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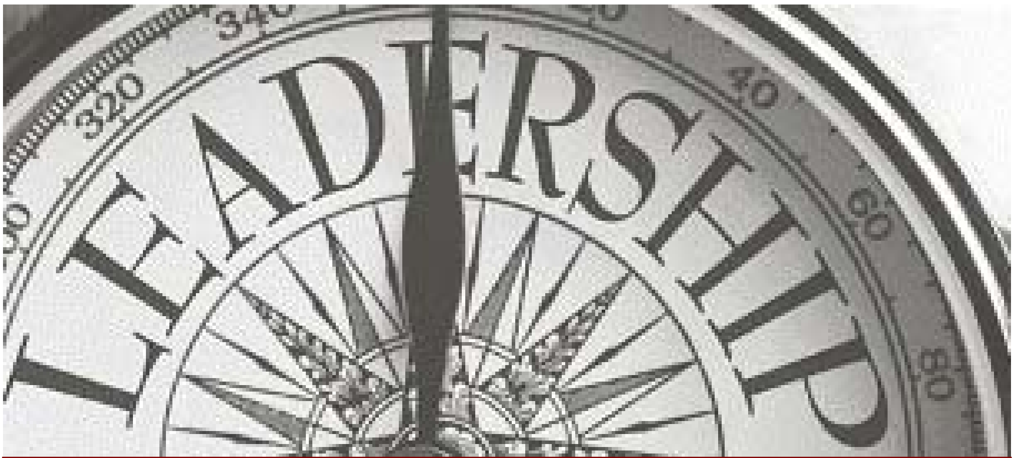

General Background Document

The Global Economic Crisis:
Causes, Evolution and Crucial Policy Issues

By José Antonio Ocampo

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The financial turmoil that erupted in the US in August 2007 became, after the financial meltdown of mid-September 2008, the worst financial crisis and the worst global recession since the Great Depression of the 1930s. The severity of what came to be called the "Great Recession" and the collapse of international trade that accompanied it surprised even experts. The crisis had global and systemic characteristics. It showed, in particular, how dysfunctional the current international financial architecture is to manage today's global economy. The global response has been coordinated by the G-20 and has had some novel features, but has also been partial in scope, leaving aside major issues that must also be included in any comprehensive reform of the international financial architecture.

The macroeconomic and financial policy responses to the crisis were strong though diverse among major economies. The financial meltdown was reversed and there was a recovery of economic activity in some economies, particularly in Asia, during the second quarter of 2009 and of a broader group of countries during the third quarter. Overall, these results represent a major success of Keynesian counter-cyclical macroeconomic policies. However, the recovery is still incomplete and, particularly, depends on the large stimulus that continues to be provided. Furthermore, credit remains subdued and financial stability has not been fully restored, international trade is still depressed and there is agreement that it will take a long time to reverse some of the social costs of the crisis, particularly the deterioration in employment conditions. We may be subject to new unpleasant surprises.

This document summarizes the crucial issues related to the origins and management of the current world economic crisis. The first two sections look at the roots and spread of the crisis. The next two analyze the areas where government actions have concentrated: the macroeconomic stimulus packages, financial bailouts and regulation. The last section considers broader reforms in the international economic architecture which have been excluded so far from negotiations and associated institutional changes.

1. The roots of the current crisis

The peculiarity of the current crisis is, of course, that it originated at the center of the world economy. The collapse of the market for asset-backed securities in the US in August 2007, including the market for subprime mortgages, can be denoted as the start of the financial crisis. However, the European financial system was also and from the beginning at the center of the turmoil. The first major bankruptcies took place in Britain (Northern Rock) and Germany (IKB) at the end of 2007. This reflects not only the significant portfolio of US "toxic" securities held by European financial institutions, but also their own problems associated with the collapse of housing bubbles in several

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countries, higher reliance by European institutions for funding in capital markets vs. deposits, and the serious financial turmoil at the European periphery (Iceland and some Central and Eastern European countries).

The roots of the crisis will continue to be debated for a long time. The major issue was undoubtedly the excessive confidence in the capacity of financial markets to self-regulate and self-correct in the face of disturbances. By now it is clear that the dominant market liberalization paradigm provided a grossly inadequate lens to analyze reality.

The regulatory deficit is now broadly recognized. This problem is most severe in industrial countries, which continued to deregulate their financial systems while many emerging economies took steps to strengthen regulation after their own past financial crises. Equally important were the insufficient supervision of financial institutions and, therefore, the unwillingness or incapacity of authorities to enforce effectively even those regulations that were in place.

At the international level, the Financial Stability Forum (FSF) was created by the G-7 in 1999 "to promote international financial stability, improve the functioning of financial markets and reduce the tendency for financial shocks to propagate from country to country, thus destabilizing the world economy". Similarly, after the Asian crisis, the International Monetary Fund (IMF) was given, together with the World Bank, enhanced responsibilities in the surveillance of financial stability. Despite their very useful technical work, the FSF and IMF patently failed in giving clear early warning of serious problems to come, as did the regulators and supervisors in major industrial countries. More serious warnings came from other quarters, particularly at the institutional level from the Bank of International Settlements (BIS) and the United Nations.

Aside from the regulatory and supervisory deficit, other factors contributed to the financial meltdown. Major failures in corporate governance and associated incentive schemes are now widely recognized as key problems, particularly the excessive focus on short-term profits and shareholder value, and the tendency to remunerate top managers on the basis of short-term returns.

The expansionary monetary policies of the first half of the 2000s are also accepted as a major contributor to the crisis, though the interpretations differ among analysts (which are not necessarily incompatible). Some see it as simply a policy mistake that, through the attempt by financial institutions to increase their returns in a low interest rate environment (the so called "search for yield"), led to very risky investments. Others see it as a reflection of the need to compensate for the weak aggregate demand generated by adverse trends in income distribution throughout the world. Access to credit was needed, according to the second view, to compensate workers for their low earnings, though it came at the cost of building up unsustainable household indebtedness.

Global imbalances also figure prominently in the debate, again with contrasting views. According to one interpretation, Asian and, particularly, Chinese "mercantilism" generated massive surpluses that increased the demand for US financial assets and kept interest rates —including long-term rates— low. The alternative interpretation emphasizes rather the fact that the crisis in Asia and other emerging economies that started in 1997 made it clear that the world lacks an efficient mechanism to manage financial crises in developing countries, as the current system has been based on IMF lending that is too small relative to the size of today's disturbances and carries excessive conditionality. The world also lacks a mechanism to renegotiate in an orderly way international debts similar to domestic bankruptcy courts. According to this view, the rational response of developing countries to this institutional deficit was to "self-insure" themselves against crises by accumulating large amounts of foreign exchange reserves, a policy that included, during the recent boom, saving a larger proportion of the commodity price boom and absorbing through reserve accumulation a larger portion of the excess supply of external financing than was typical in the past.

The role of the US as the "consumer of last resort" during the Asian crisis had dramatically increased the US current account deficit. The very high deficits in later years made one feature of the international monetary system patently clear: the lack of discipline imposed on the major reserve currency country by the current global monetary system, in which a *national* currency is used as the major world currency. This system allows the US not only to pay for its deficit by flooding the global economy with dollar assets but also to essentially impose its monetary policy on the rest of the world. However, this major deficiency of the international financial architecture is not generally recognized in current debates.

2. Intensity and spread of the crisis

Viewed from the perspective of the US financial markets and policy responses, the crisis has had five distinct phases. The first started with the collapse of the subprime market and, more generally, asset-backed securities in August 2007. The response of the authorities in the US and Europe was to activate the role of central banks as "lenders of last resort" by coordinated efforts to make emergency financing to banks more readily available and at lower interest rates. The US also adopted an early though limited fiscal stimulus. The second phase started with the collapse and rescue of the investment bank Bear Stearns in March 2008. The lack of confidence among financial institutions in the quality of each others' balance sheets increased sharply after that event, generating a much greater use of the available central bank credit lines.

The collapse of another investment bank, Lehman Brothers, during the weekend of September 13-14, 2008, and the decision of the US to not rescue it, marked the beginning of the third and, in regards to financial markets, the most dramatic phase of the crisis. During the week that followed, financial markets experienced total paralysis (a "credit freeze"), which included interbank lending and commercial paper. Many other major financial institutions went bankrupt in both the US and Europe and were generally rescued or taken over by governments, in a major correction of what was very soon perceived to have been a major policy mistake (to let a systemically important institution, such as Lehman, go bankrupt). Authorities in industrial countries responded with an even more massive increase in central bank credit to financial institutions, including many new facilities, strengthening deposit insurance, designing different schemes to capitalize financial institution with public sector funds and, to a lesser extent, buying toxic assets. Curiously, policies to alleviate household debts, particularly those associated with mortgages, did not figure out in the policy packages; some were introduced later on.

The critical phase was overcome in late October, as reflected in renewed interbank lending and the reduction of interest rates in many segments of the market. This may be denoted as the beginning of a fourth phase, in which financial panic was overcome but financial institutions continued to be seriously undercapitalized or were outright bankrupt but continued to operate under the implicit promise that in the end they would be bailed out. Since the second quarter of 2009 we can talk of a fifth phase, which came to be known as "green shoots", characterized by a significant reduction in risk premia and a recovery of stock prices but no significant revival or even continued contraction of private lending. In terms of new policy actions, the most remarkable fact during these two recent phases is the shift by major central banks towards "quantitative easing", that is, the outright increase in the money supply once central bank interest rates are brought down to zero (or near zero) and therefore cease to be a useful instrument for further monetary expansion. What this implies is that central bank lending is used to finance fiscal deficits (not the common action so far) and the private sector. In the latter case, it implies that the focus of the central banks shifted from increasing *liquidity* to reactivating *lending* and reducing the interest rates that borrowers pay.

An economic slowdown was already visible but was not dramatic during the first two phases of the crisis. Although the slowdown was stronger in Europe, there was a tendency to underestimate it in political circles (except in Great Britain), a fact that was reflected in the much more conservative attitude of the European Central Bank and the weaker fiscal stimulus adopted by Continental European countries. Responses in the US were more aggressive on both fronts. The dramatic recession in the industrial world that followed the financial meltdown of mid-September 2008 surpassed the most pessimistic expectations. GDP of industrial countries fell in the last quarter of 2008 and the first quarter of 2009 at an annual rate of 7 to 8%, similar to that during the early phases of the Great Depression, but was followed by a break in the contraction of economic activity during the "green shoots" phase. Growth recovery was initially uneven and, particularly, largely Asia-based in the second quarter of 2009, but became more broadly based in the third quarter.

Although developing countries were partly hit by the first phases of the financial crisis, particularly through reduced availability and higher costs of borrowing, they continued to grow relatively fast during the first semester of 2008 thanks to booming commodity markets and the perception that risks of lending to them were low, thanks to the high levels of foreign exchange reserves they had accumulated. The fall of commodity prices since mid-2008 may be seen, therefore, as the turning point in the spread of industrial country recession to the developing world. In any case, the September 2008 crash was a far more important shock, which was transmitted globally through two major channels: the collapse of international trade (including commodity prices) and the paralysis of private capital markets. A third transmission channel, the fall of migrant workers' remittances, also became significant in several developing countries.

The collapse in international trade was dramatic: the value of world exports fell 32% between the first semester of 2008 and the same semester in 2009. Although some recovery has taken place in the third quarter of 2009, trade continues to be depressed. Available estimates for July and August indicate that the value of world exports continue to be 27% and export volumes 17% below the levels of the first semester of 2008. Current projections by IMF and the United Nations indicate that world trade volumes will decline by 11 to 12% in 2009 and they will recover, albeit minimally, in 2010 (only 2.5% growth according to October 2009 IMF estimates). An implication of the collapse of international trade is that countries more open to international trade and, particularly, manufacturing exporters, were hardest hit in terms of economic activity. This explains why Japan and Germany ended up experiencing very strong recessions, and why most of the first generation of Asian tigers (Korea, Singapore and Taiwan, in particular) and Mexico were also strongly affected. Even China experienced a sharp fall in exports and a virtual GDP stagnation during the last quarter of 2008; its export recovery during the third quarter of 2009 also continues to be limited.

The sudden stop of private external financing hit hard the middle income developing countries, including the emerging economies. A critical issue was the paralysis of trade financing, which contributed to the collapse of world trade. Outflows of more volatile capital were severe in the developing world during the last quarter of 2008, leading to sharp depreciations of currencies in several countries. The capital account shock was particularly severe in several countries in Central and Eastern Europe, which had run risky macroeconomic policies during the boom, indeed reminiscent of Latin American patterns in the past. This was reflected in large current account deficits, weak accumulation of foreign exchange reserves, high external debt ratios and lending in domestic markets in foreign currencies, which made debtors very vulnerable to currency depreciations during the crisis. In contrast, although East Asia and Latin America were also hit, the significant accumulation of foreign exchange reserves and the reduction in external indebtedness during the boom, together with healthier financial systems (thanks to stronger regulation adopted after their own prior crises) provided a partial defense against financial contagion.

Only partial information is available on remittances. Data for Latin America indicates that the fall of remittances has speeded up, reaching a reduction of 16% in the second quarter of 2009 with respect to the same period in 2008. There have also been reductions in remittance flows to some African and Central Asian countries (dependent in the latter case on migration to Russia), but not in South Asian, Middle Eastern and North African countries for whom the major migrant destination is the Persian Gulf.

3. The macroeconomic policy response

The global recession called for strong policy responses. The International Labour Organization (ILO) estimated early in the year that the crisis would increase global unemployment in 2009 by 30 to 50 million people. This led ILO to launch in June 2009 a "Global Jobs Pact". The United Nations also estimated that there would be 72.5 million additional persons in extreme poverty, relative to a scenario where the growth expectation before the crisis would have been fulfilled. Although the strong recovery packages were able to avert the worst case scenario, there is a clear consensus that employment conditions will take a long time to normalize.

Industrial countries adopted expansionary monetary, credit and fiscal policies, but with significant asymmetries among them. Continental Europe lagged in all these dimensions relative to the US, the UK and Japan, as reflected both in the smaller size of fiscal packages and the lags of the European Central Bank in adopting more expansionary policies. China, along with a few other developing countries, also adopted strong expansionary fiscal and credit policies. On average, however, industrial country programs were more aggressive, reflecting the more limited room to maneuver that emerging and developing countries have to adopt counter-cyclical macroeconomic policies. The IMF has estimated that the average autonomous fiscal stimulus in the G-20 economies has been around 2% of GDP. Industrial countries' central bank interest rates are also at a historical minimum and all have now adopted some for of "quantitative easing".

Beyond the short-term, the crucial question is whether there will be a prolonged period of slow economic growth. The strong adjustment in the portfolios of private agents (including households), the broad-based desire to reduce indebtedness (financial deleveraging) and the excess productive capacity available indicates that private sector demand (both consumption and investment) will continue to be weak. This has been the experience with financial crises in many countries. The economic and social costs of this scenario would be large, as the experiences of Japan and Latin America during their "lost decades" indicate, as well as that of sub-Saharan Africa during its "lost quarter century". The international and domestic political implications too are deep, and could lead to a resurgence of protectionism under different guises (a factor that has been limited so far), as well as mounting political tensions within countries, which would stress the capacity of democratic regimes to address conflict through institutional channels. This implies that expansionary macroeconomic policies may be needed for a relatively long period and that withdrawing existing stimulus could be very costly. In any case, the rapid rise of public sector debts that is taking place will limit the possibility of maintaining aggressive expansionary policies for long periods.

Global imbalances have decreased relative to the boom years but must be closely watched, particularly in light of the renewed weakening of the US dollar. In any case, relying excessively on the expansionary policies of the world's major deficit country, the United States, runs the risk of igniting (or, rather, reigniting) fears of disorderly adjustment to global imbalances, which would add another highly undesirable dimension to the current crisis. More generally, relying on export-led recoveries seems highly undesirable in the face of the ongoing collapse of world trade.

The fact that many developing countries had accumulated large amounts of foreign exchange reserves during the recent boom and had lowered external and public sector debts, imply that they had more space to adopt expansionary macroeconomic policies than was typical during past crises. But there was an initial consensus that some emerging and developing economies were in a weak position and, therefore, that new financing mechanisms had to be put in place, given the strong retrenchment of private capital from the developing world that characterized the initial phase of the crisis. The problem here was the size of the shock relative to that of existing multilateral financing mechanisms. The Institute of International Finance (IIF) estimated early in 2009 that emerging markets would receive net negative private capital flows equivalent to $30 billion in 2009 vs. net positive flows of $632 billion in 2007. With the parameters that were in place before the crisis, multilateral financial institutions would have added only $28 billion in net resources—i.e., about 4% of the shortfall!

This was the reason behind the April 2 G-20 decision to launch a major initiative to give additional resources to the major international financial institutions. The IMF was the recipient of most resource injections that include $750 billion through IMF borrowing from countries, which has not been made fully effective so far. A special issue of Special Drawing Rights (SDRs) for $250 billion was also proposed, with developing countries receiving slightly under 40% of the allocation according to current quotas. Together with a smaller allocation, for 21.4 billion SDRs, approved by the IMF in September 1997 but which was not effective until it was finally approved by US Congress in June 2009, SDR allocations have reached the equivalent of $283 billion.

The G-20 decisions were preceded by a major reform of IMF credit lines in March, including the creation of a Flexible Credit Line, which allows countries with strong policies to access precautionary resources on a large scale with no conditionality, the doubling of other credit lines and the decision to make disbursements independently of whether countries are meeting structural conditionality. Fiscal targets have also softened in current programs relative to past IMF patterns. There is, however, the fear that the new IMF credit strategy would provide funds only for countries with very strong conditions, which may not need them, as well as those in severe need, but leave most developing country members without any support.

This is the reason why counter-cyclical actions by multilateral development banks have played a crucial role, as they benefit most developing countries. Multilateral banks have stretched their lending capacity, but additional capitalizations are now required by all of them. For the poorest countries, ODA with a significant component of transfers is required to avoid a debt buildup, which would be highly undesirable after the major debt reduction programs that were implemented in recent years —the Heavily Indebted Poor Countries (HIPC) initiative and the Multilateral Debt Relief Initiative (MDRI). However, there has been no major G-20 initiative in this area, aside from the weakly defined food security program approved by the G-8 in Italy in July and supported by the G-20 in its September 24-25 Pittsburgh Summit.

A final pending issue is the institutional framework for macroeconomic policy coordination. The obvious solution in this regard is to place the IMF at the center of this effort rather than continuing to rely on informal mechanisms, such as the G-7/8 or the G-20. The solution adopted at Pittsburgh designated the G-20 as "the premier forum of our international economic cooperation" but under multilateral surveillance by the IMF. This solution only succeeds in a very partial way in placing the IMF back at the center of global macroeconomic policy coordination, as its original design envisioned.

4. Financial sector bailouts and regulatory measures

Monetary and credit policies have been generally more aggressive than fiscal policies. Financial sector bailouts fall somewhere in between. And whereas Continental Europe dragged its feet on fiscal policy, the US was the reluctant partner in this case. There was also initially a clear lack of coordination of financial rescue packages at the global level. In the US, the bailout package proposed by the Bush administration was approved with the support of the opposition, as a majority of Republicans refused to do so. Even then, there was a revealed reluctance by the US government to take stakes in the banks. In Europe governments announced in a disorganized way a series of initiatives that competed with each other, particularly in terms of deposit insurance. Responses were placed on a better track after Great Britain announced its bailout package on October 7.

The most important measure was the capitalization with public funds of several financial institutions, particularly those of systemic importance. The second ingredient was enhanced deposit insurance and government guarantees on new lending. The third was the creation of mechanisms to buy "toxic assets", but this has been limited in practice given the technical difficulties in valuing complex and heterogeneous financial assets. The rescue of Citibank in November 2008 and the British package of January 2009 adopted a mix between the second and third types of interventions, as governments assumed a partial public sector guarantee on bank losses from toxic assets. Curiously, as pointed out, fewer initiatives have been taken to ease debtors' burdens, particularly in the case of mortgages.

A major effort to stabilize financial institutions was crucial, to avoid a protracted distrust in these institutions that affected Japan during its lost decade. There have been clear advances in this area but financial stability has not been fully restored. An equally important problem is the fiscal cost and the transparency of the associated bailout packages, which can result in massive subsidies to bankrupt investors. There were clear deficits in this regard in several major countries.

An important issue is also the distortion in international finance and trade that the bailouts generated. The fact that industrial countries provided large amount of resources to rescue their financial system and offered guarantees that developing countries could not match generated new asymmetries in the international system. Aside from its financial implications, these interventions distorted competition in international trade, particularly when subsidies were sectoral in nature, such as those granted to the automobile sector in several countries. Fiscal and bailout packages also brought with them protectionist clauses, such as the "Buy American" provisions and the preference for hiring American workers included in the US fiscal stimulus.

A major advance in the international debate was the recognition that the current crisis was clearly associated with inadequate regulation and supervision of financial activities. It is in this area that the G-20 played the most useful role, particularly in agreeing on certain principles, though their concrete implementation is still subject to much debate. The first agreed principle is that regulations must be comprehensive or at least much broader in scope to avoid the massive loopholes through non-banking intermediation that contributed to the current turmoil. This includes regulating hedge funds (or, more broadly, alternative investment funds), security dealers and the types of transactions that led to the current crisis, particularly securitization and derivatives. It should also force all capital markets to be open and transparent and thus limit over-the-counter operations. It is also agreed that systemically important financial intermediaries must be subject to particularly strict supervision, and perhaps to stronger regulatory standards, and that credit rating agencies and compensation practices in financial institutions should be regulated.

A second major advance has been the recognition that prudential regulations should have a counter-cyclical focus, thus forcing financial institutions to accumulate increasing capital (or reserves that cannot be distributed as profits), provisions for loan losses and liquidity cushions during booms. It has been agreed that absolute limits on leverage (the ratio of assets to the capital of institutions) should be established. Accounting rules continue to be subject to much debate. Pricing assets according to their market value (when it is available) may be preferable for reasons of transparency, but this requires the adoption of mechanisms (such as counter-cyclical loan-to-value ratios) to avoid asset price bubbles from feeding into the credit expansion, and asset price busts from speeding up the credit squeeze. Accounting rules as well as liquidity requirements should also take into account the nature of the funding used by the financial institution (short- vs. long-term).

Consumer protection also figures prominently in some of the proposals, such as the recommendation to create a Financial Safety Commission in the US. In light of the amount of toxic mortgages and highly risky investment vehicles offered to unsophisticated households during recent years, this function should be clearly enhanced, as should the principle that financial instruments offered to unsophisticated agents should be as simple as possible, as complexity brings with it information problems and difficulties for markets to price the associated instruments. The current wave of bailouts is likely to result in higher concentration in the financial industry. Restricting monopoly power, including the possibility of breaking up very large institutions, should therefore figure prominently in new regulation. Finally, and very importantly, it is essential to guarantee that prudential regulations that are in place are effectively used, and that supervision is actually done with the highest standards. As pointed out, some of the major failures leading to the current crisis came as a result of lack of supervision and implementation of existing regulations. So, increased surveillance and clear accountability mechanisms would also have to be introduced in all regulatory and supervisory bodies, both national and international.

As in the case of macroeconomic policy coordination, one of the major gaps in the current regulatory debate relate to the institutional frameworks that should be put in place. Creating a single world financial regulator is probably not viable or, for that matter, desirable, given different regulatory traditions around the world. So, the system that is designed in this area should be based on a well functioning *network* of national and regional authorities (which is still missing in the EU) and include truly international supervision of financial institutions with a global reach (such as the college of supervisors proposed by the G-20). There seems to be agreement that the IMF should *not* be at the center of the regulatory system. The Financial Stability Forum (now Board) and the Basle Committee on Banking Supervision and similar institutions are better placed. However, despite their recent broadening of membership to include all G-20 members, a major problem of these institutions is the control by major industrialized countries, which even reserve for themselves the right to choose who is a member. Thus, the design of a truly representative institution that serves as the apex of world financial regulation should be on the agenda. One alternative would be to give this responsibility to the BIS, but this would require making it a truly global institution with political accountability.

5. The broader agenda

Current international negotiations have concentrated on the coordination of macroeconomic policy packages and strengthening financial regulation. These issues do not exhaust, however, the agenda of international financial reform, which include at least three other topics: the need for a new international monetary (or global reserve) system, the role of capital account regulations in the global order, and the need for a debt workout mechanism at the international level. Institutional issues are equally important. The preference for informal organizations with restricted membership chosen by the major industrial countries is problematic, as is the inadequate representation of developing countries in international economic decision making in general.

The current international monetary system, which followed the dual gold-dollar system created at Bretton Woods, is essentially based on the use of a *national* currency (the US dollar) as the major global currency. It is secondarily a system based on the competition among national currencies (regional in the case of the euro) as reserve currencies. This system is inequitable and unstable. It is inequitable because it forces developing countries to transfer resources to those issuing reserve currencies. This transfer has actually increased over time due to the realization by developing countries that "self-insurance" in the form of large foreign exchange reserves is the only defense they have in a world of acute financial instability.

The system is also unstable because it is plagued by cycles of confidence in the US dollar: periods in which the US runs large deficits and floods the world with dollar assets, followed by others in which the credibility in the dollar as a reserve currency improves. During both phases of this cycle, the US adopts its monetary policies without any consideration as to their international impact. A system based on competing reserve currencies, such as the one we may be moving to, would not solve the inequities of the current system and could worsen another element of instability: that among the exchange rates of the alternative reserve currencies.

The deficiencies of current arrangements are why the world monetary system should be based on a truly global reserve currency: a fiduciary currency backed by the central banks of the world. This is what was hoped for when the Special Drawing Rights (SDRs) were created in the 1960s. This process must thus be completed, by transforming the SDRs into such global currency and eventually allowing it to be used in some private financial transactions. Among other advantages, this system would provide a mechanism for the IMF to play a more active role during crises, by issuing SDRs in a counter-cyclical way. Indeed, a large counter-cyclical issue of SDRs is the best mechanism to finance large official support to developing countries during crises. This would be the global equivalent to what the major central banks of the world been doing on a massive scale since September 2008. Regular issues of SDRs would also bring the size of IMF lending capacity to one more consistent with the magnitude of today's financial shocks. A major reform of IMF conditionality is necessary, anyway, to make it attractive again for developing countries to use its facilities rather than rely on "self insurance" through foreign exchange reserve accumulation.

In relation to regulations of capital flows, it must be recalled that the IMF was created on the presumption that capital account regulations could be used if necessary by any country to achieve its domestic macroeconomic and financial policy objectives. The broad based trend towards capital market liberalization has facilitated the spread (or contagion) of both booms and crises. Since developing countries are subject to pro-cyclical swings (floods of capital during booms followed by scarcity of financing during crises), they also have limited policy space to counteract such swings. Furthermore, since they usually borrow in foreign currencies, exchange rate depreciation during crises generates significant wealth losses (as several countries of Central and Eastern Europe have rediscovered in recent months). Under these conditions, external payments crisis are easily transformed into domestic financial crises.

In the ongoing debate on the role of stronger financial regulation, there should therefore be an open discussion on the use of *capital account* regulations to strengthen financial stability. Those regulations can be useful to mitigate the contagion of both booms and crises, playing therefore the role of "circuit breakers" in international finance, in the same way such breakers play a useful role in electricity networks. They can also help improve financial stability in individual countries. Therefore, the regulatory structure that must be developed for financial stability should include provisions that apply to cross-border capital movements, such as: making cross-border flows subject to taxes (the recent decision adopted by Brazil) or reserve requirements (i.e., deposits in central banks made by agents who bring capital into a country) to prevent excessive capital inflows, particularly short-term inflows during booms; minimum stay periods, similar indeed to those that mutual funds impose on investors to guarantee the stability of their deposits; and prohibitions to lend in foreign currencies to economic agents that do not have revenues in those currencies. In this regard, the IMF should not only tolerate but actually advise countries on what regulations could play a positive role under a given circumstance. The absence of any discussion of capital account issues is, therefore, a major deficiency of ongoing debates on financial regulation.

The discussions that followed in the wake of the Asian crisis indicated that the lack of an institutional framework to manage debt overhangs at the international level—i.e., a court similar to those created to manage bankruptcies in national economies, the decisions of which are legally binding—is one of the major deficiencies of the current international financial architecture. The only regular institutional mechanism in place is the Paris Club, which deals exclusively with official financing. The system has relied in the past on traumatic individual debt renegotiations or on ad-hoc mechanisms, such as the Baker and Brady Plans of the 1980s and initiatives such as HIPC and MDRI since the mid-1990s. The problem of all these mechanisms has been that they generally come too late, after high indebtedness has had devastating effects on countries. The system is also inequitable, as it does not treat all debtors or all creditors with uniform rules.

The discussion of the new international financial architecture should solve this problem by creating an international debt court, which would serve both as mediator and eventual arbitrator of sovereign loans and, possibly, some private sector loans. Negotiations would be triggered by defaults from debtor countries, and should be based on the principle of a "fresh start", which would leave a sustainable debt burden that would allow borrowers to make a (relatively) swift return to markets. Furthermore, active use of multilateral development bank lending and guarantees could play a role in financing countries while negotiations are in place and supporting their return to markets.

The major institutional drawback of current initiatives in several areas is the tendency to rely on informal structures. These arrangements are problematic, not only because they exclude small and medium-sized countries but also because they lack institutionalized mechanism to guarantee a follow up to agreed decisions. This is why the new governance system must be founded on *representative institutions*, not on any "G", which will always face problems of legitimacy. And it is necessary, for the same reason, to involve the United Nations, the most representative global institution, perhaps by taking the step, recommended in the past by many, of creating a Global Economic Council in the United Nations, with effective powers of coordination over the system of global economic and social governance. Such a body would have to be based on a constituency system, to allow the indirect representation of small and medium-sized countries while keeping the size of the Council small enough to facilitate decision making. In contrast to these proposals, one of the striking features of all three G-20 Summit communiqués has been the almost complete marginalization of the United Nations from the emerging economic governance structures.

This process should, furthermore, place at the center of international reforms efforts the discussion of voice and representation of developing countries in international economic decision making and norm setting. This includes not only the IMF, the only place where some (though extremely modest) reforms have been adopted, but also the World Bank (where such discussion is ongoing), the BIS, the Basle Committee on Banking Supervision and other world regulatory bodies. The decisions taken by the G-20 at Pittsburgh, to shift 5% of IMF quota and slightly under 5% of that in the World Bank to unrepresented countries are surprisingly modest relative to the inequities that characterize current quota systems.

Finally, the institutional design should adequately take into account the role of regional institutions. Indeed, in a heterogeneous international community, the creation of *networks* of global, regional and national institutions will provide a better system of governance than arrangements based on single global organizations. Regional and sub-regional institutions give stronger voice and sense of ownership to smaller countries, and are therefore more likely to respond to their demands. In some areas this is recognized today, such as in the system of multilateral development banks, where the World Bank is complemented by regional development banks and, in some parts of the world sub-regional (in Latin America and the Caribbean, in particular) and inter-regional banks (the Islamic Development Bank).

The recognition of the role of regional institutions is urgent in the monetary area, where the IMF should make more active use of regional institutions, such as the Chiang Mai Initiative or the Latin American Reserve Fund, and support their creation in other parts of the developing world. Indeed, the IMF of the future should be seen as the apex of a network of regional reserve funds —that is, a system closer in design to the European Central Bank or the Federal Reserve System than to the unique global institution it now is. Similar institutional design could be adopted for macroeconomic policy coordination, financial policies and for the international debt court.

The most ambitious agenda of reform, which captures most of the issues outlined above, is that proposed by the Commission of Experts of the UN General Assembly on Reforms of the International Monetary and Financial System (the Stiglitz Commission). The recent June 24-26 UN Conference on the World Financial and Economic Crisis and Its Impacts on Development approved, in turn, the most ambitious agenda agreed so far at the intergovernmental level to face the current crisis. It should be added that the 2002 Conference on Financing had approved, in turn, the Monterrey Consensus, the most ambitious agenda in the area of global financial reform, but one that has been significantly lacking in implementation.

The recent June 2009 UN Conference recognized, among other issues, the need to discuss reforms of the global reserve system and more ambitious debt restructuring mechanisms, the need for deeper governance reforms in multilateral financial institutions and standard setting bodies, and the role of regional organizations. It also recognized the role of the United Nations in the reform efforts, particularly as an inclusive forum for debate, but shied away from the more ambitious call by the Stiglitz Commission and similar proposals in the past to create a Global Economic Council. All these issues should be brought into the global agenda.