies among East Asian countries as a normal time mechanism. This mechanism does not require any currency to be globally accepted, and definitely pushes for diversification of global reserve system. If this proposal is to be accepted by Asian countries, it would promote the RMB internationalization.

In December 2008, China started the first set of RMB internationalization policy by experimenting invoicing trades in RMB between Guangdong Province and Hong Kong, Macau, between Guangdong, Yunnan Provinces and ASEAN. In July 2009, 20 provinces are allowed to conduct international trade invoiced in RMB and restrictions on foreign countries were lifted. Since 1990s, China has

12 See Table 3 for detailed country list and the specific amounts of RMB swapped in each agreement.

signed agreements with eight neighboring countries to invoice frontier trade in RMB. In 2009, cross-frontier trade invoiced in RMB reached RMB 23 billion. Also in 2009, RMB deposits in Hong Kong were over RMB 100 billion. The cross-border RMB trade in the first half of 2010 was 18 times higher than the second half of 2009. In addition, foreign banks are allowed to participate in Chinese domestic bond market with their RMB holdings. As RMB internationalization progresses, inflows and outflows of RMB inevitably increase capital mobility and openness of capital account which are the necessary ingredients of further regional monetary cooperation.

The internationalization of RMB could be a new impetus of Asian monetary cooperation. While more and more currency swap agreements, intra-regional trade and investment are denominated in RMB, Asian countries will have an increasingly strong motivation to keep their currencies pegged to RMB and eventually make RMB an important reserve currency in this area. When RMB becomes a most important currency for denomination, pricing and store in value, the chance for Asian countries to create a fixed exchange regime or single currency zone may largely increase.

However, there are two elements that could make things uncertain and complicated. First, it is unclear whether China is willing to play a key role in the regional currency cooperation and integration. If so, China has to take more economic and financial responsibilities in the area. Second, Japan may not be ready to accept the fact that RMB plays a center role in Asian monetary integration.

With regard to the prospect of RMB internationalization, it is noted that the progress cannot be made too fast, limited by under-development of domestic financial markets, tight capital controls, and lack of institutional setting. China is also unwilling to give up capital controls solely for RMB internationalization. The steps of capital account liberalization will be gradual and adjusted to current economic situation. But it is also noted that China has made decision to develop Shanghai into an international financial center by 2020. Thus, year 2020 is regarded as a time point when China finishes up RMB internationalization process and makes RMB fully convertible.

There is a clear tendency that China is pushing forward the internationalization of RMB by encouraging the development of an offshore RMB market, given the relatively strict capital control. For years, Hong Kong has been an offshore RMB center although the market scale is small. It seems reasonable to predicate that

Tokyo will play an important role in the development of offshore RMB market, since it owns well-developed financial markets and institutions. Actually, if Tokyo can finally play the role, China and Japan may become more cooperative in the process of the regional financial integration. Of course, Singapore, Manila could potentially be offshore financial centers for RMB as well.

Another way of China's facilitating RMB internationalization under the circumstance of capital control is to encourage foreign countries, particularly Japan, Republic of Korea and other Asian countries to purchase Chinese government bonds denominated in RMB. Similarly, Chinese governments should also purchase more sovereign debts issued by these countries (using RMB if possible). These moves can not only push forward the internationalization of RMB, but also help pursue their reserve portfolio diversification, reducing the reliance on the US dollar. Actually, China has started to switch gradually their reserve portfolio away from the dollar assets, purchasing more of Japanese and Korean assets. In the first half of 2010, China purchased Japanese sovereign bonds at the value of the US dollar 20 billion, four times more than the purchases in the previous five years in total. In the first seven months of 2010, Chinese holdings of Korean sovereign bonds grew 133 percent, reaching the US dollar 3.8 billion. Even though the shares of Japanese and Korean bonds in Chinese total foreign reserves are still quite minor, the will of reserve diversification of Chinese government is evident.

Finally, there is an ongoing debate about if IMF should include RMB as a compositional currency for SDR. The association of RMB with the compositional currency for SDR would surely promote RMB internationalization. First, in order to push for the RMB as a compositional currency of SDR, China will accelerate the process of capital account liberalization, which is definitely beneficial to the RMB internationalization. Second, RMB' joining into SDR would will help signal its international currency status, which will lead to a wider use of RMB in the international trade, investment and reserves. If RMB becomes a parallel currency as the current compositional currencies (US dollar, sterling pound, euro and Japanese yen) of SDR, it may gain more trust from other countries, which will better facilitate the process of RMB internationalization.

5 Main obstacles and prospects

Although the Asian financial cooperation has made much progress in the past ten years or so, it is still facing a lot of challenges. The main obstacles may be as follows. First, since East Asian financial cooperation is mainly driven by crisis, its process

may be slowed down during post-crisis era. When East Asia was hit severely by the Asian financial crisis in the late 1990s, the driving force for strengthening financial cooperation was relatively strong and finally led to the establishment of CMI even though it has never been really used. However, when the global financial crisis hit this region relatively mildly, the cooperative move or willingness might become weaker.

Second, the lack of political trust among main countries in the area is unlikely to disappear in the near future. Without enough political trust in place, it would be difficult to implement monetary cooperation which requires giving up autonomy to a certain degree. The successful landing of the single currency in European Union in the end of 1990s made a strong demonstration effect on the Asian financial and monetary integration, particularly after the financial turmoil in 1997. However, unlike the balanced leading roles shared by Germany and France, Japan was a dominant player in the region, which has been arousing alert from other Asian countries. Mainly for this reason, the push of financial integration from Japan in the end of 1990s was unsuccessful. It is true that the picture has changed to some extent since the beginning of 21st century. The convergence of economic statuses of ASEAN, China, Japan and Korea has equipped the main participants of East Asian financial cooperation more balanced bargaining power. Notably, since the mid of 2010, China has taken over Japan as the second largest economy in the world. The equivalence of Japan's and China's economic power may balance and strengthen the leadership in pushing forward financial cooperation. Republic of Korea and ASEAN may also play more important roles in the process of regional cooperation. In particular, ASEAN often takes a humble and practical approach on regional cooperation and seems easier to communicate with the big three (Japan, China and Korea). However, due to the historical concerns and geographical politics element, it is still hard to say that the issue of political distrust has fully disappeared, even though there have been lots of positive developments over the past decade.

Third, the US plays a tricky role in East Asian regional financial cooperation. Since the regional cooperation has been associated with a tendency of de-linking from the US dollar, the US is unlikely to give strong support if this process goes too far and too fast. Under the current dollar system, the US enjoys many privileges. Among them, the most important ones might be the cheap goods imports and cheap capital (foreign reserves) from Asian countries. So, it should be hard to predicate that the US is willing to give up or even weaken the dollar system, which means the US may oppose any significant development of the Asian financial cooperation and integration as it did in the late 1990s.

Fourth, China's strategy of RMB internationalization probably will leave monetary cooperation at the stage of currency swaps or a reserve pool. To make RMB a center currency or a reserve currency in the future, China is more likely to make its currency perform independently rather than cooperatively moves. Without active participation of China, monetary cooperation in East Asia may not go too far.

6 Conclusions

The pace of the ongoing regional financial cooperation in East Asia has been quickened up as the global financial crises proceed. East Asia financial cooperation is a crisis-driven process. Before the 1997 Asian financial crisis, the cooperation was sporadic and often interrupted by various struggles. After the crisis, on a bilateral base, CMI emerged as an important facility of financial cooperation among ASEAN-Plus-Three countries though it has never been used due to some of the drawbacks. The multilateralization of CMI (CMIM) will largely improve its capacity of dealing with balance of payment problems in the area and also earn itself a more independent status, detaching more from IMF. The institutionalization of CMIM in the near future is very important for it to lead the process of regional financial cooperation. The development of Asian bond markets and the exchange rate coordination are also very important parts of the regional financial cooperation and integration.

China's decision to push forward RMB internationalization opens a window for it to play a more active role in the process of regional financial cooperation in East Asia. Under the relatively strict capital control, the process of RMB internationalization may be facilitated through various ways, including the development of RMB offshore markets. Importantly, if Tokyo can become a leading offshore financial center for RMB, the interdependence of Japanese and Chinese financial markets will be increasing, making further financial cooperation possible. RMB internationalization will also loose China's capital control to some extent, which is also a necessary condition for China to open up and collaborate more with others.

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Table 1 The Swap Arrangements under the Chiang Mai Initiative
(as of January 19, 2010)

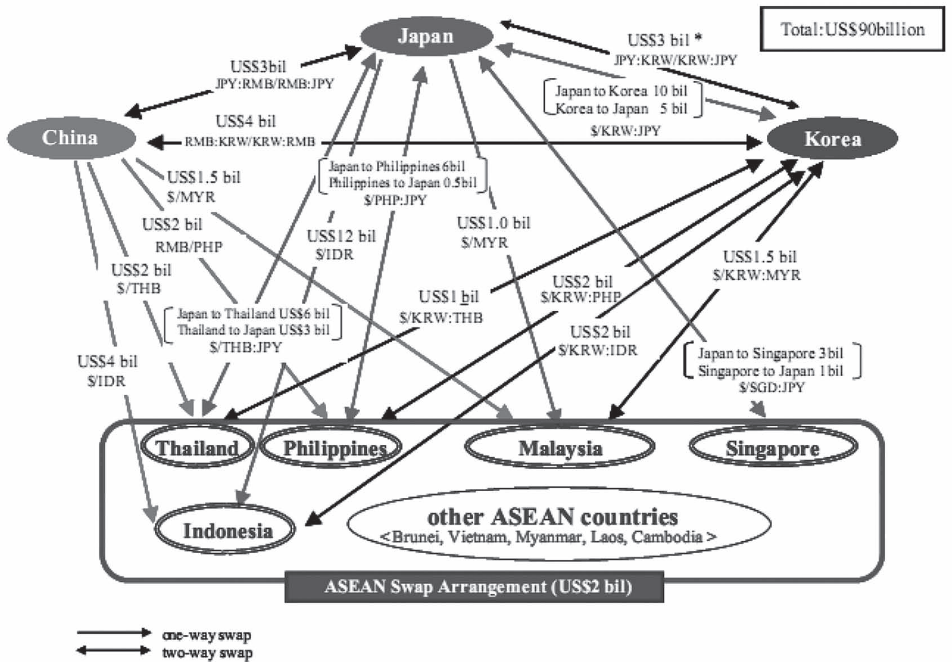
Creditor	Borrower	Currency	Amounts (US dollar bn)	Direction
China	Indonesia	USD-IDR	4	One-way
China	Thailand	USD-THB	2	One-way
China	Philippine	RMB-PHP	2	One-way
China	Malaysia	USD-MYR	1.5	One-way
China	Japan	JPY-RMB/RMB-JPY	3	Two-way
China	Republic of Korea	RMB-KRW/KRW-RMB	4	Two-way
Japan*	Republic of Korea	JPY-KRW/KRW-JPY	3	Two-way
Thailand	Thailand	USD/THB-JPY	6	Two-way
Thailand	Japan	USD/THB-JPY	3	Two-way
Japan	Indonesia	USD-IDR	12	One-way
Japan	Philippine	USD/PHP-JPY	6	Two-way
Philippine	Japan	USD/PHP-JPY	0.5	Two-way
Japan	Malaysia	USD-MYR	1	One-way
Japan	Singapore	USD/SGD-JPY	3	Two-way
Singapore	Japan	USD/SGD-JPY	1	Two-way
Japan	Republic of Korea	USD/KRW-JPY	10	Two-way
Republic of Korea	Japan	USD/KRW-JPY	5	Two-way
Republic of Korea	Thailand	USD/KRW-THB	1	Two-way
Republic of Korea	Philippine	USD/KRW-PHP	2	Two-way
Republic of Korea	Indonesia	USD/KRW-IDR	2	Two-way
Republic of Korea	Malaysia	USD/KRW-MYR	1.5	Two-way

Total: US dollar 90billion.

Note: Total amount includes those under negotiation for renewal but does not include ASEAN swap arrangement. The total amount of ASEAN swap arrangement is 2 billion. (See the graph below)

*The maximum amount of the bilateral JPY/KRW swap arrangement has been increased as a temporary measure effective until April 30, 2010, from three billion US dollars equivalent to twenty billion US dollars equivalent.

Figure 1: The Agreement on the Swap Arrangement under CMI
(as of January 19, 2010)

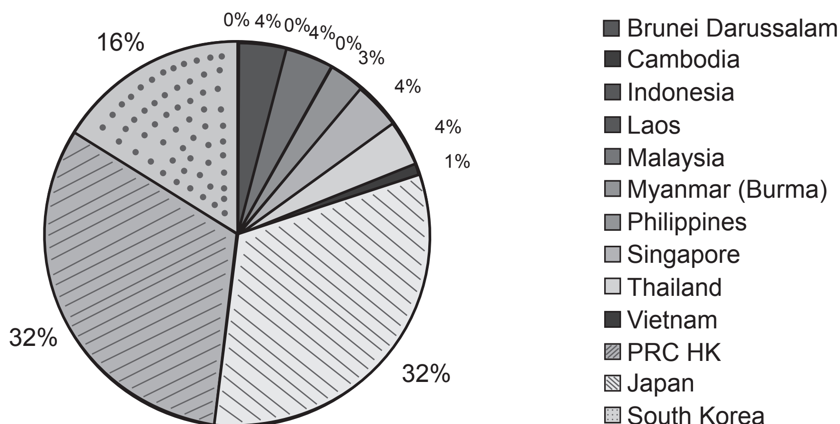


Source: "The Agreement on the Swap Arrangement under the Chiang Mai Initiative". Bank of Japan, 2010.

Table 2: Composition of the Chiang Mai Initiative Multilateral Reserve Fund (as of March 24th 2010)

Country	Financial contribution (million US dollar)	contribution/total
Brunei Darussalam	30	0.25%
Cambodia	120	1%
Indonesia	4,770	3.975%
Laos	30	0.025%
Malaysia	4,770	3.975%
Myanmar (Burma)	60	0.05%
Philippines	3,680	3.0667%
Singapore	4,770	3.975%
Thailand	4,770	3.975%
Vietnam	1,000	0.8333%
PRC HK	38,400	32%
Japan	38,400	32%
Republic of Korea	19,200	16%
Total	**120,000**	**100%**

Figure 2: Composition of the Chiang Mai Initiative Multilateral Reserve Fund (as of March 24th 2010)



Source: http://www.mof.go.jp/

Table 3: The Swap arrangement signed by China and other monetary authorities with RMB*

Time	credit	borrower	Amount (RMB billion)	Function
Dec. 2008	China	Republic of Korea	180	Facilitate the financing of Korean enterprises in China
Jan. 2009	China	Hong Kong	200	Settlement of commercial trade for both sides
Feb. 2009	China	Malaysia	80	Settlement of commercial trade for both sides
Mar. 2009	China	Indonesia	100	Settlement of commercial trade for both sides
Mar. 2009	China	Argentina	70	Settlement of commercial trade for both sides
Mar. 2009	China	Belarus	20	Make RMB as reserve currency
Jun. 2010	China	Iceland	3.5	Promote bilateral trade and investment
Jul. 2010	China	Singapore	150	Promote bilateral trade and investment

* (Total: 8 arrangements, RMB 803.5billion)

Global Imbalances and Regional Economic Integration in East Asia

Ulrich Volz*

Although the expression *global imbalances* includes the word *global*, most contributions to this topic have centred on the bilateral imbalances between the US and China, and the Chinese dollar peg as an underlying factor in particular. Given that the US has the world's largest current account deficit and China the largest current account surplus, this bilateral focus is understandable. However, it is helpful to take a broader perspective when discussing the underlying factors contributing to the Sino-American imbalances, especially when thinking about possible solutions to the problem. This brief note discusses the development of the East Asian trade-production network as one of the underlying reasons for China's current account surplus and the role that regional economic cooperation in East Asia, including regional monetary cooperation, can play in reducing global imbalances.

China's rapid economic growth has been closely associated with its integration into the world economy. China's trade expansion has also been linked to the development of an extensive regional trade-production-network which has made use of a division of labour across East Asian economies. A regional production and trade pattern has emerged, in which parts and components are shipped from other (Southeast) Asian countries to China where they are processed and assembled, before the final goods are being exported to the market of final demand, often the US and Europe.[1] China's bilateral trade surplus vis-à-vis the US and Europe, respectively, is hence also a consequence of a distinct mode of production across East Asia, with China absorbing exports from other East Asian countries before they are exported after relatively little value has been added. Therefore, parts of China's exports to the US and Europe can be characterised as "regional" exports

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1 According to the UN Comtrade Database, 70 per cent of Chinese imports from Emerging East and Southeast Asia are parts and components. According to the Asian Development Bank (ADB 2010), total final demand outside Asia makes up 71.1 per cent of total Asian exports, of which 23.9 per cent go to the US and 22.5 per cent go to the EU.

from East Asia, rather than solely Chinese exports. One should also note that these regional trade production networks are to a large extent owned by European, US, Japanese and Korean multinationals, which have outsourced production from their home markets to produce cheaply in developing East Asia in order to ship the final goods to advanced economies. Foreign direct investment from these firms has significantly contributed to China's status as the world's factory and the resulting current account surpluses. Table 1 shows China's trade balance with the US, the EU and its East Asian neighbours. Besides the huge surplus vis-à-vis the US it shows that, on an aggregate level, China has had a trade deficit the East Asian region as a whole.

Table 1: Trade balance of China with the US, the EU and East Asian countries (in million USD)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
US	29,785.6	28,174.1	42,812.4	58,694.3	80,382.4	114,353.5	144,571.9	163,183.4	171,063.4	173,483.9
EU	8,630.8	5874.8	8,974.1	17,618.4	28,667.0	57,207.0	79,437.8	107,340.7	130,703.9	96,013.8
ASEAN	−4,791.1	−4,527.3	−7,398.5	−16,123.1	−19,872.2	−19,383.4	−18,104.8	−13,999.7	−2,915.9	−1,312.2
ASEAN+3	−16,572.8	−13,110.7	−25,477.5	−53,889.6	−75,161.4	−77,511.2	−87,403.7	−93,703.2	−75,817.7	−57,193.5
Brunei	−48.3	−131.0	−220.8	−278.4	−203.2	−154.5	−115.7	−128.8	46.8	−18.1
Cambodia	104.6	170.9	227.1	268.7	422.6	508.8	662.6	830.2	1,056.4	860.4
Indonesia	−1,340.1	−1,040.9	−1,074.1	−1,267.6	−966.8	−61.4	−163.7	238.4	2,827.0	4,656.9
Japan	133.7	2,267.9	−5,006.0	−14,728.2	−20,857.8	−16,370.8	−24,038.5	−31,787.0	−34,632.0	−20,804.0
R. o. Korea	−11,915.4	−10,851.3	−13,073.0	−23,038.3	−34,431.4	−41,757.0	−45,260.4	−47,916.5	−38,269.8	−35,077.3
Lao	28.0	47.0	44.6	87.0	88.2	79.8	119.1	92.4	118.7	42.8
Malaysia	−2,915.0	−2,982.1	−4,320.0	−7,845.6	−10,087.5	−9,490.1	−10,036.5	−11,035.5	−10,747.6	−8,547.9
Myanmar	371.6	363.3	587.9	738.2	731.7	660.5	954.6	1,321.4	1,334.7	1,397.4
Philippines	−213.0	−323.5	−1,174.2	−3,212.5	−4,790.0	−8,181.4	−11,938.3	−15,623.3	−10,419.5	−4,220.7
Singapore	701.5	651.7	−85.6	−1,615.3	−1,309.3	185.5	5,513.4	12,159.4	12,233.1	2,379.3
Thailand	−2,136.8	−2,209.2	−2,639.5	−4,998.8	−5,740.0	−6,175.2	−8,198.4	−10,673.0	−10,115.5	−6,054.1
Vietnam	608.2	795.6	1,035.4	1,722.7	1,778.9	3,090.0	4,982.4	8,691.2	10,796.9	8,173.8

Source: Own calculations with IMF Direction of Trade Statistics, CD-ROM, September 2010.

While the existence of this regional trade-production network within East Asia has contributed to China's current account surplus, further regional economic cooperation and integration can also help addressing the problem of China's external – and hence also global – imbalances.

First, with prospective slower growth in the advanced economies of Europe and the US, demand for Chinese exports is likely to increasingly come from devel-

oping East Asia, along with increasing demand from developing and emerging economies in Africa and Latin America. East Asian economies are getting more and more important as destination for Chinese exports. The facilitation of trade between China and ASEAN, the Republic of Korea and Japan can further enhance business opportunities within the region and reduce export dependency of China (and other East Asian economies) on exports to the US and Europe.

Second, China has increasingly become an investor in other developing East Asian economies, following the examples of Japan and the Republic of Korea. China has already become the largest source of FDI to some low-income ASEAN countries such as Cambodia and Lao PDR. Further Chinese investment in the region would not only help position Chinese firms in the regional and international market, it would also help alleviate its balance of payments problems by shifting production abroad. Moreover, by creating employment in the host countries, Chinese FDI is likely to boost employment and income in these economies, contributing to demand for Chinese exports.

Third, the causes for the resurrection of the East Asian dollar standard (or Bretton Woods II) regime – the situation where basically all East Asian countries except Japan maintain pegs or soft pegs to the US dollar – should not only (or even predominantly) be seen as East Asian countries' attempts to seek export competitiveness through an undervalued exchange rate. Indeed, given the magnitude of exports to the US (which for most countries in the region are roughly as important as exports to Japan and Europe), pegging to the dollar makes limited sense from a trade perspective. However, the dollar pegs make sense when taking into account that the joint pegging of East Asian currencies to the dollar as an external anchor has provided a significant degree of intra-regional exchange rate stability. Arguably, the trade-production networks described above have only been able to develop in an environment of relative intra-regional exchange rate stability. Given that intra-regional trade by now accounts for about 60 per cent of total trade of East Asian countries (Volz 2010: 74) and that East Asian countries are also competing against each other in external markets, intra-regional exchange rate stability is an important regional public good. It is therefore time to discuss alternatives to the East Asian dollar standard that will provide the benefit of intra-regional exchange rate stability without the problems of the current practice of dollar (soft) pegging. In my view, intra-regional monetary and exchange rate cooperation provide a sensible way forward.[2]

2 See Volz (2010) for an analysis of the prospects for regional monetary cooperation in East Asia.

Fourth, global imbalances have to be seen in the light of the role of the US dollar in the global (and regional) monetary system. Given the importance of the dollar not only in the denomination of intra-regional trade but also in the assets and liabilities of East Asian countries' balance sheets, it is rational for these countries to try to maintain relative exchange rate stability against the dollar in order to avoid destabilising balance sheet effects. Again, regional financial and monetary cooperation that can gradually reduce dependency on the dollar is the way forward. Positive examples in this direction are the Chiang Mai Initiative Mulilateralisation process and initiatives by ASEAN+3 and EMEAP to foster the development of local currency bond markets.

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East Asian Financial Cooperation and the Role of the ASEAN+3 Macroeconomic Research Office

Masahiro Kawai*

1 Introduction: Key issues

The Asian financial crisis of 1997-98 and its spread across the region revealed several important points: financial systems and economic conditions were closely linked across East Asia; the International Monetary Fund (IMF) should not be relied upon alone for crisis management; and a regional self-help mechanism needs to be created to effectively prevent and manage financial crises. Recognizing this, the finance ministers of the ten Association of Southeast Asian Nations (ASEAN) countries, plus China, Japan, and Korea – called ASEAN+3 – embarked on several new initiatives for regional financial cooperation in 2000:

- regional economic surveillance (Economic Review and Policy Dialogue, ERPD);
- a regional liquidity support arrangement (Chiang Mai Initiative, CMI); and
- Asian bond market development initiatives.

The global financial crisis of 2007-09 again demonstrated the need to strengthen East Asia's regional financial cooperation. While the crisis affected many East Asian countries through the trade channel, it created shortages of international liquidity in a few countries, like Korea and Indonesia. Korea encountered sudden capital flow reversals in the aftermath of the Lehman collapse in September 2008 and saw a rapid loss of foreign exchange reserves and sharp currency depreciation. Unwilling to go to the IMF or the CMI for liquidity support, the Korean authorities chose to secure a US$30 billion currency swap line from the United States (US) Federal Reserve System. This had an immediately positive, stabilizing impact on the financial and foreign exchange markets in Seoul.

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This paper summarizes the progress of recent financial cooperation in the region – including the launch of CMI Multilateralization (CMIM) and the decision to set up an ASEAN+3 Macroeconomic Research Office (AMRO) – and explores the challenges in strengthening the ERPD, CMIM, and exchange rate policy coordination. A strong ERPD and CMIM would lead to the de facto creation of an Asian monetary fund (AMF).

2 Progress on East Asian financial cooperation

2.1 ERPD and AMRO

The ERPD is a regional economic surveillance process, designed to contribute to the prevention of financial crises through the early detection of irregularities, vulnerabilities and systemic risks, and the swift implementation of remedial policy actions. It was intended to facilitate: analyzing economic and financial conditions of the global, regional, and individual national economies; monitoring of regional capital flows and financial market developments; and providing policy recommendations for undertaking necessary national policies as well as joint actions on issues affecting the region. The expectation was that countries would implement better macroeconomic and financial sector policy at the national level as a result of peer pressure, and would pursue policy coordination if needed.

Without strong supporting mechanisms for regional surveillance, however, the ERPD process has not been as successful as initially expected, although gradual improvements have been made over time. Another problem is the absence of central bank governors in the process,[1] even though their deputies have been participating in ASEAN+3 finance deputies' meetings. Recognizing these problems, the ASEAN+3 finance ministers decided to create a surveillance unit in charge of regional economic surveillance, AMRO, in Singapore.

2.2 CMI and multilateralization

The CMI is a regional liquidity support facility, which is intended to reduce the risk of currency crises and manage such crises or crisis contagion. It started as a combination of (i) a network of bilateral swap agreements (BSAs) among the Plus-3 countries – China, Japan, and Korea – and between one of these Plus-3 countries and a select ASEAN member, and (ii) the ASEAN Swap Arrangement (ASA). From May 2006, the ASEAN+3 finance ministers began to improve the functio-

1 Central bank governors in the region have been collaborating through the Executives' Meeting of Asia-Pacific Central Banks (EMEAP), which is separate from the ASEAN+3 finance ministers' process.

ning of CMI – and ERPD – and to multilateralize the CMI. After step-by-step agreements, CMIM was officially implemented in March 2010. Its total size was set at US$120 billion. Member contributions and borrowing limits were decided; Japan and China contribute 32 per cent each, Korea 16 per cent and ASEAN 20 per cent. The ERPD is now considered as an integral part of the CMIM. And the AMRO is expected to "monitor and analyze regional economies, which contributes to the early detection of risks, swift implementation of remedial actions, and effective decision-making of the CMIM"[2] and thereby enhance the current surveillance mechanism. Essentially it lays the surveillance groundwork for the CMIM.

An important feature of the CMIM is that crisis-affected members requesting short-term liquidity support can immediately obtain financial assistance up to an amount equivalent to 20 per cent of the total amount that could be borrowed,[3] and that the remaining 80 per cent is provided to the requesting member under an IMF programme. Thus the CMIM is closely linked with an IMF programme and its conditionality. The CMIM's link with the IMF was designed to address the concern that the liquidity shortage of a requesting country may be due to fundamental policy problems, rather than a simple liquidity problem, and that the potential moral hazard problem could be significant in the absence of rigorous conditionality. Essentially, the CMIM is generally intended for crisis lending and hence requires conditionality. The lack of the region's capacity to formulate and enforce effective adjustment programmes in times of crisis was a major reason for requiring the CMIM to be linked to IMF programmes.[4]

One of the reasons Korea did not go to the CMI for liquidity assistance in the fall of 2008 was that sufficient funds provided would be linked with IMF programmes. This would have created political problems within the country due to the negative perceptions of the IMF stemming from its actions in the 1997-98 financial crisis. Another reason was that the Korean authorities considered that the turbulence in the fall of 2008 was not a crisis, and the CMI was not designed for non-crisis situations. Korea was fortunate in being able to secure a US Federal

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2 The Joint Ministerial Statement of the 13th ASEAN+3 Finance Ministers' Meeting, 2 May 2010, Tashkent, Uzbekistan.

3 Initially the IMF-delinked portion of the CMI was 10 per cent and it was raised to 20 per cent in May 2005.

4 Some ASEAN+3 members, such as Malaysia, believe that the CMI/M should not be linked to IMF programmes.

Reserve currency swap line, but Indonesia was rejected by the Federal Reserve.[5] This illustrates the importance of strengthening the regional financing arrangement that is accessible to countries that are fundamentally sound.

3 Policy challenges

There are several key policy challenges for ASEAN+3 policymakers to make the ERPD and CMIM effective.

3.1 Strengthening the ERPD and CMIM

An important challenge is to strengthen the CMIM and ERPD in order to reduce, and ultimately dismantle, the IMF link so that emerging East Asian countries can use the CMIM in crisis or near-crisis situations. The key is to create conditions to promote further IMF delinking. For this purpose, the newly established surveillance unit, AMRO, should become a strong permanent secretariat for regional economic surveillance and liquidity support at times of financial and currency turmoil. AMRO should be designed and managed in a way to help improve the quality of economic surveillance (ERPD) so that lending conditionality – independent of IMF programmes – can be formulated in the event of CMIM activation.

More concretely, the following actions are needed:

- Clarify rules for activating CMIM lending, including the possibility of providing precautionary (or non-crisis) lending and eschewing policy conditionality in the event of externally- or herd behaviour-driven financial turbulence or crisis;
- Establish a joint forum for finance ministers and central bank governors to intensify policy dialogue among them;
- Provide adequate resources to AMRO in order to make it a strong professional secretariat, with the required analytical expertise and policy experience, to enable it to support regional economic surveillance (ERPD), activate the CMIM, and formulate conditionality independently of the IMF;
- Enlarge the size of CMIM so that a sufficient amount of liquidity could be provided to countries in need;
- Introduce new instruments, such as precautionary facility at a near-crisis; and

5 Although Indonesia did not face a currency crisis in the aftermath of the global financial crisis, it had some difficulty funding its fiscal needs internationally and the rupiah depreciated sharply. In order to cope with potential financial turbulence, the country obtained US$5.5 billion in 2009 through a "standby loan facility" – or "deferred drawdown options" – with the funds provided by Japan, Australia, the Asian Development Bank, and the World Bank. Thus, multilateral development banks and bilateral agencies played a critical role in helping Indonesia to secure financial resources for budgetary support.

- Move beyond the simple "information sharing" stage to a more rigorous "peer review and peer pressure" stage, and eventually to a "due diligence" stage, to improve the quality of economic surveillance.

Once these actions are taken, a new de facto AMF would emerge capable of conducting effective surveillance, providing international liquidity in the event of a crisis or near-crisis, and formulating and monitoring policy conditionality. However, it may take some time to achieve these and, during a transition period, a flexible use of CMIM for precautionary lending should be provided without conditions, in the event of the type of financial turbulence that Korea experienced in the fall of 2008.

3.2 Exchange rate policy coordination

Growing economic integration that has strengthened macroeconomic links across East Asia suggests increasing importance of intraregional exchange rate stability. Furthermore, given that East Asia, comprising mainly the ASEAN+3 countries, is projected to become the world's largest economic bloc by 2020, it is natural to expect this region to eventually develop its own monetary system.

The impetus toward regional exchange rate policy coordination may come sooner rather than later – should the US dollar depreciate sharply against East Asian currencies. With its robust economic recovery from the global financial crisis and the prospect of monetary policy tightening – while advanced economies adopt low or near-zero interest rate policies and some undertake quantitative easing – large amounts of capital are already flowing into Asia. To maintain macroeconomic and financial stability in the face of persistent capital inflows, authorities of any economy should mobilize necessary policies, such as tight macroprudential measures (including capital inflow controls), fiscal policy restraint, and a certain degree of exchange rate appreciation. If currency appreciation vis-à-vis the dollar is to be accepted, this had better be done collectively, while maintaining intraregional rate stability, so that the costs of adjustment can be spread among them and kept to a minimum for individual economies.

To facilitate such coordination, the region's authorities must become more serious about policy dialogue over capital flows, exchange rates and macroeconomic management. AMRO must support this by using a set of economic and financial data, including Asian currency unit (ACU) indexes. Greater convergence of exchange rate regimes would be needed to achieve a satisfactory degree of intraregi-

onal rate stability; the most realistic option is for emerging East Asian economies to adopt similar managed floating regimes. This type of policy coordination has the potential to form the basis of an East Asian Monetary zone.

4 Conclusion

East Asia can contribute to the stability of global finance by achieving sustainable economic growth and financial stability through effective regional liquidity (CMIM) and surveillance (ERPD) arrangements. The objectives of CMIM are: (i) to address short-term liquidity problems in the region; and (ii) to supplement the existing international financial arrangements.

Progress in strengthening the CMIM and ERPD would require more cooperation and decisive action. ASEAN+3 finance ministers and central bank governors need to work closely to strengthen their policy dialogue and cooperation. AMRO should become a powerful surveillance unit with sufficient resources and expertise, so it can help transform the ERPD from "information sharing" to the "peer review and peer pressure" stage, and then to the next stage of "due diligence" – a more rigorous scrutiny of a potential debtor economy. The CMIM needs to be expanded in size, should be delinked from IMF programmes, and must offer more instruments including precautionary credit lines so it can be activated at the time of near-crisis. The next challenge would be to explore how an independent CMIM (or a future AMF) should work with the IMF.

European Financial Cooperation against the Backdrop of the Financial Crisis

Bernd Braasch*

EU cooperation is such a broad and multifaceted topic, that sufficient justice cannot be done to it within the limits of this short speech. There is therefore a clear need to bring to the fore all the lessons that can be learnt from the financial crisis with regard to EU cooperation and the stability of monetary union. What new challenges have been revealed by the financial crisis and how should they be tackled? These new challenges can be dealt with on two levels: (i) particularly in the area of financial stability and EU financial supervision and (ii) on the level of macro-policy coordination. Finally and (iii) are there lessons that can be learnt from the European integration model for closer cooperation in emerging markets? Viewed over an extended period of time, what were the biggest drivers of integration and the largest obstacles in the area of European integration? Is there only a need for adjustments to the European integration model to better adapt the new financial environment or do we need some kind of a "qualitative leap"?[1]

1 Lessons for EU cooperation in the area of financial stability

1.1 Monetary policy and financial stability

The independence of monetary policy and price stability is a significant „social asset". Credibility, which is of significant importance to guarantee price stability with low macroeconomic costs, needs years to gain, but seconds to lose. Therefore, changes in the monetary concept should be made very carefully.

Nevertheless, we have to discuss in a systematic and undogmatic manner the lessons to be drawn from the financial crisis for monetary policy. What can monetary

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1 D. Strauss-Kahn, Crisis Management Arrangements for a European Banking System. – "Building a crisis management framework for the Single Market" Keynote speech at the European Commission Conference; Brussels, 19 March 2010.

policy do to contribute to preventing asset inflation or deflation? How effective can monetary policy be in dampening the pro-cyclicality of the financial system? These questions are still open to discussion.

In this context, Mr Weber, President of the Deutsche Bundesbank has proposed to follow a more symmetric approach in monetary policy.[2] Considering that price stability remains the main objective of the central bank:

„In my view, monetary policymakers should not view boom and bust episodes on the financial markets as unrelated events. Monetary policymakers` responses to upturns as well as to downturns on the asset markets influence the risk perception of the market participants. Therefore, an (expansionary) monetary policy response which is stronger in the downswing than in the (restrictive) response in the upswing creates adverse incentives for investors which could increase the amplitudes of the financial cycle. (...) A more symmetric approach by monetary policymakers would … try to look through the financial cycle in order to steady policy. To be more specific, a more symmetric policy would also consider implicit risks in times when money and credit growth is dynamic, asset prices go up and risk perceptions decline, possibly weighing the need to act despite low current consumer price inflation rates." This approach can generate gravitational force for the further discussion, since recommendations made, for example, by the BIS and the ECB are close to a more symmetric approach.

But beyond pure monetary policy, the financial crisis has revealed the need for closer cooperation between macroprudential policy, supervision and monetary policy. Macroprudential policy has to play an important role in preventing the build-up of financial distortions. Further in-depth analysis has to contribute – inter alia – to an effective interplay between macroprudential policy and a more symmetric monetary policy, since, for example, macroprudential measures could significantly influence the transmission channels of monetary policy.[3] Monetary policy and financial stability should also be an important topic of the newly created European Systemic Risk Board.

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2 Axel A. Weber, Reflections on the financial crisis. Speech at the Mais Lecture, Cass Business School. In: Deutsche Bundesbank, Presseauszüge, [Press excerpts] 19. Mai 2009, Nr. 21, S. 3–6.

3 Bernd Braasch, Symmetrische Geldpolitik und Finanzstabilität. [Symmetric monetary policy and financial stability]. In: Wirtschaftsdienst, 90. Jg., August 2010, S. 516–523.

1.2 Creation of a European Systemic Risk Board (ESRB)

The financial crisis has revealed, in particular, clear information gaps in the area of banks' cross-border linkages, as well as with regard to the proliferation of the crisis, the impact of financial innovations on financial stability and the vulnerability of countries. Both in analyses and in the economic policy debate, greater importance is attached to macro-prudential problems which focus on the stability of the entire financial system. In this regard, on a global level, the G20 countries have strengthened the role of the IMF and the FSB. At a European level, the EU recently decided to set up a European Systemic Risk Board[4], responsible for macro-prudential oversight within the EU, in order to address this problem. It thus has a significant *preventive function*.

The main difference between the ESRB and the IMF, for example, does not lie in its examination of macro-prudential aspects on a regional level, but in the fact that the ESRB is predominantly composed of independent *central banks*. The ESRB will therefore play an important role in the concert of global or regional assessments of financial stability.

In accordance with this range of tasks, the ESRB has essentially three objectives, namely

- to develop a European supervisory perspective focused on the macroeconomic level; to counteract fragmented risk analysis
- to increase the effectiveness of early warning mechanisms; to improve the interaction between micro and macro-prudential analyses
- to improve the conversion of risk assessments into concrete measures

Moreover, the ESRB's range of tasks includes determining hierarchies of risk. At the same time, the ESRB should help to ensure a smoother interaction between macro and micro-prudential supervision. Furthermore, owing to its composition, the ESRB should present sound proposals regarding the interplay between monetary policy and macro-prudential policy. Owing to this wide range of tasks, the ESRB should, as a *general rule*, be able to request data directly from the national supervisory authorities, the national central banks or other authorities of the member states[5]. As individual institutions can be of systemic importance, the ESRB should also, upon a reasoned request, be able to gain access to the data of the European financial supervisory authorities.

4 State of discussion: 24 September 2010.

5 Council of the European Union, Note from the Presidency, Brussels, 6 September 2010, p. 18.

The ESRB is set up on the basis of Article 95 of the EC Treaty as a body without legal personality, i.e. the ESRB cannot issue any binding instructions. The ESRB's powers therefore include giving risk warnings, although there is no obligation to implement its recommendations. However, a member state must explain why it has not introduced measures (high level of *moral suasion*). The ESRB can only make the warnings and recommendations public if a request for this is agreed to by the General Board with a 2/3 majority.

It may be noted here that it is also likely to be discussed whether and to what extent a consensus on the communication strategy of the relevant international institutions may be warranted in each case. This is in no way likely to impinge on the independent judgement of the ESRB, but, at the same time, it should be noted that assessments based on different methods and models could differ significantly from one another and, therefore, care should be taken to ensure that the communication of these assessments does not produce irritation on the financial markets.

The central decision-making body of the ESRB is the General Board.[6] Its members with *voting rights* comprise the presidents of the national central banks, the President and Vice-President of the ECB, a member of the Commission and the chairs of the three European financial supervisory authorities. Moreover, the Chair and two Vice Chairs of the Advisory Scientific Committee as well as the Chair of the Advisory Technical Committee will have voting rights. A high-ranking representative of the competent national supervisory authorities of each member state as well as the Chair of the Economic and Financial Committee also participate in the General Board's activities, but do not have voting rights. The General Board is supported by the Steering Committee, which prepares the meetings of the General Board. In addition, the ESCB has set up a secretariat, whose positions are filled by the ECB.

1.3 Lessons for EU financial supervision: European System of Financial Supervision (ESFS)

On the micro-prudential level, the creation of a European System of Financial Supervision should, in particular, tackle the new challenges concerning the effective supervision of institutions that are active across borders and ensure a reciprocal exchange of information, which had previously been lacking. In this respect, the reform of EU financial supervision is a response to increasing financial

6 See also ESRB website: www.esrb.europa.eu.

globalisation and the European integration. Moreover, the aim is to achieve a greater harmonisation of rules and the application thereof.

"The ESFS should be an integrated network of national and Union supervisory authorities, leaving day-to-day supervision at the national level."[7]

The ESFS essentially consists of three elements: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). With regard to the micro-prudential supervisory structure, the ESFS will assume all the functions of the following three current institutions: the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR).

Furthermore, it is recommended that the European Supervisory Authorities should also extend their scope of supervision to include credit rating agencies.

"The Authority should have legal personality as well as administrative and financial autonomy."[8]

The ESFS should, in particular, improve the functioning of the single EU financial market by means of a high, consistent and effective level of regulation and supervision. In so doing, the special features of credit institutions and the interests of the member states should be taken into account. It should be emphasised that *"it should also be able to temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or stability of the whole or part of the financial system in the Union …"*.[9]

Furthermore, the EFSF's intensity of intervention should be increased in the event of a crisis. It is therefore envisaged that *"to overcome exceptional situations of persistent inaction by the component authority concerned, the Authority should be empowered, as a last resort, to adopt decisions addressed to individual financial institutions."*[10]

7 Council of the European Union, Note from the Presidency, Brussels, 6 September 2010.

8 Ibid, p. 7.

9 Ibid, p. 7.

10 Ibid, p. 12.

In addition to the selected tasks highlighted here, *"the Authority should also in cooperation with the ESRB initiate and coordinate Union-wide stress tests to assess the resilience of financial institutions to adverse market developments, and ensure, that an as consistent as possible methodology is applied at the national level to such tests."*[11]

Strengthening the EU financial supervision fills a gap, revealed by the financial crisis, but it does not indicate that strengthening the regional cooperation on this field implies a shift of main responsibilities to the regional level. In my view, this would be a misleading interpretation. Stability begins at home, every financial crisis had its sectoral or national roots. Moreover, such an interpretation might be no appropriate guide for emerging market economies (EMEs), in particular those, which heavily relied on the presence of foreign banks and the "import" of best practices in risk management and supervision. As Turner underlined, host country supervisors have to evaluate carefully their own responsibilities and conceptual responses against the background of experiences made with this financial crisis. They cannot just rely on assurances that risk exposures are properly managed.[12]

2 Lessons for macro-policy coordination

Moreover, as a result of the financial crisis, macro-policy coordination is facing new challenges. The European Commission has thus rightly called for a reinforcement of macro-policy coordination citing *"failures to comply with underlying rules and principles"* and the fact that "*… existing surveillance procedures have not been comprehensive enough" as its reason.* "*… these recent experiences also showed gaps and weaknesses in the current system, underlining the need for stronger and earlier policy co-ordination, additional prevention and correction mechanisms and a crisis resolution facility for euro-member states."*[13] All these proposals indicate a need for an intensified macro-surveillance, but by no means of a fine-tuning of macro-policy on EU level.

11 Ibid, p. 17.

12 P. Turner, Banking Consolidation in the Emerging Market Economies: Foreign and Domestic, in: G20 Proceedings, Competition in the Financial Sector, 2008, pp. 113-144. See: B. Braasch, Financial Market Crisis and Financial Market Channel. In: Intereconomics, No 2, 2010, pp 96-105.

13 Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the Economic and Social Committee and the Committee of the Regions, 12 May 2010.

For the Commission, a more intensive use of the instruments stipulated in the Treaty centres on the following three elements:

(1) *Reinforcing compliance with the Stability and Growth Pact*. In particular, the preventive arm of the Stability and Growth Pact needs to be strengthened. Moreover, if the Pact is breached, sanctions should be imposed at an earlier stage and on a more automatic basis, for instance by making calls for interest-bearing deposits. (2) *Extending surveillance to macro-economic imbalances.* (3) *Establishment of a European Semester for Economic Policy Coordination*. In principle, all of these activities deserve support; in particular when tightening the Stability and Growth Pact it is essential to restore the credibility that has been lost over the past few years with a view to ultimately achieving enforceability of the regulations. At present, priority is awarded to fiscal policy consolidation and the drafting of regulations to ensure in a sustained manner that all EU countries follow the consolidation path.

3 Lessons for crisis management

If all responses that have been listed so far are geared first and foremost towards prevention, the financial crisis has also presented new challenges and revealed a lack of appropriate tools for crisis management. Both the financial crisis and the state crisis have created problems that cannot be solved by state governments alone or that are beyond their control. This holds especially true for the "Greek crisis" which, in the judgment of the European Commission, *"has shown shortcomings in the existing framework and the unprecedented sovereign debt crisis left the euro area with no remedial instruments."* However, it should be stressed that this is a crisis of individual states and in no way calls into question the stability of monetary union as a whole.

3.1 Broad range of proposals on how to contain state crises

This topic has sparked a wide-ranging general debate which has certainly not come to an end with the measures resolved. One particularly noteworthy example is the proposal by Daniel Gros and Thomas Mayer[14] to introduce a European monetary fund. In addition, proposals on how to contain systemic risks in the event of state crises are currently being discussed (debt restructuring procedures). The debate has clearly shown that proposals put forward and package solutions

14 Daniel Gros and Thomas Mayer, "How to deal with sovereign default in Europe: Towards a Euro (pean) Monetary Fund. Centre for European Policy Studies (CEPS), Policy Brief No 202/February 2010.

found are occasionally limited by existing regulations and mandates. For example, in an article entitled *"Financing and representation in the International Monetary Fund"* the Bundesbank stressed that *"any financial contribution by the IMF to solve problems that do not imply a need for foreign currency – such as the direct financing of budget deficits – would be incompatible with its mandate."*[15] This is of course not for blaming institutions but it reflects in a systematic and undogmatic manner shortcomings in existing frameworks also on a global level.

3.2 Introduction of a "temporary" European stabilisation mechanism

In the meantime, measures have been resolved some of which are of a rather more temporary nature. On 9 May 2010 the European Council and the individual member states agreed on a package of measures to stabilise the financial systems. This in-cludes a "temporary" European stabilisation mechanism comprising two pillars.

- Based on Article 122.2 of the Treaty, which provides financial support in exceptional circumstances that are beyond the control of individual member states, €60 billion has been set aside for these measures. These funds can be mobilised only subject to strict conditionality.
- Intergovernmental agreement by member states to complement such resources through a special purpose vehicle up to € 440 billion.

The introduction of a European stabilisation mechanism *"… should allow the Union to respond in a coordinated, rapid and effective manner to acute difficulties in a particular member state."*[16] According to the Commission's assessment, financial support should generally take the form of loans or credit lines granted to the member state.

The EU Commission will, in the medium to long term, present a proposal for a permanent crisis resolution mechanism.

4 EU integration model: "old" concerns and "new" lessons for monetary cooperation – also for EMEs?

In my view, EMEs need no recommendations but know best themselves how to decide whether and to what extent the European integration model can serve as

15 Deutsche Bundesbank (ed), "Financing and representation in the International Monetary Fund", Monthly Report, March 2010, pp 51–64.

16 Conclusions of the Ecofin Council, 9 May 2010.

an example for emerging market economies. Considering this attitude, it may be fruitful to draw some principle lessons, which are not country or region specific and proved to be valid as well for the European Monetary Union countries as EMEs, regardless of its different stages of development and integration. Even, if a single currency union is not of primary importance for EMEs today, a group of countries willing to go the long road to achieve stronger financial integration and monetary cooperation must have enough converging visions and agreement on the final model, which route to go and on the feedback mechanism. Four aspects deserve particular attention:

(1) The success factors for stability-oriented cooperation in macro-economic policy and financial stability are in no need of revision in the wake of the financial crisis. In fact the opposite is true. The process of European integration is still a prime example that useful and promising coordination is linked to stability conditions that have a universal validity, in other words, that are valid for every integration model and independent of region-specific initial conditions. These conditions include the following:

- Similar basic approach to governance (market economy structure, state's role in economic policy)
- Similar economic policy aims and priority thereof (stability culture)
- Coordinated response and hierarchy of objectives in the event of a crisis or an external shock
- Effective coordination is unthinkable without sufficient agreement as to how economic policy functions should be allocated in the participating countries
- Guarantee that measures will actually be implemented nationally
- Common understanding of integration sequencing
- Broad coherence when assessing the need for coordination
- No-bailout clause

If cooperation in the EU, despite significant progress overall, was fairly sluggish roughly into the 1980s in the area of macro-policy coordination and was not without setbacks, this was due, in particular, to the absence of the above-mentioned success factors. At the outset, the allocation of economic policy functions varied considerably, as did the hierarchy of objectives and the countries' power to implement the resolved measures at home against pressure from national interests. Joint statements on launching a monetary union until 1980 did not make it past the planning stage (Werner Plan etc). Countries responded in many different ways to external shocks, such as the oil price crisis.

(2) *Selection of a suitable coordination mechanism.* If macro-policy coordination in Europe was increasingly stimulated by the integration of financial systems and markets in the participating countries, the issue of selecting coordination mechanisms was an important step. Not enough attention has been paid to this aspect as a driver of integration.

In this brief excursus, a distinction may be drawn between two major forms of coordination: (i) direct coordination (via bodies and committees) and (ii) indirect coordination mechanisms. Although there is no doubt that direct cooperation in the committees is useful for exchanging information and heightens the individual country's sensitivity to how other countries react to its policies, this did not notably boost integration for a long time.

Although its primary focus was on exchange rate policy, the European Monetary System (EMS), as an *indirect coordination mechanism,* unintentionally generated a key stimulus to strengthen cooperation across the entire monetary area.

EMS proved to be an extremely effective and, in particular, stability-oriented integration model in the monetary area. The fact that the Bundesbank emerged as a stability anchor shows that the Deutsche Mark, unlike in the Bretton Woods System, was not a leading currency by choice but instead gained the trust of market participants owing to its stability-oriented monetary policy (leading currency by nature). However, the accompanying regulatory effects were much more significant: as the exchange rate mechanism obliged other participating countries' central banks to follow the Bundesbank's stability course, its political independence had a major influence on the partner countries. This indirect mechanism promoted not only the convergence of price stability but also the course of each country's monetary policy. Although these partner central banks were not always politically independent in formal terms, they followed a monetary policy course which would not have been much different had they enjoyed full independence.

With regard to this coordinating function, the question has been posed, for example in a paper by Otmar Issing, former Member of the Executive Board of the Deutsche Bundesbank and the European Central Bank, written before the introduction of the euro but which is still worth reading today, whether the euro would prove to be a regulatory factor that strongly induces the other areas of economic policy to adopt stability-oriented behaviour or whether the opposite would be true and there would be a danger of the other areas emitting a destabilising force. This question is key to the survival of a monetary union. The countries resolved

the Stability and Growth Pact as a kind of protection for European monetary policy. The background of this decision was that the direct coordination of fiscal policy brought only slow successes and stronger stability-oriented cooperation in this area was evidently not expected. Instead there were concerns that the European Central Bank could find itself under increasing political pressure to keep interest rates low to reduce the government's debt service burden.

The European model's chances of success, for instance in Asia, were quickly dismissed as, unlike the situation in Europe with Germany and France, Asia is said to have no comparable political *leadership*.[17] A strong political will is without any doubt a necessary condition, but not sufficient. Of same importance is establishing an effective and stability oriented coordination mechanism which withstands the various influences of changes in the political power in the participating countries.

(3) The financial crisis has shown, that *monetary policy needs protections on the flanks* – in particular with an effective and more preventive Stability and Growth Pact, which could contain a more rules based sanction mechanism. Moreover, the current financial crisis shows, that „fiscal consolidation efforts can reduce the risk of negative and mutually reinforcing links between government finances, the financial sector and the rest of the economy."[18] The ECB underlines that the risks of a loss of confidence in the sustainability of public finances in one country are not limited to contagion across sovereign bond markets. The effect of a fiscal crisis on the holders of government debt, such as banks, pension funds and individual investors, can undermine financial stability and the outlook for the real economy. "In particular, as witnessed during the financial crisis, uncertainty can easily skip across different asset markets, so that volatility in government bond markets adversely affects activity in other financial market segments."[19]

(4) The current financial crisis has shown that in addition to the Stability and Growth Pact, *monetary policy* also *requires additional effective protection through macroprudential measures and regulation* as well as more effective European financial supervision to prevent *inter alia* the occurrence of financial distortions.

17 See Gloria O. Pasadilla, Financial Integration, Asia-Pacific Research and Training Network on Trade. Working Paper Series, No 53, March 2008. "The experience of the European Union shows that its trajectory towards SMP imposes stringent demands on the policy coordination and institution building, which would not have been possible without a strong "centre" (p. 19).

18 European Central Bank, Fiscal Anchoring and Uncertainty, Monthly Bulletin, September 2010, p. 83.

19 European Central Bank, ..., Monthly Bulletin, September 2010, p. 83.

Chapter 3

Complementary Areas of Concern

Whither the Multilateral Trading System? Implications for (South) Africa

Peter Draper *

1 Background

Most analysts of the World Trade Organization (WTO) and (discretely) many senior trade negotiators, agree that the Doha Round is not likely to conclude soon. That has serious implications for the multilateral trading system, as would the Round collapsing. Nonetheless, this briefing assumes a "Doha Light" outcome[1] at some point in the future, and speculates about where that would leave the WTO and the multilateral trading system. For the purposes of this briefing 'Doha lite' essentially refers to what is currently on the table and was nearly agreed to in the July 2008 modalities package, rather than a more ambitious outcome as certain developed country actors insist upon as a sine qua non in order to close the deal.

Two questions form the focus: What are the likely contours of the WTO beyond the Doha Round? What implications does that hold for developing countries – especially 'emerging middle powers'[2] like South Africa? I proceed by sketching the broad contours of economic and political change shaping the multilateral trading system, sketching implications for the WTO; and conclude with some thoughts regarding the implications of these changes for developing countries in Africa particularly.

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1 For the implications of such an outcome for South Africa, see Draper P. 'Towards Doha Lite? Consequences for South Africa', an electronic briefing to SAIIA members, 2007, June 19.

2 Schoeman distinguishes traditional (developed country) 'middle powers' from 'emerging middle powers'. The former are not regional hegemons, are developed, and historically have played bridging roles between the great powers (Canada and Australia are good examples) in international negotiations. The latter are major emerging markets that exert regional dominance if not hegemony. Schoeman, M. (2003) 'South Africa as an emerging middle power', in Daniel, J., Habib, A., and Southall, R. *State of the Nation: South Africa 2003-2004*. Cape Town: HSRC Press.

2 Economic drivers

The WTO's underlying difficulties have economic roots in the ongoing and far-reaching structural adjustment of global economic geography, specifically the shift of economic power from west to east. China's rapid export-oriented manufacturing ascent is central to this; compared to its "BRIC"[3] counterparts China is in a league of its own. Nonetheless, the "BI" component has major upside potential with India starting to have significant impact on some global markets especially in information technology, and Brazil in agriculture; beyond Russia's resource wealth its future presence in value-added activities is not obvious. These countries' emergence is transforming global power relations, and causing considerable anxiety mixed with anxious optimism both in the west and the developing world.

The global economic crisis has sharpened these tensions and in some parts of the world has strengthened the backlash against unilateral economic liberalization à la 'Washington Consensus'.[4] The crisis has also prompted calls for re-regulation of key economic sectors, notably finance, and has been accompanied by huge financial bailouts of some manufacturing sectors, especially automotive (for example the 'cash for clunkers' programme adopted in the United States (US)[5]. These policy measures closely followed the food crisis of 2008 which saw many countries resort to export taxes in order to retain domestic food supplies. The overall picture is one of an escalating pattern of protectionism[6] by no means confined to the developed world, encompassing inter alia 'buy local' government stimulus packages, tariff increases, and increasing resort to trade remedies.

Underpinning the protectionist impulse is the accumulation of huge global economic imbalances between chronic deficit and surplus countries and associated currency alignments. In a world of differing exchange rate regimes and potential financial deleveraging in the wake of the financial crisis the future of these imbalances is uncertain. Whilst the WTO cannot solve this problem – if any multilateral institution can it belongs squarely within the purview of the reju-

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3 Brazil, Russia, India, China – the famous acronym coined by Goldman Sachs.

4 Sally R. 'The Political Economy of Trade Liberalization: What Lessons for Reforms Today?' SAIIA Trade Policy Report, 18, 2007.

5 The Global Trade Alert database (accessed 20th January, 2011) lists 242 measures constituting 'bailouts or state aid' instituted since the crisis began. Clearly some of these may have their origins in pre-crisis dynamics, but the crisis has undoubtedly given rise to new measures.

6 See the collection of essays in Baldwin, R and Evenett, S. (2008) 'What world leaders must do to halt the spread of protectionism', VoxEU.org and CEPR.

venated International Monetary Fund (IMF) – the tensions it generates manifest in the trading system and raise sharp questions, particularly around exchange rate management and its impact on trade.

Global climate negotiations sharpen these underlying distributional conflicts. With growth and development imperatives at centre stage in the crisis, many in developed and developing countries alike are asking: who will pay the costs of mitigation? Will the developed world lead by example? What burden will major developing countries take on? These questions are underpinned by a 'competitiveness' agenda rooted in the underlying economic geography shift, which permeates the climate talks.

So far the WTO has acted as a constraint on the worst protectionist pressures building in the system, but the combination of those pressures with underlying shifts in economic geography has major implications for what countries will be prepared to concede in the context of multilateral negotiations in the future, and therefore for the shape of the multilateral trading system. Hence, global political changes already in motion prior to the crisis will be critical to how the multilateral trading system evolves.

3 Politics

Political leadership will be essential to manage the underlying economic adjustments. The first port of call still, and for the foreseeable future, is the US. However, the Obama Administration is confronted by a plethora of challenges, ranging from potential war(s) in the Middle East, through managing the economic crisis and financial regulation reform, to a complex domestic agenda. The US Administration faces capacity constraints of its own as its 'policy bandwidth' is severely stretched into the foreseeable future. Trade policy and negotiations are low on the radar screen. If and when the Administration does get around to trade policy it will encounter a hostile Congress exercised by a recent history of large current account deficits and a domestic manufacturing sector in relative decline. Furthermore, US elites' willingness to underwrite the costs of maintaining the post World War Two multilateral trading system is arguably diminishing in proportion to rising competitiveness concerns and diminishing corporate interest[7] in WTO negotiations. There-

7 Mattoo A. and Subramanian A. 'Multilateralism beyond Doha', Peterson Institute for International Economics, Working Paper Series, 8, 2008. There are divergent views on the extent of corporate interest in the Doha round; from the standpoint of many developing countries certain US corporate interests remain strongly connected to the negotiating process and broadly determinative of US government positions.

fore, it is difficult to foresee the US providing much leadership to the multilateral trading system in the absence of securing US preferences on a range of regulatory issues that may be anathema to many developing countries.

The European Union (EU) is not better placed to provide the necessary leadership. Whilst trade is a European Commission (EC) competency, the EU lacks the US's geopolitical clout. Like the US but more so it is hamstrung in the WTO by its unwillingness to substantially free up its agricultural markets, and relative lethargy on the part of corporate interests that stand to gain through opening up export markets for trade and investment. Unsurprisingly, the EU is looking to free trade agreements (FTAs) to buttress its commercial objectives.

The 'BICs' (Russia not being a WTO member) have major domestic development challenges of their own. As such they are not yet ready to play the kind of global leadership role the US traditionally has; at the same time they have a number of defensive concerns that mirror US and EU offensive interests. Those defensive concerns are echoed by a host of developing countries concerned with maintaining domestic 'policy space' especially concerning behind-the-border regulations. There may be a role for middle powers – emerging and developing alike – to assume leadership of the system and broker key compromises as the Colombian-Swiss led combine dubbed 'café au lait' did to launch the Uruguay round with the support of the Cairns group coalition of developed and developing agricultural exporters[8], but so far no such coalition has emerged.

Overall it appears that the current world of multilateral impasse on the trading front is likely to endure and potentially deepen if the US is not able to provide the necessary leadership.

4 Implications for the WTO: A case for plurilaterals

Taken together these developments imply convergence towards less ambition in WTO negotiations, paralleled by acceleration of regional and bilateral talks. This is likely to be accompanied by growing recourse to WTO dispute settlement to settle a probable escalation in disputes, particularly if the negotiating mechanism remains stalled. Hence multilateral forums outside of the WTO may gain in re-

8 Many veterans of the Uruguay round point to the importance of this coalition in reinvigorating the negotiating process leading to the actual launch of the Uruguay round in 1986 at Punta del Este. See the discussion in Kleen, P. (2008) 'So alike and yet so different: A comparison of the Uruguay Round and the Doha Round', European Centre for International Political Economy, *Jan Tumlir Policy Essays*, No.2, March.

lative importance as negotiating forums. Therefore, the WTO may be headed for a period of consolidation with the attendant risk of being increasingly bypassed by the major trading powers. This sharpens the gathering debate concerning how the WTO's membership arrives at decisions both now and in the future.

The WTO negotiating mechanism's prospects lie substantially in plurilateral agreements negotiated by like-minded subsets of WTO members.[9] This would be consistent with the current WTO practice of allowing multiple distinctions amongst members, including several extant plurilateral codes, and would have the added benefit of allowing the major trading powers – developed and emerging – to deepen rules in issues of core interest to them and avoiding the blocking power of the broader membership. This offers the prospect of reviving the WTO's negotiating mechanism, but for this approach to work it has to be contingent on not harming the interests of the broader membership. Therefore, it would be necessary to negotiate a 'code of principles' to govern plurilateral accords; such a code could reassure many developing countries that are nervous of having plurilateral agreements foisted upon them and could include, inter alia:[10]

1. that membership is voluntary;
2. the subject of the plurilateral is a core trade-related issue;
3. that those participating in plurilateral negotiations should have the means, or be provided the means as part of the agreement, to implement the outcomes;
4. the issue under negotiation should enjoy substantial support from the WTO's membership;
5. the 'subsidiarity' principle should apply in order to minimize intrusion of club-rules into national autonomy.

Flowing from these principles plurilateral codes should also be governed by a set of rules. These could include, inter alia, the following:

1. Only parties to the agreement could participate in WTO dispute settlement and, flowing from this, cross-agreement retaliation should not be allowed since it would reduce the incentives to join the agreement;

9 Khumalo N. 'Looking beyond the Doha round: Reforming the WTO negotiating process', SAIIA Policy Briefing, 4, 2009.

10 This discussion is based on the paper developed by the World Economic Forum's Global Agenda Council on Trade, in which the author participated. Global Agenda Council on Trade (2010) 'A Plurilateral 'Club-of-Clubs' Approach to World Trade Organization Reform and New Issues', *World Economic Forum*, mimeo.

2. Any WTO member could participate in the negotiations on a voluntary basis subject to demonstrating sufficient capacity to implement the outcomes, whether at the outset or through support extended by other negotiating group members;
3. Provision of benefits to non-members should not be required since that would reduce the incentives to negotiate the plurilateral, but could be allowed.

Two obvious and linked dangers are that a small group of developed country members negotiates an agreement that sets the bar so high that poorer WTO members are unable to join; and that the plurilateral(s) – as happened to the Tokyo codes in the Uruguay Round – are subsequently multilateralised in later negotiating rounds via the single-undertaking. These are powerful objections and developing countries in particular need to take them seriously.

The first problem would be minimized through active participation of developing countries in negotiating the codes, especially emerging middle powers. Since they are active participants in economic globalization they also have a strong interest in defining the rules that govern it, and therefore are likely to do so. Furthermore, they have learned from the Uruguay round experience and are unlikely to simply accept agreements being foisted upon them in the context of a single undertaking – nor indeed would the majority of developing countries – as they demonstrated during the Cancun ministerial in 2003. Nevertheless, the price of policy space is eternal vigilance.

Another potential problem is that the codes would reduce the need for a single undertaking, with consequent reduction of possibilities for cross-issue trade-offs. To take one practical potential consequence, developed countries could simply ignore demands for agriculture policy reform whilst forging ahead with a code on competition policy. In this scenario the reforms to developed country agricultural policy regimes which many developing countries are pushing for may simply never make it onto the agenda.

The obvious riposte is that cross-issue trade-offs can still occur in the absence of a single undertaking. Emerging middle powers with substantial markets could withhold participation in plurilaterals in return for developed country participation in agriculture negotiations, for example. Emerging middle powers could also contemplate launching their own plurilateral negotiations, impelling developed countries to participate. This logic could even propel the membership towards the single-undertaking approach, thus obviating the need for plurilaterals altogether. In this scenario, initiating plurilaterals provides the spark to reignite the WTO's negotiating mechanism.

So what issues could form the basis for an emerging set of plurilateral agreements? Two seem particularly obvious and are underpinned by dynamics emerging from the financial crisis: transparency in government procurement, and financial services. The former is already covered by a plurilateral code, so the key issue is to expand the agreement to major non-signatory trading powers especially emerging markets (including South Africa), and deepen it, on terms agreeable to potential signatories. Financial services are covered by the General Agreement on Trade in Services and its ensuing market access commitments are extended unilaterally on a country-specific basis. In the wake of the financial crisis and the many regulatory interventions agreed by G20 Leaders, it may be sensible to build a WTO agenda around the work of the Financial Stability Board and IMF.

A third plurilateral agreement seems theoretically plausible, if politically fraught: investment. Since a core group of emerging market countries are now actively engaging in outward foreign direct investment (FDI) as well as being recipients of FDI, their interest in multilateral investment rules may be converging with established investors in the developed world. Underpinning this is the escalation in investment nationalism in recent years, associated with national security considerations and resource, especially food and energy, security. Even poor developing countries in Africa have an interest in enforceable multilateral disciplines provided the right balance is struck between investor obligations and rights, and host nation policy space. Whether this could be translated into a plurilateral investment code is an entirely different matter, as would be its relationship to the 1,500 or so bilateral investment treaties, but one that should not be lightly dismissed.

Beyond plurilaterals there are at least two other issues that will require attention, although it is likely these would have to ultimately be negotiated across the entire membership: environment and exchange rates. The former is managed through a host of multilateral environmental agreements, some of which have trade implications. The big picture item is the UNFCCC process and the competitiveness agenda cited above. But the Doha round also has a process underway to liberalize trade in environmental goods and services, which could be harnessed into a plurilateral agreement as an 'early harvest' of the Doha round.

Exchange rates are much trickier, and fall under the purview of the IMF. The main protagonists are those large economies practicing flexible exchange rate regimes, particularly the US, EU, Brazil, and South Africa; and those pegging or closely managing their exchange rate regimes – principally East Asian countries and especially China. The IMF lacks an enforcement mechanism and must rely

on the consent of its powerful members, who lie at the centre of the issue. Hence the WTO, with its dispute settlement mechanism, is regarded as attractive by some within the flexible exchange rate regimes 'zone'. The danger with introducing such a matter into the WTO is that it could overload the system since a case would essentially revolve around currency management and monetary policies – not exactly traditional territory for the WTO.

5 Implications for South Africa

To summarise: a number of core issues concerning global trade should move into plurilateral negotiations within the WTO, or they will move to similar groupings in forums outside of the WTO. It is likely that the negotiating capacities of all countries will be increasingly stretched, but particularly for our purposes those emerging middle powers like South Africa that potentially will be invited to the high table. Since South Africa in particular is viewed, and to some extent sees it-self, as "representing" African interests, the degree of negotiating stretch will extend further than narrow national self interest since the majority of poor (African) countries cannot engage across this widening front.

Furthermore, as recent dynamics in the G 20 Leaders Forum attest, South Africa is increasingly likely to find that the BRICs share more in common with each other in the geopolitical sense than they do with South Africa (which is patently not a BRIC).[11] Therefore, coalitional possibilities will become increasingly important, and particularly those with other 'middle powers' and 'emerging middle powers' on specific issues. The nature of those coalitional possibilities will be grounded in South African economic policy realities and trajectories, which to some extent still have to be defined in the Zuma Administration.

Consequently, the South African government needs to identify its core priorities in this connected set of trade-related negotiations and organize its negotiating resources accordingly. The first step should be to settle the issues concerning who is in overall charge of economic policy within government and on that basis build appropriate intra-government forums to coordinate negotiating positions, and allocate responsibilities amongst departments accordingly. The next step should be to stake out negotiating positions on each of the potential plurilateral negotiating issues identified above, and to secure agreement on such issues within the intra-government structures established to coordinate positions. On this basis, dialogue

11 Draper P. "SA must push G20 to carry out its broader reform agenda", Business Report, 22 September, 2009.

with other African states on this agenda would be more focused and should be the next step. Finally, alliances with like-minded middle powers and emerging middle powers should be pursued on the basis of this set of consultations, whilst not ruling out potential alliances with the BRICs and indeed with the developed world should their negotiating positions converge with ours. In short, South Africa needs to move towards a proactive mode of anticipating future negotiating issues.

Macroeconomic Policy Challenges in China

Sun Jie*

In the past twenty years, China's economic growth was greatly promoted by investment and external demand. Even though the share of net exports in GDP is low, the total trade dependency (the ratio of total import and export to GDP) keeps increasing to a high level among major economies in the world. Given the growth model and facing the impact of the global financial crisis in 2008, the macroeconomic policy challenges to China are severe.

1 Policy priority on growth: The shift from external demand to domestic investment

Compared to other major economies, the growth rate of the Chinese economy was kept positive during crisis period, and the financial market is also stable in terms of TED spread[1]; we calculate the "TED" spread of China as the difference between the interest rates on three-month interbank loans (Shibor) and the interest rates of three-month government bill. However, the impact of the crisis on exports is obviously since China's export is highly related with the US import. As a result of the export shrink, trade dependence of China decreased sharply. The contribution of net export to GDP growth became negative in 2009 (figure 1 and figure 2). It is the first time that external demand reduces Chinese growth in the past twenty years.

It is no doubt that there exist a lot of potential threats to the sustainable growth of the Chinese economy like non-performing loans, sluggish domestic consumption, over-investment, income distribution, social security, contingent government debt and so on. From China's macroeconomic policy experiences, we could find that the first policy priority would be maintaining growth rate. It might be reasonable that those above mentioned issues could be possibly solved by growth

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1 The TED spread is the difference between the three months T-bill interest rate and three months London interbank offered rate (LIBOR).

in the long run, at least their deteriorations be postponed at present time. This kind of policy reaction can be seen again in 2009. The policy goal was firmly set on maintaining 8 per cent growth rate.

Despite net exports' negative contribution to GDP growth, the intensive investment became a dominant factor in growth when domestic consumption made little change. In fact, even though the importance of domestic consumption for a sustainable growth is quite clear among Chinese economists, the low consumption or high saving is hardly to be changed overnight. The booming of investment is supported by easing policy and bank loans. Most of those investment projects are policy oriented, mainly on infrastructure. Of the total 4000 billion RMB investment scheme, only 1290 billion RMB will be supported by the central government, and the rest amount will be provided by local governments, mainly supported by bank loans. Leading investment by state budget increased only for a very short time at very high growth and was soon followed by huge bank loan investment, much more than 2710 billion RMB.

We can find evidence from the data of extended bank loans (figure 3). On the one hand, in the period from November 2008 to May 2009, the loans extended to non-financial corporations and other sectors increased sharply, but later, the growth returned back to its normal rate. This indicates that the expansion might have reached its ceiling. Some research within the framework of the total factor productivity (TFP) analysis show that the efficiency of infrastructure investment in coastal areas has reached its marginal level, equivalent to the efficiency of non-infrastructure investment countrywide. On the other hand, the loans extended to the resident's sector consecutively grew at a higher rate by comparison to the past. Except for the car loans, most of the resident loans are mortgage loans which were boomed by the prosperity of real estate sector and the shift of bank business from corporate to resident.

2 Easing policy and overhang inflation/bubble

Expansion policies are key factors to maintain the growth rate in the short term, but their side effects cannot be neglected in mid and long term. If the fiscal pressure mainly on local governments and the possible non-performing loans generated from the rapid growth of the extended bank loans might be seen in the near future, the easing of monetary policy and the soaring high real estate price means that an incoming inflation or a bubble might be present immediately (figure 4).

Considering that the Chinese economy can be regarded as a bank based economy, the monthly incremental bank loans can be regarded as a key indicator of the expansion policy. As a result of bank loan expansion, M1 and M2 grew simultaneously. It should be mentioned here that the M1 grew faster and longer than M2, which may indicate that firm's business is more active since the definition of M1 in China includes corporate deposit only on the basis of M0. However, both peaks of the M1 and M2 growth rate have exceeded their peak in 2007 which was followed by inflation in 2008.

The inflation in 2008 also incorporated the soaring high primary commodity price on world market. Because the Chinese economy highly depends on imported energy, the soaring high primary commodity prices on the world market can quickly transmit into the domestic price level in China. This might be the reason why a headline CPI index is enough in China rather than to be supplemented by a core CPI index. In regards to the price increase on global primary commodity markets, the present situation might be quite similar to the situation in 2007-2008, but with a higher monetary growth. An incoming inflation might be overhung.

There is no doubt that the real estate boom in recent years contributed a lot to GDP growth in China, especially when the leading state budget investment decreased. However, the real estate price index was highly correlated with CPI index in the past ten years. Even though government policy has been focused on the containment of the possible bubble in real estate in the past half year, the real estate price is still at a high level and might also suggest an incoming inflation.

We can find from the negative real interest rate, the low Shibor rate and the neutral sterilization effect of central bank bill on monetary base in China that the easing policy still keeps on at present time (figure 4).

3 Exchange rate reform and its effect on growth

A global empirical study shows that the exchange rate can hardly be regarded as a key factor of determining the balance of payment. In fact, the booming of China's trade surplus began from 2005 when the RMB initiated the appreciation process (figure 5). The non-deliverable forward contracts (NDF) also indicate that the room for RMB appreciation is limited. The exchange market pressure of RMB against the US dollar estimation suggests that the RMB appreciation pressure is not very intensive.

The RMB exchange rate reform is the thing that the Chinese government is conducting right now, focusing mainly on the needs of the domestic development, including the promotion of international competitiveness by technology progress rather than undervalued exchange rates, shifting from export oriented growth to domestic demand, upgrading the productivity, and of course, making effort towards global rebalance. However, a gradual and prudent approach, a key element of the Beijing Consensus, might be necessary.

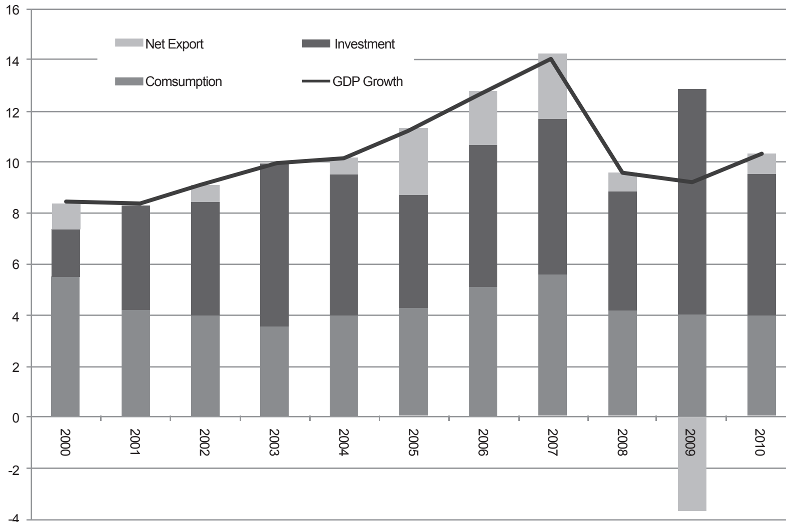
4 Conclusions and suggestions

1.) **The need for international policy coordination**
China's macroeconomic policy is now at the cross-road. The international setting comprises many uncertainties in terms of stimulus exit timing, trade relation, worldwide inflation and possible sovereign debt crisis and will make the challenge much tougher.

2.) **The transformation of economic growth takes time and a long lasting policy effort**
Shift from investment and export orientation to a more sustainable domestic consumption oriented growth is a tough task in the long run, but something needs to be done right now. The exchange rate reform might be a starting point.

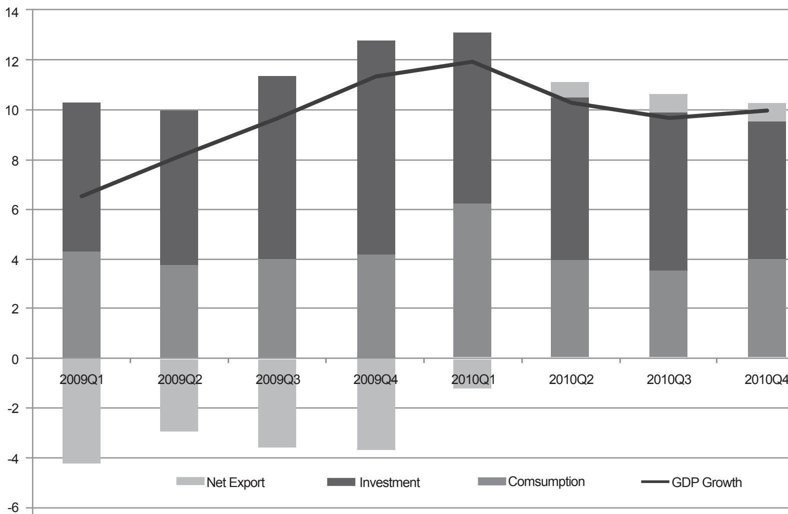
3.) **Prudent policy change**
The exit from the stimulus scheme depends on endogenous growth by private consumption and investment. Stimulation by quantitative easing should be prefered to quantitative tightening: policy exit needs to be cautious, especially for some irreversible policies like the interest rate and appreciation of the exchange rate. However, industrial policy (pointing to the real estate sector) and quantitative tightening policy (central bank bill and reserve requirement) might be the first steps to take.

Figure 1:
Investment: Key to Growth Since the Crisis (annual data)



Source: Data obtained from www.ceicdata.com.

Figure 2:
Investment: Key to Growth Since the Crisis (quarterly data)

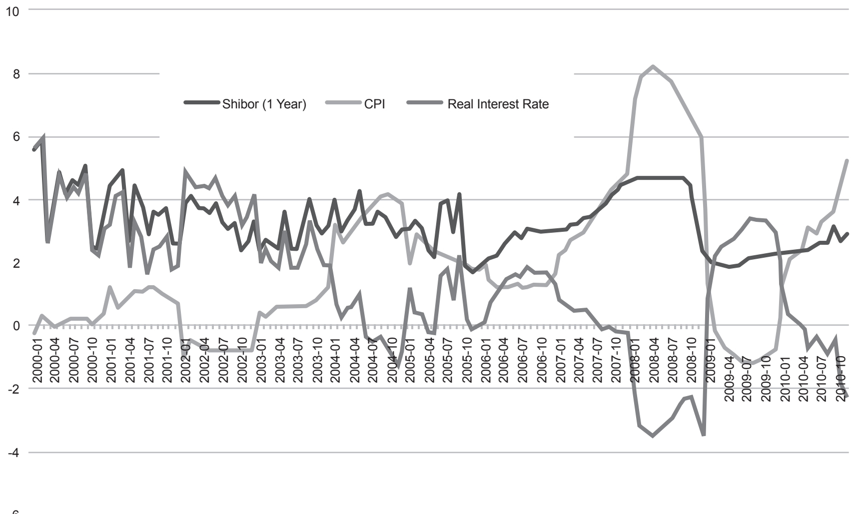


Source: Data obtained from www.ceicdata.com.

Figure 3: Bank Loans Growth by Sector in China
(change to the same period of the pervious year)

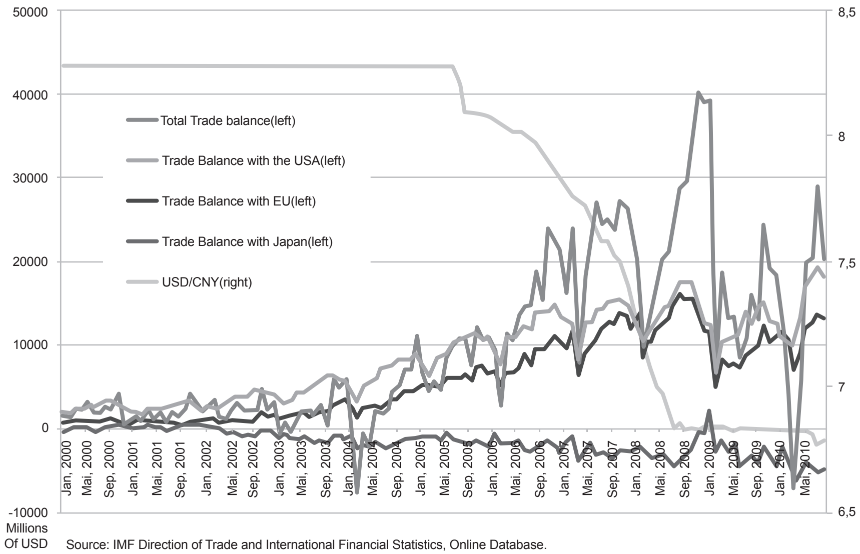
Source: Calculated by data from the website of People's Bank of China.

Figure 4: Possibility of Monetary tight: Real Interest Rate



Source: Monthly Shibor calculated by daily data from www.shibor.org and CPI obtained from http://db.CEI.gov.cn

Figure 5: RMB Exchange Rate and Trade Balance



Source: IMF Direction of Trade and International Financial Statistics, Online Database.

Financial Education, Financial Inclusion and Consumer Protection: The Relevance for the Financial System in Mexico

Germán Saldívar Osorio and
María Antonieta Paz Rotunno*

1 Introduction

A well-functioning financial system is a necessary prerequisite for the long-term growth of an economy. Against this background, we base our opinion on the idea that financial education and inclusion, and the protection of users of financial services are necessary axes, both for the growth and good functioning of the financial system which, in turn, is a very important component in achieving sustainable economic growth. Mexico does not constitute an exception to this rule and the approach reflected in this document is based on this logical condition.

In our opinion, there are three issues to be dealt with which consolidate confidence in the financial system and, despite the fact that each single issue is of great relevance, all three are complementary to one another and must be well aligned and balanced in order to actually work as development axes for the financial system.

In this document, we outline the reasons supporting the approach that these three concepts are to be considered as development axes for the Mexican financial system; secondly, we introduce some of the most relevant aspects in connection with financial education and inclusion, as well as the protection of users of financial services. Finally, we describe how these issues interact with each other and why we think they must be a priority for the authority's regulatory and supervisory

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activities. On the basis of this, we then consider why they are necessary to consolidate confidence in the financial system.

2 Why should these three concepts be considered development axes of the Mexican financial system

This approach is, on the one hand, a logical consequence of the evolution of the Mexican financial system itself and, on the other hand, it results from the interaction that exists between these three axes in the light of international trends.

2.1 Background

To understand the case of Mexico, it is important to remember some recent historical events, because it was exactly these events that made it necessary to make important changes, leading to remarkable results.

Following the crisis in 1995, the recovery of the collapsed financial system required legal reforms as well as the implementation of several measures aimed at strengthening the solvency of the financial institutions in order to create the mechanisms which favoured mainly commercial banks obtaining reasonable levels of capitalisation to cope with difficult situations. The latter was in line with the agreements adopted on an international level and also in accordance with international best practices.

Accordingly, mitigation of risks and prudential mechanisms were implemented, not only to identify cases early on where banks showed significant financial problems and negative trends, but also to establish control mechanisms to prevent any further deterioration.

Changes were made to increase access to financial services and achieve better access to formal financial services for a greater part of the population. In the non-banking sector, a series of many and varying types of financial institutions were created to provide financial services to the general public and focus on different segments of the population. This has led to a remarkable increase in competition in recent years.

After the financial system had reached a minimum degree of maturity, in particular with respect to its solvency, it was envisaged to extend the regulation and supervision framework focusing on the penetration, modernisation and expansion of this system in order to achieve growth in the financial system, and to make

it stronger and increasingly comparable to those mature financial systems that support the most important economies in the world. Given the latter, it was also considered necessary to amend the legal framework with the aim of improving the position of users of financial services vis-à-vis the institutions that offer such services. In consequence, the protection scheme for users was improved.

As far as savings are concerned, the measures to achieve increased levels of financial inclusion, sufficient measures to protect the user and to ensure that users receive an adequate financial education are necessary.

2.2 Mexico's situation at international level

Another aspect which also spoke in favour of this seminar's approach was that, according to a World Bank study from the year 2004, financial penetration rates and access to banking in Mexico were very low: i.e. around 40 per cent in some cases and 25 per cent in others. The analysis reflected from various angles that the Mexican financial system was very limited, both compared to the financial systems of the major economies, and of countries in the same region as Mexico or of countries with more or less similar or even smaller economies; the results, however, were very poor in all aspects. Some of the main criteria taken into account for said analysis were the number of branches per 1000 inhabitants, the number of terminals (ATM), system assets versus GDP, etc.

In order to achieve a model in Mexico that resembles those system models that could serve as role models, i.e. which support robust financial systems, the comparative analysis of the model which protects the user of financial services led to the conclusion that it was necessary to strengthen the agency for that purpose, and guarantee a minimum of rights and a protection mechanisms to the users of financial institutions.

In addition, in light of best international practices and recommendations (mainly from the Organisation for Economic Cooperation and Development: OECD), all that has been said above necessarily implied that the financial education scheme had to be strengthened.

As part of the process for identifying the policies needed to achieve these objectives, the Conference on Financial Education, Protection of Users of Financial Services and Competition took place in Querétaro in July 2008. It was organised by the Ministry of Finance and Public Credit, the Senate and the OECD. The aim of this conference was to establish a high-level dialogue, focusing on best

practices implemented at international level regarding financial education, the protection of the users of financial services and competition.

With the assistance of international experts and an audience at the highest level of regulatory and supervisory authorities – Senators, leading representatives from the finance industry and other policy makers, all of them with decision-making capacity – it was possible at this conference to define not only a regulatory agenda for the protection of users of financial services and for transparency, but also to engage in designing a national strategy for financial education. This was the basis for passing a number of reforms regarding these issues in both chambers of Congress in a very short period of time.

2.3 Major reforms

If we take a quick glance at the reforms that have been adopted in recent times, we see that the regulations relating to the transparency and the protection and defence of the users of financial services have experienced a development involving many changes ranging from the creation of general laws to very detailed regulations that regulate specific operations which, before they were regulated in the conventional practice of the financial institutions, were applied in many cases to the detriment of users.
If we consider the demand for financial services, the most important reforms have focused on transparency. Actions implemented in Mexico have mainly dealt with:

- Standardized service products at low cost;
- Disclosure rules for monthly statements, and for credit products, including mortgages, the total annual cost (CAT) was implemented, which makes comparable the costs of equivalent products or services.

With respect to the protection of users of financial services, the following was established:

- Regulation for contracting financial services;
- Reinforcement of sanctions and establishment of minimum rights for consumers and users of financial services.

These reforms have not only been aimed at providing access for a higher number of users, but they have also sought to guarantee greater judicial certainty to all parties involved and to provide better protection for the users of financial services. The model promotes competition and allows optimum efficiency of the system.

3 Relevant aspects with respect to financial education and inclusion and the protection of users of financial services

3.1 Financial education

Currently, financial education has become one of the main priorities of the ministries of treasury and finance around the world, mainly because of the impact it has on individuals and nations. We believe it is essential that individuals in all societies are aware of and have a minimum of knowledge about financial and economic issues, otherwise they will be more exposed to financial risks and non-rational choices at the expense of their financial wellbeing.

It is necessary for individuals to acquire economic and financial knowledge from an early age so they can fully understand the basic concepts necessary for the use of financial services such as money, savings and investment. Our goal is for consumers of financial services to be informed and literate, i.e. they are able to compare instead of picking at random, are able to make informed decisions, choose the best option and detect attempts at abuse.

In order to address financial education, we must consider that users of financial services need access to more information and must acquire a better understanding of basic financial aspects, and that they must also develop the ability to evaluate products and services enabling them to make decisions in a national and well-informed manner, and, on the other hand, to acquire the level of awareness needed to recognise what future aspects have to be considered in the present, from a financial point of view, in order to meet future financial needs.

An educated nation is a prosperous nation. If families work and spend responsibly, we are all participating in the construction of a dynamic economy, and we will enjoy the benefits of living in a stronger Mexico. If we want to be a prosperous country, we must all actively participate in the generation of that wealth. In fact, financial education is a key tool to ensure the economic development of our country.

It is very important that financial education contributes to the development of vigilant citizens with a critical sense and ample information to ask relevant questions. There is an urgent need to educate and instruct individuals on issues such as spending, saving, investing, borrowing and debt management, all of these based on education and national decision-making. The Ministry of Finance and Public Credit is aware of these issues at the different socio-economic levels in Mexico, and of the positive impact these issues will have on the economic and financial stability of all Mexicans.

Globalisation and technological innovation have paved the way for the development of increasingly complex financial products and services. This means that the users of financial services must acquire an ever higher level of financial education to understand and manage these products and services. This higher level of financial knowledge must not only include knowledge of basic aspects, the user must also develop the ability to perform a qualitative and quantitative evaluation of products and services in order to be able to make well-informed decisions.

Financial education is the process by which users of financial services, from savers at a microfinance institution to investors at the stock exchange, develop their understanding of concepts, products and financial services. This financial education should be consistent and not an isolated process, since each individual develops throughout the different stages of life. Therefore, s/he needs corresponding financial education to make well-informed decisions which become ever more complex with additional factors to consider such as the estimated age of retirement, the assets one wants to acquire, etc.

However, this education not only allows the consumer to become a confident decision-maker, it should also be considered as a preventive measure to reduce controversies between financial institutions and consumers, regardless of the communication channels or products and services concerned. In this sense, financial education effectively contributes to reducing market failures by providing the following advantages:

- An improvement in the performance of institutions due to more responsible and informed customers who demand products, services and attention of a higher quality.
- A reduction in information asymmetry, as the customer generates an exchange of higher quality information with financial institutions and vice versa.
- Customers demand services tailored to their needs and financial intermediaries have a better understanding of customers' needs, leading to a wider range of innovative financial products and services.
- A mitigation of the lack of knowledge and misperceptions, which generates confidence.

The various financial education programmes that have been implemented in Mexico by the different levels of government are based on different considerations, depending on the service sector and the characteristics of the customers concerned.

As a first step, the type of education to be promoted is established, depending on whether it is aimed at a particular product or service (budget, savings or credit), or if it is a general approach. Secondly, the financial education programmes are evaluated, both regarding their impact on increasing financial skills and their effectiveness, i.e. whether the benefits of the programme outweigh the costs of it. Thirdly, financial literature is promoted as a source of adequate information and point of support for education.

As will be discussed in the following, penetration of financial services is still low in Mexico. The lack of adequate financial education is considered to be one of the reasons for that. To address this problem and to achieve the benefits of financial education which have been referred to, the Mexican Government has implemented two important actions.

The first was to carry out a comprehensive assessment of the penetration of and knowledge about financial services in Mexico in 2007. The second was to implement a set of complementary actions regarding financial education.

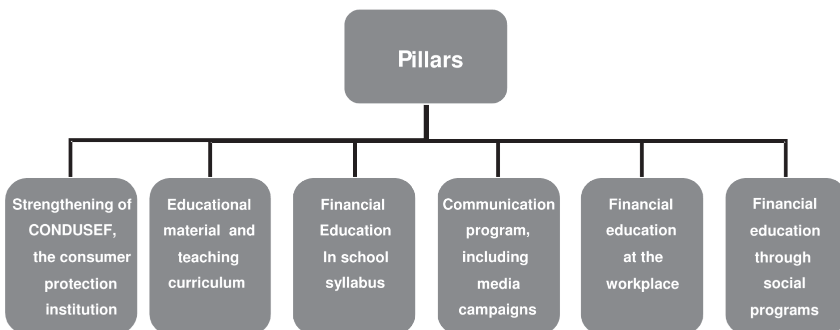
3.2 Comprehensive survey

The survey made by the Ministry of Finance and Public Credit wanted to understand how people perceive financial institutions, services and education in Mexico. This was accompanied by a national assessment on the penetration of and knowledge about financial services. The objectives were i) to quantify the penetration of products and services offered by financial institutions, ii) to ascertain the level of knowledge and understanding of the population about financial products and services available on the market, and iii) to ascertain people's information needs in this field.

The assessment results show that those in the population without access to financial services are those from the lowest socio-economic status, those with lower levels of education and those in rural areas of the country. In this sense, financial misinformation among people with little financial culture leads to a vicious cycle of misinformation and ignorance that reinforces generalisations about the financial system, its products and services.

3.3. Complementary actions regarding financial education

As part of the National Strategy for Financial Literacy, the Federal Government has implemented various measures in the area of financial education.
The National Strategy is based on six pillars:



Particularly, the following institutions are involved in the strategy: the Bank for National Savings and Financial Services, S.N.C. (BANSEFI), the National Commission for the Protection and Defence of Users of Financial Services (CONDUSEF), the Bank of Mexico (BANXICO), the Interactive Museum for Economics (MIDE), the National Programme for the Financing of Microentrepreneurs (PRONAFIM), the Federal Mortgage Society (SHF) and the National Housing Fund for Workers (INFONAVIT).

This strategy sought to define a framework to increase coverage so that all segments of the population could be reached. It also aimed to improve the coordination between supervisors, regulators, the private sector and other stakeholders.

The strategy assumes that financial education is a public good. It is also intended for people to change their spending and saving habits through financial education.

Everybody is addressed, i.e. children, when they open their first savings accounts; teenagers who already have savings accounts and probably their first cell phone, meaning they may use mobile banking services; adolescents who may have, in addition to their savings accounts, their first credit card, their first job, their first car; adults who may have their first home, or are organising their pension scheme, investment activities or vacation; and senior citizens, because they have to repay their mortgage and may want to finance hobbies, holidays and certainly pension savings.

Against this background, a media campaign was initiated. The advertising campaign on a national level covered advice to the entire population on the use of financial services. The first stage of the campaign focused on the use of credit cards, aimed at informing people about the advantages of having credit and to care about their debt level. The campaign also reinforced the image of CONDUSEF, aiming at people knowing and consulting this institution such as people currently consult the Federal Consumers Protection Office (PROFECO).

Finally, there was a strategic alliance with MIDE allowing CONDUSEF to organise a travelling exhibition to present itself at various places on the countryside. The exhibition aimed at demonstrating to children, adolescents and adults the concepts of credit, savings and insurance that are relevant at different stages of life.

3.4 Financial inclusion

As far as financial inclusion is concerned, it is necessary to ensure that a large number of users can benefit from the financial system. In countries like Mexico, it is important to recognise that financial inclusion requires the development of financial services adapted to customers' needs and that having customers involved can help alleviate poverty, contribute to social justice and allow for a better quality of life. Additionally, these services have the potential to contribute to stability, economic growth and market development.

At the present time, approximately 60 per cent of the Mexican population is using a financial service. Progress has been made in increasing the range of products and services and in generating a greater demand for them. The increase in the demand for financial services has boosted competition, improved terms benefited customers regarding costs and has extended the range of services offered by financial institutions.

However, efforts to achieve a situation in which all segments of the population may access these services should continue, always accompanied by permanent efforts to provide customers with more and better knowledge of financial services so they can take the best possible advantage of these by making informed decisions.

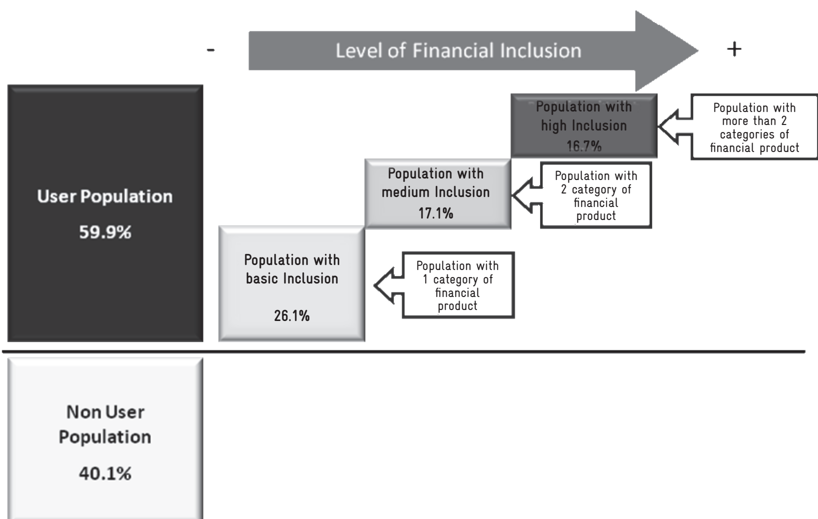
Several international organisations have defined financial inclusion as when population has access to and the possibility to use a range of financial products and services. We are taking this concept as the basis to identify the following three key issues: what is the level of financial inclusion in Mexico, what barriers prevent such inclusion and how to improve the measures taken to foster it.

3.5 Level of financial inclusion

To know the level of financial inclusion in Mexico, the SHCP conducted a National Survey on the Usage of Financial Services in April 2009.

	Percentage of respondents
• Population using a financial service in 2009	59.9
• The most-widely used financial tool is payroll payment	36.0
• The best-known financial products are credit cards	25.9
• Friends and relatives are the most-widely used source of financing for those not using any financial service	61.4

Of the 60 per cent of the population using a financial service in 2009, 53 per cent were clients of a financial institution, not taking into account Mexican Pension Funds (AFORES). As can be seen in the chart below, most of financial customers remain at a basic level of inclusion, despite the fact that the levels of financial inclusion have increased.



Category	Deposits	Loans	Insurance	AFORE	Others
Products	Savings account: checking account, debit card or payroll account	Credit card; mortgage, car loan, personal or payroll credit	Insurance contracted by customer, insurance contracted by a third party	AFORE	Investment funds, Internet banking

Source: Presentation by the Ministry of Finance and Public Credit entitled *Mobile Banking Model, Regulatory Policy to Increase the Financial Inclusion in Mexico*. February 2010.

In order to determine the level of financial inclusion, different profiles were analysed which were then classified according to the quantity and complexity of the financial services received by the customer. The challenge is to encourage the customer transition to the next level.

Level of Inclusion	Services contracted	Mexican Population in per cent
Advance	Deposits, Afore and Loans,	16.7
Medium	Deposits and Afore	17.1
Basic	Deposits	26.1
Non user	None	40.1

Source: Presentation by the MInistry of Finance and Public Credit entitled *Perspectivas de inclusión financiera en México y necesidades de estudios para su fomento*. November 6th 2009.

Accordingly, it is necessary to develop strategies which encourage the migration of customers to the next level of financial inclusion. To achieve this, it is necessary to develop financial products and services in line with the customer's characteristics so that the customer perceives the transition as conceivable.

Level of Inclusion	Product and Financial Services' Characteristics
Advance	The customer will require legal certainty, transparency and competitive products and services.
Medium	It will be necessary to foster a complementary relationship between de customer and the financial institution with an additional product like insurance.
Basic	Credit products must be accessible through simple requirements and procedure, in addition to financial education.

Source: Presentation by the Ministry of Finance and Public Credit entitled *Perspectivas de inclusión financiera en México y necesidades de estudios para su fomento*. November 6th 2009.

3.6 Barriers that prevent financial inclusion

As far as barriers to financial inclusion are concerned, the Financial Inclusion Report 2010 by the National Banking and Securities Commission states that there is a dichotomy in inclusion barriers to financial to inclusion: firstly, they must be identified, and secondly, they must be quantified. The first aspect allows for the implementation of policies to mitigate the barriers and the second, may help understand the magnitude of the obstacles with the help of studies.

With respect to the first issue, it should be noted that the existence of barriers leads to voluntary and involuntary financial exclusion. Within voluntary exclusion, there are those people who do not have adequate financial education and those without the need for financial goods or services. With respect to the involuntary exclusion, on the other hand, we have people who do not have enough income, or are physically far away from a financial outlet, do not have the necessary documentation or are excluded by the high costs of financial products or services.

After identifying the barriers, it is necessary to ascertain their scope to be able to implement appropriate public policies, either through financial education which would help to integrate non-users. Similarly, it is necessary to encourage the use of new technologies to promote dynamism in the financial system, expand the supply of financial products and services and improve the regulatory framework applicable to suppliers.

The work undertaken by the federal government in terms of financial education has already been pointed out, in a complementary manner, the SHCP, however, has been working on a series of actions focused on two aspects: a) extending the range of products and services (increase and enhance the banking infrastructure), and b) generating a greater demand for financial products and services (inform, educate and protect customers).

To extend the range of financial products and services, the limited license bank's and bank commercial outlets were incorporated in the legal framework in order to broaden the channels for the supply of financial services, to promote the establishment of more competitors and to increase competition in the banking system.

As far as the demand for financial products and services is concerned, more precise parameters were established on issues like transparency in fees charged by financial intermediaries, rules to disclose more accurately the costs associated with financial services clarity of account statements. It was also introduced the obligation for banks to offer a basic deposit banking product.

It is noteworthy that, at the level of the legal framework, the reforms necessary to increase financial inclusion have recently been implemented. For this reason, it is necessary to wait for the market to respond in order to be able to evaluate the effectiveness of the reforms. Nevertheless, continued work must be done on the following:

- Measures that seek to encourage the use of financial products through basic deposit banking products with simple and easy to understand terms for those people who haven't used yet any financial products.
- Measures that seek to promote the use of more financial products through basic credit products that are simple to understand and give certainty for the segment of the population which has a basic level of inclusion and mostly use deposit banking products.
- Implementation of the strategy for financial education in the medium and long term to encourage all segments of the population to use financial services responsibly and for their benefit through a greater understanding and comprehension of them. This strategy includes developing the skills necessary to obtain objective and reliable financial information, to properly judge said information and to make responsible informed decisions. The concepts that form the foundation of this strategy are "Budget" and "Risk." The aim of these concepts is not to exclude any segment of the population and to cover all financial products and services.
- Create flexible financial communication tools whose contents take into consideration the needs and interests of different segments of the population.
- Contemplate a constant feedback system, as well as the benefits and coordination of efforts of various public and private agents.

These actions will generate a greater inclusion of financial services, with the following benefits:

- Development of a broader range of financial products and services (savings, credit, means of payment, insurance, etc., among others),
- Creation of competitive market conditions,
- Provision of a legal and regulatory framework that gives certainty and security to customers, and
- Solve the financial needs of the population.

To the extent that financial inclusion has a positive effect on the economic development of the country, the actions outlined will have a positive and definite effect in promoting such development:

- Underbanked customers
- How to leverage broader initiatives
- Potential consumer

3.7 Customer protection

With regard to customer protection, one must bear in mind that state intervention is necessary to create adequate conditions, define and implement the legal framework and compliance by financial institutions to ensure effective consumer protection.

It is common that consumers do not have the tools necessary to make informed decisions. The foregoing results, among other things, in an increase in overdue payments and high debt levels. This problem has grown because, due to development and innovation of highly complex products and services due to new technology financial innovation that are easily accessible to the population with little financial education. Additionally, in most cases these kinds of customers do not have sufficient information to understand responsibilities, risks and rights.

Therefore, protecting customers is an issue of great importance for international organizations like the OECD. The OECD particularly has issued guidelines for authorities, financial institutions, intermediaries, other credit institutions and interest groups.

The European Union meanwhile sets minimum standards regarding customer protection. These are based on two principles: to provide adequate, accurate and complete information to customers in adhesion contracts and statements of accounts, as well as to warn the user of the risks in case of overdue payments or over-indebtedness.

In general, the best practices established at international level are aimed at ensuring access and exchange of information as well as promoting the dissemination of information about rights, obligations and risks inherent in financial services and products. In this sense, focus is placed on encouraging the establishment of regulation that ensures compliance of financial institutions, transparency of information and consumer protection. The latter promotes symmetric information and market efficiency.

In the opinion of the Finance Ministry, information, transparency and competition are essential tools. Regarding transparency, understood as an indispensable pre-

requisite for the proper functioning of the financial system, it is important to mention that this authority has worked on a legislative agenda that favours consumer protection.

In this regard, the approval of the new Law of Transparency and Regulation of Financial Services from summer of 2007 is outstanding. In 2009 and 2010 amendments were made to the new Transparency Act of 2007, and the fundamental pillars for adequate consumer protection were established by strengthening the powers of the CONDUSEF in terms of inspection, surveillance, prevention and correction. With the new law, secondary regulation of the CNBV (Mexican National Banking and Securities Commission) and CONDUSEF were established for:

Adhesion contracts

- Making the content, costs and fees transparent
- Including a summary table of the main features
- Providing clarity in the operations and services offered
- Establishing procedures to change or terminate a contractual relationship
- Cancelling the direct debit upon client request
- Disseminating customer service mechanisms
- Establishing procedures for monitoring and supervising contract formats

Advertising

- The following are particularly regulated: the nature and content of advertisement, which must be true, accurate, complete, objective and up-to-date.
- It should encourage the formation and development of financial literacy, promoting prudent and informed access to financial services.

Account statement

- Information that allows easy insight into the account's administration, and show the transactions or services rendered
- Clarity in the incorporation of fee concepts
- Data to clarify inquiries
- Information that allows comparison of commissions among similar services or transactions
- Free statement for at least once a month

Transaction records

- The information must be clear, complete and allow the customer to confirm the transaction contracted with the financial institution.

Some of the issues covered in the reform of the LTOSF (Law on Transparency and Ordering of Financial Services) with respect to consumer protection and transparency are:

- Made bank mobility more accessible.
- Allows customer to cancel a consumer credit contract before.
- Establishes restrictions to telemarketing at consumer's workplace.
- Sets standards in the statement that tend to standardize the formats of the same, with information and legends about financial literacy, warnings about charging fees, interest, balances, credit limits, operational risks and the CAT.
- Grants a grace period of 10 days to a consumer to withdraw from contracting a financial service, with the exception of mortgage loans.
- For the raising of the loan limit on credit cards, the financial institution must do a payment feasibility estimate and make an offer to the consumer, which must be accepted explicitly prior to the institution granting the credit card.

As far as the two LPDUSF (The Law of Protection and Defence of the User of Financial Services) reforms are concerned, the functions of the CONDUSEF are strengthened to turn it into a regulatory and supervisory body, as well as into the promoter of financial transparency. Additionally, conciliatory processes were accelerated and their range of sanctions was extended. In this respect, it must be noted that the new preventive, conciliatory and corrective functions of the CONDUSEF are similar to those of the PROFECO.

To strengthen the process of conciliation for the benefit of users, CONDUSEF was provided with greater powers to demand information for the correct integration of records; remote conciliation processes were established and the time for the issuance of the judgment was reduced from 90 to 60 business days. In addition, the commission supports the users in their activities vis-à-vis the Department of Public Prosecutions, reports violations to the competent authorities and implements measures in order to establish facts in the process of conciliation.

Given the aforementioned information, the Commission has two main functions. The first is a preventive function and of a technical nature, designed to promote education and financial transparency as it:

1. Promotes financial education.
2. Compiles statistics on the levels of service to consumers.
3. Makes recommendations to financial institutions.

4. Maintains the Register of Providers of Financial Services.
5. Evaluates the documents used in the offer and the design of the financial products.
6. Promotes and contributes to the Law of Transparency and Restructuring of Financial Services.

Regarding the transparency of financial products and services, CONDUSEF analyzes and brings about changes in contracts, advertising and statements of account; it develops educational programs; issues rules to promote financial transparency and encourages and facilitates the procedures for the termination of operations (portability) until they are contracted with another institution.

Thus, the powers of the CNBV were transferred to CONDUSEF to issue the regulation on transparency and protection for the users of financial services. In addition, the Commission will act as supervisor on matters of transparency and protection for the users of financial services and promote and establish policies on the financial culture and financial education.

The second function of the Commission is of a legal remedy nature, aimed at resolving disputes. This process of support includes assistance, conciliation, arbitration and even free legal defence.

CONDUSEF, as regulatory and supervisory body, now issues regulations and monitors their fulfilment, to promote sound practices, to disseminate more and better information relevant to the user and to avoid discriminatory and harmful practices.

4 The interaction between financial inclusion and financial education and the protection of the user of financial services as well as its supplementation with the regulatory and supervisory activities of the authority

Financial education and financial inclusion and protection of the user of financial services are not only highly relevant as individual issues, but if we consider all of these together we can see that that they are complementary to one another; they must be aligned and balanced and operate in a synchronized manner to truly act as axes for the development of the Mexican financial system.

From the analysis of all the issues we have dealt with throughout this document, we can conclude that it is not beneficial to privilege or neglect any of the axes. We must address all three aspects and maintain the balance between them, as a complement to the functions of the authority in terms of supervision and regulation of all other aspects that are required for the existence of a sound financial system.

This balance will lead to an increasing integration of more customers into the financial system, a more efficient participation of all individuals in the financial system, who will have the possibility to use transactional, saving or credit services which will improve their conditions in life. Large and small entrepreneurs will also benefit from having better defence mechanisms and be better aware of the services they make use of.

To ensure that customers and institutions can benefit from more balanced conditions, a better protection scheme for users is required; greater financial inclusion is required for greater access, and both necessarily require an improvement on financial literacy.

In addition, the accompanying aggregate effect will necessarily have an impact on both the financial system and the economy as a whole.

In the Ministry of Finance we are aware of these and of the positive impact the expedient and adequate consideration of these issues will have on the economic and financial security of all Mexicans in all income stratus and throughout the Mexican economy.

Challenges for the G20 and Low-Income Countries

Anna Gibson and Sony Kapoor *

1 Background

The world economy is at a critical point where 1) continuing economic uncertainty, 2) sustained economic imbalances, 3) re-emerging fragility in the financial sector and 4) an emerging divergence amongst major economies in the world on approaches to financial regulation all pose serious risks to achieving sustainable growth.

While on the one hand, some emerging economies face the danger of overheating and are having to confront massive capital inflows and raise interest rates much of the 'old' developed world remains under the shadow of anaemic growth, decimated public finances and high unemployment. Many low-income countries are somewhere in between but remain prone to many risks. The world economy is unlikely to recover on a sustainable basis with just one engine of growth.

In order to understand the challenges we face, it is helpful to delve briefly into how we got to this point.

The crisis first started in the private financial markets of developed countries but soon engulfed financial markets around the world and turned into a world-wide economic recession. Financial bailouts that were needed for several western financial institutions and the major economies of the world had to introduce in order to counter the recession. The costs of these operations together with a recessionary fall in tax revenues imposed serious fiscal stress on some developed countries. This then triggered serious problems in the sovereign debt markets especially for some European countries.

Potential sovereign defaults and marked to market losses on holdings of sovereign debts now inflict serious losses on the balance sheets of already fragile financial

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institutions. Even if such a scenario does not unfold, governments run the risk of panicking and prematurely withdrawing stimuli or launching excessive austerity measures. In either case, a double dip recession is a likely outcome.

Governments and financial markets in much of the developed world are now locked in a 'till death do us part' embrace where economic disruptions on either side will almost surely drag the other down. This has serious implications for emerging economies which as the only 'islands' of growth are attracting more capital flows than they can handle safely and low-income countries which continue to remain vulnerable to any new disruptions in international trade, commodity prices or financial flows.

2 The key questions

At this juncture, it is useful to divide the set of issues that needs to be confronted into four distinct but interrelated parts.

(1) What are the urgent issues that need to be addressed in order to minimise the risk of a double dip recession and/or a second financial crash?
(2) What are the most important issues that need to be confronted in order to bring about a long-term sustainable recovery?
(3) What is the key co-ordination challenge facing the G20 and the rest of the world?
(4) What are the interests of the non-G20 low-income countries and how to ensure that these interests are taken into account?

(1) Some urgent issues that need to be addressed

The global financial crisis brought about an unprecedented global coordination of fiscal stimulus packages, that helped prevent a global recession from descending into a global depression. However a return to global economic prosperity is by no means assured and new risks stalk the global economy. These risks need to be addressed urgently.

Tackling the undercapitalisation of banks

At the onset of the crisis many banks around the world were operating on the thinnest slivers of capital. The leverage ratios for banks such as UBS and Deutsche Bank exceeded 60, with other banks such as Barclays, SocGen, RBS and Credit Suisse all coming in over 30 which meant that they were severely undercapitalized.

This meant that when the crisis hit, many banks lacked sufficient capital buffers to withstand even small losses, which provoked a vicious circle of panic.

The two problems that now confront us are 1) what measures to put in place to prevent a similar situation in the future and 2) how to transition from the current situation to these new norms

There is a global consensus on the need to have higher capital adequacy ratios as well as to impose a leverage cap. At the same time many banks, especially in the EU, continue to be highly fragile and are inadequately capitalized. This is casting a dark shadow on economies not just in the EU but also threatens global recovery.

New capital needs to be injected in many institutions, especially if they are to meet 'new' standards for capital adequacy. This capital can come from four main sources 1) new injections of public money 2) internal profits 3) creditor haircuts accompanies by debt equity swaps 4) new raisings of equity.

While a combination of all of these is probably required, the internal generation of profits should be the first port of call. In order to channel profits, subsidized by government guarantees and low interest rates, towards the building up of capital rather than going into bonus and dividend payouts, a moratorium on such payouts may be necessary. This is likely to work well at the level of the EU where restrictions could be imposed till the EU banking system is recapitalized up to the new level of capital adequacy, likely to be 11 per cent, that will be agreed by the Basel Committee.

This will need to be supported by more public support and, in case of institutions that are below or close to minimum levels of capital threshold, mandated creditor haircuts and debt equity swaps.

Tackling overheating in emerging markets

Much of the developed world economies remain fragile but many emerging markets are exhibiting high growth. This has made them very attractive to investors who have started allocating an ever larger percentage of their portfolios to these markets. While these economies are large, they are simply not large enough to absorb the capital flows being channelled towards them without overheating and developing structural distortions. Many of them have responded by raising interest rates to cool markets but these higher interest rates have attracted even

more investors who now face the prospect of long term low interest rates in much of the developed world.

It is critical that these inflows into emerging markets, which often lack deep financial systems, are not allowed to build up excessive risks that endanger their domestic financial systems and economies. While the use of capital controls has been much maligned in the past by institutions such as the IMF, their utility in slowing down speculative capital flows across borders, which seldom benefit domestic interests, has been demonstrated in several cases. Most recently, Brazil decided to place a 2 per cent levy on short-term, speculative capital inflows last year in order to temper the negative externalities of these flows – namely exchange rate appreciation, rendering its exports uncompetitive, and the creation of unsustainable asset bubbles.

While tighter capital controls do not prevent such 'hot money' flows altogether, they serve to dampen them to a more less distorting level, thus allowing for greater exchange rate stability, not to mention increased public revenue.

More market based capital control mechanisms can be combined with prudential norms such as, leverage caps, limits to maturity and currency mismatches in order to foster economic stability, particularly for emerging economies where interest rates have been much higher than in advanced economies. While countries need the policy space and flexibility that capital and prudential controls can bring about, there is a need to ensure that this does not evolve into protectionism – a difficult balance to achieve.

Tackling sovereign debt problems

While the collapse of the financial sector was the first consequence of the global financial crisis, the impending sovereign debt crisis has been the second. The interconnectivity between the private and public sector is becoming increasingly apparent, as governments have collectively bailed out 'too big to fail' financial institutions with the view of curtailing further financial meltdown.

This has resulted in a considerable transfer of debt from the private to public sector, which, combined with further counter-cyclical measures taken by governments to tide the crisis and stimulate growth, has fomented an increasingly unsustainable level of sovereign indebtedness across advanced economies. The cases of Greece, Spain, Portugal and Iceland are merely symptomatic of the widespread indebtedness of countries in the developed world, as the UK and US face debt/GDP stocks nearing 70 per cent and 90 per cent respectively.

For several decades, development professionals tried to get the broader world community to adopt a systematic methodology to resolve sovereign debt problems when they became unsustainable. However, since this was very much a crisis 'out there' in poor developing countries much of the large rich countries did not feel the need to have a systematic debt resolution mechanism for sovereigns. The financial crisis, by bringing problems much closer to home, has highlighted the fallacy of that approach.

Many countries, both developed and developing, will likely suffer problems with excessive sovereign debts sooner or later. Many European countries, such as Greece, are already in the throes of a serious debt crisis. That is why this is the right time to finally introduce a systematic international debt resolution mechanism for sovereign debt. A model based on the Chapter 9 Municipal bankruptcy code of the US would perhaps work best.

This mechanism would need to be supplemented by institutions such as the IMF providing greater degree of liquidity and restructuring support to sovereigns in debt trouble.

(2) Long-term sustainable recovery

While the need to tackle short-term threats to global prosperity is clearly crucial, measures must also be taken to ensure that this recovery is sustainable in the long-term and that the underlying structural weaknesses of the global financial system are addressed.

Tackling global imbalances

One of the structural triggers of the financial crisis was the growth of global imbalances, which also manifested themselves at the regional level, particularly within the EU.

The fact that China and much of Asia have been generating substantial current account surpluses and domestic savings, whilst the US and some other parts of the developed world maintained hefty current account deficits was seen to have fomented excess liquidity which inflated the prices of financial assets to unsustainable levels in the US and other major economies. It also contributed to the commodity price bubble in the run up to the crisis.

Within the EU Germany generated considerable current account surpluses, while many of the Mediterranean countries racked up unsustainable current account deficits, adding a European twist to the discussion on the implications of imbalances for financial stability.

Sustained global imbalances must be addressed if we are to regain long-term stability to the financial system. For this to happen, China, it is widely believed, will need to stimulate domestic consumption and gradually shift from its tried and tested export led growth model, or to significantly diversify its capital exports away from US markets. However, this re-balance must be achieved on both sides: Americans did not simply save less just because China was saving more – the low interest rates and sub-prime mortgage deals encouraged its citizens to live beyond their means. Deficit-running countries need to address their profligacy and restore some sense of fiscal stability if they are to reduce saving imbalance on their side.

The imperative, then, is to ensure an orderly and coordinated response to the problem of global imbalances through open channels of negotiation that do not place the blame on either side of the debate. The G 20 can act as a conduit for this coordination, but it is also the role of international financial institutions like the IMF to ensure that domestic policies are devised with the impact of global financial stability in mind, not merely at the national level.

A multilateral adjustment path, to reducing the most glaring imbalances in the world economies, should be chalked out by the G 20 and be followed as closely as possible. Monitoring and responding to imbalances is a continuing process and not a one off action so the crisis should be used as an opportunity to institutionalize mechanisms for doing exactly that.

(3) Some key coordination challenges facing the G 20 and the rest of the world

As the previous sections have highlighted, we live in a complex and interdependent world where the actions of actors in one part of the world affect those elsewhere, irrespective of shared interests or connections, it is essential that we pursue a coordinated response to the challenges afflicting global growth and sustainable development. The failure to act by one region or country leaves open loopholes which have the potential to undermine the entirety of the global system – this is particularly evident in terms of tackling illicit cross-border tax flight, financial instability or climate change.

Nonetheless, the problems of collective action at the global level are manifest and threaten the success of rigorous proposals for regulatory reform. The fact that inaction by a minority of key players within the G 20 and other global governance fora serves to stall progress for all those involved begs the question whether an *entirely* global response is really the best way to achieve substantive action towards resolving these global predicaments.

Instead, a more nuanced approach to global governance may be needed, requiring a co-ordinated but differentiated response.

For example, in terms of financial system reform it is clear that, while all have attested to the need for substantive regulatory reform, not all countries agree on the specific ways in which this should be done. Yet, the pushes for global agreements for financial regulation means that the rules and regulations legislated become weakened in order to achieve international harmonisation. As Rodrik remarks, "that is why bankers love international coordination"[1] – it is a recipe for inaction and diluted regulation.

However, coordinating a *differentiated response* to financial system reform through global governance fora is still vital to the healthy functioning of the global economy and the plugging of regulatory loopholes that arise by those seeking to maintain the competitive advantage, often at the cost of detrimental domestic and global consequences.

To achieve this as a first step, there should be increased coordination at the regional level in order to achieve greater policy harmonisation at a viable scale, which, in turn, will facilitate more effective and expedient coordination at the global level. Regulatory diversity coordinated at the regional level also has the added benefit of fomenting enhanced democratic accountability, as individual countries are able to establish financial oversight institutions with the clear and legitimate authority to sanction those who do not comply with the given standards. As past experience has shown, the lack of an overarching global authority endowed with the credibility and legitimacy to impose effective sanctions at the macro level has threatened the efficacy of global governance altogether. However, as has been mentioned, there is still a crucial place for cross-border controls that monitor activity and compliance with national and regional regulation at the global level: coordination is key.

1 Rodrik, Dani, "The Case Against International Financial Coordination," February 11, 2010, *Project Syndicate*.

While this degree of regulatory diversity internationally may impose certain costs on the financial sector, these are considerably disproportionate to the costs that the financial sector has imposed on the rest of global society due to a lack of rigorous regulation. A certain degree of regulatory autonomy that imposes minimal transaction costs is well worth withstanding in order to achieve regulation with ‘teeth’ that can be imposed effectively at the national level and monitored at the global level.

What could this global monitor look like?

One notion is to reform the IMF’s surveillance role and establish an independent IMF surveillance mechanism. Currently, the IMF is mandated to oversee the international monetary system and monitor the economic and financial policies of its 187 members, highlighting possible risks to domestic and external stability, and specifically coordinating an “orderly unwinding of crisis-related policy interventions.”[2] In this sense, it provides both a monitoring and advisory role at the bilateral and multilateral level. However, given the past deficiency of its role in adequately foreseeing the build up of systemic risk in the financial system, it is clear that the functioning of this surveillance role needs to be improved and potentially made independent from the IMF if it is to suitably coordinate and monitor fiscal and monetary policies within the global economy. By making the IMF’s surveillance mechanism independent from the remaining work of the institution, it can be given greater autonomy to pursue its oversight role with clear targets and objectives, removing potential conflict with other IMF objectives. Much like the way granting independence to a central bank gives it greater policy flexibility to maintain strict inflation targets, so an independent surveillance mechanism could better facilitate coordination and compliance of monetary policy at the global level.

So, despite a general wariness of the efficacy of ambitious global agreements, it is evident that the role of multilateral organisations in facilitating and monitoring global coordination and compliance is by no means obsolete. In fact, it is only through a multilateralization of many existing bilateral or regional treaties that certain systemically significant global players can be brought into the fold. This is particularly the case with some of the emerging Asian economies, most notably China, whose growing economic weight has endowed it with the power to evade or stall progress for global coordination on the basis of its sheer size and influence. Within the remit of a multilateral framework, whether the G20 or, more

2 IMF, March 2010, *“Surveillance Priorities for the International Monetary Fund 2008-2011,”* http://www.imf.org/external/np/pdr/surv/2008/index.htm.

legitimately, more formal and permanent institutions such as the UN and WTO, there is increased pressure for these countries to partake in global efforts to foster systemic stability and sustainable growth.

Moreover, in the case of tackling tax and capital flight, a multilateral solution is the *only* way to achieve substantive progress if all tax evasion loopholes are to be plugged. While the OECD has championed the spread of tax information exchange agreements (TIEA) between a growing number of countries across the globe, so far not a single TIEA has been signed with low-income countries. In this case, the need for a multilateral system for tax information exchange becomes apparent, so that the poorest countries are able to benefit from the TIEA framework, un-regulated havens allowing tax evasion, fraud and corruption are abolished, and richer countries are held to account by their peers within a multilateral context.

The G 20, then, as the most influential ad hoc global governance forum, faces considerable challenges in terms of discerning when to take a strictly coordinated approach to global reforms, when to decentralise policymaking to regional or national authorities, and when to channel negotiations through more equitable and democratic, permanent multilateral organisations. What is clear, however, is that the end goal from this period of post-crisis reform should be structural change, rather than mere tweaks to policy. It was the structural deficiencies with the global financial system that allowed a collapse in one market to spread to the real economy, not only in the US but across the globe, and so it is this structural reform that should be at the core of coordinated but differentiated strategies to foster global growth and sustainable development.

Without appropriate international governance mechanisms in place, the highly inter-connected world we live in is doomed to see a repeat of the financial, fiscal and economic crisis we are struggling to escape from.

(4) Representing the interests of the low-income countries (LICs)

While the G20 sits around the table and while the Basel Committee and Financial Stability Board meet to discuss the future shape of the world economy and the world financial system, the group of low-income countries is conspicuous by their absence. Purportedly, their interests are represented indirectly by the World Bank

and to a lesser extent by the International Monetary fund but any neutral observer will notice that the governance of these institutions is also dominated by G20 members who are part of all the main institutions of international economic and financial governance. The United Nations, which perhaps has a better governance structure to represent LICs' interests is unfortunately considered to be somewhat of a lightweight on macroeconomic issues by these other institutions and has little if any expertise on financial regulation.

That is why, it is imperative for the G20 and other international fora for regulatory discussions to explicitly factor in the interests of low-income countries in their discussions. The signals from the presidency of the Republic of Korea have been encouraging in this regard.

The crisis and low-income countries

The channel of transmission of the crisis to these economies was not the same asset price decline which worked its way across interlinked developed financial markets but more the sudden stop mechanism where capital and trade finance flows to developing countries dried up. The effects of these were amplified by the fall in commodity prices and the reduction in demand for developing country exports.

While the financial problems in the United States and other developed country was linked to 'too much finance' and an excessive availability of credit and capital, the contributing factor in poor developing countries was perhaps the opposite – 'too little finance'. Savings in these countries are depressed and remain often locked up in non-monetary forms partly because of a lack of access to basic financial services, and as a consequence the financial system is unable to support the real sector through effectively intermediating these into productive investments. This in turn depresses growth as well as tax revenues.

Both the private and public sectors, not having access to this pool of savings, are forced to be excessively dependent on external sources of finance in the form of aid, foreign borrowing, private capital flows and trade finance. Not only does this increase the vulnerability of these countries to volatility in the international financial markets but it makes them highly susceptible to the kind of sudden stop we saw in the most recent crisis. Moreover, the need for credit makes these countries stand ready to accept high conditional aid, build up excessive debt burdens and try and attract investment even on highly unfavourable terms.

The international financial system that these countries confront is not sensitive to their needs and in fact in many aspects is biased against small poor and open economies. The system, in its current form, is far too volatile and too short term oriented to effectively support development needs. Moreover, the various rulebooks of the system, such as the Basel Accord, make it highly procyclical and do not give enough credit to developing countries as real sources of risk diversification.

Large international banks and other financial market actors dominate the landscape moving credits and market prices including those of commodities at a speed which overwhelms any small open economy especially when it is poor and dependent on external sources of finance.

Many of these countries are locked into a low income-low savings-low productive investment-low growth trap, and in order to escape this trap what is needed is the urgent development and deepening of domestic financial systems accompanied by efforts to make the international financial system more development friendly.

Maximizing the development friendliness of the G20 reform effort

The current financial reform international discussions centred on the G20 will have far reaching consequences for the shape and form of both domestic and international financial systems. Making sure that the interests of developing countries are taken into account in this financial system overhaul presents an unprecedented opportunity for engendering development promoting reforms. A failure to take account of the interests of small poor developing countries in particular on the other hand could seriously setback any hope for the development of growth supporting financial systems.

And yet the G20 reforms are being carried out primarily with their own interests in mind. While many of the proposed reforms will contribute to the overall stability of the international financial system, there will be unintended consequences on poor developing countries which need to be factored in. These will take two forms: first, the direct impact of reforms such as increasing capital and liquidity requirements, as well as tackling credit rating agencies, too big to fail institutions and systemic risk etc., which will affect the availability and the price of capital to developing countries.

Second will be the indirect impact through new norms of financial sector regulation and supervision, which would affect the way that developing countries

manage their domestic financial systems. Thinking these through would be critical for developing countries as well as the G20 to ensure that the positive aspects of the reforms are maximized and the negative impact addressed up front. Basel III, for example, would need to incorporate the lessons from the development unfriendly Basel II, and there might be merit in the idea of considering a Basel III-lite accord for LICs.

It must also be noted that the interests of emerging non-OECD economies and low-income countries are also not the same – those that fit in the category labeled "developing countries" do not necessarily hold homogenous views. While emerging economies are seeing an influx of inward FDI and portfolio investment as they appear to be a robust alternative in the midst of a sea of sovereign debt, LICs are still in many cases trying to get on the next rung of the ladder in terms of initial integration in financial markets. So the degree of capital controls and financial regulation needed to enhance domestic resource mobilization in both cases will be vastly different.

Nonetheless, given the growing economic weight of emerging economies within the G20, they have the potential to play a strong role in advancing the interests of LICs, if they are willing to do so. In this vein, President Lee Myung-bak has recently stated that the Republic of Korea will seek to represent the voices of both emerging and poorer nations on the global stage so that all those involved in the negotiations can work together under a shared goal of achieving sustainable, balanced long-term growth.

Learning Lessons and Developing Domestic Financial Systems

In order to develop a 'development friendly' G20 agenda, it is necessary to draw on lessons learnt from past experiences. What the financial crisis has reinforced is that financial systems remain the nerve centers of economies: poorly developed financial systems in developing countries leave these countries vulnerable at volatile times, and depress growth in 'peacetime'. In the wake of the financial crisis, the traditional mantra of aspiring to models that exist in rich economies is not good enough anymore since many of these OECD financial systems came unstuck and exposed some fundamental problems that need to be addressed.

Both given their recent crisis experience as well as the aid and external finance squeeze that developing countries are likely to encounter, there is an urgent need to redouble efforts to mobilize domestic sources of finance through the development of national financial systems. In fact, developing countries have good

important lessons to learn from the failures exposed by the crisis so they develop more growth-friendly and robust financial systems and do not repeat the mistakes made by many of the OECD countries.

In this context, the crisis has had important lessons for developing country financial system development in areas of:

- The need for better capitalization of financial institutions
- The need to maintain a diverse institutional structure in finance
- The importance of managing liquidity in banking systems and financial markets
- The need to build counter-cyclicality into the regulation of finance
- Not allowing the growth of 'too-big-to-fail' institutions
- The need to track and manage systemic risk
- The need for a proper regulation of the shadow financial system
- The critical need to grow lending to the small and medium sized enterprise sector

The potential impact of forthcoming regulatory changes

It is important to consider what impact specific measures for improving cross-border financial regulation are likely to have on developing countries at large, taking into account their specific circumstances.

In many low-income developing countries, foreign banks constitute a significant share of banking activity – 40 per cent to 50 per cent being fairly typical. While few developing country financial institutions or financial actors have a significant presence in developed markets, OECD country banks and increasingly other financial institutions have a substantial and increasing presence in developing country markets. Similarly an increasing number of OECD country institutional investors are very active in the capital markets of developing countries.

That is why changes to regulations that deal with the cross border provision of financial services are of special relevance to developing countries because these new rules could significantly impact the nature of their financial sector even though they do not have a seat around the table of policy makers formulating these rules. Of special relevance, for example, is whether there is regulatory pressure that changes the current mixed branch/subsidiary model in one direction or the other. The main distinction between these is that branches of foreign banks are not required to adhere to local standards of capital adequacy nor maintain ring-fenced local buffers of capital whereas subsidiaries are required to have their

own in country capital base. The other big difference is that the main supervision of branches is done by the home country and of subsidiaries by the host country. On other issues such as maintaining liquidity buffers etc, the host country supervisors have some discretion over making branches adhere to some standards.

It has been shown that foreign banks respond to conditions both in their home as well as host countries, with the collapse of foreign bank lending in the 4th quarter of 2008 being a case in point. Typically, many of these institutions can be quite large from the developing country perspective but developing countries' share of their global portfolio tends to be much smaller, so small changes in the behavior of such large financial institutions can affect developing countries, while they have an asymmetrically low influence on their operations.

Between half and two third of foreign bank lending in developing countries is subsidiary based, so these have to apply host country rules and home country prudential rules apply only to domestic not global operations so changes in home country regulations are unlikely to directly affect DC operations. However, new proposals call for more effective cross-border supervision to prevent regulatory arbitrage so home country requirements are much more likely to impact host country operations than in the past. Thus, the tightening of home country regulations would lead to curtailment of credit growth in host countries and could possibly even lead to the retreat of some financial institutions from developing countries at least in the short run.

Cyclical variations in prudential norms in the home country would be transmitted into host country operations though the business cycles between the two are not likely to be in syncronisation and this has a potential to create economic disturbances. Moreover, colleges of supervisors do not include many of the developing countries in which cross border institutions operate, since they are too small to be systemically significant. This reduces their influence over financial institutions operating in their territories.

The problems noted with cross-border subsidiaries are much starker when foreign banks operate as branches. And the issue of home country conditions affecting credit growth and behavior in developing countries is the strongest when cross-border loans are considered. For this reason, the tightening of home country prudential norms is likely to have a significant and negative impact on the availability of credit in developing countries through branches and cross-border lending.

Moreover, the introduction of cyclically adjusted prudential norms in home countries is likely to transmit home country economic fluctuations to developing countries through the channels of cross-border branch operation as well as cross-border bank lending. Trade financing is too dependent on cross-border banking and is also likely to suffer as a result. There will most likely be a shift towards the subsidiary model away from the branching model for cross-border bank operation.

While it is likely to increase developing country policy space and reduce the threat of cross-border contagion, it might lead to some institutions deciding to get out of developing country operations if they are no longer able to move capital around 'efficiently'.

Some possible ways forward to consider LIC interest in financial reform

Without going into too much detail, we have established that the regulatory discussions afoot in the G20 and various other international fora will have a significant footprint on poor developing countries that do not have a seat around the table. Hence, there is a need to take on board their interests in the international processes to reform international finance and improve macroeconomic management.
This can be done by

- Including LICs in discussions relevant to them
- Introducing a special and differential treatment for LICs in financial regulation
- Offering compensatory financing facilities for losses that LICs may encounter as a result of changes
- Basel III Accord – Include diversification benefits for investing in developing countries etc
- Including LIC voices in supervisory colleges where relevant
- Basel lite, Liquidity lite – having less onerous and simpler capital and liquidity accords for LICs
- Greater focus on domestic resource mobilization – savings mobilization in particular
- A greater focus on developing regional financial markets
- Doing a low-income country impact analysis of all new financial regulations
- Keeping the access-versus-stability debate alive – often there is no trade-off but sometimes there is.

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