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WIDER Annual Lecture 14

**Reforming the International
Monetary System**

José Antonio Ocampo

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The World Institute for Development Economics Research (WIDER) was established by the United Nations University (UNU) as its first research and training centre and started work in Helsinki, Finland in 1985. The Institute undertakes applied research and policy analysis on structural changes affecting the developing and transitional economies, provides a forum for the advocacy of policies leading to robust, equitable and environmentally sustainable growth, and promotes capacity strengthening and training in the field of economic and social policy making. Work is carried out by staff researchers and visiting scholars in Helsinki and through networks of collaborating scholars and institutions around the world.

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FOREWORD

The unsettling years since 2007 have shown how unfit for the purpose the current international monetary and financial system is. On 9 December 2010, Professor José Antonio Ocampo delivered the 14th WIDER Annual Lecture at the UN headquarters in New York, formulating global recommendations for a serious overhaul of the struggling international system. During the lecture he approached the reform agenda from the perspective of developing countries—elaborating that global governance must design a system that not only provides the global public goods necessary to guarantee macroeconomic financial stability and balanced growth but, crucially, one that also corrects the many asymmetries that developing countries face under the current dysfunctional architecture.

The WIDER Annual Lecture is delivered by an eminent scholar who has made significant contributions in the field of economics of development and transition. José Antonio Ocampo falls squarely into this category being an internationally known and respected scholar on development issues, along with having authored numerous influential studies on finance and market liberalization. I am confident that readers will find this publication of the lecture most absorbing. José Antonio Ocampo has managed to tease out the many complex facts in an accessible manner, and his logical and sequential analyses, along with his conclusive argument in favour of a comprehensive yet evolutionary reform of current international monetary system, is most convincing.

Finn Tarp, Director
UNU-WIDER Helsinki

AUTHOR'S ACKNOWLEDGEMENTS

It was an honour to deliver the 14th Annual WIDER Lecture at the United Nations Headquarters in New York on 9th December 2010. I have been associated with UNU-WIDER since its early days, participating initially in projects led by Gerry Helleiner and Lance Taylor, and at a conference in honour of my great professor, Carlos Díaz-Alejandro. I have had since the opportunity to work with UNU-WIDER as both a researcher and a UN official.

This lecture borrows from my work on these issues over many years, both at the UN and at Columbia University. It also benefited greatly by the debates that took place in the 2009 Commission of Experts of the UN General Assembly on Reforms of the International Monetary and Financial System, of which the author was a member. I am grateful to the Ford Foundation for supporting my work on this topic at Columbia University, as well as to many persons with whom I have debated the issues covered in this Lecture in recent years, and from whom I have learnt considerably, including Yilmaz Akyüz, Amar Bhattacharya, Kemal Derviş, Barry Eichengreen, Roberto Frenkel, Kevin Gallagher, Stephany Griffith-Jones, Eric Helleiner, Jomo K.S, Peter Kenen, Jan Kregel, Isabelle Mateos y Lagos, Joseph E. Stiglitz, Lance Taylor, and John Williamson. Some of them also provided comments to previous drafts of this lectures but do not necessarily agree with my points of view. For reasons of space, some topics are, unfortunately, only dealt with in passing.

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ABOUT THE AUTHOR



José Antonio Ocampo is Professor and Director of the Economic and Political Development Program at the School of International and Public Affairs and Fellow of the Committee on Global Thought at Columbia University. He holds a BA in Economics and Sociology from the University of Notre Dame (1972), and a PhD in Economics from Yale University (1976). He has received a number of personal honours and distinctions, including the 2008 Leontief Prize for Advancing the Frontiers of Economic Thought and the 1988 Alejandro Angel Escobar National Science Award of Colombia. In 2009, he was a Member of the Commission of Experts of the UN General Assembly on Reforms of the International Monetary and Financial System. In 2008-2010, he was co-director of the UNDP/OAS Project on ‘Agenda for

a Citizens’ Democracy in Latin America’.

From 2003 to 2007 he served as the United Nations Under-Secretary-General for Economic and Social Affairs and, prior to that, as Executive Secretary of the UN Economic Commission for Latin America and the Caribbean (CEPAL/ECLAC). From 1989 to 1997, he held a number of high-level posts in the Government of his native Colombia, including Minister of Finance and Public Credit, Director (Minister) of the National Planning Department, and Minister of Agriculture. He also served as Executive Director of FEDESARROLLO, Professor of Economics at Universidad de los Andes, and Professor of Economic History at Universidad Nacional de Colombia, and visiting professor at Cambridge, Oxford and Yale Universities.

He has published extensively on macroeconomic theory and policy, international financial issues, economic and social development, international trade, and Colombian and Latin American economic history. His most recent books include *Historia Económica de Colombia* (2007), *Capital Market Liberalization and Development*, co-edited with Joseph E. Stiglitz (2008); *Growth and Policy in Developing Countries: A Structuralist Approach*, with Codrina Rada and Lance Taylor (2009); *Time for a Visible Hand: Lessons from the 2008 World Financial Crisis*, edited with Stephany Griffith-Jones and Joseph E. Stiglitz (2010); *Desarrollo, vaivenes y desigualdad: Una historia económica de América Latina desde la independencia*, with Luis Bértola (2010); and the *Handbook of Latin American Economics*, edited with Jaime Ros (forthcoming 2011).

1 The context

The recent global financial crisis showed how dysfunctional the current international monetary and financial architecture is for managing today's global economy. Calls for and steps taken to reform such architecture are, therefore, welcome. Similar calls for reform were made after the Asian, Russian, and Latin American crises of the late twentieth century,¹ but they led to at best marginal reforms. The fact that this time industrial countries have been at the centre of the storm has led to a broader set of initiatives.

The financial meltdown unleashed by the crisis in the market for subprime mortgage-backed securities in the USA in August 2007 and, particularly, by the collapse of Lehman Brothers in September 2008, made clear that there was significant deficit in the regulation and supervision of financial activities. European banking also suffered major problems associated with investments in high-risk assets issued in the USA, real estate euphoria in a number of countries, and the lending booms in several Central and Eastern European countries, among other factors.

While the massive expansionary monetary policies and interventions to rescue bankrupt financial institutions in the industrial economies contained the haemorrhage, they have only had mixed effects in generating strong recoveries in industrial countries. Steps taken to reregulate finance under the leadership of the G-20, including through the reformed Financial Stability Board (previously Forum) and the Basle Committee on Banking Supervision, have been positive, though the incomplete character of the agenda and slow speed of implementation remain a matter of concern. Significant effort to reform IMF credit lines, increase the resources available to this institution and make the largest issue of IMF's Special Drawing Rights (SDRs) in history have also been important achievements in the global monetary field.

However, monetary expansion in industrial economies and, particularly, in the USA has had major international spillovers, which ignited what came to be known as the 'currency wars', a term coined in 2010 by the Brazilian finance minister, Guido Mantega. This, plus the debates on the contribution of global payments imbalances to the current crisis, as well as calls for reforms of the role of the US dollar in the international economy have also made clear that the global monetary system also needs deep reforms. This is an area where action has been very limited so far. Since 2009, there have been proposals for deep reforms of the global reserve system by the Chinese Central Bank governor (Zhou 2009) and the UN Commission of Experts on Reforms of the International Monetary and Financial System (United Nations 2009b), headed by Joseph E. Stiglitz, among others. The currency wars now indicate that the international exchange rate system—or, rather 'non-system', as it involves a mix of all possible exchange rate regimes—may also need an overhaul. And in the face of the flood of capital that they have received since mid 2009, many emerging and developing countries are responding by strengthening or reimposing capital account regulations. These interventions may also be generating international spillovers of their own, indicating that cross-border finance may also require regulations of its own, in fact as part as the global effort to re-regulate finance.

¹ This was accompanied by extensive academic debates. See, among others, Kenen (2001), Eatwell and Taylor (2002) and Ocampo et al. (2007).

These developments indicate that four central elements of global monetary system—the global reserve and exchange rate systems, capital account regulations, and emergency balance of payments financing—are closely interlinked. This is reflected, first of all, in the fact that countries can adjust to variations in external shocks, particularly those coming through the capital accounts, through a mix of four mechanisms: (first) absorbing such shocks through changes in foreign exchange reserves, (second) letting their exchange rates move, (third) controlling capital inflows or outflows, and (fourth) receiving IMF financing. The linkages between the four elements were also reflected in the way the post-war monetary system was designed at Bretton Woods, which included a dual gold-dollar standard, together with the principle that exchange rates would be fixed but could be adjusted in the face of fundamental balance of payments disequilibria, the capacity of countries to resort at any time to regulate capital flows, and limited IMF balance of payments financing.

The collapse of the first of the components of the global monetary architecture in the early 1970s gave way to a system in which totally inconvertible (fiduciary or fiat) dollars are at the centre of the global reserve system, though in potential competition with other currencies, with major currencies fluctuating against each other. IMF members were then allowed to adopt any exchange rate regime they chose, so long as they avoided ‘manipulating’ their exchange rates—a term that has escaped so far a clear definition. The USA and the then managing director of the IMF, Michel Camdessus, tried to add a third leg to the system during the IMF meetings in Hong Kong in 1997: the principle that capital accounts should be liberalized. They failed, but market pressure and mainstream economic thinking largely imposed this principle in practice.

Global monetary reform should include a fifth and essential element: global monetary policy co-operation. However, although this was envisioned in the IMF Articles of Agreement, it has been limited so far in history to exceptional circumstances, including the current global financial crisis, and have relied on limited form of co-operation through ad hoc bodies (G’s) rather than multilateral organizations (the IMF in this case).

So, we now have a global monetary system based on: (i) a fiduciary dollar standard (secondarily, competition of different currencies in their role as reserve currencies); (ii) the freedom of countries to choose whatever exchange rate system they prefer, with flexible exchange rates being the dominant mechanism among major currencies; (iii) largely free capital movements or the market expectation that countries would move in that direction, but with the capacity of countries to control capital flows; (iv) IMF financing that has been small relative to the magnitude of contemporary balance of payments crises; and (v) ad hoc macroeconomic policy co-ordination under crisis conditions.

Lastly, the ongoing crisis in peripheral Europe has reminded us not only that the global financial crisis is far from over, but also that there are two additional gaps in the international monetary and financial architecture. The first is the need for strong regional pillars, which has been filled by the creation, as an emergency measure, of the European Financial Stability Facility, which would be succeeded in 2013 by the European Stability Mechanism. After its own crisis, East Asia created the Chiang Mai initiative in 2000, which was given final multilateral form in December 2009, but which was not tapped

during the current crisis. The second gap is the lack of a regular institutional framework to manage debt overhangs at the international level.

2 The need for a comprehensive yet evolutionary reform

The dynamics of the crisis has thus brought into the debate an increasing number of ingredients of global monetary and financial reform, most of which had been off the agenda during previous periods of turbulence. This represents an opportunity to undertake the difficult task of negotiating a comprehensive reform. What makes it viable is that many of the elements of reform can evolve out of some existing arrangements, as has been happening already with the issuance of SDRs, new IMF credit lines, new Basel Committee guidelines, etc. The G-20 and its associated bodies have made advances in other areas, including new mechanisms of macroeconomic policy co-ordination upon which the international community can build. So, advances underway create the real possibility of comprehensive yet evolutionary reform.

Reform should have two major objectives: global macroeconomic and financial stability. The first must respond to the fact that the system is fundamentally an *international* one, formed therefore on the basis of different *national* monetary systems (regional in the euro area and some other cases), using their own national fiduciary currencies, and under authorities that obviously determine their policies based on their own national (or regional) priorities. The challenge is how to make that system consistent with a reasonable level of *global* macroeconomic stability, thus avoiding both expansionary and recessionary biases and thus sharp world business cycles, as well as inflationary and deflationary surges, guaranteeing in particular that adjustments of balance of payments imbalances do not have major global repercussions. In turn, fulfilling the second objective means that the system should avoid or at least mitigate financial volatility and contagion, particularly through adequate prudential regulation and supervision. A long history of crises indicates that the two dimensions of stability are closely interlinked. In both cases, priority should be given to crisis prevention, but history also indicates that there is also a significant deficit of good tools for crisis management.

This study will concentrate on the first of these dimensions of stability, though recognizing its links with the second. In fact, some of the elements of reform can be classified under either of the two categories. Thus, regulations of capital flows can be seen as part of the monetary or financial architecture, and it is certainly part of the family of ‘macroprudential’ regulations. This is also true of debt workout mechanisms.

A comprehensive global monetary reform should thus include five major objectives: (i) designing an international reserve system that contributes to the stability of the international economy, in particular through the provision of adequate international liquidity, and is considered as fair by all parties; (ii) creating mechanisms that facilitate the consistency of national economic policies of major countries with the stability of the world economy systems; (iii) in close relation to this, and given the central role that it plays in payments adjustments, designing an exchange rate system that promotes stability and avoids negative spillovers on other countries; (iv) regulating cross-border finance, in order that it facilitates trade but also mitigates the pro-cyclical behaviour of international capital flows and the risks it generates; and (v) offering appropriate emergency balance of payments financing during crises, the limited version, at the international level, of the

function that central banks perform at the national levels as lenders of last resort. Since emergency financing is only a good alternative when payment difficulties are associated with liquidity problems, the latter objective closely interacts with a sixth, which, as noticed, may be seen more as either a financial or monetary tool; (vi) creating adequate debt workout mechanisms at an international level to manage problems of over-indebtedness.²

In the following sections, we will briefly deal with these objectives and how they interact with each other. Section 3 will analyse the global reserve system. Section 4 will discuss the interlinked issues of monetary co-operation and the exchange rate system. Section 5 will then tackle capital account regulation. Section 6 will focus the interlinked issues of emergency financing and debt workouts. This will be followed by a discussion of the institutional design. The study ends with some short conclusions.

3 The global reserve system

As already noticed, the current global reserve system evolved out of the unilateral 1971 decision of the USA to abandon the gold-dollar parity and convertibility of dollars for gold for governments and central banks established at Bretton Woods, thus evolving into a system characterized as essentially based on a fiduciary US dollars. Although other currencies can compete with the US dollar as international means of payments and potential foreign exchange reserve assets, this competition has been weak due to the ‘network externalities’ in the use of currencies and the fact that the USA has by far the largest market for liquid treasury securities. Over the last decade, more than 80 per cent of foreign exchange transactions have been made in US dollars and about two-thirds of foreign exchange reserves have been held in that currency. The other feature is that alternative reserve currencies float against each other—an issue that links to the debate on the exchange rate system.

This system can be characterized as facing three distinct problems, which in fact may be said to have arisen in a historical sequence (Ocampo 2010a, 2010b). The first is the problem that Keynes (1942-43) emphasized in his proposals for a global monetary system in the years leading to the Bretton Woods agreement, and that, as he pointed out, was also a feature of all international monetary systems that we have known: the asymmetric adjustment pressures that it imposes on deficit versus surplus countries. As the former are forced to adjust, whereas the latter are not, this creates a clear recessionary pressure on the world economy. This problem is, of course, felt with particular severity during global recessions, when deficit financing dries out. This problem may be called the ‘anti-Keynesian bias’ of the system.

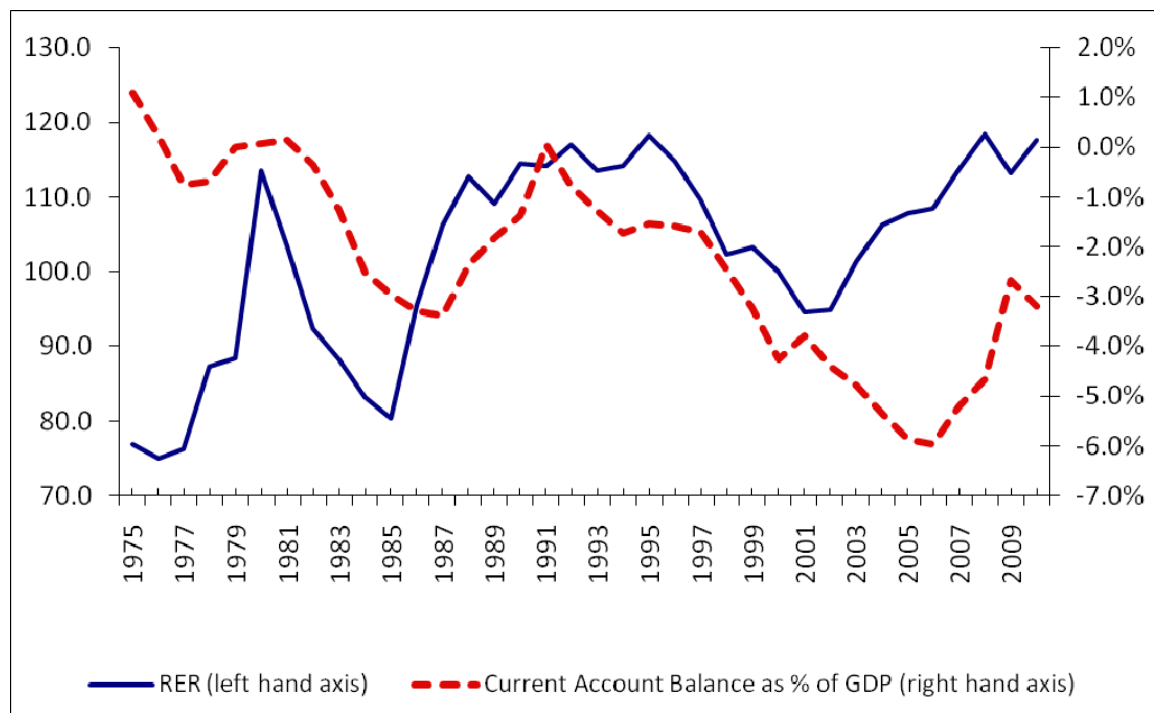
The second problem is that generated by use of a national currency, the US dollar, as the major international currency. It was formulated in the 1960s by the Belgian economist Robert Triffin (1961, 1968) and thus came to be known as the ‘Triffin dilemma’. The essential issue is that provision of international liquidity requires the reserve issuing

² This agenda coincides in part with that suggested by the IMF (2011b), which includes strengthening of macroeconomic policy collaboration, monitoring and management of capital flows, improving the global financial safety net, and strengthening the system through financial deepening and reserve and asset diversification.

country (or countries) to run a balance of payments deficit(s), either in the current or the capital account. In the 1960s this generated a tendency of the USA to gradually lose gold reserves. However, if the USA tried to correct its deficit to avoid a loss of its gold reserves, it would have generated a scarcity of international liquidity, perhaps not unlike the ‘dollar shortage’ of the early post-war period. After failing to manage the loss of gold reserves through a partially multilateral framework, the Gold Pool (Eichengreen 2007: ch. 2), the USA finally took the decision to abandon such convertibility in 1971.

This changed the nature of the Triffin dilemma. The USA was essentially left with no effective constraint to run balance of payments deficits. This generated both a long-term trend towards rising current account deficits, and strong fluctuations in the exchange rate of the dollar against other currencies. Both problems are shown in Figure 1. The first could be said to generate world expansionary (and, under some conditions, inflationary) pressures during the periods when the USA is running deficits; in turn, reductions of the US current account deficit have always been associated with global slowdowns or recessions (1980-82, 1990-91, 2008-09, but much less in 2001). Thus, the system may be said to alternate between expansionary and recessionary biases. The instability of the US dollar exchange rate may be understood, in Triffin terms, as cycles in the confidence in the US dollar as a reserve currency. It also means that the dollar lacks since the early 1970s what should be an essential feature of the currency that is at the centre of the global monetary system: a stable value.

FIGURE 1
US CURRENT ACCOUNT BALANCE AND REAL EXCHANGE RATE



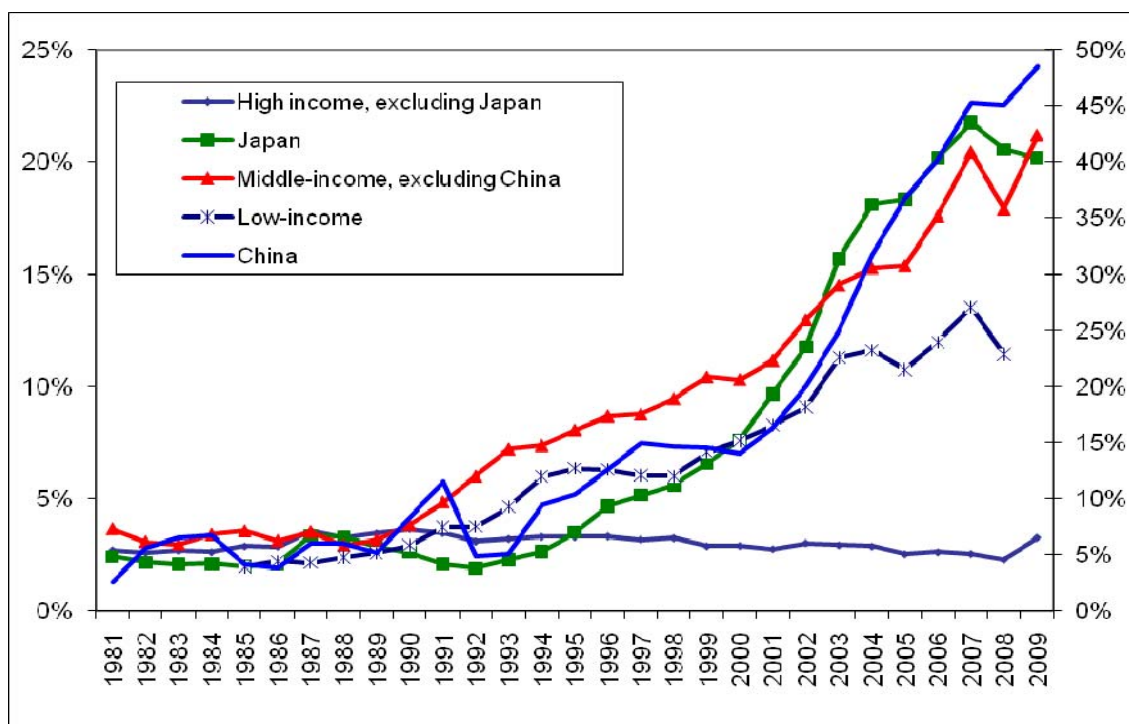
Source: IMF, *International Financial Statistics*. The real exchange rate is depicted here to show an increase when there is a real depreciation (the opposite convention to that used by the IMF). It is calculated as the inverse of the real exchange rate estimated by the Fund.

Being at the centre of the system generates several advantages for the USA: the appropriation of seigniorage from the use of the dollar as a global currency, the ability to borrow at low interest rates and an increased demand for the services provided by its

financial industry. But it also has costs, particularly if it involves current account deficits, as it normally has in recent decades, as this is a leakage in aggregate demand. This means, in turn, that the effectiveness of its expansionary policies is reduced by the spillovers it generates on the rest of the world during periods of dollar appreciation. This is what happened in the aftermath of the Lehman Brothers collapse in September 2008, which implied that part of the stimulus of US expansionary policies was exported to the rest of the world.³

The third problem is the inequities generated by the need that developing countries face to accumulate foreign exchange reserves to manage the strong pro-cyclical swings of capital flows, which are nothing other than transfers of resources to reserve-issuing countries. This *inequity bias* became very visible in the 1990s and, particularly, in the aftermath of the sequence of emerging country crises that started in East Asia in the late twentieth century. As Figure 2 indicates, until the 1980s the foreign exchange reserves of low-income and middle-income countries were not unlike those of high-income countries; around 3 per cent of GDP. Since then, they started to diverge, and sharply so since the Asian crisis. Prior to the current financial crisis (end of 2007), middle-income countries, excluding China, held on average reserves equivalent to slightly over 20 per cent of GDP, and low-income countries over 13 per cent. With the exception of Japan, high-income countries continued to hold reserves equivalent to around 3 per cent of GDP.

FIGURE 2
INTERNATIONAL RESERVES BY LEVEL OF DEVELOPMENT (% OF GDP)



Source: World Bank, *World Development Indicators*, based on information from IMF.

³ This problem for the reserve-issuing country that has been highlighted by Stiglitz (2006: ch. 9), and can be seen as a lack of control by the reserve-issuing country over its balance of payments, as underscored by Greenwald and Stiglitz (2010).

This phenomenon, which came to be called ‘self-insurance’, involves not only accumulating reserves to face an eventual ‘sudden stop’ in external financing but also absorbing through reserve accumulation large part of what countries consider excess capital inflows. The basic rationale for this policy is avoiding appreciation pressures and growing current account deficits during periods of booming capital inflows which, as past experience indicates, are strong predictors of crises during the downswing of the capital account cycle. There is increasing evidence that strong reserve positions and avoidance of overvaluation and current account deficits significantly contributed to relatively good performance of developing countries during the recent global financial crisis.⁴ So, in a broad sense, self-insurance is nothing else than a prudential or counter-cyclical macroeconomic policy aimed at moderating the domestic effects of pro-cyclical capital flows. Despite this positive effect, it must be emphasized that this policy generates ‘fallacy of composition’: if many countries adopt a policy aimed at generating surplus or small current account deficits, they contribute to the generation of global imbalances.

Overcoming these interlinked problems requires a significant reform of the global reserve system (Eichengreen 2011: ch. 6). In this regard, there are two basic ways forward.⁵ The first one, which in a sense is the inertial solution, is to enhance the potential multi-currency character of the current system. The increasing use of the euro for global transactions and as a global reserve asset is one of the possibilities—though the recent crisis has shown that this currency has to overcome the sense that it is an imperfect substitute for the dollar, as it is backed by a heterogeneous group of countries with uneven strength and there is in fact no homogeneous eurobond market. The internationalization on the renminbi is a second complementary possibility. It is a process that is being pushed by market forces and facilitated by Chinese authorities, particularly by allowing Hong Kong to play the role of intermediary in the process. The constraints are given here by limitations of domestic financial development in China and by the inconvertibility of the renminbi. Full convertibility may not be necessary for the renminbi to play the role of reserve asset (though full convertibility for central banks that hold renminbi as reserves would be essential) and may be inconvenient for the Asian giant, as it can lead in the transition to destabilizing forces which other developing countries are familiar with. On top of the euro and the renminbi, other currencies can play a secondary role, and local currencies can be used in a broader scale for intra-regional trade among developing countries, following several successful experiences of the sort that sprang up during the recent crisis and also in the past.

The multi-currency solution does not solve, however, any of the fundamental problems of the current system. It does not help correct the anti-Keynesian bias; it would continue using currencies that are still not stable stores of value; and it maintains the inequities of the current system, as most developing countries would be investing their reserves in assets issued by industrial countries. The exchange rate flexibility that the system will

⁴ See, among many others, Frankel and Sarvelos (2010) and Llaudes et al. (2010).

⁵ There are, of course, other alternatives. One would be going back to some form of gold standard, or at least to a greater use of gold as a reserve asset. But this goes against long-term trends towards moving away from this ‘Barbarous relic’, to use Keynes’ terminology, which includes the growing demonetization of gold since the 1970s. It would also go against the ‘embedded liberalism’ of the post-Second World War arrangements, as emphasized by Eichengreen (1996). A more interesting proposal would be to think of a commodity-based reserve system, such as that suggested by Hart et al. (1964), which in fact has some interesting counter-cyclical features, but it has become obsolete given the tendencies of the world economy towards a reduced share of commodity trade.

maintain implies that it would not face the inflexibility that led to the collapse of dual systems with fixed exchange rates in the past: bimetallism in the late nineteenth century and the gold-dollar system in the early 1970s. But this does not mean that the system will be stable, and indeed it may lead to greater exchange rate volatility among major reserve currencies, and potentially destabilizing effects of decisions of central banks to change the composition of their foreign exchange reserves. For that reason, it may actually need an IMF substitution account to serve as a stabilizing mechanism; i.e., it may have to rely on at least some elements of the second solution.

This alternative is to move towards a global currency, possibly in the first stage only as a reserve asset. Although other possible routes may be considered,⁶ the best is unquestionably the use of SDRs issued by the IMF, indeed fulfilling the aspiration that was written in the Fund's Articles of Agreement of 'making the special drawing right the principle reserve asset in the international monetary system' (Article VIII, Section 7 and Article XXII).⁷ As Triffin (1968) envisioned, this would complete the transition since the nineteenth century of placing fiduciary currencies at the centre of modern monetary systems. This would also represent an additional step in the direction set by G-20 and IMF members when they decided to allocate US\$250 billion in SDRs in 2009. Due to the unsettled nature of the world economy, a group of economists have recently made a proposal to the G-20 to support an annual allocation of 150-250 billion SDRs over the next three years, which is equivalent to US\$240-400 billion at current exchange rates (Stiglitz et al. 2011).

Proposals for periodic SDR allocations follow two different models. The first are counter-cyclical allocations, thus concentrating them in periods of world financial stress and possibly partially destroying them once financial conditions normalize (United Nations 1999; Camdessus 2000; Ocampo 2002; Akyüz 2005). This would develop a counter-cyclical element in world liquidity management. The second model proposes regular allocations in proportion to the additional world demand for reserves. During the 2003-08 period, the average annual accumulation of reserves was US\$738 billion or US\$370 billion excluding China and Japan; so, an allocation of something in the order of US\$250-300 billion a year could be reasonable. This is also the magnitude of SDRs that must be issued in the long term under a counter-cyclical rule.

To push forward this reform, several additional problems must be resolved. The first one is that SDRs must become the major, or only, mechanism of financing of IMF lending, an issue to which we return below. If SDRs are used to finance IMF programmes, this would also help correct a second problem: the significant imbalances that have been built up by lags in increasing the size of the Fund in relation to that of the world economy, and particularly of international capital flows (IMF 2010). A third problem is that, despite the reallocation of quotas agreed to since 2006, and particularly in 2010, quotas do not reflect the shares of different countries in the world economy today. The under-representation of developing countries in quota allocations enhances the inequities associated with the fact that the largest demand for reserves essentially comes from developing countries.

⁶ The reform could also be implemented by creating a new institution (a Global Reserve Bank) or a network of regional arrangements. See, in this regard, United Nations (2009b: ch. 5). But creating new institutional frameworks would be time-consuming and may not be politically viable.

⁷ See Solomon (1977: chs. 4-8) for a history of the debates on global monetary issues that led to the creation of SDRs.

This implies, of course, that efforts to reform quota allocations must continue. These inequities can also be partially corrected with either one or a mix of three types of reforms (since they are not mutually exclusive). The first is an asymmetric issuance of SDRs, which would imply that all or a larger proportion of allocations would be given to those countries with the highest demand for reserves; i.e., essentially developing countries. One simple formula that Williamson (2010) has proposed is giving 80 per cent of allocations to emerging and developing countries, and 20 per cent to industrial countries, with allocations within each group determined according to IMF quotas. The second would be to create a ‘development link’ in SDR allocations. One alternative—in a sense similar to that proposed by the Group of Experts convened by UNCTAD in the 1960s (UNCTAD 1965)—would be to allow the IMF to use the SDRs that are not utilized by member states to buy bonds from multilateral development banks, which would then finance the demands for long-term resources by developing countries.⁸ The third is encouraging the creation of regional reserve arrangements among developing countries—such as the Latin American Reserve Fund, and the Chiang Mai Agreement—that provide a complementary form of collective insurance. United Nations (1999) and Ocampo (2002) have suggested that incentives can be created to contribute to such arrangements, by making allocations equivalent to IMF quotas for the purpose of SDR allocations. The effectiveness of such arrangements could also be enhanced by allowing the IMF to lend to them or rediscount the obligations of countries with regional arrangements.

A reform such as this would go a long way to correct some major problems of the current system, particularly the Triffin dilemma and the inequity bias, but it would not solve the anti-Keynesian bias. This problem could be partly solved by two complementary reforms: (i) the creation of at least a moderate version of Keynes’ overdraft facility, an issue to which we return below; and (ii) withdrawing allocations of SDRs to countries with ‘excessive reserves’, using a definition of such ‘excess’ that would take into account the high demand for reserves that developing countries have.

SDRs could also be used for other purposes. One is to create a ‘substitution account’ similar to that launched in the debates of the late 1970s, which would have allowed countries to transform their dollar reserves (or those denominated in other currencies) for SDR-denominated assets issued by the Fund (Bergsten 2007). This instrument would provide stability to the current system and, as already pointed out, may actually prove essential to manage some of the instabilities generated by the multi-currency arrangements that are likely to develop over the next few years; it would also be an essential transition mechanism of an ambitious reform effort (Kenen 2010b). The 1st July 2009 IMF decision to issue SDR-denominated notes to some emerging economies could be considered a step in that direction. Of course, it is essential to negotiate how to distribute the potential costs of this mechanism, but backward simulations by Kenen (2010a) based on historical data for 1995-2008 indicate that such costs may be small.

⁸ There is also the possibility of using the allocation to industrial countries to finance additional official development assistance and the provision of global public goods (Stiglitz 2006: ch. 9). In the same line of reasoning, IMF Managing Director Strauss-Kahn has raised the possibility of using them to finance programmes to combat climate change. These proposals have many virtues but pose the problem that such transfers are fiscal in character, and may thus require in every case the approval of national parliaments.

The reform could also include more currencies into the SDR basket (notably the renminbi) and could allow the broader use of SDRs in private transactions, as some authors have suggested through the years (see, for example, Kenen 1983: ch. 7). One simple reform could be allowing deposits by financial institutions in central banks (either reserve requirements or excess reserves) to be held in SDRs. However, and contrary to the views of some authors (Eichengreen 2011: ch. 6), the system could also work as one in which the only uses of SDRs are as a reserve asset and a means of financing of IMF lending, so long as central banks keep the basic commitment to convert SDRs into convertible currencies when asked to do so, which is what makes the SDRs an effective monetary instrument for transactions among central banks. Furthermore, allowing the broader use of SDRs would make the reform costly for the USA and therefore likely to face greater resistance from this country, and could make SDRs subject to the instability that characterizes private markets. In any case, it may be necessary to embed the reform in rules that make holding SDRs attractive for central banks (an adequate return) and/or other rules that guarantee that there is an active demand for SDRs (e.g., commitments not to reduce SDRs held by individual central banks below certain limits relative to the allocations they have received, obviously if they are not borrowing from the Fund).

4 Monetary co-operation and the exchange rate system

Global monetary co-operation was incorporated at Bretton Woods in the Articles of Agreement of the IMF, which states that the first objective of this institution is to provide ‘the machinery for consultation and collaboration on international monetary problems’. This objective has clearly not been met in the past. In fact, one of the essential features of the current international arrangements has been the tendency of major economies to sidetrack the Fund in major efforts at macroeconomic policy co-ordination, and use alternative informal mechanisms among major countries (‘Gs’ of different character), following a pattern that may be called ‘elite multilateralism’.

This is how the crisis of the early 1970s was managed, leading to the 1971 Smithsonian Agreement, as well as the global imbalances of the 1980s, which were dealt with through the 1985 Plaza Agreement and 1987 Louvre Accord. All these agreements were related to exchange rate management among major currencies. The G-20 is the most recent of these fora, although it uses the IMF to assist the country-led, consultative Mutual Assessment Process (MAP), a major innovation introduced in the September 2009 Pittsburgh Summit. There are also other cases in which direct communication among central banks has been used to co-ordinate provision of liquidity under critical circumstances. They include the reactions to the 11th September 2001 terrorist attack in the USA, and the synchronized expansionary policies following the August 2007 sub-prime crisis in the USA and the September 2008 Lehman Brothers collapse. There are also infrequent episodes of concerted interventions in foreign exchange markets, such as the March 2011 efforts to weaken the yen following the appreciation that took place after the devastating earthquake and tsunami in Japan.

In contrast to these interventions in exchange rates and co-ordinated monetary expansion, there are fewer cases of co-ordinated fiscal policy. The Maastricht agreement among European countries is perhaps the best example, but also one that has been characterized by frequent deviation from commitments. Although tougher European rules were agreed in March 2011, it remains to be seen how they will perform in practice. The London G-20

agreement of April 2009 to undertake common efforts at fiscal expansion is another case, but it soon broke down leading rather to diverging fiscal policies. Indeed, common action among major economies to adopt expansionary fiscal and monetary policies at the beginning of the global financial crisis is perhaps the best example in history of macroeconomic co-operation, but even in this case it failed to deal with exchange rate issues and lasted only a short time period.

In turn, the best case of a global macroeconomic issue that was dealt with within a multilateral institution (the IMF) was the creation of the SDRs in the 1960s. The multilateral consultations on global imbalances launched by the Fund in 2006, with the participation of the USA, the euro area, Japan, China, and Saudi Arabia, was an interesting initiative, but it lacked binding commitment by the parties and a clear accountability mechanism, and thus soon turned insubstantial. The IMF more recently created a new mechanism of surveillance that can have multilateral implications, under the name of ‘spillover reports’. In a different context, the Monterrey Consensus, approved by the United Nations International Conference on Financing for Development, held in 2002 (United Nations 2002), constitutes perhaps the best agreed document on global financial co-operation, but it has lacked clear follow-up and accountability mechanisms. The same can be said about the outcome document at the 2009 United Nations on the World Financial and Economic Crisis (United Nations 2009a).

Macroeconomic policy co-operation has to deal with major spillovers that national decisions have on other countries. An optimal framework should involve all major macroeconomic policies, but there is no example of this type of co-operation so far in history. As we have seen, several agreements have dealt in the past with exchange rates and co-ordinated monetary expansion, typically during financial crises or critical conjunctures. The rarest has been fiscal co-operation. Furthermore, in a system that continues to be essentially international (only partly supranational in the case of the European Union), it is unclear how much international rules should limit national democratic decision making processes which are at the centre of fiscal policies. This fact, together with different perspectives on monetary policies—particularly, the tendency of the US Federal Reserve to have a clearer counter-cyclical focus in its actions relative to the European Central Bank—is why some level of exchange rate flexibility is essential to adjust for different national (regional) decisions.

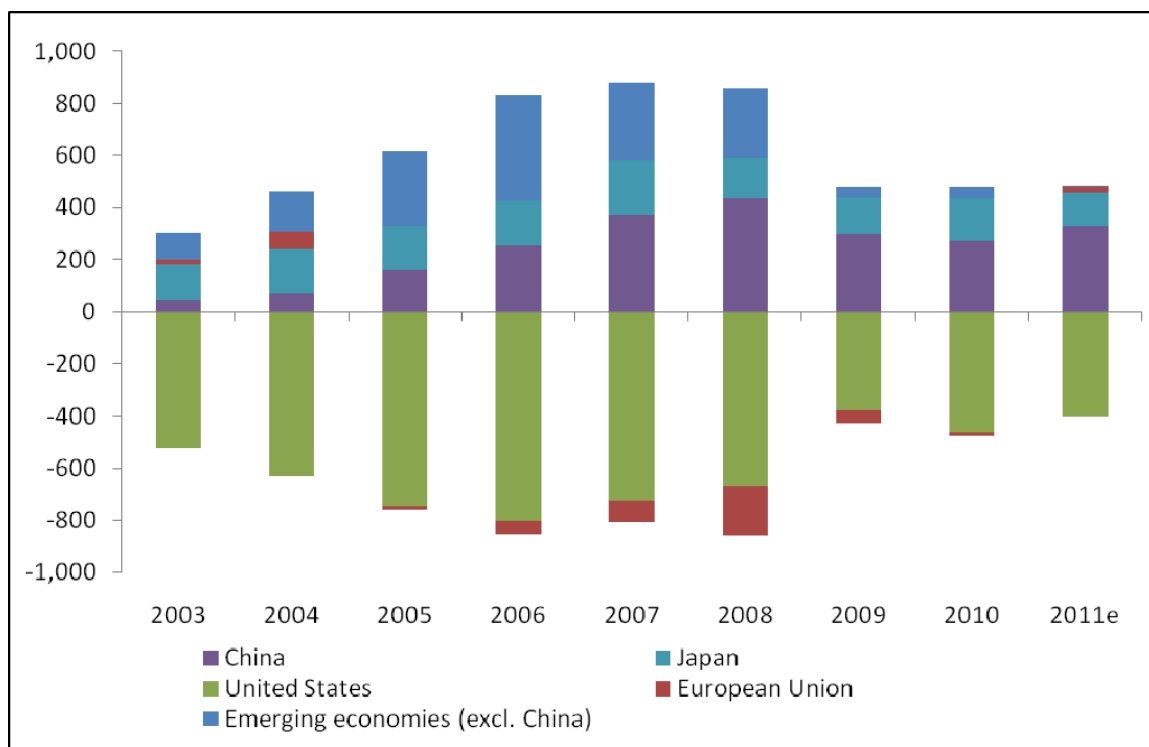
Because of this, and the fact that since its creation it was agreed that the IMF should focus its attention on exchange rates,⁹ this is perhaps the area in which the international community should look for better forms of co-operation. This is important not only for exchange rates as such, which of course can generate major externalities, but more importantly because exchange rate movements reflect divergence in other macroeconomic policies, as pointed out in the previous paragraph. The 2010 debate on the ‘currency wars’ was, for example, associated with the effects that monetary expansion in the USA was having on capital flows towards emerging economies.

The major problem in this regard is, as already noticed, that the system that evolved since the breakdown of the original Bretton Woods arrangement is in fact a non-system, as all

⁹ It is interesting to remember in this regard that in its original design this included the principle that modifications of the exchange rate parities should be subject to consultation, a principle that, nonetheless, never worked in practice.

countries are essentially free to choose any exchange rate regime. The only constraint is that, as Article IV of the IMF Agreement reads, countries should ‘avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members’. This is also stated in the June 2007 decision on bilateral surveillance. However, both the IMF and the G-20 have failed to determine so far what ‘manipulation’ means. Beyond that, it can be said that an even more important problem of the exchange rate (non)system is that it may distort trade flows and is dysfunctional in terms of correcting global payments imbalances. Thus, it can be said that it has failed to meet the objective set in the first IMF Article of Agreement: ‘to facilitate the expansion and balanced growth of international trade’. A major paradox of the current system is, indeed, that there is no mechanism linking world trade and exchange rate rules. Countries spend years negotiating trade rules, but exchange rate variations can have within days (or even hours) more effects on trade than those painstaking deals.¹⁰ On top of that, exchange rate movements are essentially determined by financial flows, which may also have strong effects on trade patterns, as the long literature on the ‘Dutch disease’ indicates.

FIGURE 3
CURRENT ACCOUNT DEFICIT (BILLION DOLLARS)



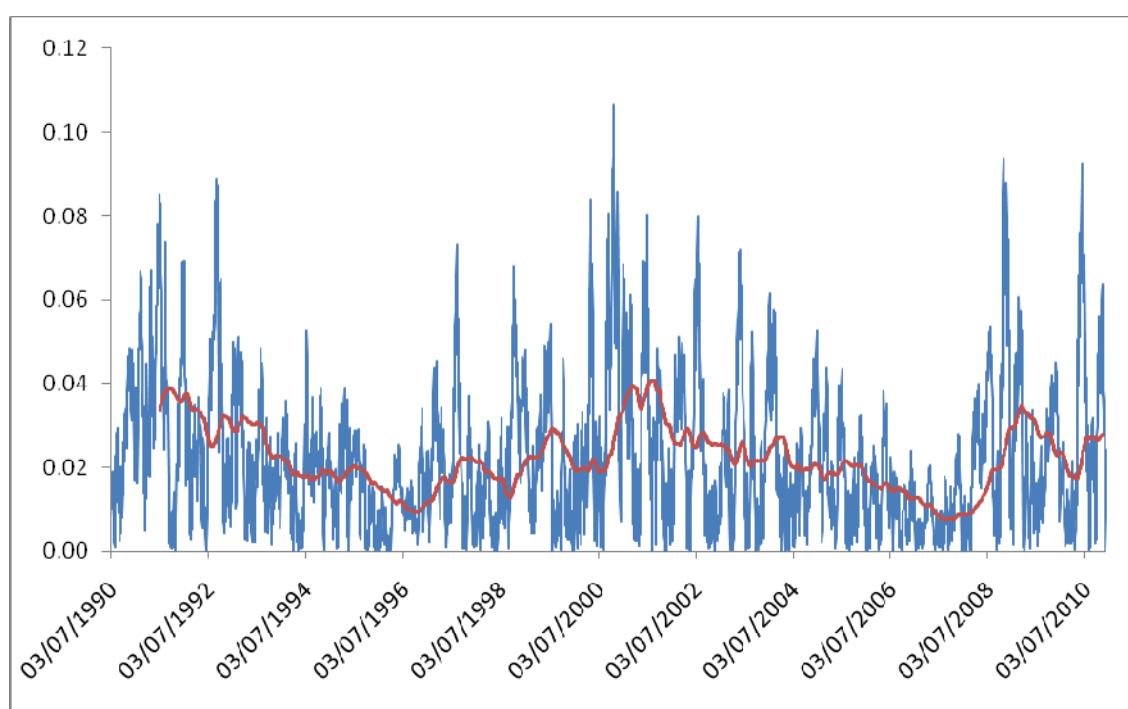
Source: International Monetary Fund, World Economic Outlook Database, 2010-12.

It can be said that the current exchange rate (non)system has also failed to meet two additional objectives set in the first IMF Article of Agreement: to ‘lessen the degree of disequilibrium in the international balance of payments’, and ‘to promote exchange stability’. The issue of global payments imbalances is illustrated in Figure 3. These

¹⁰ This does not mean, however, that exchange rate issues should be brought into WTO dispute settlement, as suggested by Matoo and Subramanian (2008), as this may end up weakening one of the few effective mechanisms of the sort at the international level.

imbalances grew dramatically during the world economic boom of 2003-07 and continued to be high up to 2008. The major trend was rising deficits in the USA and, at the end of the boom, Europe, counterbalanced by surpluses in China, Japan and the rest of the developing world, mainly oil exporters. Within these groups, there were also major surpluses and deficits, particularly in Europe (a major surplus in Germany but also large deficits in some peripheral countries) and in the developing countries (many countries ran deficits). The dramatic recession that followed after September 2008 led to a sharp cut in the imbalances, to about half of previous levels and have remained fairly stable since then, with the USA and Europe cutting their deficits and developing countries, excluding China, reducing their surpluses.¹¹

FIGURE 4
VOLATILITY OF THE EURO/US DOLLAR EXCHANGE RATE
(DEVIATION WITH RESPECT OF THE 12 MONTHS MOVING AVERAGE IN
ABSOLUTE VALUE)



Source: Bloomberg.

The incapacity of the system to provide exchange rate stability is illustrated in Figure 4 in terms of the major bilateral exchange rate, that between the euro and the US dollar. This rate has experienced a significant level of ‘excess volatility’ since the global financial crisis. As the graph shows, such volatility has similar intensity to that experienced in the early 1990s, during the strong European monetary crisis that followed the adoption of full capital account convertibility by European countries in 1990, and in the early 2000s, during the burst of the technology bubble in the USA. Indeed, the dollar-euro bilateral rate has experienced two full cycles since the outbreak of the sub-prime crisis and is in the midst of third one: an initial depreciation of the dollar following that event followed by a significant appreciation during the ‘flight to safety’ unleashed by the Lehman Brothers

¹¹ There is an extensive literature on this issue. One of the best known papers, by Obstfeld and Rogoff (2010), underlines the links between the global imbalance and the financial crisis.

collapse; a new depreciation of the dollar during the normalization of financial markets since March 2009 followed by an appreciation during the first semester of 2010 as a result of the series of crises in peripheral Europe; and a new cycle that started in mid 2010 and has probably not finished. It is unclear what purpose the high level of volatility between the world's two most important currencies serves.

The system could therefore be improved by introducing elements that provide some level of stability to exchange rates. Returning to fixed exchange rates among major currencies is, of course, impossible, given the level of capital account flows that characterize today's world economy, and inconvenient, given that different priorities of macroeconomic policies among major countries. The world should rather evolve into a system of reference rates among major currencies, as has been suggested by Williamson (2007), among others. This implies that major countries would follow some form of managed floating—the system which most emerging economies have actually chosen, more as a result of empirical learning than theoretical arguments. Multilaterally agreed parities or bands would be the cornerstone of such a system, and would help give some level of stability to the way markets operate, which in the past have been characterized by extended periods of deviation from equilibrium. Guidelines would indicate that interventions in foreign exchange markets and policies with strong effects on exchange rates would have to support the movement of exchange rates towards the agreed parities or bands (i.e., reinforce depreciation if the currency is perceived to be overvalued and appreciation if it is undervalued). Such rules would also imply an implicit definition of what 'manipulating' the exchange rate means. A country (or region, in the case of the euro) may choose not to intervene, but this would only increase the level of interventions required by other countries to reach equilibrium and may reduce the effectiveness of interventions.

In this framework, the process leading to deciding on exchange rate parities would have to take into account other macroeconomic determinants of the exchange rate, and in this sense the parities would summarize a significant amount of information. But a complementary, or, perhaps, alternative, approach would be to look directly at payments imbalances, and particularly at *current* account imbalances, which as we know are equivalent in macroeconomic terms to looking at saving-investment imbalances and to those between aggregate spending and production. Indeed, as Derviş (2010b) has pointed out, the definition of current account target zones that the USA proposed in 2010 was a recognition that the focus should be on the effects of overall economic policies on national savings and investment, not just on exchange rate policies.¹² Of course, looking at payments imbalances would have to take into account divergence in savings rates across countries, and the presumption that high savers would not only be high investors but also tend to generate current account surpluses.

Even better, of course, would be to look at payments imbalances among countries together with global macroeconomic imbalances; i.e., measures of the global output (including employment) gaps and associated expansionary and recessionary pressures, (which in some cases may also be inflationary or deflationary). Furthermore, they could include indicators of public and private sector debt ratios, to analyse both debt

¹² It is also interesting to recall that in the discussions of the early 1970s, the USA backed a 'reserve indicator' system, under which each IMF member would have been assigned a target level of reserves and forced to adjust to keep reserves around that target.

sustainability issues as well as the policy space for expansionary macroeconomic policies. The ‘indicative guidelines’ chosen by the G-20 for its Mutual Assessment Process include public debts and fiscal deficits, private savings rates and private debt, and current account imbalances debts, also ‘taking due consideration of exchange rate, fiscal, monetary, and other policies’ (G-20 2011: par. 3). In any case, complexity may not be a good starting point for an incipient process. For that reason, a simple set of indicators may be better. This is why the reference exchange rate proposal is a good idea, or alternatively a focus on current account deficits and global output gaps.

There are also major institutional challenges to building these forms of co-operation. One is the continuity of the co-operation framework. History informs us that there is strong demand for co-operation only during crises, but it is equally essential to have co-operation during periods of prosperity, which many times incubate crises. An additional issue is representativeness, the central topic dealt with in Section 7. For both reasons, it would be better to fulfil the expectation that the IMF should be ‘the machinery for consultation and collaboration on international monetary problems’. A basic advantage of the G-7 is, nonetheless, that small groups help build up confidence and thus broader exchange among a small set of relevant policy actors (Derviş 2010a). But this is not in contradiction with the objective of representativeness if the regular and intensive dialogue among the countries that are systemically important is embedded into a global institution. This is precisely what 2006 multilateral consultations on global imbalances launched by the Fund aimed at. This was indeed a better framework, both because it was embedded into the IMF and because it involved in fact a smaller number of relevant actors. This is perhaps why the G-20’s MAP should be done within the IMF framework, possibly involving a smaller number of countries.

5 Capital account regulation

‘Excessive’ exchange rate volatility associated with capital flows points towards an additional leg of international monetary reform: capital account regulations. It is useful in this regard to recall that a major agreement during the recent crisis was that deregulated financial activities can be a source of major macroeconomic disruptions. The G-20 thus led a major effort to re-regulate finance, mainly at national level. However, *cross-border* finance was left almost entirely out of the agenda, as if it did not require any regulation—or indeed as if it was not part of finance. A particular twist of terminology is also involved in discussing this issue: domestic financial regulations are called by that name, but if they involve cross-border flows, they are called ‘controls’. We would refer to them by their appropriate name: capital account *regulations*.

The essential problem here is that capital flows, like finance in general, is pro-cyclical. Agents that are perceived to be risky borrowers are subject to the strongest swings in the availability and costs of financing. These riskier agents include small firms and poor households in all domestic markets and emerging markets and, more generally, developing country borrowers in global markets. There is overwhelming evidence that capital flows to developing countries are pro-cyclical and have become one of the major determinants (and perhaps *the* major determinant) of business cycles in emerging economies (Prasad et al. 2003; Ocampo et al. 2008). Furthermore, the cyclical supply of finance is increasingly driven by portfolio decisions in industrial countries which may be entirely delinked from demand for capital by emerging and developing countries. These

countries face further problems: their domestic financial markets are significantly more ‘incomplete’ and are plagued by variable mixes of currency and maturity mismatches, and their capital markets are shallower and small relative to the magnitude of the speculative pressures they face.

It is important to emphasize that the cyclical behaviour that characterizes capital flows goes beyond volatility of short-term flows. Even more important are the *medium-term* cycles in the availability and costs of financing. Since the mid 1970s, we have experienced three full medium-term cycles—from the mid 1970s to the end of the 1980s, from 1990 to 2002, and from 2003 to 2009—and we are at the beginning of a fourth one. The major problem with these cyclical swings is their strong effect on major macroeconomic variables: that is, on exchange rates, interest rates, domestic credit, and asset prices. As a result of this, pro-cyclical capital flows exacerbate major macroeconomic policy trade-offs, significantly limiting the space to undertake counter-cyclical macroeconomic policies. For example, during a boom, countries may float the exchange rate to maintain some degree of monetary policy autonomy, but this merely displaces the effects of pro-cyclical capital flows to the exchange rate. The resulting deterioration in the current account allows these countries to ‘absorb’ the increasing flows but experience indicates that it also increases the probability and costs of crises. More exchange rate volatility generates, in turn, disincentives to invest in export and import-competing sectors. If there is hysteresis associated to dynamic economies of scale (e.g., if productivity tomorrow depends on production today), there may be permanent losses in production structure during booms, and therefore adverse effects on growth.¹³

Since a restrictive monetary policy would only exacerbate appreciation pressures, an alternative for authorities to reduce the expansionary pressures generated by capital inflows is to adopt a contractionary fiscal policy. But this makes fiscal policy hostage to capital account volatility. Fiscal policy may lack the flexibility to respond rapidly to variations in capital flows, and there may not be political backing for doing so. Authorities may also try to stabilize the exchange rate by accumulating foreign exchange reserves while sterilizing their domestic monetary effects. But such sterilized accumulation generates quasi-fiscal losses that are particularly costly in countries with high domestic interest rates. When foreign exchange reserves are already high, as they are in many emerging and developing countries, these costs are hard to justify. Such interventions also destroy the rationale for capital inflows in the first place, which is to transfer resources to the country. To the extent that such reserves are a way to counterbalance the risk of future reversals of capital flows, they destroy the additional rationale for capital account liberalization, which is to diversify risks. In fact, experience indicates that they are rather a source of additional risk.

During boom periods, capital account regulations can therefore be justified as a way to help authorities manage booms while avoiding exchange rate appreciation, the risks associated with rising current account deficits and/or useless foreign exchange reserve accumulation. During crisis, they may also be used as a way to avoid or mitigate capital flight, which has the opposite macroeconomic effects. More generally, these regulations can play a dual role: they can be a complementary macroeconomic policy tool and help reduce the risks associated with liability structures tilted towards reversible capital flows. As a macroeconomic policy tool, they provide some room for counter-cyclical monetary

¹³ See the review of the literature in Frenkel and Rapetti (2010).

policies. During booms, they increase the policy space to undertake contractionary monetary policy while reducing exchange rate appreciation pressures. In turn, during crises, they can create some room for expansionary monetary policies. Viewed as a liability policy, capital account regulations recognize the fact that pro-cyclical behaviour and, particularly, reversibility varies significantly according to the nature of capital flows: foreign direct investment is more stable than portfolio and debt flows and, among the latter, short-term debt flows are particularly volatile.¹⁴

Capital market regulations obviously *segment* domestic from international markets, but this recognizes the fact that markets are already segmented. Indeed, the basic flaw of capital account liberalization is that it does not recognize the implications of this basic fact. As with prudential regulations, capital account regulations can be either quantitative (or administrative) or price-based, but there are more complex typologies (see, for example, IMF 2011a).¹⁵ The former include, among others, prohibitions or ceilings on certain capital flows, derivative operations or net exposure in foreign currencies; minimum stay periods; and restrictions on foreign investors taking positions in domestic securities or rules on what type of agent can undertake some capital transactions (residents versus non-residents, and corporate versus non-corporate). In turn, price-based regulations include unremunerated reserve requirements on capital inflows, taxes on inflows or outflows, and larger reserve requirements for external liabilities of net balances in foreign currencies. Furthermore, they can be partly substituted by domestic prudential regulations when they involve domestic financial intermediation, though not when they entail access to external capital markets by non-financial domestic agents.¹⁶ They thus belong to the family of what have come to be called ‘macroprudential regulations’, including particularly of counter-cyclical prudential regulations (for an early analysis of this link, see Ocampo 2003).

The concrete analysis of experiences with the use of capital account regulations leads to several conclusions.¹⁷ First, regulations on either inflows or outflows can work (though the more orthodox literature is sceptical of the effectiveness of the latter), but the authorities must have administrative capacity to manage them, which includes acting on time to close loopholes and respond to ‘innovations’ by private agents aimed at circumventing regulations. As a result of the link with administrative capacity, permanent regulatory regimes that tighten or loosen the norms in response to external conditions may be the best choice rather than improvising a system in the face of shocks. Second, regulations help generate a mix of increased monetary autonomy, reduce exchange rate pressures and alter the magnitude of flows, with greater scepticism on the latter effect by several authors. Some of these effects may be temporary, largely due to greater circumvention of regulations as time passes, and in this sense regulations may act as

¹⁴ See, for example, Reddy (2010: ch. 21). The classic treatment of the riskiness of short-term capital is Rodrik and Velasco (2000).

¹⁵ There are also terminological differences. IMF (2011) coins the term ‘capital flow management measures’, and Epstein et al. (2003) have suggested the term ‘capital management techniques’.

¹⁶ In the latter case, price-based regulations can also be substituted by tax provisions applying to foreign-currency liabilities (see, for example, Stiglitz and Bhattacharya 2000).

¹⁷ See, among others, three papers by the IMF and IMF experts (Ariyoshi et al. 2000; Ostry et al. 2010; IMF 2011a), Magud and Reinhart (2007), Kawai and Lamberte (2010) and my own work (Ocampo 2003, 2008).

‘speed bumps’¹⁸ rather than permanent restrictions; this implies that further reinforcement may be required to maintain their effectiveness. Third, capital account regulations on inflows help improve debt profiles and thus act as an effective liability policy that reduces external vulnerability. Finally, and perhaps most importantly, regulations are a complement to sound macroeconomic policies, not a substitute for them.

Overall, the evidence is therefore that capital account regulations are a useful and effective complementary instrument of counter-cyclical policy management (IMF 2011a). There is also evidence that countries using regulations on capital inflows fared better during the recent global financial crisis (Ostry et al. 2010), and that the new regulations put in place by some countries since 2010 have been at least partly effective (Gallagher 2011; IMF 2011a).

Debates on this issue since 2010 have emphasized some *global* dimensions of these regulations that must be at the center of attention. The first and essential problem is the asymmetry generated between the strength of several emerging economies and the continuing weakness of most industrial countries. This situation, which is likely to continue, implies that the latter have to maintain expansionary policies, but the former are gradually moving towards more restrictive policies, though partially constrained for doing so by massive capital inflows. In short, the ‘multi-speed’ character of the recovery creates a need for a mirror asymmetry in monetary policies, which would be very difficult to manage without some restrictions on capital flows.

A second problem is that monetary expansion may be largely ineffective in industrial countries but can generate large externalities on emerging markets. This is particularly problematic when it involves the country issuing the major global reserve currency. Indeed, expansionary monetary policies in the USA, including now quantitative easing, has had at best mixed effects in generating a reactivation of credit, the major transmission mechanism of monetary expansion to domestic economic activity, but the low dollar interest rates associated with that policy are inducing massive capital flows to emerging markets, where they are generating appreciation pressures and risks of asset price bubbles. They may also be contributing to the weakening of the dollar, with negative effects on trading partners.

A third problem is that unilateral actions by countries also have negative externalities on other countries; that is, regulations by some countries may generate even stronger flows towards those not doing so. This is also true, of course, of interventions in foreign exchange markets.

So, cross-border capital account regulations are an essential part of global monetary reform. Actually, the basic principle that should guide actions in this field is the ‘embedded liberalism’ under which the IMF was built: that it is in the best interest of all members to allow countries to pursue their own full employment macroeconomic policies, even if this requires blocking free capital movements. It is therefore positive that the Fund has recognized that capital account regulations can play a positive role, as part of the broader family of macroprudential regulations, and has taken the step to openly discuss this issue and has suggested a possible ‘policy framework’ for discussion (IMF

¹⁸ This is the term used by Palma (2002) and Ocampo and Palma (2008).

2011a). Furthermore, this is the first step taken to include cross-border capital flows within ongoing efforts at strengthening prudential regulation worldwide.

Such policy framework should start, however, by designing mechanism to co-operate with countries using these policies, helping in particular make those regulations effective. In fact this may require eliminating provisions in several free trade agreements (particularly those signed by the USA) that restrict the use of such regulations. This type of co-operation is excluded from the IMF guidelines even while recognizing that capital account volatility is a negative externality inflicted upon recipient countries.

The guidelines try to identify ‘best practices’ in this area. As indicated, such best practices include the recognition that they are a complement and not a substitute for counter-cyclical macroeconomic policies. However, the guidelines tend to view them as interventions of ‘last resort’ (or a second, third or fourth line of defence), to be used once other macroeconomic policies have been exhausted: exchange rate adjustments, reserve accumulation and restrictive macroeconomic policies. This is a limited view of their role, as they should actually be part of the counter-cyclical package, which should include avoiding excessive exchange rate appreciation and reserve accumulation in the first place.

Also, the guidelines tend to view them as temporary measures. This goes against another IMF recommendation, which calls for ‘strengthening the institutional framework on an ongoing basis’. This implies that regulations should be part of the permanent toolkit of countries, which are strengthened or weakened in a counter-cyclical way. Also, and again against the guidelines, almost by necessity they require some discrimination between residents and non-residents, which reflects the segmentation that characterizes financial markets in an international system: as different moneys are used in different territories, residents and non-residents have asymmetric demands for assets denominated in those currencies.

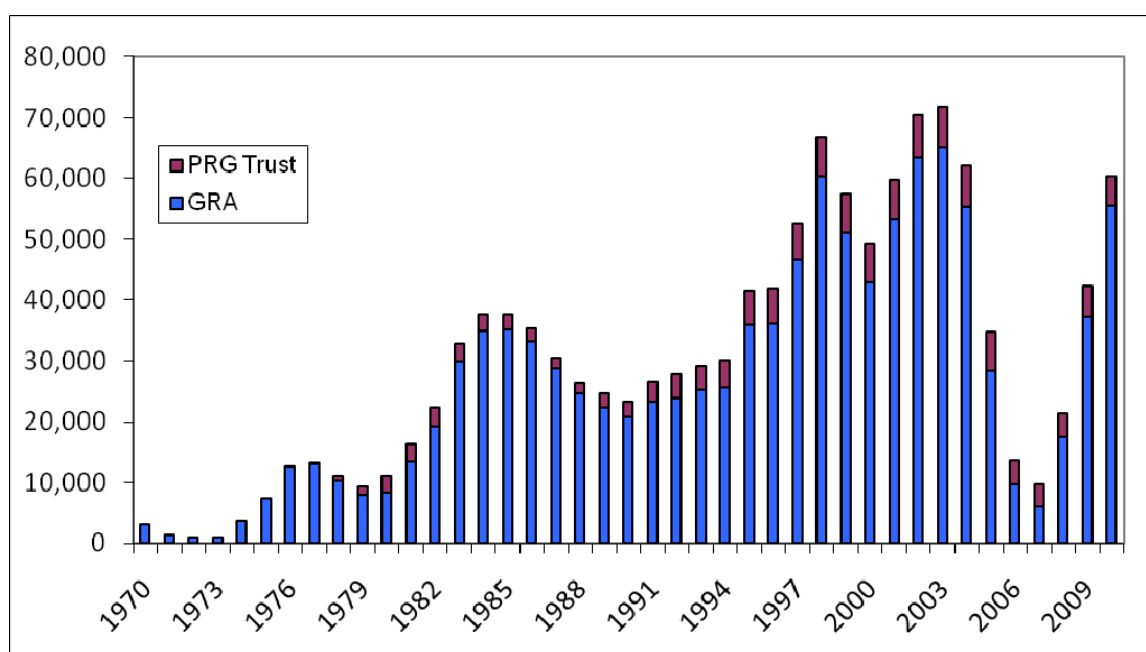
In any case, any guidelines in this area should recognize the fact that there is no obligation to capital account convertibility under the IMF Articles of Agreement—an issue that was settled in the 1997 debates—and therefore countries have full freedom to manage their capital account. In the words of the Group of Twenty-Four (G-24 2011: par. 8): ‘Policy makers of countries facing large and volatile capital flows must have the flexibility and discretion to adopt policies that they consider appropriate and effective to mitigate risks’. So, although the IMF has made a positive contribution by bringing the issue of capital account regulations into the global debate, it can only be taken as a first step in the necessary task of including this issue in the efforts to re-regulate finance and avoid global macroeconomic imbalances.

6 Emergency balance of payments financing and debt workouts

Since the Second World War, the international community has been able to count on emergency financing from the IMF during balance of payment crises. As Figure 5 indicates, this mechanism provided increasing counter-cyclical financing until the start of this decade, especially during the debt crisis of the 1980s and the succession of crises that began in 1994: Mexico, East Asia, Russia, South America and Turkey. Following this pattern, the IMF increased its loans significantly in 2008, and especially in 2009 and 2010, to countries affected by the global crisis.

After the Mexican crisis, the need to create new credit lines to mitigate the effects of capital account volatility and, more generally, to expand the magnitude of programmes for individual countries began to be recognized. So, in the face of the Asian crisis, the IMF created two new credit facilities: the Supplemental Reserve Facility, which served as a framework for the large loans made during the crises of the late twentieth and early twenty-first centuries, and the Contingent Credit Line, which had a more preventive aim. The latter was never tapped, possibly because using it was perceived as an indicator of vulnerability, and it was suspended in 2003. In 2006 the IMF proposed an alternative facility, the Reserve Augmentation Line, but it was never approved. For the poorest countries, the structural adjustment lines created in the mid 1980s were transformed in 1999 into the Poverty Reduction and Growth Facility (PRGF). In January 2006, a credit line was added for those countries aimed at facilitating recovery after negative shocks—from trade and natural disasters—and conflicts with neighbouring countries.

FIGURE 5
USE OF IMF RESOURCES (MILLION SDRS)



Notes: PRG Trust: Facilities for low-income countries. GRA: General Resource Account.

Source: International Monetary Fund (<http://www.imf.org/external/np/fin/tad/extcred1.aspx>).

The global financial crisis led to further reforms in all of these areas. In October 2008, the IMF created a new precautionary facility for countries with ‘sound macroeconomic policies’, a short-term liquidity facility (SLF), which could be disbursed without the traditional IMF ex-post conditionality. Yet, as the global crisis deepened and spread through the developing world, no country called upon it. Interestingly, the same day that the IMF announced the creation of the SLF, the US Federal Reserve finalized reciprocal currency arrangements with Mexico, the Republic of Korea, Singapore, and Brazil, which were extensively used. This implied that, despite their shorter maturities, the Federal Reserve swap lines (and others that arose later on around the world) were clearly superior to IMF loans in terms of scale, flexibility, and lack of conditionality.

As a result of strong pressure to adopt stronger measures, in March 2009 the IMF approved an overhaul to the Fund’s lending framework. First of all, it created a new

preventive facility, the Flexible Credit Line (FCL), again for countries with solid fundamentals but a risk of facing problems in their capital account.¹⁹ Its terms were improved in August 2010, by increasing the scale of the resources and extending the period for which it can be used. Second, the March 2009 package doubled the other credit lines and allowed a wider use of Stand-by agreements for preventive purposes (termed ‘high-access precautionary arrangements’). In August 2010, an additional step was taken, with the creation of the new Precautionary Credit Line (PCL) for countries which the IMF deems have good policies, but that do not meet the criteria of the FCL. The other significant reform introduced in March 2009 was to eliminate the relationship between IMF disbursements and structural conditionality. These reforms were accompanied by the elimination of several existing credit lines.

In terms of low-income countries, the IMF increased the global capacity of the IMF loans to these countries to US\$17 billion until 2014, which is done through either the Extended Credit Facility, which replaced the PRGF, or through faster disbursing and lower conditionality emergency facilities. The IMF also decided that all low-income countries would receive an exceptional cancellation of all owed interest payments on concessional loans until the end of 2011, as well as lower rates of interest on future loans. In December 2009, it reformed its concessional loan lines from a single design to a menu of options, which aimed to be more flexible to different situations facing countries in relation to their vulnerability to debt and their macroeconomic and public finance management capacity (‘capacity’). Within this framework, countries where debt vulnerabilities is high will always have concessional loans, but those with limited vulnerability and high capacity can eventually access non-concessional facilities.

Aside from continuing to improve this menu, the major pending issue relates to how IMF lending is financed. The typical mechanisms used in the past are quotas and ‘arrangements to borrow’. The disadvantages of the first are that quota adjustments have tended to lag in relation to the size of the world economy, and that the Fund is forced to manage a multiplicity of currencies, most of which cannot be used to finance its programmes. This is why arrangements to borrow—a network of loans from central banks or governments to the Fund—are a necessary complement. Its basic disadvantage is that, despite the expansion of the number of countries that contribute to these arrangements, it is not a truly multilateral mechanism.

This is why it makes sense to have a fully SDR-funded IMF, which would blend the creation of international money with its lending functions, in a similar way to how central banks’ money creation and financing operate at the national level. Aside from the basic advantage of making IMF lending self-financed, it would actually make SDRs a more useful international monetary instrument, by allowing unutilized SDRs kept as international reserves by countries to be used to lend to countries that need them for liquidity purposes. This would thus match the counter-cyclical *allocations* of SDRs (if they are essentially issued during crises) with counter-cyclical *financing*.

¹⁹ An important drawback of this line, as with similar ones in the past, is nonetheless that it divides countries into two groups: those that have ‘good’ policies and those that the IMF does not classify under this category. The then UNDP Administrator, Kemal Derviş (2008) pointed out in relation to the SLF that preceded the FCL, this all or nothing classification is unclear and can create serious tensions.

There are two alternative ways to design fully SDR-funded IMF lending. The first is that suggested by the late IMF economist Jacques Polak three decades ago: IMF lending during crises would create new SDRs (similar to the way lending by central banks creates domestic money), but such SDRs would be automatically destroyed once such loans are paid for (Polak 1979). This would be an entirely counter-cyclical financing mechanism. A corollary of that is that the Fund should be allowed, in any case, to create SDRs in almost unlimited amount in the face of a major global disturbance (Stiglitz et al. 2011). The other mechanism would be to treat the SDRs not used by countries as deposits in (or lending to) the IMF that could then be used by the institution to lend to countries in need (Ocampo 2010a, 2010c). Either of these proposals would involve eliminating the division between what are called the ‘general resources’ and the SDR accounts, which severely limits the usefulness of SDR allocations. It would also imply a change in the meaning of the ‘quotas’ of member states, which would not involve actual transfers of resources to the IMF, but would in any case be essential to determine borrowing limits and SDR allocations (Polak 2005: part II).

For any of these solutions to work, it is, of course, essential that IMF credit lines should continue to improve in terms of their size, timeliness and conditionality. However, recent reforms seem to have been unable to overcome the stigma associated with borrowing from this institution, and thus have not corrected the demand for ‘self-insurance’. This is why a more ambitious reform is required, perhaps by adopting at least partially one part of Keynes’ original plan for a post-war arrangement: the creation of an overdraft (drawing) facility that can be used *unconditionally* by *all* IMF members up to a certain limit and for a pre-established time period.

Such a facility would also contribute to making the system more symmetric between surplus and deficit countries, so as to partially correct the anti-Keynesian bias. Some rules for SDR allocation could also contribute to this purpose, particularly penalizing countries with large surpluses and/or excessive reserves by suspending their right to receive SDR allocations. Concentrating issuance during crises would also help circumvent the recessionary pressures that the world economy faces during crises due to the asymmetric pressure on deficit versus surplus countries to adjust. This purpose would also be served by the more active role of the Fund as an emergency balance of payments lender and thus as a source of ‘collective insurance’. These reforms are thus essential to reduce the demand for self-insurance, but that may require a more active use of capital account regulations to avoid excessive capital flows to emerging and developing countries, which is an additional source of demand for self-insurance. The active use of SDRs would also contribute to correct the Triffin dilemma and the inequities of the system. As a group, these reforms would thus contribute to significantly correct some of the major problems of the current international monetary system.

It can be added that the system cannot rely exclusively on emergency financing, as the availability of such financing could raise moral hazard issues for private sector lenders and/or public sector borrowers. Emergency financing serves to correct the problems of access to liquidity during crises from turning into insolvency, but are not adequate to manage problems of over-indebtedness. This is why a regular institutional framework to manage debt overhangs at the international level must be created: a debt court for sovereign debts similar to those created to manage bankruptcies in national economies, the decisions of which are legally binding.

The only regular institutional mechanism of this type in place is the Paris Club, which deals exclusively with official financing. The system has relied in the past on ad hoc mechanisms, such as the Baker and Brady Plans of the 1980s and the Heavily Indebted Poor Countries Initiative since the mid 1990s and its successor, the 2005 Multilateral Debt Relief Initiative. But it has depended heavily on traumatic individual debt renegotiations, including those with banks under the so-called ‘London Club(s)’. The problem with all these mechanisms, and therefore with the existing (again) non-system is that solutions generally (or even always) come too late, after over-indebtedness has had devastating effects on countries. The (non)system is also horizontally inequitable, as it does not treat all debtors or all creditors with uniform rules.

The proposed debt court would serve as mediator and, if it fails in that task, as arbitrator of both public and private sector international disputes involving sovereign debt.²⁰ Privately-run restructuring mechanisms, based on London Club negotiations or the active use of collective action clauses in bond issues, are clearly insufficient in this regard. Aside from the fact that debtors may delay using the mechanism to avoid antagonizing creditors, market mechanisms do not generate a uniform treatment of creditors and fail to treat official and private lending with a unique set of rules, therefore maintaining the horizontal inequalities of the current system. Also, and as ongoing European debates on this issue indicate, the mechanism has to be global in character, but putting into place an European mechanism may be the first step in bridging this major gap of the global international financial and monetary architecture.

7 Building an inclusive international financial architecture

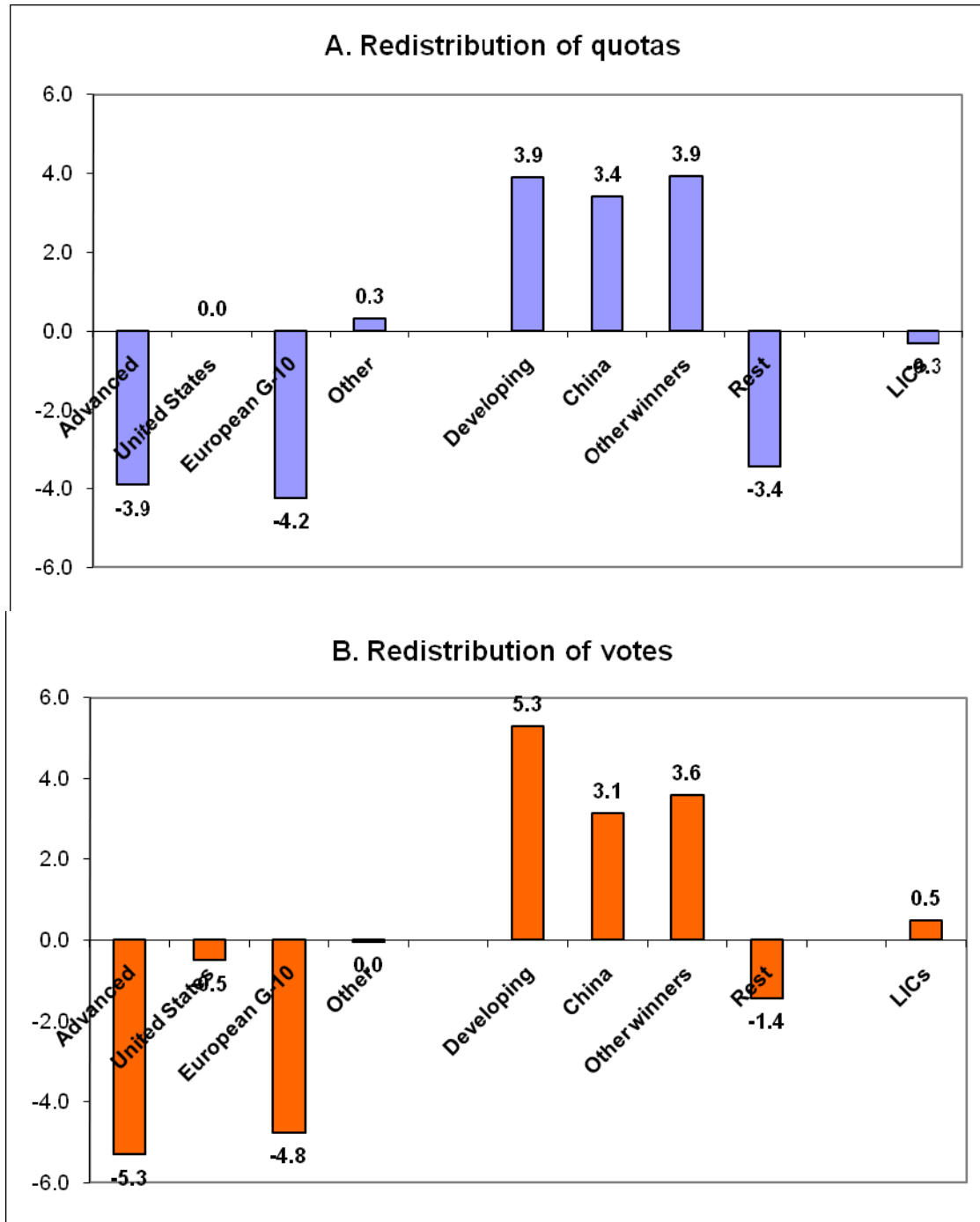
Substantive reforms must be matched by the design of appropriate governance structures. Good but incomplete steps have been taken in this area. The most important have been the decision to extend membership of global financial regulatory institutions to the G-20 members, and the inclusion of major developing countries in the G-20 itself, which self-designated itself in the September 2009 meeting in Pittsburgh as ‘the premier forum for our international economic co-operation’. But such ‘elite multilateralism’ also faces a major problem, as ad hoc self-appointed bodies cannot replace representative institutions in a well-structured international economic architecture.

The reforms of ‘voice and representation’ of developing countries in the Bretton Woods Institutions (BWIs) predate the creation of the G-20 at the leaders’ level, and have continued to take place partly on a parallel track. In 2006 and 2008 modest agreements were adopted on reforming quotas and votes in the IMF Board, which entailed a redistribution of the quotas and a tripling of the basic votes. In October 2010, just before the heads of state meeting in Seoul, the ministers of the G-20 agreed on, and the IMF Board approved in November 2010 a more ambitious reform. It included doubling the quotas, revising the allocation of quotas and voting power of developing countries while protecting those of the poorest countries, reducing by two the European representatives in the IMF Board and electing all of its members. Relative to the pre-2006 situation (i.e., prior to the Singapore 2006 annual meeting), the increase in the quotas (3.9 percentage points) and voting power (5.3 points) of developing and transition economies was less than expected by these countries, and the large gains by some of them (China, Republic

²⁰ See in this regard, the contributions to Herman et al. (2010), as well as United Nations (2009b: ch. 5).

of Korea, Brazil, India, Mexico, and Turkey, in that order), which adds up 7.3 and 6.7 percentage points in terms of quota and voting power, respectively, came partly at the expense of other developing countries (Figure 6). Furthermore, although the quota and voting power of European countries was reduced, its over-representation continued to be a fundamental problem, as is the under-representation of some emerging economies relative to their actual share in the world economy. Given current dynamics, this problem is likely to worsen over time.

FIGURE 6
REDISTRIBUTION OF QUOTAS AND VOTES IN THE IMF
(VERSUS PRE-2006 SITUATION)



Notes: European G-10: Belgium, France, Germany, Italy, Netherlands, Sweden, Switzerland. Developing countries, other winners: Brazil, India, Mexico, Turkey and Republic of Korea .LICs: Low-income countries.

To these we must add other important proposals made on various occasions, including that by the 2009 Commission for IMF Governance Reform headed by Trevor Manuel (IMF 2009): a reduction in the threshold of votes needed to approve important IMF reforms from the current 85 per cent to, for example, 70-75 per cent; the creation of a Council of Ministers with effective powers to adopt the most important political decisions, thus replacing the International Monetary and Financial Committee; and a clear redefinition of the relations between this Council, the Board, and the administration.

For its part, in the spring 2010 meetings, the World Bank approved a transfer of 3.13 per cent of voting power from the developed economies to the developing and transition economies, which will now hold 47.19 per cent of voting power and have received a promise that they will reach parity in the near future. The increases were mainly concentrated in middle-income countries, especially from Asia, which were heavily under-represented, while low-income countries saw limited change. This change was achieved through an ad hoc capital increase, not through a formula based on clear principles, including the Bank's development mission. There was agreement that this would be done by 2015.

The G-20 has also agreed that the senior management of these organizations should be chosen on the basis of transparent and open processes, based on the merit of the candidates, and regardless of nationality. We still have to see how this principle will work in practice when the majority of voting power in both institutions is still concentrated in the hands of the USA and EU members, who currently head the two major organizations. It would also be useful for the staff of these institutions to be more diverse, not just in terms of nationality but also in terms of education and professional experience, as well as gender.

The broader issues on global financial governance relate, however, to elite multilateralism; i.e., to the G-20 itself. The creation of this G at a leaders' level was, of course, a step forward compared to the G-7, in terms of representation of developing countries. But this solution also created problems because of the ad hoc nature of the co-operation mechanism adopted, including the way in which the membership was defined, which implies the exclusion of some large countries (Nigeria is the most prominent case) and (once again) the over-representation of Western Europe.

This preference for 'Gs' over representative international institutions has deep historical roots in the case of major industrial countries, and reflects a revealed predilection of these countries for mechanisms over which they can exercise greater influence, but such bias may now be affecting other members of the G-20. The basic problem is the challenge of overcoming the tension between representativeness and the legitimacy associated with it, on the one hand, and power structures, on the other. This issue is sometimes expressed as the tension between inclusiveness and effectiveness, but this is clearly a wrong way to pose it, as national democracies have shown that representative institutions can be effective. It is, of course, true that some decision-making processes may require small bodies, but this is not inconsistent with the principle of representation, as those small bodies can be embedded in larger representative institutions that elect their members according to agreed criteria.

Therefore, although Gs can play an important role in placing new issues on the agenda and facilitating consensus among major powers, and in general in steering changes that generate a consensus among the most influential countries, no structure of governance can generate legitimacy as long as decision-making processes are not inclusive. For this reason, the G-20 should be seen as a transition to a more representative, and thereby legitimate, mechanism of international economic co-operation.

One such mechanism would be the Global Economic Co-ordination Council proposed by the previously mentioned UN Commission of Experts on Reforms of the International Monetary and Financial System (United Nations 2009b: ch. 4), which is in turn part of a long history of proposals to create a UN ‘Economic Security Council’. According to this proposal, the Co-ordination Council would be set in the framework of the UN *system*, to which the BWIs belong and the WTO would become a member. It would be formed on the basis of constituencies elected through weighted votes, thus following the model by which the boards of the BWIs are made up, though with formulas for representation that overcome the problems that those institutions face.

Aside from this potential mechanism, the UN can play an important role in global economic governance. It has proven to be a very effective mechanism for consensus-building (in the realm of global finance, in the case of the Monterrey Consensus), and in the generation of new ideas and a framework for international co-operation (in particular, the Millennium Development Goals), though its effectiveness has been limited by the tendency to limit its role in the implementation of these agreements. In retrospect, some of the analytical contributions of the UN Secretariat on global economic and financial issues—by the UN Department of Economic and Social Affairs, UN-DESA, the UN Commission on Trade and Development, UNCTAD, and the UN Economic Commission for Latin America and the Caribbean, ECLAC, in particular—have been, if anything, more sound than those of the BWIs, despite the much more limited amount of resources that these institutions manage. The UN has also made important contributions to these debates through the convening of high-level technical groups, such as in the area of global finance the Zedillo and Stiglitz commissions (United Nations 2001 and 2009b, respectively).

Finally, in all of the areas of reform, the global architecture should rely more broadly on regional institutions. Indeed, in a heterogeneous international community, the creation of *networks* of global, regional and national institutions can provide a better system of governance than arrangements based on single global organizations. This is based on old federalist principles: regional and sub-regional institutions give stronger voice and a sense of ownership to smaller countries. These institutions are, therefore, more likely to respond to their demands. This has already been recognized in some areas, such as the system of multilateral development banks, where the World Bank is complemented by regional development banks and, in some parts of the world, by sub-regional (in particular, in Latin America and the Caribbean) and inter-regional banks (the Islamic Development Bank). Although the density of institutional arrangements is quite diverse around the world, their historical record is broadly positive.²¹

²¹ See, in this regard, the contributions to Ocampo (2006), and the evaluation of the contribution of different regional mechanism to international monetary stability by McKay et al. (2011).

The creation of such an institutional network is particularly urgent in the monetary arena, where the IMF should make more active use of regional institutions, such as the Chiang Mai Initiative and the Latin American Reserve Fund, and support their creation in other parts of the developing world. The creation of a European Financial Stability Facility and the future European Stability Mechanism are also major steps in that direction. Indeed, the IMF of the future should be designed as the apex of a network of regional reserve funds rather than a mere global fund (Ocampo 2002, 2006). Aside from its benefits in terms of participation by all countries, this design would be much better to promote macroeconomic policy dialogue and crisis prevention and management at the world level.

However, careful consideration should be given to the links between global and regional arrangements. In this regard, during the recent crisis, Europeans chose rescue packages that mixed resources from the IMF and the European Financial Facility. In contrast, as access to Chiang Mai swap lines beyond a certain limit (20 per cent of the agreed swap lines) requires an IMF programme, countries that may have used the initiative during the crisis (Indonesia and the Republic of Korea) did not do so as they were unwilling to agree on any such programme. In turn, the use of the Latin American Reserve Fund has traditionally been delinked from any programme with the global institution. The links between the IMF and regional arrangements must be subject, therefore, to flexible designs.

8 Conclusions

This study argues in favour of a comprehensive yet evolutionary reform of current international monetary system. A comprehensive reform would include six areas: (i) designing an international reserve system based on the counter-cyclical issuance of SDRs that are also the source of financing for IMF credit lines, thus transiting to a fully SDR-funded IMF; (ii) broader mechanisms of macroeconomic policy co-operation embedded in the IMF; (iii) an exchange rate system among major countries based on a system of reference rates; (iv) regulating cross-border finance to mitigate the pro-cyclical behaviour of international capital flows; (v) offering appropriate balance of payments financing during crises; and (vi) providing adequate debt workout mechanisms at an international level to manage problems of over-indebtedness. The reform can be evolutionary, as it can build upon existing arrangements in most of these areas. This also makes it more politically viable, though the negotiation process is likely to be complex.

This should be matched by an institutional reform that is more inclusive, with three major elements. The first is the transition from the G-20 to a more representative global mechanism of international economic co-operation, which should be part of the UN system and based on constituencies elected through weighted votes. The second is continued reform of the BWIs to make their voting structure more coherent with today's global economy, as well as dynamic, and to improve other aspects of their governance structures. The third is a multi-layered architecture in which global institutions interact with a denser body of regional arrangements.

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