

# REFORMING AND STRENGTHENING THE GLOBAL FINANCIAL SYSTEM

**Andres Velasco, Minister of Finance, Chile**

## **Preliminary considerations**

- The present global financial crisis is the most serious in several generations. Although it is premature to assess its impact on growth, employment and poverty rates, there is consensus that the developed economies are heading for at least two years of low or non-existent growth.
- Prior to the crisis, Chile and other emerging countries took measures that will cushion them against its impact. Learning from their experience in the crises of the 1970s, 1980s and 1990s, a number of emerging economies, including Chile, improved market regulation, particularly that of financial markets, while reducing borrowing and strengthening their fiscal situation. The same cannot be said of most developed countries.
- Previous crises left two key lessons, the first of which has to do with financial regulation and supervision. Chile learned their importance during the 1980s, with the severe crisis of 1982-83 and the ensuing recession. As a result of that experience, Chile took measures to control excessive risk exposure by financial institutions and regulated conflicts of interest and the disclosure of information. As a result, Chile today has a rigorously regulated and well capitalized financial system, which has stood well under the current global turbulence.
- The second lesson has to do with fiscal responsibility. In previous international crises, emerging countries were at a disadvantage due to chronic fiscal deficits, a high level of public debt and an exchange-rate mismatch in the form of short-term dollar-denominated borrowing that became very difficult to service in a context of financial stress. However, Chile corrected these problems through prudent fiscal management and by paying down public debt, thereby reducing the vulnerability of its economy. Moreover, taking this process a step further, it introduced a fiscal rule under which it saves in boom periods and, by law, created sovereign wealth funds designed precisely to protect its economy against this type of adverse external shocks.
- Had the world's largest economies also learned these two lessons, the story today might be different. Lack of financial regulation and supervision helped trigger the crisis, while fiscal weakness and large public debts hinder governments' ability to engineer countercyclical policies.
- But, clearly, these are not the international economy's only problems. The crisis has also revealed serious deficiencies in the global financial system, such as:
  - limitations in the ability of the Bretton Woods institutions to play an active role in guarding against macroeconomic disequilibria and in providing liquidity to those emerging economies that need it;

- inadequate supervision and regulation of financial markets in developed countries and, once the crisis broke out, a delay in coordinating intervention of these markets;
  - under-representation of emerging economies in the governance of the main multilateral lending institutions.
- In this context, proposals are needed to limit the effects of financial turbulence on emerging and developing economies in the short term and, in the longer term, to reform the global financial architecture.

## 1. **Proposals for limiting the effects on emerging and developing economies**

- In recent years, the U.S. Federal Reserve has acted as a central bank for the developed countries, providing liquidity to the European Central Bank, the Bank of England, the Swiss National Bank and the Reserve Bank of Australia. More recently, Brazil, Mexico, Korea and Singapore have been granted access to swap lines. Other emerging and developing countries do not have access to this emergency source of liquidity.
- As a result, we support the effort by the International Monetary Fund (IMF) to create a **short-term liquidity line** for emerging and developing economies which face a liquidity crisis caused not by deficient domestic policies but by the severing of sources of financing due to a systemic crisis.
- This liquidity line should be available rapidly and on a scale sufficient to meet the needs of large and small economies.
- Details of eligibility requirements, the amount of resources to which an economy would have access, the mechanism for paying out resources and some type of ex-post conditions need to be defined.
- For this to work, an **early-warning mechanism** must be created, also within the framework of the IMF, to anticipate and respond promptly to the risk of contagion in an emerging or developing country. As the experience of some European countries has shown, a country's economic conditions can change within the space of just a few weeks. Ideally, the mechanism should be able to anticipate such changes but, if this is not possible, prompt action is essential.
- Finally, this is an appropriate time to look at whether multilateral institutions and regional development banks have **sufficient financial resources** to support economies that face difficulties. If this is not the case, rapid and creative measures are required. It is key that large economies with substantial reserves, such as China, participate in such an effort.

## 2. **Proposals for reforming regulation and supervision of the financial system**

- We must not wait until the crisis has passed before proposing reforms to the global financial system to address the deficiencies that have become evident. We must not

- Just as Chile learned from experience and reformed its domestic financial regulation, it is clear that reform is also required in the developed countries along with the creation of a mechanism for coordinating global financial supervision:
  - The absence of coordination, either in supervision and regulation of financial players during normal times or in intervention at times of crisis, defies explanation in a globally integrated financial system, particularly when it involves the developed countries. Over the past month, we have fortunately seen coordinated measures by the economic and financial authorities of the largest economies.
  - Regulatory reform, at both the local and global level, should be grounded in some basic principles which, although they may seem obvious, are easily forgotten: transparency, responsibility on the part of the different players, prevention of conflicts of interest, bank soundness and appropriate incentives for those who manage financial institutions.
- Any reform of the global regulatory framework or the way in which this integrated financial market is regulated and supervised must take account of the opinions and views of the emerging and developing countries.
- Firstly, because it has been demonstrated that sound economic policies do not make us immune from financial crises originating in the developed countries; second, because financial institutions from developed countries operate in our financial markets; and, last, simply because any such reform, with its global implications, must be discussed by all those who would be affected.
- At present, discussions are located in the Financial Stability Forum and have the support of the United States and the European Union. However, membership of this body is confined to a small number of central banks and/or supervisors, the multilateral financial institutions and associations of financial regulators. In the case of the first group, it includes only the G7 countries plus Australia, Hong Kong, the Netherlands, Singapore and Switzerland.
- For this reason, we propose that discussion about reforms to the regulatory and financial framework for private markets be broadened to include the emerging economies without, of course, excluding the contribution that the Financial Stability Forum can make.

### **3. Reform of the governance of multilateral institutions**

- A package of reforms was approved this year in the IMF. However, although Chile supported it, it is insufficient because countries like Brazil, China and Russia and other emerging economies continue to be under-represented as regards voice, voting rights and access to the Fund's resources.

- In our view, debate about governance and representation in the Bretton Woods institutions - the IMF and the World Bank - should be re-opened. The present crisis should be taken as an opportunity to do this, not an excuse for procrastination.
- Countries with substantial reserves and important weight in the world economy, such as China, must be part of the solution. However, this requires that their importance be reflected in their representation and voice in the governance of these institutions.

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