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Fourth I.G. Patel Lecture

New Global Financial Architecture: Approaches and Issues

By
Y. Venugopal Reddy

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The London School of Economics and Political Science
and
Administrative Staff College of India

New Global Financial Architecture: Approaches and Issues

Delivered by

Y. Venugopal Reddy
Former Governor, Reserve Bank of India
Honorary Fellow, London School of Economics

on
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I. G. Patel

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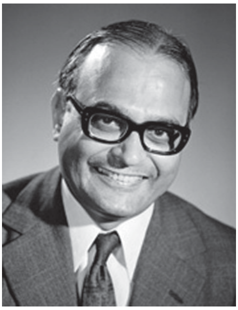

I. G. Patel was the 9th Director of the London School of Economics and Political Science (LSE), from 1984 to 1990. He became an Honorary Fellow of LSE in 1990. He was the 14th Governor of the Reserve Bank of India (1977–82). Building on his long and very distinguished career in the Indian government, at the International Monetary Fund, the United Nations and the Reserve Bank of India, I. G. Patel made a vital contribution to the LSE as an institution and to economics and social science research in general. His leadership of the LSE laid the foundations for the School's entry into the twenty-first century and equipped it with a renewed vision of reform, driven by intellectual curiosity and rational analysis. He was bestowed the Padma Vibhushan in 1991.

Writing in the *Independent*, Sunday, 20 July 2005, Professor Lord Meghnad Desai observed:

I.G. Patel belonged to a generation that was too young to have taken part in the struggle for Indian independence but was imbued with the high ideals of public service, exemplified by Gandhi and Nehru. All his life he sought to serve the higher cause of economic progress with social justice. He was present at the creation of the post-war policy infrastructure for economic development in Washington and in Delhi. He was there at the launch of the Colombo Plan; he was involved in the Indian Second Five-Year Plan in 1956 as well as the later two plans; he took part in building up the reputation of the UN Development Programme; he searched for solutions to the international currency crises in the aftermath of the breakdown of the Bretton Woods System; and he consolidated the reputation of the Reserve Bank of India as an architect of monetary stability.

The I. G. Patel Chair in Economics and Government has been set up at LSE in partnership with the Reserve Bank of India and the State Bank of India. Professor Lord Nicholas Stern is the first I. G. Patel Chair at LSE to lead and contribute to research in economics and public policy, aimed at understanding the inter-relationship between economic development and social welfare in a global economy, with specific reference to India.

Opening Remarks by

Mr. M. Narasimham

Chairman, Court of Governors
Administrative Staff College of India

Lord Stern, Dr. Reddy, Dr. Rao, Ladies and Gentlemen:

The Administrative Staff College of India is happy to be associated with the London School of Economics in organizing the Fourth I. G. Patel Lecture, instituted by the LSE to honour the memory of its late Director, Dr I. G. Patel.

Dr. I. G. Patel—IG as he was fondly known to his many friends and colleagues—was an eminent economist and a distinguished civil servant who held some of the most important posts in the area of economic governance in the country, such as Secretary in the Ministry of Finance and Governor, Reserve Bank of India, during the years when India was coming to grips with the problems of accelerating economic growth without sacrificing price stability. After his illustrious career in India, he served as the Director of the London School of Economics for a term.

We have as the speaker for this evening Dr. Y. Venugopal Reddy, another distinguished civil servant, who, like Dr. Patel, was also a Governor of the Reserve Bank of India. Dr. Reddy was at the helm of the RBI during the period of the recent international financial maelstrom, and his wise and sagacious leadership ensured that the Indian financial system was, by and large, unscathed by the international financial turbulence around that time.

He has chosen to speak on "Towards a New International Financial Architecture"—a subject whose topicality and relevance does not require much elaboration.

The international financial architecture, at present, is still basically the structure set up in the aftermath of the Second World War, centred around the International Monetary Fund and the Word Bank. The IMF has evolved over the years, but one cannot but observe that, in terms of its major objectives, as set out at Bretton Woods, namely instituting a par value system for exchange rates and providing the framework for international monetary cooperation through surveillance over policies of its member countries to prevent disturbances to international monetary stability, it has fallen short of expectations and indeed the needs of the times. The system of what was in effect a dollar exchange standard also was buffeted by the problems of the dollar and the collapse of the par value system. One would have thought that the effective international surveillance of national economies and currency markets would be enhanced, but that has not happened.

More recently, the Fund has been found wanting in tackling the issues arising out of what has been now termed global imbalances, wherein some countries have excess of savings and been accumulating vast payment surpluses. Part of the problem of global imbalances arises from the increasing resort by countries to using exchange rate management as a policy instrument of neo-mercantilism. We have not yet been able to fashion a system to discipline surplus countries, unlike the original intent of trying to help out and discipline deficit countries and now enshrined in recent years in the so-called Washington Consensus. As for dealing with persistent surplus countries, the Fund has done precious little. The scarce currency clause was meant to deal with such situations, but it has never been invoked. Conditionality has to be applied both in respect of surplus and deficit countries. What is sauce for the deficit goose should also be sauce for the surplus gander. The present system has little by way of coordination of regulation of banks and financial institutions across countries. Given the importance

of financial stability, such coordinated regulation, in whatever form it is devised, has been beyond the Fund's capacity.

The functional inadequacies of the Bretton Woods system as it has evolved have been compounded by what one might call congenital institutional inadequacies pertaining to the governance of the Washington institutions. At the time of its foundation, the Fund instituted the system of quotas—that unique device which governs members' contributions to the Fund, their access rights to its resources and, most importantly, their voting power. Even if one were to discount the apocryphal story that the US and the UK decided at Bretton Woods on what their respective shares should be and asked the technicians to devise a formula to provide this, the infamous Bretton Woods formula was the result, in terms of which weights were assigned to the size of economies, their share in international trade and the size of their reserves. In effect, it became a means test which tilted the balance overwhelmingly in favour of the developed countries and led to an oligopolistic distribution of voting power—an extreme consequence of which is that one country, viz., the US, by virtue of its quota size, had the effective right of veto on any substantive amendment to the Articles of Association.

We have a situation where, despite its relative decline in terms of GDP and other variables, even today, 9 out of 20 odd members of the Executive Board of the IMF are from Europe and where countries like Belgium and the Netherlands have had higher quotas than India and, until recently, China. The centre of economic gravity has decisively shifted towards the developing countries, especially China, India and Brazil. Clearly, any re-ordering of the financial architecture must address these important issues of governance, give the developing countries a much greater representation in the executive boards of these institutions, and give them due weight in terms of their relative GDPs calculated in terms of purchasing

power parities. This would redress the iniquitous governance structure that has been prevailing all these years. If the Fund fails to meet the aspirations of the developing countries, especially of the Asian countries, it would not be beyond one's imagination to expect that some of these countries might choose to set up their own arrangements for cooperation. The Chiang Mai initiative is a pointer in this direction. One could even think of an Asian Monetary Fund, backed by the major economies of Asia with their significant share in world GDP and international trade and their strong reserve position, especially of countries like China, Japan, Korea, India and Taiwan. Clearly, the new architecture must provide for reform in the governance structure of the Fund. The just concluded meeting in Korea is an attempt to do this.

The other aspect of the financial architecture is the question of the reserve currency. For the last 50 years, we have effectively operated a dollar reserve system. Though from the days of General de Gaulle, there have been concerns expressed about the seignorage privilege enjoyed by the US, apart from the dependence on one country's deficits to provide for international liquidity, and efforts have been made to look for a substitute reserve asset. No such viable substitute is, however, in sight. The Special Drawing Rights (SDRs) have only flattered to deceive. The SDR may be a unit of account but cannot be regarded as a satisfactory store of value and means of payment. Nor can other candidate currencies such as the euro, yen or yuan fill the bill. Therefore, to paraphrase Winston Churchill's aphorism about democracy, the dollar is perhaps the worst form of reserves barring all the others.

In essence, a re-ordering of the international monetary system should provide for effective surveillance of surplus and deficit countries, effective measures to prevent competitive depreciation of exchange rates—what has been sometimes sensationalized as

exchange rate wars—and, most importantly, provide for a greater say in the governance structure for developing countries, reflecting current international economic realities. We clearly need a Bretton Woods II.

These are all complex and tricky issues. Dr. Reddy has been an active interlocutor in international discussions on the subject, and we look forward to hearing his views on the way forward for the new international financial architecture.

New Global Financial Architecture: Approaches and Issues

Y. Venugopal Reddy

Chairman Narasimham *garu*, Professor Lord Nicholas Stern, Dr. S. K. Rao, Dr. Ruth Kattumuri and distinguished friends:

I am honoured by the kind invitation to deliver the Fourth I. G. Patel Lecture. I am thankful to LSE-India Observatory and, in particular, to the Director of LSE, Mr. Howard Davies, for this opportunity. I have had the privilege of knowing Dr. Patel for over 30 years, personally and professionally. He was the Governor of Reserve Bank of India when I was working in the World Bank; and I saw the leaders of global economic policy-making treating him with awe and respect. In later years, we worked together in several committees and boards, where his sagacity and wisdom were all pervading. Not many are aware of his leadership of one of the most leading academic institutions of the world, London School of Economics and Political Science (LSE)—the school that has produced the largest number of heads of governments in the world. Both Mr. Narasimham and Lord Nicholas Stern had a long and close association with Dr. Patel, and that adds to my pleasure of being here.

Dr. I. G. Patel had many links with Hyderabad. He was an ardent admirer of Ms. Vanaja Iyengar and Mr. Mohit Sen of Hyderabad, his contemporaries in Cambridge University; and his write-up remembering them is eloquent and touching. Mrs. Alaknanda Patel still often visits her several friends here, and was keen to be with us today; but could not make it, unfortunately.

In view of Dr. Patel's interest in the global economy and given the current global financial crisis, I have chosen to speak on the issue

of global financial architecture (GFA). I will briefly recall what appear to be the pillars of the GFA and then explain the current context. I will mention the proposals and initiatives in the past and then detail the current approaches and proposals. I will narrate the new initiatives on the GFA and conclude by listing some relevant issues.

Globalization is a process that involves reducing the barriers to the movement of people, goods, services, capital, etc., between countries. The process of globalization in recent years has given immense benefits, but there have also been costs. The recent financial crisis has brought out the huge risks involved in the globalization of finance. GFA refers to the institutional and policy arrangements aimed at enhancing the benefits and minimizing the risks of globalized finance.

Pillars of GFA

The IMF and World Bank group constitute the most important pillars of the GFA. The two institutions are inter-governmental organizations generally referred to as Bretton Woods institutions. They have, as members, the governments of almost all the countries. Although both of them are cooperative institutions, the members have unequal voting strength within the two organizations. Representation on the Board of Directors that manages the day-to-day affairs is skewed in favour of advanced economies, in particular Europe. Major decisions require special majorities, and this bestows a virtual veto on important matters to the US—the single largest shareholder.

The IMF's main functions are: monitoring the global economy, surveillance over exchange rate and related policies of individual countries, and providing liquidity support to countries to overcome temporary problems of balance of payments. The IMF also provides technical assistance to some member countries to improve their

macro-economic management. The members of the IMF have to observe some obligations, such as avoiding dual exchange rate, subjecting themselves to surveillance, and enabling full convertibility of their currency on the current account. The IMF's core competence and responsibility relate to the global financial system, in particular balance of payments, exchange rate and related macro-economic policies. The IMF derives its resources mainly from the contributions of member countries, which are supplemented, as necessary, by the borrowings from member countries.

The World Bank consists of two entities, namely, the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). The World Bank is also an inter-governmental organization with governance arrangements similar to the IMF. It provides resources and advice to developing countries for economic development. The World Bank group includes private sector affiliates, like the International Finance Corporation and others. IBRD operates with the capital provided by the members and by the borrowings from financial markets. IDA draws its resources from member governments, IBRD, repayments and retained earnings.

The World Trade Organization (WTO), as a third pillar, deals with the subject of international trade and is designed to bring down the barriers to trade. WTO covers, apart from trade in goods, subjects like trade in services and minimum standards for intellectual property protection. The General Agreement on Trade in Services (GATS) of the WTO is designed to establish a multilateral framework of rules for trade in services with a view to ensure expansions of such trade under conditions of transparency and progressive liberalization. One of the services covered by GATS is financial services. These cover a wide range of insurance, re-insurance and other insurance-related services as well as a host of

banking and other financial services. The WTO is unique as far as its decision-making methodology is concerned since each member has the same weight in voting. The WTO continues the practice of decision-making by consensus, which is defined as absence of formal objection. Since voting is seldom resorted to in practice, in a sense, every WTO member enjoys veto power.

Recently, the G-20 (a group of 20 systemically important countries) has been described as the fourth pillar of the GFA. The Group of Twenty (G-20) finance ministers and central bank governors was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy. From 1999 till 2008, G-20 was essentially a discussion forum that ended in the issue of a communiqué. The financial crisis of 2008 came as a rude shock to the global community, in particular to the advanced economies. First, the centre (G-7/G-8) became the origin of the crisis. Second, the periphery (developing countries) became the innocent victim but was less affected. Third, the financial crisis spilt over into a serious economic and, possibly, a social crisis. It was clear that the crisis in 2008 was essentially global in nature, and the policy responses had to be globally coordinated. These events led to the initiation of summit meetings of the G-20 in November 2008 in Washington DC, with the USA and the UK taking the lead in the process. Since then, there have been summit meetings at the level of heads of states or of governments. In the context of management of the crisis and creating a post-crisis world that would be more secure and stable than before, G-20 evolved as the most important economic policy forum in the world.

The Bank for International Settlements (BIS) is an international organization with some (not all) central banks as members. The BIS fosters international monetary and financial cooperation and serves as a bank for central banks. It acts as a forum to promote

discussion and policy among central banks and the international financial community. Its customers are only central banks and international organizations. The BIS plays a critical role in enabling the evolution of standards of capital adequacy for the banking system and was instrumental in developing the Basel standards. The operating arm for this work is the Basel Committee on Banking Supervision (BCBS), which is hosted by the BIS.

There are a host of other international organizations that are also part of the GFA but may not be described as pillars. These are the Financial Stability Forum (replaced by the Financial Stability Board after the global crisis); the Financial Action Task Force (FATF); the International Organization of Securities Commission (IOSCO); the International Association of Insurance Supervisors (IAIS); the Joint Forum of national regulators in banking, securities and insurance; and the International Accounting Standards Board (IASB). Credit rating agencies that are for-profit organizations are also considered by some to be one of the pillars of the GFA.

Context for the New GFA

The global financial crisis has several dimensions, but there is a consensus that the GFA was one of the relevant factors in not preventing the crisis. First, macro-economic imbalances developed, which were a source of financial instability. Second, the surveillance of systemic risk for the global economy was obviously less than adequate. Third, financial markets have been globalized and financial institutions have been operating cross-border finance without adequate global coordination of regulations. In other words, the cross-border arrangements for financial regulation were non-existent or inappropriate. Fourth, the institutional arrangements for the provision of liquidity support to countries that suddenly faced serious difficulties, to smoothen the necessary adjustments against shocks, were not available. Fifth, infrastructural

arrangements, such as credit ratings and international accounting standards, proved to be pro-cyclical and hence sources of instability. Broadly speaking, the inadequacies relate to macro-economic policies, financial sector regulations and the institutional set-up to deal with globalized financial markets. In regard to macro-economic policy in particular, it was felt that the international monetary system and the exchange rate arrangements were responsible for the generation of macro-economic imbalance and their perpetuation without necessary correctives.

The gross inadequacies of the GFA were brought into focus as a result of the crisis. In regard to the IMF, there is a recognition that surveillance by the Fund was not sufficiently objective, in the sense that too much faith was placed in a particular ideological position that trusted unfettered markets. It was also felt that the surveillance failed to take into account the systemic risks that were building up, in particular the risk to financial stability. Moreover, the IMF has not been even-handed in its surveillance in so far as it has not brought out clearly some of the weaknesses in major advanced economies. When the crisis occurred, it was noticed that lendable resources available with the IMF were inadequate to meet the requirements of a number of developing economies. Many of these developing economies had been impacted by the financial crisis mainly because of global circumstances, and not their own weaknesses. Finally, the IMF was not in a position to command adequate legitimacy and trust in view of its reputation built on past experiences. The ownership rights, the design of governance and the composition of the board were responsible for the infirmities in the governance of the IMF, and in any case, did not reflect the changed global economic realities.

In respect of the World Bank, according to many, its contribution in realizing the objectives of development have not been cognisable, though its contribution to thinking on developmental

issues is arguably significant. In terms of the flow of resources for development, it was playing a smaller role in relation to private capital flows. When the crisis occurred, the resources available with the World Bank were less than adequate to meet the demands of developing countries. Above all, the governance structure of the World Bank suffered from weaknesses similar to the IMF. In regard to the WTO, many members have undertaken commitments for liberalizing the financial services sector. The push for such liberalization through the WTO could have been one of the contributory factors to the global crisis.

Within the BIS, which has restricted membership, there is domination by North America, Europe and the UK, and their ideological preferences. The regulatory standards evolved under the aegis of the BIS, described as Basel II, could not prevent the financial crisis, in particular, the banks' balance sheets. The Financial Stability Forum (FSF) constituted after the Asian crisis in 1998, which was meant to be a watchdog to monitor global financial stability, neither anticipated the 2008 crisis nor took any steps to mitigate its impact. Similarly, the G-20, which was also brought into existence in 1999, after the Asian crisis, failed to appropriately anticipate the forces that led to the 2008 crisis. These realizations have led to a serious reconsideration of the GFA.

Past Proposals

It is necessary to recognize that the inadequacies in the global financial architecture are not entirely new. There was a realization that inadequacies existed. The first and foremost effort to set up a global financial architecture was undertaken after the Second World War. This initiative led to the creation of the Bretton Woods institutions. When the US dollar's link with gold was broken in 1971, there were discussions on the international monetary system. However, no significant change took place. A major review of the

GFA took place consequent upon the Asian crisis. There were several proposals, particularly within academic circles. The first proposal related to lender of last resort. It was noted that during the 1990s, the G-7 group of industrialized countries, i.e., the US, Japan, Germany, France, the UK, Italy and Canada, acting in close coordination with the IMF and World Bank, had performed the functions of a global lender of last resort. It was, however, observed that the resources available for the lender of last resort were grossly inadequate. First, it was felt that a larger fund for the IMF as the lender of last resort may encourage banks in industrialized countries to take more risks and, at the same time, also encourage developing countries to take on huge external liabilities. No significant progress was made towards increasing the resources for the IMF. Second, an international financial manager was proposed. The crisis manager may not necessarily need large resources, but should be in a position to provide comfort to the international community. The issue was whether the functions of the crisis manager and the lender of last resort can be separated.

A third proposal was to set up an International Bankruptcy Court in order to adjudicate debt issues between sovereign debtors and their creditors. This was expected to be similar to Chapters 9 and 11 of the US Bankruptcy Law. There is, however, a difference in the sense that in regard to a domestic bankruptcy, fixed assets can be seized and action can be taken against the board of directors of the company. No such options are available in regard to a country. However, countries have a sense of continuity and, therefore, there were strong incentives to honour their debt obligations so that they continue to be credit-worthy. The International Bankruptcy Court, however, may help in coordinating expectations about a good international sovereign borrower and a good international sovereign lender. An international authority to insure institutional investors against debt defaults was proposed. The authority would insure loans in advance when they are floated, and the G-7 would deny

bailouts of loans that were not insured. There was a view that there should be no lender of last resort at all in global finance so that both lenders and borrowers are prudent.

Some proposals related to a global financial regulatory authority to be run by investment professionals to oversee both banks and non-bank financial intermediaries. It was felt that this would help harmonize the standards of global regulation. Increasing transparency and improving financial regulation in developing countries was a more acceptable proposal. An International Deposit Insurance Corporation to insure sovereign debt issues with floating rates was another suggestion.

A World Monetary Authority akin to the European Central Bank (ECB), but on a global scale, was also proposed. The World Monetary Authority would have the ability to issue currency to address global liquidity flows. In addition, proposals to impose controls on capital flows were also propagated. These would control capital inflows or capital outflows, or both. Build-up of a higher level of foreign reserves was considered as yet another option. Finally, opening up more to foreign banks was suggested to reduce the costs of any bailout after the crisis. Yet another suggestion was that there should be a correction to the bias in favour of debt financing. There is a bias towards debt finance since there is no risk sharing, and international debt contracts are often enforced through creditor country codes and G-7 institutions.

Past Initiatives

It is interesting that almost none of the above proposals or improvements in the GFA were considered seriously among policy circles. The problem at that time was considered to be essentially one of the debt of developing countries, of inadequate development of financial markets and weak regulation of the financial sector. The problem was also thought to be one relating to the currency

markets and to the banking sector of developing countries. In brief, the problem was essentially local and marginally of global significance. Accordingly, three changes were brought about in the GFA. The Financial Stability Forum (FSF), a forum of select advanced economies and important financial centres, was brought into existence to monitor financial stability. This was working mainly under the aegis of the BIS. The G-20 was constituted consisting of both developed and developing countries. The objective was to bring together systemically important industrialized and developing economies to discuss key issues relevant for global economic stability. This had both finance ministers and central bank governors of various countries. The BIS, the IMF and the World Bank took initiatives to have a set of internationally acceptable standards and codes in regard to the financial sector. Financial Sector Assessment Programs (FSAPs) were initiated in respect of most countries. A very modest beginning was made to change the composition of the voting strength in the IMF and the World Bank to reflect the changing global realities in economies and trade.

Current Approaches

As a result of the current global financial crisis, some of the proposals which were originally mooted soon after the Asian crisis are, in a way, being revisited more seriously than before. There is better appreciation of the problem as being global in nature, though in reality the problem originated in the advanced economies but was transmitted through contagion to many developing economies. It is interesting that the role of two new institutions in the GFA (G-20 and FSF, both constituted in 1999), which were created consequent upon the Asian crisis and which failed to address the issue of financial stability, has now been expanded and strengthened.

It is also necessary to note that during the period between the Asian crisis and the current crisis, the role of the IMF in handling the Asian crisis had come in for severe criticism. The stigma attached to obtaining resources from the IMF was intensified on account of its role in Asia. Subsequent to the Asian crisis, there have been crises in developing economies, in particular, in Latin America, which required support from the IMF. However, as the global economy picked up considerable growth momentum, the demand for support from the IMF waned. Operational income for the IMF reached a stage where it found it difficult to maintain itself. There was a feeling in some circles that the IMF had become somewhat irrelevant, while many felt that it was necessary to have a global institution conducting economic surveillance over countries and over the global economy.

Asian economies, in the light of experiences from the crisis of 1997, improved their performance in a dramatic manner; and they built significant reserves as a deliberate policy of self-insurance. The World Bank was, in the meantime, not in a position to significantly increase its net transfer of resources. The BIS expanded its membership to include some central banks of developing countries. In brief, the GFA almost went out of the active agenda in the consideration of the global economy in the events leading up to the current crisis. The crisis brought the GFA back into sharp focus.

There are two possible approaches to the design of the new GFA under discussion, viz., to create new institutions to replace or to supplement the existing global institutions. These include an institutional framework for a new global reserve system, including the establishment of a Global Central Bank, a Global Economic Coordination Council, an International Debt Restructuring Court and, above all, a new Bretton Woods conference to consider a new GFA. Those who advocate in favour of new institutions argue that

the existing architecture cannot be improved through marginal changes, in view of the inherent structural weaknesses in the institutions, their lack of credibility, their poor track record and, above all, their resistance to divert, in substance and style, from entrenched interests in the existing institutions. They also argue that such a process of designing a new GFA should not be difficult since the world is far more conducive to global cooperation now than before. On the earlier occasion, discussions took place soon after the Second World War and it was possible to come to an agreement through an intellectual exercise backed by political considerations. The current crisis is of such magnitude that a fundamental change in the institutional structures is called for and, hence, a new GFA is required.

An alternative approach is to proceed on the assumption that creating new institutions would be an extremely complex process; and hence, it would take time. It would also divert attention from the immediate tasks. More important, the existing institutions are repositories of talent, skill and experience, which could be built upon. It is also argued that since there is a clear recognition of the problems arising out of the crisis, it is possible to effect improvements to the existing institutional structures and their way of functioning, with a proper mandate and direction. On balance, the consensus appears to be in favour of reforming the existing institutions. In other words, the current approach is that a new GFA should come about through reforming the existing institutions rather than building new institutional structures.

The fundamental weaknesses of the international monetary system, which is closely related to but not exactly a part of the GFA, have been placed on the table as an issue. It has been recognized by most analysts that it is an issue that has to be addressed, but it is not easy to find technical solutions that would be politically feasible; and in any case, the transition would be complex.

However, in view of the urgency as well as the necessity to explore improvements in the international monetary system, ways are being explored by which the SDR or SDR-like mechanisms can be strengthened and utilized, with the IMF playing a critical role. Such a critical role could be through the sub-structures of the IMF. This is an issue on which considerable debate should be expected in the near future.

New Initiatives

Several initiatives have been taken by the IMF for internal reform, under the overall direction of the G-20. First, the IMF has initiated a process of reappraisal of its policies as evidenced from several research documents. It is not very clear whether the open mind and objective approach, as found in the research documents, is being reflected in the IMF operations.

Second, in regard to surveillance, the coverage of the financial sector has been increased and its assessment is being integrated into surveillance mechanisms. There is greater effort to address systemic issues in the surveillance while ensuring even-handedness. In fact, in September 2010, the IMF made it mandatory for 25 jurisdictions with systemically important financial sectors to undergo financial stability assessments under the FSAP every five years. Selection of countries for mandatory assessments has been based on the size and interconnectedness of their financial sectors, and will be reviewed periodically to make sure it reflects developments in the global financial system.

Third, lendable resources have been enhanced through several channels, in particular through additional borrowings under the IMF's New Arrangements to Borrow.

Fourth, global safety nets are being put in place. For countries that have strong policies and fundaments, there is the option of an

assured resource by opting for flexible credit lines. For countries which have policy strengths in most areas, they may opt for a precautionary credit line that will make resources available, but with ex-post (after disbursement) conditionality. The IMF is also examining the possibility of global stabilization mechanisms as part of the global safety nets. It is not clear whether the possibility of collateral lending to supplement conditionality is being explored. Above all, an effort is being made to erase the stigma associated with approaching the IMF.

Fifth, with its programme of lending to Greece in association with the European Central Bank, the decision of the IMF to link with regional bodies is under reappraisal.

Finally, in regard to governance, agreement has since been reached in the G-20, on 23 October 2010, for a shift in quota shares in favour of dynamic emerging market economies (EMEs) and under-represented countries of over 6 per cent while protecting the voting share of the poorest. India's quota share will improve from 2.44 per cent to 2.75 per cent. Europe will give up two of its seats on the Board.

In 1978, the Articles of Agreement of the Fund were amended to allow the setting up of a Ministerial Council of the IMF. Unlike the International Monetary and Financial Committee (IMFC), which is an advisory body, the Council would be a decision-making body with voting based on the current vote shares in the IMF. The composition of the Council is similar to the Executive Board. The Council will also have powers delegated to it by the Board of Governors. The activation of the Council requires a majority of 85 per cent of the voting power of the Board of Governors. The activation of the Ministerial Council has been recommended by the Independent Evaluation Office of the IMF and an Expert Group chaired by Trevor Manuel, the former Finance Minister of South Africa. However, there is no indication of action on this part.

In regard to the World Bank, lendable resources have been enhanced. The voting shares of developing and transition countries are being increased by 3.13 percentage points (from 44.06 per cent to 47.19 per cent). The authorized capital of the bank is also being raised. For multi-lateral development banks as a whole, the capital base is being increased by 85 per cent. During the crisis, the World Bank had extended assistance to several developing countries, and there has been front loading of IDA disbursements. There is, however, resentment among several less developed countries that countries like China and India continue to draw resources from IBRD and IDA on a significant scale.

As regards the WTO, there has been no significant debate on the implications of the financial crisis. In its functioning and the commitment of its members, the FSF has been expanded to include several developing countries, virtually mirroring the composition of the G-20. The FSB has been functioning as the operating arm of the G-20 in regard to the financial sector. This includes monitoring of standards and codes, and setting regulatory standards. The recently released BCBS guidelines on Basel III focus on five aspects of financial sector regulation, viz., micro-prudential regulation, specially for capital adequacy; macro-prudential regulation in terms of counter-cyclical measures; addressing liquidity issues; improving trade practices in regard to financial markets; and special provision for systemically important institutions.

The G-20 has been regularly holding meetings and considering coordination on various issues. These include issues relating to the global financial architecture. However, the decisions of the G-20 are made operational through the existing global institutions and actions by respective national governments in their relationship with existing institutions that comprise the GFA.

Some Relevant Issues

There are several issues that would determine the outcomes of the new GFA. First, the changes that have been brought about so far are aimed at addressing the infirmities observed in the existing institutions and their functioning. There is no evidence of a fundamental review of the ideological base of the global economy and global finance.

Second, the actions taken so far relate to operational aspects within the existing institutions with some indication of a possible shift in governance. As per all indications, the shift is likely to be very marginal. In other words, the new GFA is new only in operational terms but not in strategic terms.

Third, the approach so far is proceeding with only two layers, viz., national and global. However, the three-layer approach involving regional arrangements, such as in the euro area and in Asia, may be more appropriate. In particular, safety nets should be considered at the national, regional and global levels, taking into account the circumstances of different countries and regions.

Fourth, the link between the financial and real sectors has not been adequately explored. There is still an assumption that real activity will have to necessarily adjust to financial markets.

Fifth, the trade-offs between growth, stability and regulation have not been sufficiently explored in the design of improvements to the GFA. In particular, the design seems to be aimed at addressing the stability issues of advanced economies rather than the structural and developmental issues of developing economies. The missing element in regulation is the inter-connected and cross-border financial processes, especially in the activities of international banks. Highly leveraged private institutions operating in cross-border markets remain somewhat unregulated.

Sixth, while the G-20 has flagged the issue of tax havens and tax secrecy, the importance of global fiscal coordination has not been adequately addressed. There is a review of progress in the Tax Information Exchange Agreements, but they only refer to quantitative aspects. Quality of agreements signed, relevant partners, domestic regulation of tax haven jurisdictions, etc., are not addressed. The GFA is incomplete without binding institutional structures for coordinating tax regimes since the tax regimes and regulatory regimes of the financial sector closely impinge on each other.

Seventh, no serious effort has been made to revisit the financial services commitments undertaken with the WTO. It can be argued that the commitments already undertaken with the WTO need to be reviewed to ensure the integrity and stability of the financial system; and that since the problem is not relatable to a single member or only a group of members, it is desirable to adopt a ministerial declaration enabling the members to revise their schedule. In fact, the preamble to the GATS recognizes the right of members to regulate and to introduce new regulations on the supply of services to meet national policy objectives. Members may have to roll back some of their commitments in the financial services sectors under GATS on the way forward to prevent the recurrence of a global financial and economic crisis.

The question that remains unanswered so far is: How new will the new GFA be? Much will depend on the functioning of a revived IMF and a rediscovered G-20, which happen to be the cognisable new elements of the new GFA.

There are three distinct challenges for both the IMF and the G-20. First, how to manage the asymmetry in the extent of global integration of labour, capital and financial regulation? Second, how to design global governance that is equitable for the people at large

with unequal nations, unequal in terms of economic strength? Third, how to reconcile the public policy autonomy needed by national governments, essential for their accountability, and the arrangements for governance at the global level? In addressing these issues, it is essential to recognize that developments in technology have a tendency to favour globalization in general.

India has an important role to play in the evolution of the new GFA. It is unique among major economies in not causing the macro-imbalances and not contributing to the financial crisis. India adopted pragmatic policies successfully; and hence, it can be objective and impartial in the deliberations on the GFA. This has been recognized by the global community, and our Prime Minister has emerged as a global economic statesman. There is every reason to be cautiously optimistic about a desirable and acceptable new GFA.

Concluding Remarks by

Prof. Lord Nicholas Stern

I. G. Patel Professor of Economics and Government and

Director, India Observatory, London School of Economics and Political Science

I must begin with some thank you's. It is a great honour to be able to share a platform with three such distinguished people. I thank you Dr. S. K. Rao, Director of ASCI, for your role in putting all this together and your thoughtful words of introduction. As you know, I. G. Patel was indeed not only the Governor of the Reserve Bank of India but also the Director of the London School Economics. So, it is a special pleasure to be able to share the platform with two of I. G.'s real colleagues—two former Governors of the RBI. They are of his spirit. You heard today their thoughtfulness, which was not only of the kind that I. G. offered, but also of which I. G. would have been very proud had he heard them today.

I am currently the I. G. Patel Professor. I.G. actually hired me to the London School of Economics. So, the evidence of his wise judgment was already very powerful, but I had to regard it as overwhelming when I received the offer from him! In an important sense, he was an uncle figure to me; we talked a lot about the Indian economy and the world. So, it is a great honour to have the I.G. Patel Lecture given today by Governor Reddy, our friend Venu. It was a very special lecture. I will make two-three brief observations as concluding remarks.

This is the fourth I. G. Patel Lecture. Just to underline the strength of the tradition, the first one was given in London by Montek Singh Ahulwalia, who has provided such important direction for India's

reforms; the second one was given by myself in Delhi; the third one was given by the truly great economist and philosopher Amartya Sen in London; and the fourth one has been given here in Hyderabad in such a distinguished way by Dr. Venugopal Reddy. So, this is something of an event that is partly from LSE and partly from India; and we move back and forth like that.

I must also thank the Reserve Bank of India and the State Bank of India for their support for the I. G. Patel Lecture, the I. G. Patel Chair, and for the India Observatory—a Centre at the LSE to foster research and knowledge exchange related to India. All these are a very special part of the heritage. Thanks also to Dr. Ruth Kattumuri who played such a major role in not only establishing the Centre but also in organizing all the I. G. Patel Lectures.

I would now like to make a few observations as an economist and also as someone who has been inside the institutions referred to in the lecture. I was Chief Economist of the World Bank for a period; I was also the Chief Economist to the European Bank for Reconstruction and Development for a period preceding that. So, in a sense, I have served my decade in these international institutions.

I think the emphasis on governance is of enormous importance. I would like to add one task which is not a part of the formal governance but is very much a part of the informal governance. There is a convention whereby there is a European at the head of the International Monetary Fund (IMF) and an American at the head of the World Bank. That is a presumptuous, arrogant and outdated convention. And the point is we can actually stop it quite soon if we want to. It is quite likely that the current head of the IMF may seek a future in French politics. I take my hat off to Dominique Strauss-Kahn. I think he has been a very good head of the IMF, but he may move next year into French politics. May be,

we do not know this for sure. So there may be a moment next year when Europe can do the right thing. The request, perhaps a demand, should go out to Europe now, particularly from those of us who are Europeans but also from outside of Europe to say one simple thing—we will not seek to put a European at the head of the IMF. Let there be a competition, let the best person win. But we would hope and expect that person would be from outside Europe and the United States. I think that will be a tremendous step forward, a very simple thing to do, and part of the reform of the informal governance of these institutions.

Second, as both our speakers underlined very clearly, this is not simply about the rules of governance—it is about policies, analyses, understanding and ideas. It is about the behaviour of all of us in the international economic community. And those policies, rules and behaviour should be organized around the world as we now see it, the world as we anticipate it because rules last for quite sometime. We have seen just how long the Bretton Woods structures have lasted. So, we have to think through what the new rules would look like. I do like the idea that Governor Narasimham had set out for a Bretton Woods II. Now, we can argue whether we should get there incrementally or we get there through another conference. But, I think, if those eminent people sitting around in New Hampshire in 1944 were to reconvene and ask the questions now, what kind of answers would they come up with? That would give us, as it were, a benchmark towards which incremental reform could move. Or the systems could be redesigned if we were able as a world to actually do that. I do like the idea of a Bretton Woods II. I think it is of value even if we proceed down the incremental route in that direction.

I would add one more thing, and you will probably expect it of me. I think if John Maynard Keynes and Harry Dexter White, the

two chief designers of the Bretton Woods institutions, were to sit down today, they would have a World Environment Organization as well as the World Trade Organization, the World Bank and the IMF. They may even put the World Bank and the IMF under one roof; there would be no harm in doing that.

Thirdly, it is very important to do institutional reforms outside crisis, if at all possible. Bretton Woods was born of 30 terrible years in the world—the two World Wars and the Great Depression. The evidence that collaboration was better than what had gone before was on the floor; it was in blood. People could see why it was so important to try to resolve our problems through international collaboration and understanding and good policies. This, if you like, was the evolutionary approach; you test to destruction, and you find out that you need something else. Would it not be much better, having come close to the edge quite recently, if we did our reforms thoughtfully and quietly, and not driven by immediate crisis? My guess is that we would do better if we did it that way, even though the short-term political impetus might be less.

Finally, the question is: Where do propositions and ideas come from? In the G-8 world, propositions and ideas came from the rich countries and wise poor countries would say: "No, that's a bad idea", and bat them back. I think that the dynamic has changed and should change more explicitly. Right at the end of his lecture, Venu spoke about the source of ideas and how India is and can be a very powerful source of ideas. Not only from the wonderful intellectual and practical experience of the people we have on the platform today, but also from the performance of India over the years. I think that's also true of Brazil, China and South Africa, for example. You saw at the recent international Conference on Climate Change held in Copenhagen, those countries which are charmingly called the BASIC countries—Brazil, South Africa,

India and China—were a very powerful source of ideas. Disappointing though the outcome of that Conference was, there was a dynamic there that was different. There is a source of ideas now which is associated not only with the ideas themselves, but also with the authority that comes from values. That seems to me to be a source of ideas which would be enormously important to use. So it is not a story of the rich countries trying to put something together and then selling it to the rest of the world. The source of ideas and the dynamics go the other way round. Perhaps, we have seen the beginnings of that here today.

Thank you very much indeed.