Preparatory Process for the Third International Conference on Financing for Development

Substantive informal session: "International monetary and financial system; regulations to balance access to credit with financial market stability"

9 December 2014, 10:00 a.m. to 1:00 p.m.
Trusteeship Council Chamber, United Nations, New York

A stable monetary and financial system, as well as other systemic issues, such as trade and global governance, are crucial elements of an international enabling environment that will facilitate the implementation of the post-2015 development agenda and achievement of the Sustainable Development Goals (SDGs). The need to address systemic issues and strengthen the international monetary and financial systems in support of development was recognized in the Monterrey Consensus, which also emphasized that reforms to the international financial architecture should aim at poverty eradication.

The 2008 world financial and economic crisis highlighted significant systemic flaws in the financial system. Since the crisis, important reforms have been put in place to improve the functioning, stability and resilience of the international monetary and financial system. The global financial safety net has been strengthened, new coordination mechanisms have been established, and regulatory reforms have been initiated. However, vulnerabilities remain in the banking system and international capital flows continue to be extremely volatile. Systemic shortcomings, structural flaws, regulatory gaps, barriers and misaligned incentives continue to pose risks to financial and economic stability. Furthermore, the financial system does not adequately allocate resources to areas critical to sustainable development, such as infrastructure, small and medium-sized enterprises (SMEs), and financial services for all.

To achieve the post-2015 development agenda, the international financial system needs to intermediate credit toward sustainable development in a stable manner. Ultimately, stability and sustainability are mutually reinforcing: long-term investment should contribute to a more stable financial and monetary system, while without a stable system, the post-2015 development agenda risks being derailed by future crises.

This session will explore how the Third International Conference on Financing for Development can help strengthen the international and monetary and financial system in support of sustainable development. These and other systemic issues will impact the implementation of all the SDGs.[1]

[1] Friday morning's panel on partnerships will include discussions of some specific sectors and goals.

Draft Programme

Co-Chairs

- H.E. Mr. George Wilfred Talbot (Guyana)
- H.E. Mr. Geir O. Pedersen (Norway)

Moderator and setting the scene

- Professor José Antonio Ocampo, Professor of Professional Practice in International and Public Affairs, Columbia University

Speakers

- Ms. Tarisa Watanagase, Former Governor of the Bank of Thailand; Alliance for Financial Inclusion (AFI) Associate
- Mr. Rupert Thorne, Deputy Secretary General, Financial Stability Board
- Mr. Athanasios Arvanitis, Assistant Director and Chief of the Emerging Markets Division, Strategy, Policy and Review Department, International Monetary Fund (IMF)
- Professor Catharine Schenk, Professor of International Economic History, University of Glasgow

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Briefing note

Since Monterrey Consensus, the international community has undertaken important reforms to strengthen the international financial system (e.g., through banking regulation) and monetary system (e.g. through a strengthened a financial safety net). However, additional efforts are needed to reduce the risk of future crises and ensure the adequate allocation of credit for sustainable development.

Reforms of the international financial system

The role of the financial system should be to facilitate the flow of funds from savers to borrowers and to effectively allocate funds throughout the economy. Safety and soundness is crucial for this effort, but reducing risks while promoting access to credit presents a complex challenge for policymakers since there can be trade-offs between the two. For example, in the extreme, a safer financial system would only lend to AAA or other highly rated borrowers, such as developed country sovereign bonds – but this clearly would not be an effective allocation of resources for long-term growth. The regulatory and policy framework thus needs to strike a balance between stability, particularly in reducing systemic risks, and access.

The current approach to the reform of international financial regulation has focused primarily on ensuring the safety and soundness of the financial system, centred on the banking sector through Basel III, supplemented by a set of recommendations from the Financial Stability Board (FSB). Basel III reforms include higher minimum capital requirements, an improved quality of capital, a leverage ratio and larger liquidity buffers. Along with the traditional micro-prudential approaches, which focus on reducing risks of individual banks, Basel III also attempts to strengthen the macro-prudential policy framework through the introduction of a counter-cyclical capital buffer, though it is unclear whether it is strong enough to achieve its intended purpose.

Most large internationally active banks are on course to meet the new Basel III capital requirements in advance of the agreed deadline. However, concerns remain related to the impact of the regulations on access to credit necessary to finance sustainable development. To contain risks, capital requirements are designed to impose higher costs on activities deemed to have higher risk. Yet, some of the sectors deemed to be of higher risk are precisely those that need investment for achieving sustainable development, such as lending to entities with low credit ratings, investment in locations or entities where it is more costly to get information (for example where there is insufficient data on default histories, e.g. trade finance), and longer-term lending. The FSB has been monitoring the impact of the rules on long-term finance, in particular, and has found that, to date, "it remains too early to fully assess their impact on the provision of long-term finance or changes in market behaviour in response to these reforms. The FSB will continue to monitor their impacts in order to identify potential financial regulatory impediments to the promotion of market-based financing, the development of new instruments to finance long-term investment, or the supply of long-term financing by domestic or foreign intermediaries."[2]

[2] FSB (2014). Report to G20 Finance Ministers and Central Bank Governors. "Update on financial regulatory factors affecting the supply of long-term investment finance."

There are also concerns of higher risk activities moving from regulated banking to unregulated shadow banking. The term ‘shadow banking’ was originally introduced to refer to activities of financial intermediaries that were not subject to regulatory oversight. In recent years, the term has been used more broadly to refer to any type of credit intermediation outside the conventional banking system.[3] In the 2008 financial crisis, highly leveraged shadow banking activities contributed to the crisis, highlighting risks inherent in unregulated financial intermediation.

The size of shadow banking assets is difficult to estimate. However, estimates put it at over $70 trillion.[4] While shadow banking is larger in developed countries, it has been growing more quickly in developing countries. Nonetheless, shadow banking in developing countries is often of a different nature than in developed countries, incorporating areas of inclusive finance, which could have positive impacts on sustainable development financing. The challenge lies in determining how these activities should be regulated, and in designing regulations to incorporate the full scope of activities while balancing risk mitigation with the imperative of an inclusive financial system.

On a global level, the FSB has been working to further strengthen the oversight and regulation of shadow banking entities, including through information-sharing.[5] These reforms are complemented by additional efforts, including reducing systemic risks associated with securities financing and investments in equity of funds, measures to address “too-big-to-fail” entities and strengthen the oversight and regulation of global systemically important financial institutions, implications of domestic banking reforms on financial institutions and markets in third countries,[6]and reforms of derivatives markets – though implementation on the national level has at times been slow. Other regulatory initiatives under discussion include work on accounting standards, reduction in the reliance on credit rating agencies and reform of certain compensation practices.

The Basel Committee has reached out to countries that are not FSB members to facilitate the implementation of Basel III in these countries. There are, however, questions on how to apply the full range of Basel III rules to developing and emerging economies, especially since the rules were designed for financial institutions in major advanced economies. On the other hand, it is argued that differing regulations can create room for regulatory arbitrage.

Despite outreach efforts, formal representation in international financial regulatory bodies remains limited to advanced economies and a number of major emerging market economies. The development and implementation of international financial regulation could benefit from greater representation of and participation by developing countries in the regulatory reform process.

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[3] IMF (2014). Global Financial Stability Report October 2014: Risk Taking, Liquidity, and Shadow Banking: Curbing Excess While Promoting Growth. Washington, D.C.:IMF.
[4] United Nations World Economic Situations and Prospects, 2014.
[5] FSB Chair's Letter to G20 Ministers and Governors on financial reforms, 4 April 2014.
[6] Report to the G20 Finance Ministers and Central Bank Governors, 2012. “Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences.”

Strengthening the global monetary system

Global imbalances on the current accounts of major economies have narrowed considerably over the past few years, representing a reduction of risk in the monetary system.[7] Nonetheless, many of the structural issues underlying global imbalances remain, creating the potential for a future build-up of risk while diverting resources that could otherwise be used for financing sustainable development. In particular, a proportion of existing global savings are currently in the form of international reserves held by central banks. From 2000 to 2014, global foreign-exchange reserves increased more than fivefold from $2.1 trillion to $12 trillion, with emerging and developing countries holding an estimated $8 trillion.[8]

Several factors explain the continued build-up in international reserves. For many countries, reserves are a form of "self-insurance" against potential external shocks. Reserve accumulation can also be an outcome of central bank interventions in foreign exchange markets aimed at smoothing exchange rate volatility, managing excessive capital inflows during boom periods, or maintaining an undervalued currency to support export-led growth strategies. Empirical studies suggest that no single explanation can account for the behaviour of all countries at all times,[9] though reserves have been higher than what would be predicted solely by precautionary[10] or export-led growth strategies.

Nonetheless, there are costs associated with the build-up of reserves. Reserves are typically invested in safe liquid assets, with United States treasury securities accounting for 61 per cent of global foreign exchange reserves, and euro-denominated sovereign-backed assets accounting for 24.5 per cent.[11] The accumulation of reserves in low-yielding investments comes at significant opportunity costs, since savings could be invested domestically to achieve greater economic, social and environmental benefits.[12] In addition, excessive reserve accumulation, while potentially stabilizing for countries at the national level, nonetheless adds to global imbalances, further destabilizing the monetary system on the global level.

A sustained reduction in global imbalances has been an objective of the G20. The Commission of Experts of the President of the United Nations General Assembly recommended that the international reserve system make greater use of IMF Special Drawing Rights (SDRs) as a way to reduce systemic risks associated with global imbalances, and as a low-cost alternative to accumulation of international reserves. However, this idea has not yet gained sufficient political support in policy discussions.[13] The lack of political agreement underscores the importance of reducing risks embedded in the international financial system to reduce the perceived need for self-insurance, and free up reserves for productive investment. This includes managing risks associated with volatility of cross-border private

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[7] IMF (2014), "World Economic Outlook October 2014: Legacies, Clouds, Uncertainties." Washington D.C: IMF.

[8] IMF (2014). Currency Composition of Official Foreign Exchange Reserves (COFER), Available from http://www.imf.org/external/np/sta/cofer/eng/cofer.pdf (accessed 17 November 2014).

[9] Atish R. Ghosh, Jonathan D. Ostry, and Charalambos G. Tsangarides (2012). "Shifting Motives: Explaining the Build-up in Official Reserves in Emerging Markets since the 1980s." IMF Working Paper, WP/12/34.

[10] United Nations, "World Economic Situations and Prospects."

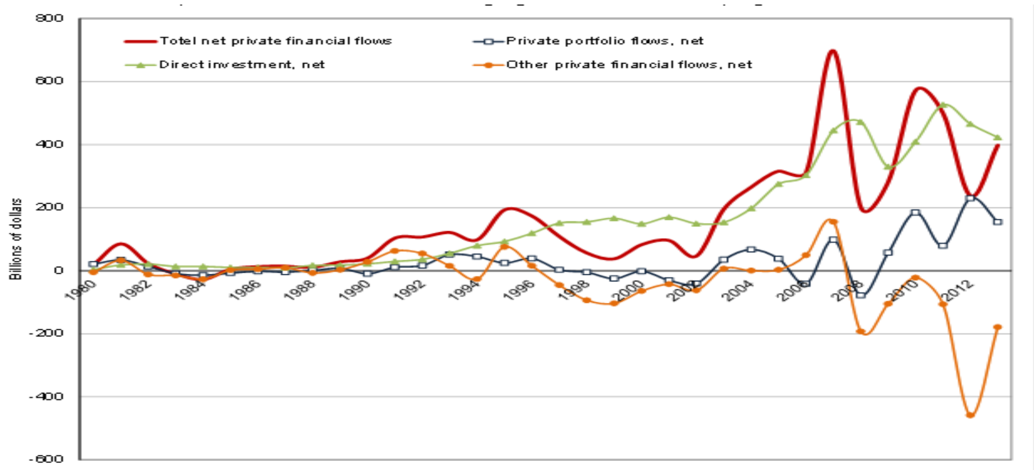
[11] IMF, COFER Database, accessed in November 2014.

[12] The accumulation of foreign-exchange reserves also increases the domestic money supply. The cost of sterilization can be high as borrowing in local currencies to sterilize the inflow usually carries a higher interest rate than what central banks earn in interest on foreign assets.

[13] United Nations (2013). "International financial system and development: Report of the Secretary-General." A/68/221.

capital flows, better coordination of monetary and exchange rate policies and providing more robust financial safety nets.

Cross border capital flows remain highly volatile

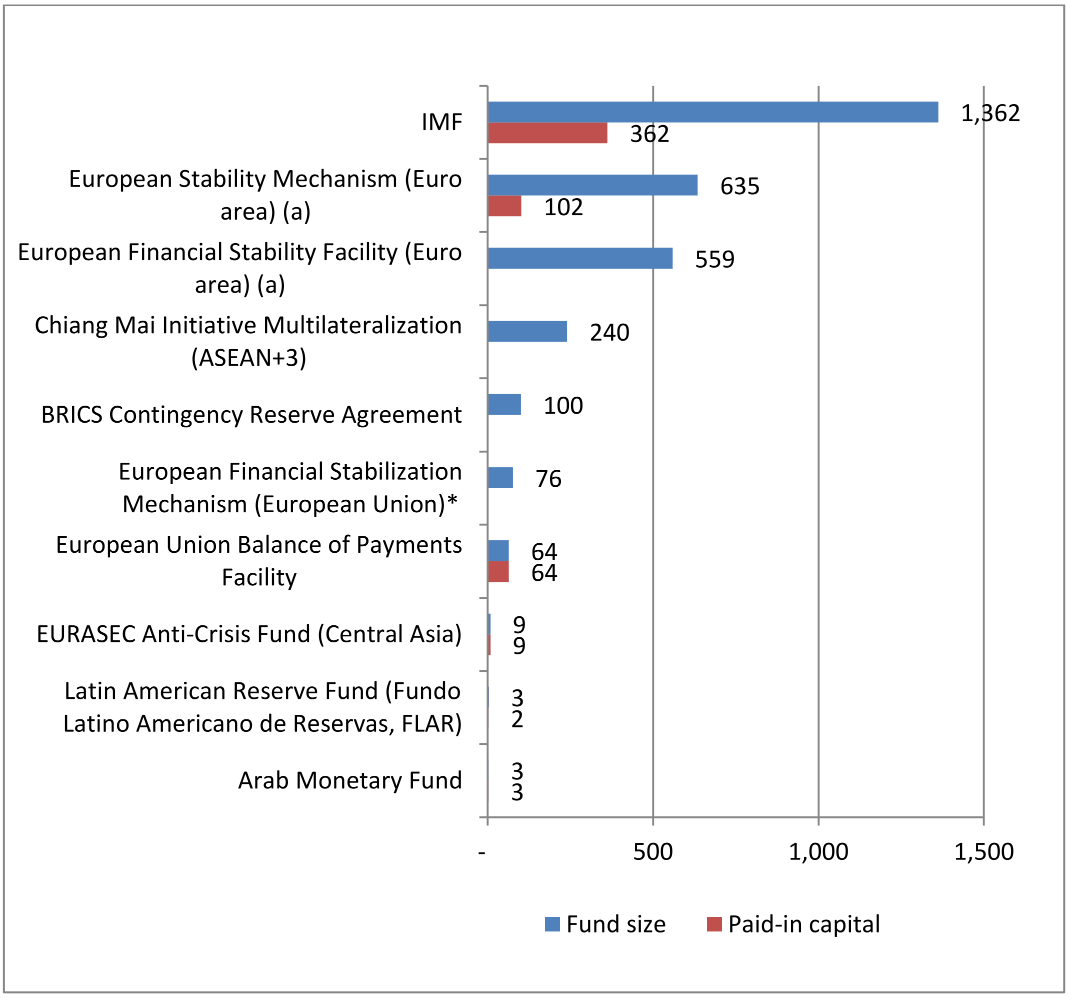


Conventional approaches to managing cross-border capital flows focus on macroeconomic policies, including the adoption of exchange rate, monetary and fiscal policies to enhance an economy's capacity to absorb inflows. However, these policies may not be sufficiently targeted to stabilize financial flows and may have undesired side effects. Attempts by policymakers to counteract the expansionary impact of excessive capital inflows by tightening monetary policies could also be partly self-defeating, as the higher interest rates may attract additional capital inflows, thereby exacerbating upward pressure on the exchange rate and further limiting domestic policy space. Greater attention is therefore being given to other tools to manage volatile capital flows. Macro-prudential policies as well as more direct controls have gained recognition among experts and policymakers as important tools to complement traditional policy approaches. Many economists recommend that policymakers consider a toolkit of options to manage capital flows.[14]In 2012, the IMF changed its earlier position of opposing the use of capital account management techniques in all cases, to acknowledging that there are circumstances where such measures may be useful.[15]

A reliable global financial safety net remains an important element in ensuring global financial stability. A safety net can provide liquidity in times of systemic crisis, and reduce the incentive for countries to accumulate excess reserves as a form of self-insurance against adverse shocks. In this regard, the IMF has quadrupled its lending resources since the global crisis and has revamped its lending toolkit, which has enabled it to enhance its ability to pre-empt and mitigate financial crises, contributing to the strengthening of the global financial safety net. The IMF has also refined the overall lending framework for low-income countries, with a view to increasing the flexibility of existing instruments.

[14] Stiglitz, Ocampo, and Spiegel, (2008) "Capital Market Liberalization and Development," Oxford University Press.
[15] International Monetary Fund, "The Liberalization and Management of Capital Flows: An Institutional View" (Washington, D.C., 14 November 2012).

Size and paid-in capital of global and regional financial arrangements (billion USD)



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Source: IMF; Rhee, Changyong, Lea Sumulong and Shahin Vallée (2013). Global and regional financial safety nets: lessons from Europe and Asia. Bruegel Working Paper, 2013/06. Brussels: Bruegel. November

The involvement of major central banks will remain pivotal for a functioning and sufficient global financial safety net. In some cases, more permanent frameworks of liquidity lines among key central banks have been introduced. Moreover, regional financing arrangements can play an increasingly important role in the global financial safety net. Existing regional financial arrangements include the Arab Monetary Fund (established in 1976), the Latin American Reserve Fund (established in 1989), the European Union Balance of Payments Assistance Facility (established in 2002), the Chiang Mai Initiative Multilateralization (established in 2010), the Anti-Crisis Fund of the Eurasian Economic Community (established in 2009), as well as the European Stability Mechanism (established in 2012) and the BRICS Contingency Reserve Agreement, among other arrangements (see Figure). Enhancing cooperation and increasing complementarities between the IMF and regional financing arrangements could contribute to global financial stability and sustainable growth.

Guiding questions

1. *What is the impact of current financial regulatory reforms on development and developing countries? How should developing countries implement Basel III?*
2. *How should countries understand the nexus between the push for financial inclusion and the need for stability of the broader financial system?*
3. *What are the options to more effectively manage and coordinate cross-border finance to mitigate the pro-cyclical behaviour of international capital flows?*
4. *How can we ensure adequate balance of payments financing in times of crises?*
5. *What steps should be considered to increase the stability of the international reserve system?*