



The cost of reserves

Developing countries pay the price of global financial instability

A EURODAD BRIEFING

By Nuria Molina and Marta Ruiz

January 2010



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Acknowledgements

Report written by Marta Ruiz and Nuria Molina (Eurodad). We would also like to thank Peter Chowla (Bretton Woods Project), Rick Rowden, Frank Schroeder, Antonio Tricarico (CRBM), and Arnaud Zaccharie (CNCD) for their comments and contributions.



This report was produced with the financial support of the European Commission. The views presented in this report do not necessarily represent the views of the Commission.

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EXECUTIVE SUMMARY

The world is experiencing the worst financial crisis since the 1930s. Originating in the United States, the crisis quickly spread and is now having devastating effects in each and every corner of the world. But developing countries are suffering the most severe economic and human impacts as the financial crisis has exacerbated existing poverty, debt, food and climate crises.¹ The International Labour Organisation (ILO) estimates that up to 61 million workers have lost their jobs due to the crisis,² and more than two thirds of these jobs have been lost in developing countries. Worldwide 100 million people may be pushed back below the \$1 per day poverty line. Foreign Direct Investment (FDI) is projected to fall by at least 30%. Migrant remittances to developing countries are predicted to fall by \$24 billion.³ Developing country debt levels are rising once again, and the United Nations Conference on Trade and Development (UNCTAD) has expressed serious concerns about unsustainable debts in 49 Least Developed Countries (LDCs). According to the World Bank this crisis caused a financial shortfall for developing countries of between \$350 and \$635 billion in 2009 alone, and most developing country economies will recover more slowly than those of richer countries.⁴

Lack of appropriate regulation and the global monetary (dis)order have been at the heart of the current financial crisis. The absence of appropriate coordination and adjustment mechanisms of global monetary policies, and the unfettered liberalisation of

global financial markets led to dramatic global imbalances and global economic disaster.

How did we reach the current global monetary (dis)order?

In July 1944, the allied countries gathered in Bretton Woods to define a new financial and monetary order. The International Monetary Fund (IMF) was created as a part of this system to ensure global financial stability and cooperation and to prevent competitive devaluations. Under the agreement, IMF members also committed to maintaining balanced current accounts and were allowed to regulate capital flows. The so called Bretton Woods system was based upon fixed exchange rates to the US dollar, which was in turn pegged to the value of gold.

By the early 1970s the US had accumulated huge budget deficits⁵ as a result of an excess of printed dollars and a negative trade balance. This led other nations to lose confidence in the dollar and move to exchange their dollars into gold. Unable to ensure the dollar convertibility, the US government unilaterally abolished the Bretton Woods exchange rate system in 1971. The system that emerged was no longer based on a “gold standard” but upon confidence that the US economy was able and willing to absorb the growing demand for dollars. The US was free to continue printing money without any constraint (as the rest of the world demanded dollars as a reserve currency and for international trade settlements) and became the world’s “consumer of last resort”. This paved the way for an increasing US deficit and significant global imbalances to emerge during the 1980s.

Financial liberalisation, global imbalances and instability

Following the collapse of the Bretton Woods system and the move to flexible exchange rates, many industrialised countries liberalised

¹ What Happened at the G20? Initial Analysis of the London Summit, Oxfam GB, April 2009. At: www.oxfam.org.uk/resources/policy/economic_crisis/downloads/bn_what_happened_at_g20.pdf

² ILO: The Key Indicators of the Labour Market, 6th Edition – Economic Crisis and Labour Markets Impact

<http://www.ilo.org/public/english/employment/strat/kilm/download/chap1a.pdf>

³ Migration and Development Brief, World Bank (July 13 2009). At: http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934_1110315015165/Migration&DevelopmentBrief10.pdf

⁴ Global Development Finance, p. 7, World Bank (2009). At: <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/EXTGDF/EXTGDF2009/0,,menuPK:5924239~pagePK:64168427~pk:64168435~theSitePK:5924232,00.html>.

⁵ An important part of the deficit was due to Vietnam war military expenses, which were financed by printing more dollars.

their capital accounts in the late 1970s and early 1980s. In the 1990s, financial sector liberalisation spread to developing countries, pushed by conditions attached to World Bank and IMF loans,⁶ and through multilateral and bilateral trade and investment agreements. Financial sector liberalisation was supposed to increase access to financial markets in other countries, but it actually enhanced financial complexity and instability.

During the 1990s, emerging economies absorbed huge amounts of capital inflows.⁷ But the financial crisis that hit Asia in 1997 and spread to Russia and Latin America in the following years showed the dangers of capital account liberalisation.⁸ Governments did not have the right mechanisms to regulate the rapid capital inflows, nor the economic policy tools to prevent the sudden capital outflows at the outbreak of the late 1990s financial crisis, when short-term investors and speculators panicked and rushed to exit these countries.⁹ In the midst of the crisis, Asian economies could only resort to the IMF and its harsh macroeconomic adjustment programmes which had devastating social and human consequences, some of which lasted for years.

The distrust in the IMF that ensued from this experience pushed developing countries to build huge reserve buffers as insurance for speculative attacks against their currency or sudden capital outflows.

The global paradox in which the South finances the North

Since the end of the 1990s we have witnessed the paradox of developing countries lending their vast surpluses to the United States and, to some extent, to other developed countries. At the end of 2007 developing countries held more than three quarters of the world's total reserves – some

\$4.9 trillion (figure 2).¹⁰ Although this increase can be partially explained by commercial reasons – that is, to the increasing share of emerging economies' world trade – the growth of developing countries' reserves has been heavily influenced by their precautionary desire to avoid future financial crisis.

Although reserves provide a comfortable insurance against financial flows and aid volatility, they come at a very high price. The cost for developing countries is estimated at \$300 billion a year. But this is calculated strictly as the difference between investing reserves in lower yielding US treasury bonds and higher yielding investments.¹¹ It does not include the opportunity costs of not investing a share of reserves in boosting domestic economic growth, neither the costs of borrowing reserves in international capital markets, which are estimated to carry an average annual cost of \$130 billion.¹²

If combined, these conservative estimates account for more than four times annual Official Development Assistance (ODA), and more than 2% of the combined Gross Domestic Product (GDP) for all developing countries. This constitutes a massive transfer of financial resources from developing to developed countries. **Even more troubling is the fact that the poor are actually paying the price for financing the spending habits of the rich.**

In addition, the current global monetary system is prone to global imbalances and financial instability,¹³ and is severely biased towards preserving the value of financial assets rather than of wages and labour.

Proposals for reforming the global monetary and reserves system

The worsening global imbalances that led to the current crisis have revived old proposals

⁶ As for developed economies, the IMF did not have a real impact, since most of its conditional funding was directed to developing economies.

⁷ Much of the surplus absorbed by Asian emerging economies in the second half of the 1990s came from European Union countries. In order to comply with the Maastricht criteria that would allow them to enter the European Monetary Union, European governments had to substantially reduce their current account deficits. This led to the accumulation of more than \$100 billion surpluses in 1997 (see Op. cit. Brender and Pisani 2007, p 20)

⁸ IMF Independent Evaluation Office, XXXX

⁹ This is why, after the 1997-98 financial crisis, capital controls were introduced by a few countries – such as Malaysia

¹⁰ Report of the Commission of experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System. June 2009.

¹¹ Cho, Youngwon: "Capital Account Liberalisation in the Developing World and the Global Reserve System: Imbalances and Inequities," International Studies Association, New York, February 2009.

¹² Akyuz Yilmaz "Policy response to the global financial crisis: key issues for developing countries" May, 2009.

¹³ Only in the past forty years the world has suffered more than 100 financial crises.

for reforming the global monetary system and have also incited new ones. Emerging economies with large stocks of reserves are increasingly calling for a new system that would decrease dependence on the dollar. A UN Commission of Experts on the Reform of the Monetary and Financial System, gathered by the President of the UN General Assembly, has also put forward proposals for a new international reserve system, which civil society groups have widely echoed and supported.

These proposals call for:

- **a supranational reserve currency** that substitutes the US dollar and which is not linked to the creation of a spiral of deficits of the reserve currency issuing country, and thus of destabilising global imbalances;
- **a global system of symmetric coordination to allow for equitable adjustments** of global imbalances between surplus and deficit countries. This would effectively remove the pressure on deficit countries to adjust by cutting their aggregate demand and the so-called “deflationary bias” of the system which undermines the possibility to guarantee full employment and equitable growth;
- **an efficient mechanism to create global liquidity.** This mechanism should be counter-cyclical so that increased liquidity can be provided in times of crisis to support counter-cyclical fiscal policies;
- **policy space for developing countries to implement capital management mechanisms.** This should enhance exchange rate stability, curbing speculative attacks on currency and other kind of speculative capital flows. This should also be made possible through the provision of capital management mechanisms within World Trade Organisation (WTO) agreements and General Agreements on Trade in Services (GATS) and also in bilateral and regional investment agreements with developing countries.

However, the above measures must go hand in hand with broader and **deeper reforms of the global financial architecture** that give a **stronger voice to developing countries.** These should include:

- reforms of the International Financial Institutions (IFIs) to ensure greater representation of developing countries. At the IMF, this could be achieved by establishing a system of double-majority voting.¹⁴ In addition, if the IMF is to have a role in reforming the global monetary system, the use of Special Drawing Rights (SDRs) should radically change and the IMF should become an “SDR based institution”.
- strengthening the role of the UN in global decision-making on economic and financial matters. The proposal made by the Stiglitz Commission to establish a Global Economic Coordinating Council that has a mandate to look at economic, social and ecological issues, is a good model.

Global institutional arrangements should complement enhanced regional cooperation, such as initiatives in Asia and Latin America to move towards a more balanced and stable regional financial architecture.

The G20 have failed to address these fundamental issues so far. But developing countries are increasing their calls for a new global reserve system. As pointed out by UNCTAD, all countries need “*a combination of financial stabilisation with expansive monetary and fiscal policies. In the absence of such a policy mix more and more countries will quickly end up on the verge of collapse.*”¹⁵

¹⁴ Bretton Woods Project: “Bridging the democratic deficit: double majority decision-making at the IMF”, available at <http://www.brettonwoodsproject.org/art-549743>

¹⁵ UNCTAD 2009, op. cit. p. 54

INTRODUCTION

The world is experiencing the worst financial crisis since the 1930s. Originating in the US, the crisis quickly spread and is now having devastating effects in each and every corner of the world. But developing countries are suffering the most severe economic and human impacts as the financial crisis has exacerbated existing poverty, debt, food and climate crises.¹⁶ The International Labour Organisation (ILO) estimates that up to 61 million workers have lost their jobs due to the crisis.¹⁷ More than two thirds of these jobs will be lost in developing countries. Worldwide 100 million people may be pushed back below the \$1 per day poverty line in 2009. FDI is projected to fall by at least 30% in 2009. Migrant remittances to developing countries are predicted to fall by \$24 billion this year.¹⁸ Developing country debt levels are rising once again, and UNCTAD has expressed serious concerns about unsustainable debts in 49 Least Developed Countries. According to the World Bank this crisis caused a financial shortfall for developing countries of between \$350 and \$635 billion in 2009 alone, and most developing country economies will recover more slowly than those of richer countries.¹⁹

Lack of appropriate regulation and the global monetary (dis)order have been at the heart of the current financial crisis. The absence of appropriate coordination and adjustment mechanisms of global monetary

“The outbreak of the current crisis and its spillover in the world have confronted us with a long-existing but still unanswered question, i.e. what kind of international reserve currency do we need to secure global financial stability and facilitate world economic growth, which was one of the purposes for establishing the IMF?”

Zhou Xiaochuan, The Peoples' Bank of China

policies, and the unfettered liberalisation of global financial markets led to dramatic global imbalances which contributed to the current crisis. For decades, the International Monetary Fund (IMF) was the only global institution mandated to oversee the monetary policies of its members and foster “a monetary system that does not tend to produce erratic disruptions.”²⁰ However, distrust in the institution – which grew in particular following the Asia crisis in late 1990s and the subsequent response by the Fund – encouraged developing countries to pile up large stocks of reserves to insure their economies against trade and financial volatility.

As a result, since the end of the 1990s we have witnessed the paradox of developing countries and emerging economies lending vast amounts of reserves to the world's rich – and in particular, to the United States. According to some estimates, **this transfers amount to more than four times annual official development assistance** and more than 2% of the combined GDP for all developing countries. This is a massive transfer of financial resources from the poor to the rich. What makes this even more troubling is the fact that **the poor are actually paying the price for financing the**

¹⁶ What Happened at the G20? Initial Analysis of the London Summit, Oxfam GB, April 2009. At:

www.oxfam.org.uk/resources/policy/economic_crisis/downloads/bn_what_happened_at_g20.pdf

¹⁷ ILO: The Key Indicators of the Labour Market, 6th Edition – Economic Crisis and Labour Markets Impact

<http://www.ilo.org/public/english/employment/strat/kilm/download/chap1a.pdf>

¹⁸ Migration and Development Brief, World Bank (July 13 2009). At:

[http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-](http://siteresources.worldbank.org/INTPROSPECTS/Resources/334934-1110315015165/Migration&DevelopmentBrief10.pdf)

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¹⁹ Global Development Finance, p. 7, World Bank (2009). At: <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/EXTGDF/EXTGDF2009/0,,menuPK:5924239~pagePK:64168427~piPK:64168435~theSitePK:5924232,00.html>.

²⁰ IMF Articles of Agreement, Article IV, Section 1 and 3: “Recognizing that the essential purpose of the international monetary system...each member shall... seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions... The Fund shall oversee the international monetary system in order to ensure its effective operation... the Fund shall exercise firm surveillance over the exchange rate policies of members.”

spending habits and overconsumption of the rich.

Leading economic commentator Martin Wolf of the Financial Times has said that these capital transfers are “perverse” and that they set up an “incendiary situation” where China and other countries hold large amounts of dollar reserves, which could dramatically lose value if the dollar’s reserve currency status is threatened.²¹ Aware of this “incendiary” potential, decision-makers from the US, China, Japan and the European Central Bank were convened under the IMF auspices to discuss ways to even out these dramatic imbalances. They were unable to find a solution.

Since the start of the global crisis, many voices have **stepped up calls for a new global financial architecture including a stable monetary system**. Not surprisingly, China has led the calls for a new global monetary and reserve system under IMF’s control. The United Nations has put forward further reaching proposals. A commission of experts convened in 2008 by the President of the UN General Assembly and led by Joseph Stiglitz²² made a plea to address the flaws of the current monetary system and made a recommendation to establish a new global reserve system. The UN Conference on Trade and Development (UNCTAD) made similar recommendations, calling for a multilateral regime to stabilise exchange rates, and an international monetary authority to enforce such regulations and to act as lender of last resort.²³

In an attempt to get commitments from member states on crucial global financial reforms, the UN held a conference in June 2009 on “[The world financial and economic crisis and its impact on development](#)”. The [outcome of the conference](#) acknowledged the calls made by some emerging economies for a new global reserve system and stressed the complementarities that regional arrangements could play in this new system.

Unfortunately, the world’s largest economies gathered in the G20 have for the most part ignored this fundamental issue. A lack of political will from the world’s biggest economies to agree and implement much-needed reform in the global monetary system may lead to unsustainable pressure and disorderly resolution of current global imbalances. Even if the system changes to see a progressive replacement of the dollar’s dominance by the Euro or a basket of currencies – such as the IMF Special Drawing Rights (SDRs) – this risks failing to address other fundamental flaws of the current global monetary system.

We are at a crucial historical moment where fundamental decisions will have to be taken on how to move from chaos to a new global monetary order. Without implementing such measures, leaders’ attempts to “re-found the financial system” will amount to little more than tinkering.

This briefing provides a brief historical overview on how the world reached the current non-system of global monetary coordination (section 1); and on how global financial liberalisation pushed through by rich countries has exacerbated inherent problems in the global monetary and reserves system (section 2). It shines light on the costs of maintaining the current status quo, both in terms of global financial and monetary instability, and the direct and indirect costs borne by developing countries, which are shouldering, with their reserves, unsustainable global imbalances and overconsumption in the North (section 3). This briefing also provides an overview of the main flaws in the current system (section 4). Finally, sections 5 and 6 summarise key proposals for reform, including current initiatives to set up regional monetary institutions.

²¹ Wolf, Martin. Fixing Global Finance, 2008, p. 4.

²² Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System. More information available at http://www.un.org/ga/president/63/commission/financial_commission.shtml

²³ UNCTAD: “The global economic crisis: systemic failures and multilateral remedies”, 2009. Available at: http://www.unctad.org/en/docs/gds20091_en.pdf

1. HOW DID WE REACH A NON-GLOBAL MONETARY SYSTEM? A BRIEF HISTORY OF CONTEMPORARY GLOBAL MONETARY POLICY

From the Bretton Woods gold-standard to the fiduciary-dollar standard

In July 1944, in the aftermath of the Great Depression and at the end of World War II, the US and allied countries gathered in Bretton Woods to define a new financial and monetary order. Its ambitious goal was to foster financial cooperation and stability so as to put an end to the aggressive protectionism and competitive devaluation policies triggered by the crisis during the 1930s. This system set the basis for post World War II economic reconstruction and development.

The so called Bretton Woods system was based upon fixed exchange rates to the US dollar. The US dollar itself was pegged to the value of gold at a fixed amount of \$35 per ounce. Part of this new system was the creation of the International Monetary Fund (IMF) funded by all allied governments' contributions, which was in charge of ensuring global financial stability and cooperation and tasked to prevent competitive devaluations. Under the agreement, IMF members also committed to maintaining balanced current accounts and were allowed to regulate capital flows. Last but not least, the IMF set itself the goal of promoting high levels of employment in all countries.²⁴ Countries facing deficit problems could obtain liquidity from the Fund, thus restoring their current account balance and the parity of their currency. Given the slow process of building up IMF resources, and because dollars were convertible into gold, governments increasingly used dollars to build up reserves and ensure their currency stability.

The development of the Euro-dollar market

In the late 1950s and early 1960s Europe - particularly the city of London- developed the so called Euro dollar market²⁵, which

allowed the increase of dollar-denominated transactions²⁶. This at first benefited all countries: the US saw its economic power consolidated, the UK saw a way to become a new financial centre that would compensate for the loss of power suffered as sterling lost its status as a leading international currency, and European countries found a way to finance their reconstruction on more favourable terms. Consequently, the amount of dollars in circulation increased from 3 billion in 1960 to some 82 billion in 1972.²⁷ Yet, this proliferation of dollars also attracted the interest of speculators, who increased the pressure against the dollar.²⁸

The end of the Bretton Woods system

The US had accumulated huge budget deficits by the late 1960s and early 1970s.²⁹ The excess of printed dollars, fuelled by the Euro dollar market and financial liberalisation, as well as the negative balance of trade led other nations to lose confidence in the dollar. This translated into a general move by countries to exchange their dollars into US gold. Not being able to ensure the dollar convertibility, the US government unilaterally abolished the Bretton Woods exchange rate system in 1971. Following this so called *Nixon shock*, the \$US became the reserve currency for all the states that had signed the Bretton Woods agreement. Despite strong opposition from other countries³⁰ all major currencies were free floating against the dollar by 1976. The system that emerged *de facto* was therefore founded upon confidence that the US economy would be able and willing to

²⁶ Because dollar denominated transactions in Europe carried a more attractive interest rate than in the US.

²⁷ Zacharie and Malvoisin, op. cit. 2003. p 20.

²⁸ As explained by Anton Brender and Florence Pisany, countries like Germany and Japan had accumulated strong current account surpluses and started speculating against the devaluation of the dollar.

²⁹ An important part of the deficit was due to Vietnam war military expenses, which were financed by printing more dollars.

³⁰ It is with the objective of restablising the global exchange regime that France convoked for the first time in 1975 the grouping of industrialised countries that would later become the G7. At the first few meetings there were only five governments present.

²⁴ See IMF purpose at :

www.imf.org/external/pubs/ft/aa/aa01.htm

²⁵ Zacharie and Malvoisin in FMI, la main visible. Ed. Labor, 2003. pp 18-20.

absorb the growing demand for dollars by increasing its deficit.

The 1980s debt crisis

With a dollar-based global reserve system, the US was free to continue printing money without any constraint as international prices were set in dollars and so was its deficit. On the other hand, the rest of the world would use dollars for international trade and buy dollars to insure themselves against financial and currency crises. This regime set the basis for an unstable world, characterised by the build up of increasing global imbalances between deficit economies and surplus economies. Furthermore, this reserve system reduced governments' abilities to use their monetary policies in a more development oriented way, and hindered the IMF's goal of high employment levels. As expressed by the UN Experts Commission on the financial crisis, *"this system has proven to be inequitable and incompatible with global full employment."*³¹

During the early 1970s, the Euro-dollar market absorbed high levels of liquidity generated by oil price rises – petrodollars accumulated by oil exporters. These surpluses were then lent to developing countries that suffered from large current account deficits. The massive indebtedness of developing countries and their increased vulnerability, due to the degradation of their terms of trade, set the conditions for the developing countries' debt crisis a decade later. In 1979, the US Federal Reserve unilaterally increased interest rates to tackle US inflation and many developing countries entered into a full-blown debt crisis. The debt crisis shows the shortfalls of the liberalised system that replaced Bretton Woods. It also paved the way for further significant global imbalances to emerge during the 1980s.³²

³¹ Report of the Commission of experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System. June 2009.p. 92.

³² Anton Brender and Florence Pisany: «Les déséquilibres financiers internationaux », La Découverte, 2007. p. 14.

2. FINANCIAL LIBERALISATION, GLOBAL IMBALANCES AND INSTABILITY

In the late 1970s and early 1980s, following the collapse of the Bretton Woods system and the move to flexible exchange rates, many industrialised countries liberalised their capital accounts. In the 1990s financial sector liberalisation spread to developing countries pushed by conditions attached to World Bank and IMF loans,³³ and through multilateral and bilateral trade and investment agreements. Financial sector liberalisation was supposed to increase access to financial markets in other countries. However, it has actually enhanced the complexity and instability of financial markets, and since 2000 it has pushed developing countries to build huge reserve buffers as insurance for speculative attacks against their currency or sudden capital outflows.

Lifting capital controls was supposed to increase credit availability and enhance funding sources, thus enhancing stability. As Joseph Stiglitz explains in his book “Stability with Growth”, it was argued that “just as water naturally flows downhill, capital should flow from developed countries to low-wage developing countries (where its relative scarcity implies high marginal returns).” It was said that countries which liberalised would receive counter-cyclical funding as “when a country faces an economic downturn and domestically funded investment drops, declining wages and asset prices will attract international funds, thereby helping to stimulate the economy”.³⁴

But experience of capital account liberalisation shows that this orthodox economic theory works better on paper than in practice.

“The idea of having national monetary sovereignty in markets with open borders for goods and capital is an illusion and the exchange rate cannot be considered as a tool for domestic economic policy. (...) There is an impossible duality (...). Therefore, multilateral or even global exchange rate arrangements are clearly necessary to achieve and maintain global monetary and financial stability”.

- UNCTAD

³³ As for developed economies, the IMF did not have a real impact, since most of its conditional funding was directed to developing economies.

³⁴ Stiglitz, Joseph (ed.): *Stability with growth: macroeconomic, liberalisation and development*, Oxford University Press, 2006, p. 169.

During the 1990s, emerging economies absorbed huge amounts of capital inflows.³⁵ But the financial crisis that hit Asia in 1997 and spread to Russia and Latin America in the following years showed the dangers of capital account liberalisation. Governments did not have the right mechanisms to regulate the rapid capital inflows, nor the economic policy tools to prevent the sudden capital outflows at the outbreak of the late 1990s financial crisis when short-term investors and speculators panicked and rushed to exit these countries.³⁶ In the midst of the crisis, Asian economies could only resort to the IMF and its harsh macroeconomic adjustment programmes which had devastating social and human consequences, some of which lasted for almost a decade.

Having learnt the lesson the hard way, Asian economies decided to accumulate enough reserves to repay their IMF debts, get rid of the Fund's pro-cyclical conditions, and build strong buffers for a rainy day. They did so by devaluing their currencies and deploying export oriented development strategies that generated increasing surpluses which were then accumulated as reserves.³⁷ Once again, the US offset emerging economies' surpluses with its growing trade deficit.³⁸ This situation generated the new wave of global imbalances that we have witnessed since the year 2000 and which was one of the causes of the current global financial crisis. Even former advocates of financial liberalisation such as Kenneth Rogoff, former chief economist at the IMF, concluded that "*benefits from an international financial integration are relatively low, even for countries receiving large amounts of capital*".³⁹

³⁵ Much of the surplus absorbed by Asian emerging economies in the second half of the 1990s came from European Union countries. In order to comply with the Maastricht criteria that would allow them to enter the European Monetary Union, European governments had to substantially reduce their current account deficits. This led to the accumulation of more than \$100 billion surpluses in 1997 (see Op. cit. Brender and Pisani 2007, p 20)

³⁶ This is why, after the 1997-98 financial crisis, capital controls were introduced by a few countries – such as Malaysia

³⁷ As UNCTAD explains, for many emerging economies, the only way to combine some exchange rate stability with domestic capacity to handle trade and financial shocks and with successful trade performance was to unilaterally stabilise their exchange rate at an undervalued level.

³⁸ Op. cit. Brender and Pisani 2007, p.22.

³⁹ See IMF (2003) "Effects of financial globalization on developing countries: some empirical evidence", by E. Prasad, K. Rogoff, S.J. Wei and M. Ayhan Kose, International Monetary Fund, Washington DC, 17 March.

Besides increasing financial instability, experience shows that capital account liberalisation is not a prerequisite for increased foreign capital inflows. China has retained capital controls and has attracted more foreign direct investment (FDI) than any other developing country. Other countries that imposed capital controls, such as Chile, also continue to attract FDI. In the context of the current crisis, countries receiving large amounts of inflows, such as Brazil, have established some temporary capital controls in order to avoid speculative attacks.⁴⁰ Even the IMF is retracting on their former stances on capital account liberalisation. The IMF Managing Director, Dominique Strauss-Kahn, recently said in a speech in London that capital controls can be part of the toolkit of policy options that countries employ to address the challenges of capital flows. He said that this is a pragmatic issue and the Fund will be "completely open minded".⁴¹

⁴⁰ In order to avoid speculative investments due to its currency appreciation towards the dollar (more than 41% in the last three quarters of 2009) Brazil has established a 2% tax on foreign capital inflows and an additional 1.5% tax on the American Deposit Receipt, used by foreign investors to invest in Brazilian stock exchange. See: le Monde "Les pays émergents luttent contre la chute du dollar" 23 Novembre 2009.

⁴¹ "Take-Off or Holding Pattern? Prospects for the Global Economy", An Address to the Confederation of British Industry Annual Conference by Dominique Strauss-Kahn, Managing Director, International Monetary Fund. London, November 23, 2009.

BOX 1: Currency speculation and global imbalances

One important reason for the growing global imbalances is the so called “carry trade”. This refers to the movement of relative prices in traded goods as a result of speculation in currency and in the financial markets. Hence speculators will borrow low yielding currency assets and lend them in high interest rate countries in order to benefit from the rate differential.

This type of currency speculation has been quite common during the last decade and has frequently been associated with banking and financial crises in emerging economies such as the Argentinean and Chilean crisis in the 1980’s, Mexico in 1994, East Asia in 1997-98, the Russian Federation in 1998, Brazil in 1999 and Argentina in 2000-2001. As noted by UNCTAD, “they all culminated in currency attacks and found their origins in the build up of financially fragile positions via currency speculation and /or widening external imbalances due to unsustainable pegs”.

Indeed, speculative flows of this type generate unsustainable currency mismatches in the balance sheets of firms, banks and even households. As explained by UNCTAD, this pattern can work for a while, as long as foreign speculators enjoy the larger returns, from currency differentials which are generally invested in financial real state and other speculative assets”. But UNCTAD warns that it eventually leads to serious consequences. “Those capital inflows lead to real appreciation of domestic currency and destroy competitiveness of enterprises in the capital receiving country”. This lost of competitiveness, explains the UNCTAD, “provokes huge and rising current account deficits or large losses of market shares and makes devaluation unavoidable, yet extremely costly given the widespread currency mismatch and the mushrooming debt burden for domestic companies.”⁴²

For example, in Eastern European countries, Iceland, New Zealand and Australia, it was profitable for private households and companies to borrow in foreign currencies with lower interest rates, such as the Swiss franc and the Japanese yen. Between 2004 and 2008 the Icelandic Krona, the Australian and New Zealand dollars, the Brazilian real, the Turkish lira, the South African rand and the Korean won, as well as currencies in some Eastern European countries such as Romania and Hungary, have all experienced persistent trends of appreciation despite high inflation rates. The carry trade funding currencies (Swiss franc, yen and US dollar) were driven in the opposite direction, depreciation, despite very low inflation rates and even deflation in the case of Japan.

Source: UNCTAD, *The Global Economic Crisis: Systemic Failures and Multilateral Remedies*, 2009.

⁴² UNCTAD 2009, op. cit. p. 42.

3. THE GLOBAL PARADOX IN WHICH THE SOUTH FINANCES THE NORTH

“Developing countries are lending the United States trillions dollars at almost zero interest rates when they have huge needs themselves (...). It's indicative of the nature of the problem. It's a net transfer to the United States, a form of foreign aid.”

- Joseph Stiglitz

Since the end of the 1990s we have witnessed the paradox of developing countries lending their vast surpluses to the United States. These reserves provide a comfortable insurance against financial flows and aid volatility, but they come at a very high price. The cost for developing countries is estimated at \$300 billion a year. The estimate of \$300 billion is calculated strictly as the difference between investing reserves in lower yielding US treasury bonds and higher yielding investments,⁴³ But it does not include the opportunity costs of not investing a share of reserves in boosting domestic economic growth, nor the costs of borrowing reserves in international capital markets, which are estimated to carry an average annual cost of \$130 billion.⁴⁴

If combined, these conservative estimates account for more than four times annual official development assistance, and more

⁴³ Cho, Youngwon: “Capital Account Liberalisation in the Developing World and the Global Reserve System: Imbalances and Inequities,” International Studies Association, New York, February 2009.

⁴⁴ Akyuz Yilmaz “Policy response to the global financial crisis: key issues for developing countries” May, 2009.

than 2% of the combined GDP for all developing countries. This is a massive transfer of financial resources from developing to developed countries. Even more troubling is the fact that the poor are actually paying the price for financing the spending habits of the rich. Such reserves holdings:

- prevent the transfer of real resources into the economy through increased imports or through credit for domestic private investment; and
- require central banks to sell government securities to sterilise the monetary impact of their reserves, usually paying higher interest rates on these securities than they receive on the US dollar-denominated Treasury bonds in which they hold their international reserves.⁴⁵

The reasons behind reserve accumulation

Developing countries have been amassing huge quantities of foreign exchange reserves during the last decade.⁴⁶ At the end of 2007 developing countries held more than three quarters of the world's total reserves - some \$4.9 trillion (figure 2).⁴⁷ Although this is partially due to commercial reasons – that is, to the increasing share of emerging economies' world trade, the growth of developing countries' reserves has been predominantly influence by their precautionary desire to avoid future financial crisis. The former rule of thumb for a prudential level of reserves – three to four months of imports – has been replaced by “a new rule of thumb that recommends developing countries to match every dollar of short-term external liabilities with a dollar in reserves.”⁴⁸

⁴⁵ Rowden, Rick: “SDRs: Short-term and long-term solutions”, Background note, Macroeconomic and development policies branch, UNCTAD, June 2009., pp. 5-6.

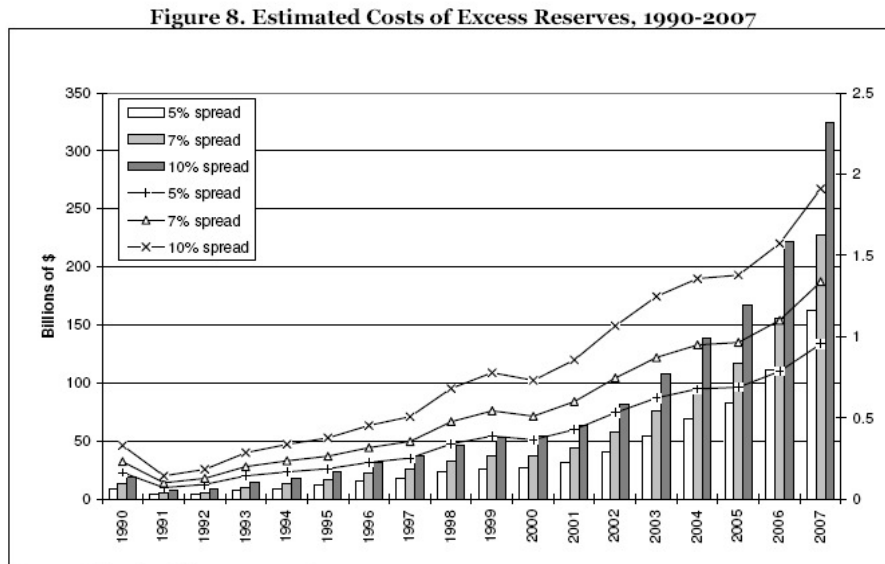
⁴⁶ See also global imbalances graphic in annex I

⁴⁷ Report of the Commission of experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System. June 2009.

⁴⁸ Cho, Youngwon: “Capital Account Liberalisation in the Developing World and the Global Reserve System: Imbalances and Inequities,” International Studies Association, New York, February 2009.

Figure 1: What is the cost of holding (excessive) reserves?

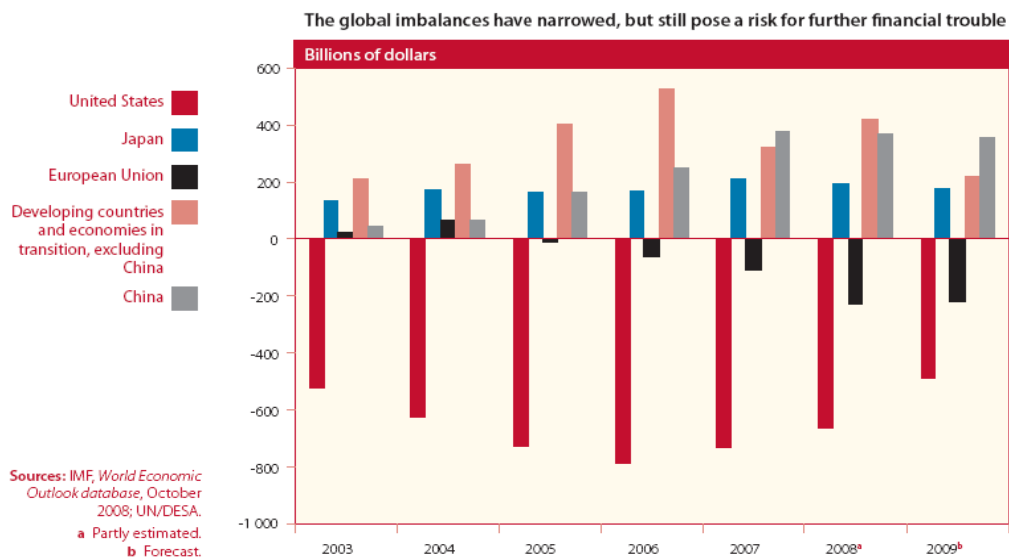
Source: Cho, Youngwon: "Capital Account Liberalisation in the Developing World and the Global Reserve System: Imbalances and Inequities," International Studies Association, New York, February 2009.



Source: Calculated from IMF, IFS.

Figure 2: Southern surpluses finance Northern deficits

Source: UN DESA, 2008.



Many developing countries have been amassing large surpluses for a decade. This has been the case of some Asian and Latin American emerging economies. China, by far the biggest surplus country, has become the world's largest producer and exporter of manufactured products. China's exports have generated the bulk of the country's double digit growth rate in the last decade. By investing much of its surplus (as much as \$800 billion in US treasury bills by June 2009),⁴⁹ China has become the US's biggest creditor, thus facilitating a growing US deficit. Some of these countries have accumulated reserves to prevent exchange rate appreciation and maintain the competitiveness of their external trade. Others have also accumulated huge reserve levels as a result of steep hikes in the price of oil or other raw materials such as copper. \$3.2 trillion of these reserves in emerging economies and developing countries are being channelled through Sovereign Wealth Funds.⁵⁰

However, many other countries have accumulated large reserves despite their persistent trade deficits. These countries have increased their reserve holdings from just \$30 billion in 1990 to \$607 billion in 2007.⁵¹ **These reserves essentially came from borrowed money or from setting aside development aid.** The spread between the

cost of acquiring the reserves and the income earned on them or "carry cost" is estimated to be \$130 billion a year. Moreover, in reality the cost is even higher since this estimate does not consider the opportunity cost of the foregone economic growth by not investing in domestic productive sectors.⁵²

The current system is inefficient and costly particularly for developing countries. Aware that the loss in output from currency crises is estimated as ranging between 8 to 25% of GDP,⁵³ and of the social and human costs of the type of adjustments required by an IMF bail out, developing countries have chosen to build a reserves war-chest to shore the effects of a financial crisis. However, the lack of a global financial architecture which ensures financial stability is costing developing countries the substantial amount of 2% of GDP every year.

The current non-system of global monetary coordination is deeply unfair. It severely worsens global inequality as it exacerbates the reverse flow of resources from poorer to wealthier countries.

⁴⁹ Actionaid and Third World Network "Fruits of the crisis. Leveraging the financial crisis of 2008-2009 to secure reform of the global reserve system". October 2009, p. 6.

⁵⁰ Sovereign Wealth Funds Institute: <http://www.swfinstitute.org/funds.php>

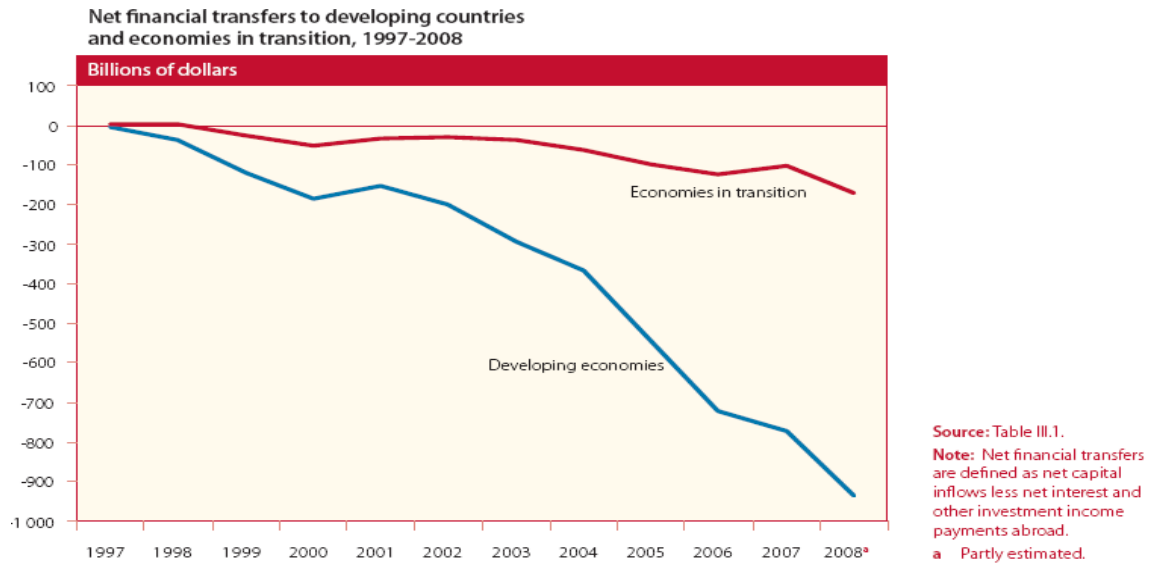
⁵¹ Cho, Youngwon: "Capital Account Liberalisation in the Developing World and the Global Reserve Sytem: Imbalances and Inequities," International Studies Association, New York, February 2009.

⁵² See Action Aid and Third World Network, 2009, Op. cit. p. 8.

⁵³ HUTCHINSON AND NOY QUOTED BY CHO PAGE 16

Figure 3: Net South to North transfers

Source: UN DESA, 2008.



4. MAIN FLAWS OF THE CURRENT GLOBAL MONETARY SYSTEM

The most staggering flaw of global monetary coordination is the fact that the world's poor are financing the lavish habits of the North. But there are other important flaws, some of which have been present since the inception of the system at the Bretton Woods Conference in 1944 and others that have emerged as the global monetary system has evolved throughout the last sixty years. Among these flaws is the fact that the current non-system is prone to global imbalances and financial instability,⁵⁴ and is severely biased towards preserving the value of financial assets rather than that of wages and labour.

A national currency-based system: the recipe for ongoing global imbalances

The UN Commission of experts report on the global financial and economic crisis pointed out that regardless of the US's monetary policy choice to counter the effects of the crisis (either expansionary or contractionary) *“the result is likely to be growing imbalances, exchange rate instability and the erosion in confidence in the dollar reserve currency”*.⁵⁵

This is because the use of the dollar as a global reserve currency requires confidence in the dollar and the ongoing willingness of the US to absorb the global demand for dollars by incurring large deficits. In recent decades, the US was willing to play this role: US authorities issued huge amounts of Treasury-bills, and fostered domestic consumption with loose monetary policies.⁵⁶ Thus, US consumers have been able to borrow very cheaply and consume imported goods beyond their means. This has placed the US in a position of “world consumer of last resort” while its trade and fiscal deficits have skyrocketed.

Increasing US deficits poses a serious threat to the world's confidence in the dollar as the global reserve currency. In the 1960s the US economist Robert Triffin pointed out that reliance on a single currency as a global reserve currency would unavoidably lead to the reserve currency country having to run increasing deficits, which would lead to global imbalances and a loss of confidence in the reserve currency. This phenomenon has been named “Triffin's dilemma”.⁵⁷

As US deficits increase as a result of the global crisis, the risk of a loss of confidence in the dollar is also mounting. Any such collapse would have severe knock-on effects for the many countries that hold their reserves in dollars.⁵⁸ Yet, replacing the dollar by another currency such as the Euro would lead to the same problem. According to the Robert Triffin dilemma, reliance on a single reserve currency (or even a basket of currencies) poses serious risks to the stability of the global monetary system.

The in-built bias against national income and labour

Another major flaw of the current system is that it lacks a mechanism for a coordinated and symmetric response to global imbalances. The current system has a built-in bias, the so-called “deflationary bias”, which systematically favours surplus countries and penalises deficit countries (except for the country issuing the reserve currency). Deficit countries have to compensate for capital outflows by increasing interest rates (to attract foreign capital) or cut back domestic financing and spending. They bear the burden of these adjustment measures, which lead to reduced national income and reduced demand for imports. Although *“This would improve the external balance, (it comes) at the*

⁵⁴ Only in the past forty years the world has suffered more than 100 financial crises.

⁵⁵ Op. cit. Commission of experts of the UN President of the GA. 2009. pp. 90-91.

⁵⁶ Already in 1970, \$US gold coverage fell from 55% to only 22%. Between 1960 and 1972, the amount of dollars in circulation increased from 3 billion to 82 billion. This amount rose to \$ 570 billion in 2000 and to 829 billion by the end of 2007. Since then, the federal reserve has kept printing huge amounts of dollars as a response to the crisis.

⁵⁷ The Triffin dilemma appeared in the context of the Bretton Woods system, where the dollar was convertible in gold. In order for the global economy to have sufficient liquidity, the US had to run balance of payments deficits, but such deficits could in turn undermine global confidence on the convertibility of the dollar.

⁵⁸ Rowden, Rick: “SDRs: Short-term and long-term solutions”, Background note, Macroeconomic and development policies branch, UNCTAD, June 2009.

*cost of a lower level of output and employment.*⁵⁹ This type of adjustment which prioritises external balance at the cost of lower output effectively means that the costs of adjustment are mostly borne by labour, while all efforts in monetary policies are put towards preserving the value of financial assets.⁶⁰

⁵⁹ Kregel, Jan: "Some simple observations on the reform of the international monetary system", Policy Note, The Levy Economic Institute of Bard College, August 2009.

⁶⁰ Kregel, Jan: "Some simple observations on the reform of the international monetary system", Policy Note, The Levy Economic Institute of Bard College, August 2009.

5. BUILDING MOMENTUM FOR A REFORMED GLOBAL MONETARY AND RESERVE SYSTEM: EXISTING PROPOSALS AND NEXT STEPS

“It is imperative that the international community begins working on the creation of such a new global reserve system. A failure to do so will jeopardise prospects for a stable international financial system.”

- Report by the UN Commission of Experts on Reforms of the Monetary and Financial System.

The unstable global monetary system has today become unsustainable and creates a paradoxical and unjustifiable transfer of resources from South to North, from the poor to the rich. The costly and inefficient “self-insurance” strategy that many developing countries have been forced to adopt in recent years would no longer be necessary if a new global monetary system were established which:

- effectively corrects global imbalances;
- ensures global macroeconomic stability; and
- establishes an efficient and fair lender of last resort to respond to liquidity crises.

Such global arrangements could provide developing countries with the necessary space to undertake monetary policies which could support equitable and stable growth and poverty reduction. The current global financial and economic crisis is making it all the more urgent to find a bold new approach.

Proposals for reforming the global monetary and reserves system

The worsening global imbalances have revived old proposals for reforming the global monetary system and brought forward new ones. In this vein, some voices are now echoing Keynes’ proposal to create a supranational currency, the *bancor*, and an International Clearing Union in charge of addressing the imbalances among deficit and surplus countries.⁶¹

Emerging economies with large stocks of reserves are increasingly calling for a new system that would decrease dependence on the dollar. At the Brazil, Russia, India, China (BRIC) summit that took place mid June 2009 in the Russian city of Yekaterinburg, BRIC leaders called for a “more diversified

⁶¹ This global currency would be based on the value of 30 representative commodities.

monetary system to reduce dependency on the greenback".⁶² In May 2009, China and Brazil already began studying proposals to use Chinese yuan and Brazilian reais in their bilateral trade arrangements instead of the dollar.

China is the biggest holder of dollar denominated reserves. It is therefore not surprising that it has taken this very seriously and is calling for a new global monetary system. Only a few days before the G20 summit in April, China announced the need for a new reserve system under the IMF's institutional framework.⁶⁴ Later in June, the People's Bank of China renewed this

call and said that "To avoid the shortcomings of sovereign credit currencies acting as reserve currencies, we need to create an international reserve currency that can maintain the long-term stability of its value"⁶⁵ The Bank of China added that "Special drawing rights (SDR) of the IMF should be given full play, and the international body should manage part of its members' reserves." By asking SDRs to play a central role in the new system, China is also asking to include the Chinese currency into the basket of currencies composing the SDRs (currently dominated by the dollar, the euro, the pound and the yen) and a greater say in the governance system of the IMF.

Box 2: Some key elements of the Chinese proposal to broaden the use of SDR⁶³

The scope of the SDR should be broadened, to enable it to fully satisfy the member countries' demand for a reserve currency.

-Set up a settlement system between the SDR and other currencies. Therefore, the SDR, which is now only used between governments and international institutions, could become a widely accepted means of payment in international trade and financial transactions.

- Actively promote the use of the SDR in international trade, commodities pricing, investment and corporate book-keeping. This will help enhance the role of the SDR, and will effectively reduce the fluctuation of prices of assets denominated in national currencies and related risks.

- Create financial assets denominated in the SDR to increase its appeal. The introduction of SDR-denominated securities, which is being studied by the IMF, would be a welcome starting point..

- Further improve the valuation and allocation of the SDR. The basket of currencies forming the basis for SDR valuation should be expanded to include currencies of all major economies, and the GDP may also be included as a weight. The allocation of the SDR can be shifted from a purely calculation-based system to a system backed by real assets, such as a reserve pool, to further boost market confidence in its value.

The Fund should centralise the management of its member countries' reserves, thus promoting the SDR as a reserve currency. To achieve this, the IMF can set up an open-ended SDR-denominated fund based on the market practice, allowing subscription and redemption in the existing reserve currencies by various investors as desired. This arrangement will not only promote the development of SDR-denominated assets, but will also partially allow management of the liquidity in the form of the existing reserve currencies. It can even lay a foundation for increasing SDR allocation to gradually replace existing reserve currencies with the SDR.

⁶² See:

www.bloomberg.com/apps/news?pid=20601087&sid=a5z7pjiZoYpg

⁶³ See : www.pbc.gov.cn/english/detail.asp?col=6500&id=178

⁶⁴ See: www.upi.com/Business_News/2009/03/23/China-calls-for-new-reserve-currency/UPI-58991237852525/

⁶⁵ See :

www.bloomberg.com/apps/news?pid=20601087&sid=a5z7pjiZoYpg

The UN Commission of Experts on the Reform of the Monetary and Financial System has also put forward specific proposals for a new international reserve system. The main purpose of the Commission's proposal is to move away from a single reserve currency in order to reduce the risk of a loss of confidence. These proposals have been echoed at the outcome document of the UN conference on the World Financial and Economic Crisis and its Impacts on Development, held in New York from 24 to 30 June 2009.⁶⁶ The UN Commission of Experts sets two possible approaches on how this system might work. One option would require countries to agree to exchange their own currencies for a new currency (the so called International Currency Certificates-ICC) or IMF SDRs in a sort of worldwide "swaps" system among Central Banks. Otherwise, the managing institution could also create global reserves by issuing the global currency. Under either of these schemes, countries could agree to hold a certain fraction of their reserves in the global currency. This would generate more stability in the value of reserve holdings.

The global currency could be allocated to countries on the basis of some quota formula, based on their weight in the world economy (GDP) or on their needs. Ways could be explored to allocate to developing countries a larger proportional share to meet their needs for additional liquidity. The UN Commission even considers that "one possibility is to give developing countries all allocations" as opposed to the current system at the IMF.⁶⁷

However, the introduction of another global reserve currency – even if it is a basket of currencies such as the IMF SDRs – will not alone correct the problem of global imbalances and the need for a coordinated symmetric adjustment by both surplus and deficit countries ensuring that sufficient liquidity is available so that the global

⁶⁶ See: www.un.org/ga/search/view_doc.asp?symbol=A/RES/63/303&Lang=E

⁶⁷ Commission of experts of the UN President of the GA. 2009. pp. 96

economy works to its full potential. According to some views, such a mechanism should be "sufficiently compatible with global aggregate demand to provide full employment and support the national development strategies of developing countries."⁶⁸

The UN Commission of experts suggested that, to adjust global imbalances symmetrically and equitably, the allocation of the global reserve currency could provide incentives against maintaining surpluses: "Countries that maintained surpluses would lose all or part of their quota allocation if they are not utilised in a timely manner to increase global demand. (Also) the size of annual emissions should be targeted to offset the increase in (non-borrowed) reserves, i.e. reductions in global purchasing power resulting from reserve accumulations".⁶⁹ Regular emissions could take place annually, or otherwise, they could be adjusted in a countercyclical way, so larger emissions are made when global growth is below potential.

Short-term reform proposals as a stepping stone towards further-reaching reforms: the IMF's role

The proposal by the UN Commission of Experts on Reforms of the International Monetary and Financial System did not go as far as to recommend which institution should be given responsibility for managing such a new system. It mentions that the IMF could be such an institution, or a new institution such as a "Global Reserve Bank" could be created for this purpose.

The UN Commission highlights possible institutional steps to pave the way towards its proposals for a new global reserve system,

⁶⁸ US economist Jan Kregel, in his article "Some simple observations on the reform of the international monetary system" (August 2009), comments further "the problem of the instability of the international reserve currency's purchasing power is less a question of the asset that serves as a currency and more a question of the operation of the international adjustment mechanism, and of whether that mechanism is automatic or coordinated, and also sufficiently compatible with global aggregate demand to provide full employment and support the national development strategies of developing countries".

⁶⁹ Commission of experts of the UN President of the GA. 2009. pp. 96

including reforms of the IMF so that it could play a more active and pro-cyclical role during crises. A strong advantage of the Special Drawing rights is that they do not have the traditional IMF conditionality attached, which is the main reason why developing countries are unwilling to resort to the Fund in times of crisis and liquidity shortages⁷⁰.

However, a number of **crucial issues should be considered to ensure that IMF SDRs become a meaningful way to create liquidity for developing countries**, and particularly for low-income countries:

- IMF Special Drawing Rights arrangements could be broadened so as to **make their issuance automatic and regular**.⁷¹ Exceptional and counter-cyclical issuances could also be made during crisis periods. Unlike dollar reserves, holding SDRs does not entail cost as long as they are not used.⁷²
- **Allocations should be made on the basis of need**, instead of using the quota formula which results in an allocation overly favourable for industrialised countries – the countries that receive most SDR are those which need it least. For instance, out of the recent allocation of \$250 billion SDR agreed by the G20 leaders in their meeting on April in London, developing countries have only received as little as \$100 billion. Of this \$100 billion, low-income countries only received \$19 billion.
- **The costs of using SDRs should be eliminated for the most vulnerable countries**, or subsidised by other IMF

funds. Countries using SDRs have to pay interest rates which are so far determined by the market. Even though market interest rates are low at the moment, this will not necessarily be the case in the long-run. Therefore, rates for low-income countries should be waived or, at the minimum, they should be fixed and strongly subsidised by rich countries.

In its paper from May 2009, "Policy Response to the Global Financial Crisis", former UNCTAD chief economist Yilmaz Akyüz warns that "*regular allocations of SDRs on the basis of existing rules cannot promote the SDR to be a major reserve asset and address the inequities and instability resulting from the current system based on national currencies, even if such allocations are done more often than have been the case.*" Akyüz suggests that a way forward is to make the IMF an SDR-based organisation. This would require replacing the contributions made by members through quotas and through on-lending to the IMF⁷³ as the single source of funding for the IMF. The Fund should be able to issue SDRs and allocate them to members according to criteria other than quota (i.e. allocations should be made, inter alia, according to need). The IMF would "*no longer be subjected to arduous and politically charged negotiations dominated by major industrial countries (...)* Such an arrangement could thus bring a considerable improvement to the governance of the IMF, allowing it to stay at equal distance to all its members and help to perform policy surveillance even-handedly and effectively."⁷⁴

⁷⁰ For a critical analysis on this see also ActionAid and Third World Network report "Fruits of the crisis. Leveraging the Financial and Economic Crisis of 2008-2009 to Secure Reform of the Global Reserve System". October 2009.

⁷¹ The UN Commission suggests annual issuances of a magnitude of \$150 to \$300 billion, gauged to meet the level of demand for additional reserves in the world economy. The first figure corresponds to the world demand for reserves in 1998-2002 but the demand for reserves was much larger in 2003-2007, indicating that even \$300 billion a year might be insufficient.

⁷² SDRs are allocated to IMF member states and then "disbursed" in their Central Banks. However, in order to make use of SDRs, countries need to swap them for hard currencies through voluntary exchanges with other countries, or by the Fund designating members with strong external positions to purchase SDRs from those with weak external position. When members' holdings rise above or fall below their allocation, they earn or pay interest respectively.

⁷³ Through General Arrangements to Borrow and New Arrangements to Borrow.

⁷⁴ Akyüz, Yilmaz: "Policy response to the global financial crisis: key issues for developing countries," May 2009, pp. 22.

BOX 3: UNCTAD's proposal: a multilateral approach to global exchange rate management

UNCTAD proposes a multilateral monetary framework governed by strong institutions that would be based upon the following five principles:

- Ensure a level playing field: keep stable exchange rates among a group of countries (a region or more);
- Avoid currency speculation: nominal exchange rates need to adjust to interest rates in other countries in order to ensure interest rate parity;
- Enduring symmetric response: an international financial system needs to be built on a symmetric responsibility of both the depreciating and the appreciating currencies. This means that the costs and profits of interventions are equally shared;
- Multilateral code of conduct: this code would be based on the need to balance the advantages of one country against the disadvantages of other affected countries. This code would end the competition of nations. *"It is not countries that should compete but companies on a level playing field"*.
- Global organisation of the system: The international financial institutions need to be fundamentally redesigned or a new global advisory and supervisory institution should be created as a global monetary authority. Several lead currencies ("planets") which can be real or artificial should be envisaged, to reflect the current multi-polar system. These "planets" would be linked with each other and regional blocks could be formed ("satellites") that would be linked to one or more lead currencies. This authority would also play the role of lender of last resort, in order to supply liquidity in case of crisis.

Source: UNCTAD. *The Global Economic Crisis: Systemic Failures and Multilateral Remedies*, 2009.

6. REGIONAL ARRANGEMENTS: EXPERIENCES IN ASIA AND LATIN AMERICA

The absence of a global system which efficiently coordinates exchange rate policies, prevents global imbalances, and provides a lender of last resort which is trusted by all countries, has fostered proposals to establish **regional monetary arrangements to fill in the void of the global non-coordination.**

Europe has been at the forefront of these efforts. Already in the 1950s Europe made steps to enhance trade and monetary cooperation within the region. In 1950 the European Union of Payments (EUP) was created with the aim of facilitating currency transfers among European Central Banks therefore fostering regional trade exchanges.

In 1979 an arrangement was established where most nations of the European Economic Community (EEC) linked their currencies to prevent large fluctuations relative to one another. The main rationale behind the European arrangement was to disconnect from the dollar as the reference currency for international trade, as Europe's intraregional trade was being overly affected by the dollar's instability. Initially, the countries involved in the European Monetary System agreed to maintain stable exchange rates within a narrow range – the European "currency snake". As the system evolved, a European Monetary System was developed, involving a European Currency Unit, an Exchange Rate Mechanism, and a European Monetary Cooperation Fund, which allocated ECUs to members' central banks in exchange for gold and US dollar deposits. After three decades of monetary cooperation, in 1999, the euro was finally launched and the member countries fixed their mutual exchange rates.

Countries of other regions could intensify their efforts to join forces in creating currency unions or looser cooperative mechanisms. The main **advantage of monetary cooperation is that it helps to contain exchange rate fluctuations thus having positive implications for trade.** In addition, countries

participating in regional arrangements can also pool their reserves or even take steps towards a common currency, which would **shield them from financial crisis and speculative attacks on their currencies.** However, observers point out that far-reaching regional monetary agreements will most likely proceed at a snail's pace, given the absence of regional institutional frameworks that can provide support for these arrangements, and most importantly, to the fact that participating countries have to relinquish some of their national autonomy not only on monetary matters, but also on fiscal action.

Outside Europe, **East Asian countries** are furthest ahead in seeking closer monetary cooperation. At the height of the Asian financial crisis, Japan put forward proposals to create an Asian Monetary Fund, which would provide liquidity in case of a renewed crisis. The proposed fund omitted the type of economic policy conditions that the International Monetary Fund attached to their crisis lending for Asian countries imposing pro-cyclical policies which aggravated the crisis and undermined the prospects for a speedier recovery. Opposition by the US government jeopardised this far-reaching proposal, which was then replaced by the so-called Chiang Mai Initiative, a liquidity pool based on a network of bilateral swap arrangements⁷⁵ covering the exchange of national currency against other currencies which includes the ASEAN countries⁷⁶ plus China, Japan and South Korea. This arrangement, endowed with \$90 billion, is in fact a regional liquidity fund similar to the IMF and it requires, beyond a certain threshold of funds withdrawn, compliance with IMF conditionality. It is striking that, despite the willingness of Asian countries to strengthen their monetary cooperation, they have so far failed to both depart from the IMF's conditions that seemed to be at the origin of

⁷⁵ See annex II

⁷⁶ The ASEAN countries are [Brunei](#), [Burma \(Myanmar\)](#), [Cambodia](#), [Indonesia](#), [Laos](#), [Malaysia](#), the [Philippines](#), [Singapore](#) and [Thailand](#) and [Vietnam](#).

the regional monetary arrangements and to set up an institutional framework to provide support for the Chiang Mai Initiative. The lack of institutions and the fact that “some Asian countries, including China and Japan, are engaged in competitive exchange-rate policy not only vis-à-vis the US and the eurozone but also among themselves”⁷⁷ limits the prospects of closer monetary cooperation in the mid-term.

In **Latin America** several proposals and attempts for closer monetary cooperation have been put forward with uneven success. At the end of 2006, a group of Latin American countries – including Argentina, Bolivia, Brazil, Ecuador, Paraguay, Uruguay and Venezuela decided to create the Bank of the South, which in fact comprises the establishment of a Regional Development Bank as well as a stabilisation fund. The initiative was triggered by “the obsolescence of the existing international financial architecture, the decline of the dollar as the world currency reserve and as the reference currency for international trade, and last but not least the lack of trust on the Washington based financial institutions to organise the Latin American economic and financial sectors.”⁷⁸ The capital endowment of the Bank of the South is relatively small, with just \$US 7 billion. This is well below an amount which could reasonably provide a regional alternative to the IMF as a lender of last resort able to provide liquidity for member countries in times of crisis.

Despite the absence of the institutional framework and the funds that could make a regional stabilisation fund possible, academics and civil society from the region have put forward proposals for a monetary union which integrates the currencies of ten Latin American countries. The proposal to a certain extent resembles the initial European Monetary System, including a fluctuation band and some coordination of the exchange rate policies, while the economies’ fiscal and external deficits, monetary supply and inflation converge. However, the current

context does not seem to indicate further progress on these proposals any time soon. “While the possibility that the Bank of the South may serve to advance regional integration cannot be ruled out, at present it does not offer any realistic prospects for monetary regionalism.”⁷⁹ Another initiative was launched in 2009, by members of the Bolivarian Alternative of the Americas (ALBA)⁸⁰. The proposal is to create, starting in early 2010, a common currency area that would replace the dollar with a new regional currency, the “SUCRE”⁸¹ for international payments among these countries.

⁷⁷ Griesse, Jören and Kellermann, Christian: “What comes after the dollar?”, International Policy Analysis, Friedrich Ebert Stiftung, April 2009.

⁷⁸ Ugarteche, Oscar: “Pasos regionales en la construcción de una nueva arquitectura financiera internacional”, Universidad Nacional de México, July 2008.

⁷⁹ Griesse, Jören and Kellermann, Christian: “What comes after the dollar?”, International Policy Analysis, Friedrich Ebert Stiftung, April 2009.

⁸⁰ Members of this initiative are : Antigua & Barbuda, Bolivia, Cuba, Dominica, Ecuador, Honduras, Nicaragua, St. Vincent & Grenadines and Venezuela,

⁸¹ Sistema Unico de Compensación Regional (Unique System of Regional Compensation).

7. CONCLUSIONS AND RECOMMENDATIONS

The global monetary system in place in the last forty years has failed to address, and has at times even worsened, fundamental flaws in the global financial architecture such as global imbalances, exchange rate volatility and global financial instability. The result has been particularly damaging for developing countries, which pay a very high price for the lack of global monetary coordination. The cost that developing countries must pay to protect themselves against financial instability and speculation is up to \$430 billion a year.

The financial and economic crisis that the world is experiencing today, as well as the huge deficit from the US and some European countries, which are ever larger as a result of the stimulus packages launched in response to the global crisis, increase the pressure on the unfair and unsustainable global monetary system. An abrupt collapse of the current system would have devastating effects for all. It is more urgent than ever that decisive steps are taken towards a new global reserve system which is both fair and stable.

Developing countries, civil society and the United Nations are increasing their calls for a new global monetary system **addressing the main flaws of the system and the current lack of coordination**. These proposals call for:

- **a supranational reserve currency** that substitutes the US dollar and which is not linked to the creation of a spiral of deficits of the reserve currency issuing country, and thus of destabilising global imbalances;
- **a global system of symmetric coordination to allow for equitable adjustments** of global imbalances between surplus and deficit countries – which effectively removes the pressure on deficit countries to adjust by cutting their aggregate demand and the so-called “deflationary bias” of the system which undermines the possibility to guarantee full employment and equitable growth;

- **an efficient mechanism to create global liquidity**. This mechanism should be counter-cyclical so that increased liquidity can be provided in times of crisis to support counter-cyclical fiscal policies;
- **policy space for developing countries to allow them to implement capital management mechanisms**. This should enhance exchange rate stability, and curbing speculative attacks on their currency and other kind of speculative capital flows. This should also be made possible through the provision of capital management mechanisms within WTO/GATS agreements and also in bilateral and regional investment agreements with developing countries.

These proposals must go **hand in hand with broader and deeper reforms of the global financial architecture that give a stronger voice to developing countries**. These should include:

- reforms at the International Financial Institutions to ensure greater representation of developing countries. At the IMF, this could be achieved by establishing a system of double-majority voting.⁸² In addition, if the IMF is to have a role in a reform global monetary system, the use of Special Drawing Rights should radically change and the IMF should become an “SDR based institution”.
- strengthening the role of the United Nations in global decision-making on economic and financial matters. The proposal made by the Stiglitz Commission to establish a Global Economic Coordinating Council that has a mandate to look at economic, social and ecological issues, is a good model.

Global institutional arrangements should

⁸² Bretton Woods Project: “Bridging the democratic deficit: double majority decision-making at the IMF”, available at <http://www.brettonwoodsproject.org/art-549743>

complement enhanced regional cooperation, such as initiatives in Asia and Latin America to move towards a more balanced and stable regional financial architecture.

The G20 have failed to address these fundamental issues so far. But developing countries are increasing their calls for a new global reserve system. If governments are serious about creating the conditions for financial stability, and preventing further collapse of the financial and economic system, they must undertake reforms in this area. As pointed out by UNCTAD all countries need *“a combination of financial stabilisation with expansive monetary and fiscal policies. In the absence of such a policy mix more and more countries will quickly end up on the verge of collapse.”*⁸³

⁸³ UNCTAD 2009, op. cit. p. 54