# ORF ISSUE BRIEF

JANUARY 2014 ISSUE BRIEF # 66

# The Global Financial System: A post-GFC Report Card

Jayshree Sengupta

## Introduction

In the recent past, a series of crises have shaken the International Financial Architecture (IFA). The Asian Financial Crisis of 1997 which had a global impact was one of the first of these crises and triggered much rethinking about improving the IFA. The pillars of the International Financial Architecture—the G7, IMF, World Bank and Bank of International Settlements-BIS (Basel)—met several times after the Asian crisis to plan reforms in the global financial system. But despite the initiatives taken the Global Financial Crisis struck in 2008, followed by the European debt crisis. These developments led to renewed calls for further reforms to the IFA.

After the Global Financial Crisis, efforts were made for reforms in the IFA with the following objectives:

- To take stock of the main features of the Global Financial Crisis and to examine how it was able to occur notwithstanding the existing international financial standards that were installed after the Asian Economic Crisis;
- To summarise and assess the initiatives taken with a view to strengthening the IFA;
- To provide an overview of the reformed IFA, especially its institutional and procedural aspects; and
- To provide a tentative outlook on the implementation and future role of the organisations that set the International Financial standards.[1]

1. Mario Giovanoli : The Reform of the International Financial Architecture After the Global Crisis, N.Y.U Journal of International Law & Politics, 2009

Observer Research Foundation is a public policy think-tank that aims to influence formulation of policies for building a strong and prosperous India. ORF pursues these goals by providing informed and productive inputs, in-depth research and stimulating discussions. The Foundation is supported in its mission by a cross-section of India's leading public figures, academics and business leaders.

Since much of the rethinking about crisis prevention through reforms in the IFA began with the Global Financial crisis (GFC) of 2008, it is important to understand the genesis of the crisis and its spread across the global economy. The salient features of this crisis were as follows:

(a) The GFC was essentially a domestic crisis that originated in the USA and occurred within the subprime mortgage market in the US against the backdrop of an expansive monetary policy following excessive and imprudent lending to borrowers who did not meet normal criteria of creditworthiness.

(b) These loans were securitised and resold en mass to banks and other financial intermediaries all over the world on the strength of inflated credit ratings by international credit rating agencies to the bundled assets held by investment banks (like the famous Lehman Brothers) transacting such business.

(c) In addition, derivative trading in the form of credit default swaps led to additional dissemination of the related credit risks.

(d) When the US subprime mortgage market eventually collapsed after the burst of the real estate bubble, the related assets became worthless or toxic. As a result, banks (especially investment banks) suffered huge losses which culminated in the bankruptcy of Lehman Brothers in September 2008 and signaled the advent of the GFC.

(e) When it appeared that a number of major banking institutions and other financial intermediaries all over the world had held large exposures to toxic assets, general mistrust among banks caused the virtual collapse of the interbank money market. This caused a huge shortage of liquidity in the financial markets, making banks reluctant to lend, thus deepening the GFC.

(f) The extensive government support offered by the US government to the financial sector only partially restored confidence

(g) The credit crunch resulting from financial crisis was transmitted to the real economy. Thus, the entire US economy was adversely affected resulting in deep recession.

(h) The government's support packages to the larger affected sectors of the economy in addition to the support already granted to the financial sector, massively increased the US public expenditure and fiscal deficit.

(i) Following the lead taken by the US, large sized support packages were launched in all countries seriously affected by the GFC. This led to larger fiscal deficits and rapidly increasing sovereign indebtedness in some countries. The worst affected in this respect were some of the Euro-zone countries termed as PIGS (Portugal, Italy, Greece and Spain) and PIIGS (with additional 'I'

denoting Ireland). Even at present, some of these countries are not able to meet their financial obligations because of increased 'spreads' for newly issued debt. The deepening of the Euro-zone debt crisis led to further strain on the already troubled international monetary system.

The GFC not only revealed very serious shortcomings in the financial system but also exposed the relative slackness and incompetence of the regulatory and supervisory authorities in several affected countries, both at domestic and international levels. Initially, all corrective policy measures to tackle the impact of the global financial crisis were taken at the domestic level with bailout packages being financed by the national governments.

At the international level, the approach adopted to tackle GFC was to revive the G20 (Grouping of twenty major countries). The G20 has been described as an informal forum that promotes open and constructive discussion between industrial and emerging market countries on key issues related to global economic stability. G20 had been more or less dormant since its inception in 1999[2] but after the GFC, it became very important as the main forum for deliberations on reforming the international financial architecture.

The G20 in its various meetings (held in chronological order in Washington DC; London; Pittsburgh; Toronto; Seoul, Cannes; Los Cabos; and St. Petersburg) agreed to take steps to help initiate reforms in the International Monetary Fund (IMF) and strengthen the Basel based organisations, including the Bank of International Settlements issuing Basel norms for banks' surveillance, for ensuring more prudent banking business. The Financial Stability Facility (FSF), formed after the Asian Financial Crisis of 1997, had a membership of only developed countries. The aim of the FSF was to bring together key national and international regulators in an attempt to eliminate the perceived regulatory gap which had enabled financial contagion to spread in Southeast Asian countries. The G20 decided that the FSF (renamed Financial Stability Board) or FSB should include all G20 member countries. The G20 also invited the Basel Committee on Bank Supervision (BCBS) and other standard setting bodies to expand their membership and promote global compliance of revised Basel norms for ensuring more prudent banking to reduce risks of any new GFC.

At the summit held in November 2008 in Washington D.C., the G20 focused on the international response to the global financial and economic crisis. The G20 Finance Ministers set themselves the task of working in five selected thrust areas:

2. G20 comprises of 19 countries: Argentina, Australia, Canada, Germany, Italy, Mexico, South Africa, Turkey, EU, Brazil, France, India, South Korea, Japan, Russia, China, Indonesia, US and UK. The IMF is the twentieth partner institution in the G-20.

(1) Strengthening transparency and accountability of financial institutions;

(2) Enhancing sound regulation of the financial sector;

(3) Promoting integrity in financial markets;

(4) Reinforcing international cooperation for global financial stability; and

(5) Reforming International Financial Institutions.

In addition, reforms were required for a well functioning international financial architecture that would avoid exchange rate instability and facilitate current account adjustment to rebalance the global economy. It was also necessary to provide sufficient international liquidity for the world economy and promote international trade and investment and economic growth. Basically, the IFA needed to be restructured to ensure a stable international financial environment that would help in solving problems faced by nations in their economic policy making in countering adverse effects of any GFC.

Ever since the Washington summit of G20 which took place at the height of the GFC in November 2008, there has been an attempt to strengthen bank capital adequacy standards and bank regulations. Reforms of regulations and practices involved not just banks but financial markets and all institutions working in the domain of the FSB.

After the G20 meeting in Washington D.C., the IMF emerged as a stronger institution than before in the new financial architecture. The G20 replaced G8 in making important decisions regarding international level financial sector reforms. The Financial Stability Board was also given more prominence although the division of labour between BCBS and FSB, both Basel based organisations, has not been quite clear.

The G20 summit in London in April 2009 pledged to provide additional resources to the IMF and other multilateral institutions to the extent of $1.1 trillion. The G20 also committed $500 billion to the renewed and expanded New Arrangement to Borrow (NAB), a facility which was established at the IMF after the Asian Financial Crisis.

The first major step for reforming the IFA was taken at the Pittsburgh G20 summit held in September 2009. At this meeting, world leaders agreed to initiate a peer review process or a cooperative process of "mutual assessment of policy parameters and implications of those frameworks for the pattern and sustainability of global growth". This process was agreed upon in order to reframe certain policy requirements to try to prevent another financial crisis.

The leaders went on to add that "G20 members will set out a medium term policy framework and will work together to assess the collective implications of national policy frameworks for the level and pattern of global growth and identify potential risks to financial stability." They proposed that the IMF would help with its analysis of how respective national and regional policy frameworks would fit together. The World Bank was tasked to advise on the progress in promoting development and poverty reduction. The FSB was tasked to monitor the progress in implementing regulatory and supervisory reforms. It was also asked to work together with the IMF to undertake macro-prudential monitoring of member countries' financial policies to provide early warning signals of systemic risks.

At the Seoul summit (November 2010), the members of G20 also proposed strengthening the international regulatory system—and agreed that it would have to be tightened. G20 members agreed to improve the quantity and quality of bank capital as per the new Basel III norms.[3]

## Basel Norms

Basel I and II norms were formulated before the latest Basel III norms. Basel I was a set of international banking regulations put forth by the Basel Committee on Bank Supervision (BCBS) which set out the minimum capital requirements for financial institutions with the goal of minimising credit risk. Banks that operate internationally were required to maintain a minimum amount (8 per cent) of capital based on a percentage of risk weighted assets. Basel I accord was notified in 1988 and focused mainly on credit risk by creating a bank asset classification system. If a bank had risk weighted assets of $100 million, it was required to maintain capital of at least $8 million.

Basel II superseded Basel I and was aimed at aligning the required minimum capital more closely with lenders' real risk profile. It entailed a voluntary agreement between banking authorities of major developed countries. Today, most banks are regulated by Basel I rather than Basel II. Basel III on the other hand, presents the details of global regulatory standards on bank capital adequacy and liquidity ratios agreed upon by the central bank governors.

The framework sets out higher and better quality capital, better risk coverage, the introduction of leverage ratio as a backdrop to the risk based requirement measures to promote the build up of capital that can be drawn down in periods of stress and introduction of two global liquidity standards.

3. Basel III is a comprehensive set of reform measures developed by BCBS to strengthen the regulation, supervision and risk management of the banking sector. It was agreed upon by members of BCBS in 2010-11 and was scheduled to be introduced from 2012 until 2015. But now it has been extended from April 2013 to January 31, 2019. It is supposed to strengthen banks' capital requirements by increasing bank liquidity and decreasing bank leverage.

The G20 Seoul Summit, 2010, stated in its Leaders' Declaration: "The new standards will markedly reduce banks' incentive to take excessive risks, lower the likelihood and severity of future crises and enable banks to withstand without extraordinary government support stresses of a magnitude associated with the recent crisis". Basel III has been more of a response to the crisis and does not supersede Basel I and II. It would be fully completed in January 2019.

To reduce speculation, the G20 advised that all standardized 'over the counter' derivative contracts ought to be added on electronic trading platforms and cleared through a central clearing house by the end of 2012. This provision would lend more transparency to the system.

In the Cannes (2011) and Los Cabos (2012) summit meetings, the leaders of G20 deliberated again on the reforms in the international financial architecture. In Cannes, the G20 adopted an action plan to support the development and deepening of local currency bond markets; scaling up technical assistance from different international institutions; improving the data base; and preparing joint annual progress reports to the G20. They called upon the World Bank, Regional Development Banks, IMF, UNCTAD, OECD, BIS and FSB to work together to support the delivery of the action plan of G20.

In St. Petersburg in September 2013, the G20 leaders again discussed further reforms to the IFA. They decided to focus action on a few focal points that include:

- Monitoring of Basel III implementation among its members;
- Promotion of shadow banking regulations that would cover all unregulated financial institutions and banking channels including financial companies, hedge funds, money market lenders and investment banks estimated at US $467 trillion worldwide. Such transactions currently do not fall under the IMF's surveillance mechanism.
- Reduction of mechanistic reliance on Credit Rating Agencies;
- Completion of 'over the counter' reforms;
- Completion of the transformation of FSB into a full fledged international organisation and specification of its internal governance rules and procedures;
- Persuading Asian countries to make all efforts to develop and deepen their own financial markets so that their currencies can be used more frequently in international trade, investment and finance;
- Promoting moves towards regional financial stability through arrangements like the CMIM (Chiang Mai Initiative Mechanism) and AMRO (ASEAN+3 Macroeconomic Research Office) and Asian Financial Stability Dialogue (AFSD) in cooperation with the IMF and FSB.

Despite the above efforts at reforming the IFA, problems still remain in the international financial system due to slow implementation of the proposed reforms. Several problems continue to trouble the global economy. These include, among others: sharp exchange rate volatility, persistent 'currency wars' and the possibility of a recurrence of another financial crisis. Unsustainable global imbalances still exist and there is a rise in sovereign debt crisis globally. The ultra easy monetary policy in developed countries is also affecting Emerging Market Economies (EMEs). The expected tapering of the Quantitative Easing by the Federal Reserve Board in the next few months is likely to adversely affect inflows of capital into the EMEs and create further problems for these countries.

**Global Imbalances**

The core issue of the IFA reforms of how to tackle global imbalances in financial flows however has remained unresolved though such imbalances have narrowed in the aftermath of the global financial crisis. The global imbalances refer to current account imbalances across major economies. The recent G20 discussions have been mired in disputes and controversies about which way the new monetary system and the international financial system should go. While there was widening of current account deficits during 2012, the general trend towards narrowing of these current account imbalances cannot be seen as a sign of greater global financial stability and more balanced growth.

It should be noted that the global imbalances have fallen due to the overall weaknesses in global demand and synchronized downturn in international trade and not through the more desirable structural shifts in saving rates and demand patterns in the global economy.

The future of the IFA thus is still uncertain. The main problems arising from global imbalances remain just as they existed before the global financial crisis. This is because the 2007-08 financial crisis was caused not just by regulatory failures but also by global imbalances which encouraged large capital inflows into the US, fuelling its financial bubble. The US trade deficit was at $800 bn in 2006. It narrowed to $467 bn in 2012. Also, in the post-crisis environment, global imbalances have endured though external surpluses in China, Germany and Japan and a group of fuel exporting countries have narrowed. Persistent global imbalances will lead to growing trade protectionism.

The problem of global imbalances arises because the decisions regarding regulating capital flows and exchange rates are taken at the national level by governments. As part of the post crisis reform agenda, G20 leaders addressed these imbalances by creating a new framework for strong sustainable and balanced growth through macroeconomic coordination. But in the recent past, the initiatives to foster macroeconomic coordination within G20 have been unsuccessful or their success has been short-lived because governments guard their freedom to decide on monetary and fiscal policies.

The IMF is anxious to develop standards for acceptable practices in these areas since national policies can have cross border and systemic implications as well as spillover effects. Controls on capital flows undertaken by major EMEs like Brazil while improving the internal economic situation may have certain externalities on capital flows of other countries which in the current setting of global imbalances, can have harmful consequences.

China has argued that global imbalances are driven by different national desires for savings and (in the context of the Asian financial crisis) when international organisations failed to perform their regulatory responsibilities over abnormal capital flows. Instead, excessive and stringent conditionalities were imposed. Most of the East Asian countries seemed also to have taken note that during the Crisis of 1997 when massive capital flight took place, only national forex reserves were helpful. Consequently they have been building foreign exchange reserves and increasing the rate of domestic savings in order to beef up their defence against a future global financial crisis.

Thus one of the key causes of global imbalances is the demand for larger than ever foreign exchange reserves in developing countries in the wake of global financial crisis. They are seeking to protect themselves not just from speculative international financial flows but also from the IMF whose role has been viewed as 'overly intrusive, counterproductive and too much influenced by US objectives.'[4] Supercharged export led growth strategy has been employed by most export-led developing countries to generate higher foreign exchange reserves. This behaviour is explained by the experience of the developing countries which proved that during the last financial crisis, countries with large reserves were less affected by the crisis from the impact of huge capital outflows.

Just like large current account deficit is a problem with India and some other EMEs, current account surpluses in some countries are another problem. The emerging market economies which adopted floating exchange rates are now suffering from the attempts of other countries to hold down their exchange rates. For example, most countries in the Asian region have been worried about the undervalued yuan vis-à-vis the dollar even though the Chinese government has revalued it in the recent past.

G20 countries have agreed that global imbalances have to be dealt with but have only managed to select the indicators to judge whether there is an imbalance. These include:

(i) The size of public debt and fiscal deficits;

(ii) Private saving rate and private debt;

4. Helleiner (2011), 'International Financial reform after the crisis: the costs of failure', *Socio - Economic Review,* 1-30, pp 2-30

(iii) The size of external imbalance composed of the trade balance and net investment income flows and transfers taking due consideration of the exchange rate, fiscal, monetary and other policies.

(iv) The idea of promoting the Special Drawing Rights (SDRs) as a reserve currency with other important currencies in it has also been floated.

In the Los Cabos summit held in 2012, the G20 welcomed the progress by countries with large current account surpluses to increase domestic demand and actions by countries with large current account deficits to increase national savings. G20 countries advised that emerging surplus economies would have to carry out further actions to increase domestic consumption and promote domestic demand, notably through liberalisation of service sectors and promotion of investment.

**Capital Controls**

Like the problem of global imbalances, remains the problem of excessive or uncertain capital inflows. Many countries have used capital controls to stem the volatility of capital flows. Capital controls can mean outright prohibition of capital flows to quotas on the amount of money that could be moved in or out of a country. China still employs such controls. Iceland and Cyprus have used them. The role of capital flows in economic development remains an important issue for debate in India and in many other emerging market economies. In order to address this problem, the central Bank of Indonesia organised a conference in Bali in March 2011 to discuss developments in capital flows and practices for effectively managing such flows. Further research is required for devising appropriate policies for managing volatility of capital flows.

Volatile capital flows thus remain a major risk for emerging economies and capital flow management measures must be a part of the policy to secure financial stability. Developing countries have often been excluded from the debate on global capital flows. The FSB launched in 2009 includes all members of G20. However, the vast majority of developing countries are still excluded from the process of management of capital flows suggested by the FSB. While regional groupings have been set up to liaise with non members, in practice non members have minimal say over the standards, codes and best practices with which they are expected to comply.

In the recent past, India has also been facing volatility in capital flows and the rupee has been sharply depreciating against the dollar. It depreciated by more than 20 per cent between May and July, 2013. India has imposed some temporary controls to slow down the exodus of capital. One such measure taken by the government relates to the limit to money that can be taken out of the country—from $200,000 to $75,000 a year.

Then President Nicholas Sarkozy at the 2011 Cannes G20 Summit called for a code of conduct on capital controls and tasked the IMF to propose a set of guidelines. The IMF recommended that countries should deploy capital controls only as a last resort—that is after such measures as building up reserves, currency appreciation and reduction of budget deficits have all been undertaken.

Due to the concerns expressed by developing countries, an independent task force of academics and former policy makers was set up by G20. In stark contrast to the IMF's past guidelines, the guidelines of the G20 Task Force concluded that 'there is no one size fits all' approach or rigid definition of conditions for the use of capital flow management measures and that such measures should not be solely seen as a last resort.

The IMF however has specified that only countries with sufficient reserves and exchange rates that are not undervalued and which have economies that are overheating, should try to use capital controls. Both China and Brazil have voiced wariness of the rigid rules formulated by the IMF for using capital controls and have expressed their desire for maintaining a freer hand.

**IMF Reforms**

Since the global financial crisis, the IMF has also tried to move away from its much criticised 'conditionalities'. It has tried to dismantle 'one size fits all' approach to stabilization. But reforms of governance of the IMF were tardy after the Asian Financial Crisis. Many critics after the crisis felt that the IMF had lost its legitimacy. Not only had its lending operations declined significantly; it was also suffering from a precarious financial situation. The IMF credit outstanding which had peaked at almost $100 billion before the end of 2005, had declined to about $10 billion by the end of September 2008. IMF's income which is related to its lending operations dwindled, leading to staff retrenchments. However, in the aftermath of the global financial crisis, its legitimacy and effectiveness increased as a relevant partner in reforming the IFA. The G20 summits have given a new life to the IMF which has now been elevated to the position of an innovative crisis manager.

At the Cannes summit, the G20 supported the IMF in putting forward the new Precautionary and Liquidity Line (PLL). The PLL would provide, on a case by case basis, increased and more flexible short term liquidity to countries with strong policies and fundamentals facing exogenous and systemic shocks. The G20 also supported the IMF in putting forward a single emergency facility to provide non-concessional financing for emergency needs such as natural disasters and other emergency situations in fragile and post-conflict states.

G20 at Cannes also urged reforms in governance and quota structure of the IMF. It called for strengthening of IMF's surveillance. In this context, the G20 stated that a strengthening of

multilateral surveillance and a better integration with bilateral surveillance along with enhanced monitoring of inter-linkages across sectors, countries and regions would be useful.

It urged the IMF to make progress towards a more integrated, even handed and effective surveillance, taking into account the Report of the Independent Evaluation Office on surveillance with special reference to the financial sector; and national fiscal, monetary, and exchange rate policies and their impact on external stability.

The G20 called on the IMF to continue to regularly monitor cross border flows and their transmission channels and update its work on drivers and metrics of reserve accumulation taking into account country specific circumstances. The G20 also desired that along with the BIS, the IMF should step up the work on identifying reliable global liquidity indicators with a view to incorporate these indicators in the IMF's future surveillance and other monitoring processes.

The G20 stated that "we will avoid persistent exchange rate misalignments and we asked the IMF to continue to improve its assessment of exchange rates and to publish its assessments as appropriate."[5]

To increase the transparency of IMF's surveillance, the G20 reaffirmed the importance of all IMF members to contribute to improve data availability and support the Managing Director's proposal to publish multilateral assessments of external balances and timely publication of surveillance reports.

Since the last Global Financial Crisis, IMF's lending volume has increased to $160 billion. There was a request by the EU to the IMF to take part in rescue operations of Greece. This development has enhanced the clout of IMF further. Consequently, IMF's lending capacity has been tripled to $750 billion. A number of countries agreed at Los Cabos to contribute to IMF's increased resources. India also pledged $10 billion.

As mentioned above, along with the FSB, the IMF has been involved in the peer review process. Even so, the IMF lacks trust of many members and is viewed as the agent of western countries. According to Nobel Laureate Joseph Stiglitz, the future global financial architecture should comprise of a network of regional monetary funds working in coordination with a trimmed IMF.

At Los Cabos G20 summit in 2012, it was decided that the IMF quota reform process should be sped up from 2013. But the IMF's own governance reforms have not yet taken place. The IMF needs to work with regional surveillance and monitoring bodies. IMF surveillance review in October 2011 revealed that the IMF's surveillance has been too fragmented in dealing with risk assessments. These assessments have been lacking depth and have provided insufficient focus on interconnections and

5. G20 Cannes Summit Final Declaration, 4 November 2011, p.4

transmission of shocks. Surveillance by the IMF also had less impact on the larger developed member countries.

Thus there is an urgent need to reform the IMF's surveillance, lending and governance systems. The quotas have to be increased on the basis of a transparent formula which would lead to larger representation of developing countries on the Board of the IMF.

The IMF has paid little attention to how new global financial regulations will affect developing countries. It has not addressed the relevant questions regarding how stringency in global standards can be balanced with flexibility that would allow countries with different levels of financial development to select policies best suited to their needs.

In the IMF, the role of the Special Drawing Rights could be increased as a reserve asset. This step could help to meet the increased demand for building up reserves in a manner that does not impact the dollar or global imbalances. The G20 leaders took the first step in this direction in 2009 when they endorsed the first increase in the allocation of SDRs since 1981. Fresh allocation of SDRs worth $250 billion was made. This boosted the share of SDRs in the world's non gold official reserves overnight from less than 0.5 per cent to 5 per cent. Thus the G20 has added to the increase in supply and attractiveness of SDRs.

At the Cannes meeting. the G20 agreed that the composition of the SDR basket should continue to reflect the role of currencies in the global trading and financial system and should be adjusted over time to reflect key currencies' changing role and characteristics. It said that a broader SDR basket will be an important determinant of its attractiveness and in turn influence its role as a global reserve asset. This will serve as a reference point for further appropriate reforms of the IFA.

At the G20 meeting held at St. Petersburg recently, the implementation of the IMF's doubling of quota resources and reviewing the IMF's quota formula was agreed upon in order to adequately reflect the current weightage of its members. The G20 also discussed further strengthening of the IMF surveillance framework and multilateral analysis, including the assessment of spill over effects and developing global liquidity indicators.

The leaders of the G20 collectively agreed that better coordination of macro prudential priorities with an effective regulatory and supervisory framework would help to minimise the capture of the regulatory process by the private sector. In addition, it would be necessary to ensure that the much needed governance reforms at the IMF would be carried out with full sincerity and seriousness.

## Financial Regulatory Reforms

Some major problems remain regarding implementing financial regulatory reforms. Basel III, the cornerstone of new global financial regulations, has major shortcomings. It allows large banks to use their internal models for risk weighting of assets. This implies that the banks are free to choose models which deliberately lower their capital requirements. Basel III is also an overly complex document with text of 616 pages. In comparision, Basel I rules were covered with text of only 30 pages. In this context, it also needs to be noted that the large banks successfully lobby to water down new regulations to their advantage. Lobbying by powerful banks is partly to blame for the weaknesses of the Basel III norms.

Disagreement among various governments regarding Basel III has resulted in fragmentation among various countries on its implementation. Large banks as well as national governments have been wary of ceding autonomy to international rules and are pursuing their own often distinct regulatory agendas.

In the new reformed International Financial Architecture, the G20 will thus have to depend on the IMF for surveillance. This would not be welcomed by those developing countries which do not entirely trust the IMF due to the limited progress made by the IMF at its own reforms.

Whether a single reserve currency system dominated by the U.S. dollar should be replaced by a mix of other major international reserve currencies for a more diversified international monetary system (for example with euro and the Chinese yuan) is a moot question.

Many economists feel that the policy makers should do more to support regional reserve pooling mechanisms like the Chiang Mai Initiative in East Asia. It should be noted that regional reserve pooling arrangements have proven their usefulness as a supplementary avenue for bailing out countries in trouble in Southeast Asia and East Asia. Such regional arrangements have also been effective in easing the distress caused by the European debt crisis through the the European Financial Stability Facility (EFSF) working in conjunction with the supportive policies by the European Central Bank (ECB) in partially bailing out distressed member countries of the Euro zone from their financial difficulties.

In recent times, regulatory reforms have had to deal with a changing international financial scene. From 2011 there has been excessive volatility in global capital markets that continues to this day. Because of loose monetary policy, low interest rates and slow recovery in the US, accompanied by high interest rates and rapid growth in emerging markets, the foreign investors flocked from the north to the south—to Brazil, China, South Korea, Taiwan and other countries. More recently due to the Eurozone crisis, capital has retreated from emerging markets to the US.

In view of the recovery and higher growth being currently experienced by the US, the main concern of the Emerging Market Economies (EMEs) is the Federal Reserve's plan to taper down its Quantitative Easing policy in the coming months and eventually phase it out completely in one to two years. This news has already led to a plethora of problems with investors withdrawing their money from the EMEs and sending it back to the US. The pressing issue for the EMEs is how to keep the hot money within their countries and not let it go back to the US. It is widely acknowledged that the inflows of foreign investment, in the forms of both direct foreign investment and foreign institutional investment (portfolio flows) have helped in the past to finance current account deficits of some of the EMEs and other developing economies.

The reforms in the International Financial Architecture thus far have strengthened the role of the IMF's role as an important pillar of this architecture. The other major pillars of this architecture are: the Financial Stability Board and the Basel Committee on Bank Supervision. The only new development is that the G8 has been replaced by the G20 as the decision making body with regard to reforms in the financial architecture so that there is a serious attempt at rebalancing of global economic growth. This development correctly reflects the incremental changing balance of economic power in the global economy.

There is still an urgent need for strengthening financial regulation further and better governance through the concerned international financial institutions. Hopefully, reforms at the IMF will also take place sooner than later for further strengthening the IFA.

**Conclusion**

The international financial institutions created under the Bretton Woods system are still suffering from the predominant influence of members of the 'rich club'—the US and the EU. To increase G20's credibility it is vital that the voice of the emerging economies be heard in the reforming of the IFA. There needs to be speedy implementation of the 2010 IMF quota reform. G20 also needs to stick to its commitment of increasing inclusiveness by opening the door to countries that are developing and are least developed. G20 should seek macroeconomic cooperation and coordination that would help to reinvigorate the world economy and it should help usher in a more open and fair global trading system.

G20 as an important pillar of the IFA has to ensure the regulation of global financial markets. In doing so there has to be more effective banking supervision by BCBS and FSB. Regarding Basel III, some economists have asserted that the high capital requirements are costly and would affect credit markets adversely. Others have argued that requiring banking institutions to be funded with significantly more equity entails large social benefits and minimal societal costs.

The Global Financial Crisis gave regulators a golden opportunity to achieve far reaching consensus on critical regulatory reforms and G20 and BCBS adopted a framework for regulation of capital and liquidity. There is little doubt that forcing banks to hold more high quality capital reserves will significantly reduce the potential for future crisis. Many countries including India have already begun to integrate Basel III requirements into their domestic laws.

The G20 has also emphasised the importance of regulating financial institutions and FSB has backed it up with studies monitoring the progress of individual countries. Many advanced countries have implemented significant legal reforms to prevent banks from becoming too large to manage and have come up with effective frameworks to strengthen weak institutions. Yet the work of G20, IMF, FSB and BCBS is far from finished and in order to retain their current mandate of controlling as well as reforming the IFA, the reform process has to be continued to foster international cooperation and financial stability globally.

## References:


1. IMF: Resources and the G 20 Summit (October 14, 2011)
2. DIIS Working Paper: The new Global Economic Council: Governance reform at the G20, the IMF and the World Bank by Jakob Vestergaard and Robert Wade
3. International Law and Politics August 2009

   The Reform of the International Financial Architecture after the Global Crisis by Mario Giovanoli
4. Oxford Journal—Social Economic Review Volume 9 Issue 3

   International financial reform after the crisis: the costs of failure by Eric Helleiner
5. Reforming the International Financial Architecture, 2011 Edition By Barry Eichengreen
6. RSIS Working Paper No. 201

   Reform of the International Financial Architecture: How can Asia have a greater impact in the G20 by Pradumna B. Rana ( S. Rajaratnam School of International Studies, Singapore) June 2010
7. Breugel (Brussels) and Peterson Institute for International Economics: Reform of the Global Financial Architecture by Garry J. Schnasl and Edwin M. Truman
8. Reforming the International Financial Architecture, Chapter V
9. Reforming the International Financial Architecture: The New Political Agenda by Randal Germain
10. United Nations ECLAC: Reforming the International Financial Architecture by Jose Antonio Ocampo
11. Commonwealth Secretariat Economic Paper Series: Reforming the Global Financial Architecture by Montek Ahluwalia
12. ICRIER Policy Series No.11 December 2011

    Challenges in International Monetary System Reforms: A global and Emerging Markets' perspective by Alok Sheel
13. The Reform of the International Financial Architecture: A Latin American and Caribbean Vision SELA, April 2010
14. G20 Summit Declarations at Cannes, Los Cabos and St. Petersburg
15. Duke Journal of Comparative & International Law (Volume 22:239)

    Banking on Cooperation: The Role of the G20 in improving the International Financial Architecture by Arie C. Eernisse


---

**ABOUT THE AUTHOR**

Jayshree Sengupta is a Senior Fellow at Observer Research Foundation, New Delhi.

**Observer Research Foundation,**
20, Rouse Avenue, New Delhi-110 002
Phone: +91-11-43520020 Fax: +91-11-43520003
www.orfonline.org email: orf@orfonline.org