Monterrey Financing for Development Systemic Issues

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The Monterrey Approach to Systemic Issues

The financial and balance of payment crises of the mid-1990s led many countries to realize that while international financial integration promised developing economies increasing capital inflows, such net inflows have been temporary and have led to crises with often devastating consequences.

The 2002 Monterrey Consensus advanced some important principles to guide the reform of the international financial architecture. In particular, it proposed "the urgent need to enhance coherence, governance, and consistency of the international monetary, financial and trading systems." (para 52). It also stressed the need to create liquidity facilities that could help affected countries to fight crises and contagion (para 59). Finally, the Declaration stressed the need to develop sovereign debt workout mechanisms (para 60).

Most international financial institutions characterized by a *democratic deficit*. The Monterrey declaration also sought to enhance the participation of developing countries in the governance of such multilateral financial institutions (paras 62 and 63).

Changes in the International Financial Architecture

Until 2007, the international economic context has been benign. The combination of persistently low interest rates in the developed economies, liquidity-increasing financial innovations and post-9/11 developments encouraged financial agents and institutions to accept higher risks. As a result, practically all types of capital flows to developing countries grew in this period.

Sources of Financial Fragility

Capital flows to developing economies have been heavily concentrated among relatively few recipients. The largest emerging market economies have received increasing amounts of private capital while the least developed countries only receive official aid.

Even when capital flows to developing countries, their vulnerability remains high because of:

1. *dimension*: given the disparities in size between capital markets in developed and developing countries, marginal adjustments in the portfolios of institutional investors in developed countries can generate considerable volatility in developing countries' capital markets.
2. *controllability*: capital flows abroad are influenced by events in source (developed) countries, over which recipient (developing) countries have no control.
3. *absorption*: if capital inflows exceed demand for foreign currency, the exchange rate will appreciate, or governments in receiving countries are often forced to sterilize such inflows, compromising their fiscal position.
4. *externalities*: appreciation of the local currency may negatively effect net exports; excessive outflows, on the other hand, threaten the solvency of debtors in foreign currencies.

Additional sources of vulnerability include:

1. Practices and methods of foreign public debt renegotiation may not be appropriate when debts are mostly private, as is currently the case of many developing countries. The dynamics of balance of payments crises are not yet well-known and effective methods to resolve them are not yet defined.
2. The increasing appeal of securities placements – rather than bank loans – by developing country borrowers makes the coordination of creditors increasingly difficult in case of renegotiation.
3. The sharp increase in the use of financial derivatives and other innovations makes financial transactions more opaque and increases the difficulties of measuring and pricing risk.

Reserves Accumulation by Emerging Economies

Many developing countries have become exporters of capital to advanced economies. Developing countries' current account balances increased from US$34.4 billion

in 2000 to US$348.5 billion in 2006. In 2005 and 2006 alone, a few developing countries added more than US$1 trillion to their reserves.

The generalized dismantling of capital controls have made emerging economies more vulnerable to capital flow reversals, which alternately cause floods and droughts of capital. Moreover, most emerging countries facing balance of payments crises, have appealed to the IMF for rescue facilities. But the conditionalities attached to Fund loans include steeply increasing interest rates and imposing tight fiscal restraints. As a result, aggregate demand fell sharply, incomes contracted and unemployment rose significantly. There were also *structural conditionalities*, imposing trade and financial liberalization, privatization, greater labour market flexibility, and opening domestic markets to foreign interests, among other demands.

To avoid crises, many developing countries have sought to 'self-insure' by accumulating international reserves, borrowing from domestic financial markets (instead of internationally), and increasing net exports, to run current account surpluses.

It is often argued that large reserves would be better used if invested domestically, instead of being "exported". The criticism neglects the possibility, that a country may not be able to generate enough domestic demand to support full employment, especially with tightly constrained fiscal and monetary policies. The creation of liquidity facilities that do not require excessive conditionalities would reduce the incentive for such 'self-insurance'.

The IMF and the BIS

Capital account crises have three characteristics that are different from the current account crises the IMF was created to deal with: 1. they involve much bigger outflows; 2. they develop much more quickly; 3. they may lead to *contagion*, which hardly ever happens with trade imbalances.

Having limited success in dealing with the capital account crises of the 1990s, the IMF has been redefining its strategy since. Accordingly, the Fund has pursued some options including:

1. streamlining its conditionalities to focus on areas of Fund expertise, macroeconomics and monetary and financial matters.
2. transforming into an institution to undertake surveillance and provide advice.

Two relevant initiatives deserve mention: 1. multilateral consultations with systemically important members were initiated in 2006, to examine ways to resolve current global imbalances. 2. *New Decision on Bilateral Surveillance over Members' Policies* was adopted with a clear focus on member country surveillance for the preservation of *external stability*, understood as "a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements." However, the approach adopted by the IMF is still insufficient to guarantee a higher degree of systemic stability since it does not address crucial systemic problems such as autonomous capital movements and financial crisis contagion.

Another systemically important institution deserving attention is the Basel Committee for Banking Supervision (BCBS), sponsored by the BIS, because of its role in setting common regulations for banks worldwide, as with the 1988 Basel Accord and the 2004 New Basel Accord.

The Monterrey Declaration urged reforming these institutions to ensure greater developing country participation. The IMF has recognized the need to overhaul its voting rules, although the process has been tentative and *ad hoc*, with little real progress so far. Governance problems are even more serious with institutions like the BIS and its committees, like the BCBS, since they are not publicly accountable or inclusive multilateral entities, but nevertheless effectively make the financial rules.

Recommendations for the Doha Review Conference

Besides ensuring greater compliance with the 2002 Monterrey Consensus declaration, it is essential that its limitations be overcome in the Doha review conference, including those identified here:

* In-depth examination of the concepts of systemic risk and systemic crisis, and the role of autonomous capital movements and contagion in crisis generation for the

design of effective institutions and policies to minimize systemic instability.

* Design of international regulatory and supervisory frameworks to strengthen the resilience of the international financial system while enhancing its contribution to promoting economic growth worldwide.

* Sharply reduction of the democratic deficit in the governance of international, financial institutions, taking into consideration the change in mission being implemented with the Medium Term Strategy. The UN is the most appropriate forum to explore these alternatives given its own one-country-one-vote governance mechanism.

*Balanced consideration of strategies to promote systemic stability that require cooperative behaviour.

* Greater accountability of entities like the BIS and the BCBS, guaranteeing wider participation in their governance mechanisms. Enlargement of their membership should encourage developing countries to consider financial regulation options to promote economic growth while safeguarding systemic stability.

* Creating adequate liquidity facilities to facilitate crisis resolution, including sources of liquidity and conditions for access, and the creation of regional monetary funds, although a global facility will probably continue to be necessary to manage crisis situations in the future.

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