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# KEYNOTE ADDRESS

# PROSPECTS FOR GLOBAL FINANCIAL REFORM

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There are at least three underlying causes of the global financial and economic crises in recent decades. Since the collapse of the Bretton Woods system in 1971, a small handful of currencies, especially the US dollar, have basically served as reserve currencies for the world. This has allowed the issuers of these currencies to run massive trade deficits, contributing to ultimately unsustainable global imbalances in savings and consumption.

A second underlying cause has been growing financial fragility arising from the global financial 'non-system' in place since the collapse of the Bretton Woods system as well as macro-financial dynamics. The lack of coherence and coordination in the system has been exacerbated by the strong trend towards financial deregulation, liberalization and globalization over the past three and a half decades. Referring to this 'non-system' as an international financial 'architecture' is truly insulting to architects.

The third underlying cause of the global financial and economic crisis has been the ascendance, transformation and hegemony of the financial sector -- often termed 'financialization' -- over the past three to four decades. Finance is indeed a very important, if not essential hand-maiden for the functioning of the real economy, but the term refers to the ascendance of the financial sector over the financing needs of the real economy.

Partly as a consequence of financialization, decision-makers are now often more concerned with short-term financial indicators than with other basic economic indicators, usually presuming the former reflect the latter. This subordination of the real economy to finance is a fundamental part of the problem.

So, to address the root causes of crises, what is needed is much better, especially more appropriate regulation of the financial system, ensuring consistently counter-cyclical macro-financial institutions, instruments and policies, and subordinating the financial sector to the real economy. There is no simple prescription of how this is to be achieved, as circumstances vary considerably, both over time, with popular practices and trends, and also depending on extant frameworks.

The crises have catalyzed many debates on these issues, some old, some new, for instance between Keynesian/Minskyian economists and their opponents, between the supposedly Anglo-American and continental European worldviews, and between North and South. Any sustainable solution will clearly require extensive international cooperation and co-ordination.

## INTERNATIONAL COORDINATION

Why is global co-ordination so necessary? There are two main reasons. One of the big problems before the Second World War was the lack of international coordination. So, in 1944, at the end of the Second World War, President Roosevelt convened the United Nations Conference on Monetary and Financial Affairs -- better known as the Bretton Woods Conference – even before the UN was set up the following year in San Francisco. After almost a month of meetings, the conference created the basic framework for the international monetary and financial system after the war, including the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), or World Bank.

This system lasted until 1971 when it was unilaterally ended by US withdrawal during the presidency of Richard Nixon. The leading international monetary economist of the post-war period, Robert Triffin, described the post-1971 arrangements as amounting to a ‘non-system’. Now, with the international monetary system essentially the cumulative outcome of ad hoc responses to perceptions of various incentives, deterrents and challenges, the need for coordination is all the more urgent.

A strong case for co-ordination has been made in the *World Economic Situation and Prospects* published by the United Nations Secretariat and prepared by its Department of Economic and Social Affairs (DESA). For example, the 2009 Mid-year Update showed how better coordinated and more equitable fiscal stimuli would have benefited all parties -- developed countries, developing countries, transition economies and, most of all, the least developed countries.

Although recent and current international coordination leaves a lot to be desired, there have been some efforts to improve the situation. For instance, in October 2008, at the time of the annual IMF-World Bank meetings, there were some efforts to improve coordination by the G-7 as well as in Europe soon afterwards. Unfortunately, these efforts did not achieve much.

Meanwhile, President Sarkozy of France saw the problem and discussed holding a summit at the UN with the UN Secretary-General. He subsequently consulted US President Bush who insisted on hosting the first ever G20 summit in mid-November 2008 in Washington DC. (The G-20 Finance Ministers had been meeting for a decade after it was created by US Treasury Secretary Larry Summers and then Canadian Finance Minister Paul Martin after the 1997-1998 Asian crisis.)

Why is it so difficult to achieve meaningful coordination while everybody agrees that it is desirable? The 1950s and 1960s have been referred to as the Golden Age, a period of rapid reconstruction, growth and employment expansion after the destruction of the Second World War. It was also a period of beginning development and structural transformation in many post-colonial developing countries, albeit with mistakes and flaws, with the benefit of hindsight.

This came to an end when deliberate multilateral coordination collapsed following President Nixon's decision to renege on its 1944 commitments as the basis for the post-war international monetary system. The end of the Bretton Woods system in 1971 contributed to poorer growth, greater volatility, more instability, slower progress in raising economic welfare and so on.

## UNDEMOCRATIC GOVERNANCE

Meanwhile, the relationship between the Bretton Woods institutions (the World Bank and the IMF) and the rest of the UN system has changed over time. The BWIs were initially conceived as part of the post-war system of multilateral governance to ensure the conditions for peace, growth, development, employment and prosperity. Today, however, the Bretton Woods institutions' governance arrangements remain very different from those of the rest of the UN system, with all its variety. This is part of the problem. To put it crudely, the Bretton Woods or Washington institutions are governed by a principle of 'one dollar, one vote', whereas in New York, the UN is governed by 'one country, one vote', at least at the General Assembly.

Europe is over-weighted in the Bretton Woods institutions while developing countries are generally under-weighted, even in terms of economic output. These governance arrangements in the Bretton Woods institutions have created a sense of exclusion; developing countries feel they are not fairly represented, especially with the dilution of the weight of the basic vote over the decades.

For example, in the mid-1940s, there were 44 members of the Bretton Woods institutions, with the weight of the basic vote for the 44 totaling 11.4 per cent. Today, there are 189 members. So, if the weight of the basic vote remained the same, the total weight of the members would be just under half (189/44 x 11.4%). A decade ago, just before a modest reform, it was only 2.2 per cent, or less than 5% of what it should have been! Such governance issues inevitably undermine legitimacy, and thus constrain more effective global coordination, but of course, there are other problems as well.

For many years now, there have been some important differences across the Atlantic, arguably since the 1960s. During the recent crisis, the European approach relied initially on its long-standing automatic stabilizers, arguing that Europe did not need the big fiscal stimulus which the US and the UK – unusually -- advocated in 2009. Later, the European Central Bank warned incessantly of the threat of inflation, while the IMF seemed to take the view, like the rest of the UN system, that the bigger threat was that of protracted deflation, recession and stagnation.

Under the leadership of UK Prime Minister Gordon Brown, the G-20 committed to a huge capital infusion for the IMF in April 2009. It would have been better if the G-20 had provided this capital boost on condition that the IMF reform itself to better serve the developing countries, especially those most marginalized by existing governance arrangements. Without sufficiently reforming itself sufficiently, the IMF has continued to suffer from legitimacy and credibility problems, undermining its ability to provide more effective leadership.

While the IMF is undoubtedly very important, there is no World Finance Organization or Authority, unlike with trade, where there is the WTO. Through its General Agreement on Trade in Services (GATS), it has been the WTO which has been legislating on financial services liberalization. Besides the WTO, the Bank of International Settlements, the Basel Committee on Banking Supervision, the Financial Stability Board and other international organizations where the OECD economies have effective control, have jurisdiction in cross-border financial matters. Meanwhile, important UN initiatives, e.g., the Financing for Development (FfD) Conference, have been largely ignored in various discussions on international financial reform.

Almost a decade after the 2008 financial crisis erupted, it remains doubtful whether there is enough shared political commitment to see through needed global financial reforms. It took fifteen years, a world war and Roosevelt's extraordinary leadership before the world was able to reform the international financial system in 1944. Have we learned from history?