# University of New South Wales

University of New South Wales Faculty of Law Research Series 2010

*Year* 2010 *Paper* 13

# Resilience and global financial governance

Ross Buckley\*

This working paper is hosted by The Berkeley Electronic Press (bepress) and may not be commercially reproduced without the permission of the copyright holder.

http://law.bepress.com/unswwps-flrps10/art13

Copyright ©2010 by the author.

<sup>\*</sup>University of New South Wales

### Resilience and global financial governance

Ross Buckley

#### **Abstract**

Resilience is generally seen as a positive attribute that should be enhanced. When a system is dysfunctional and needs to change its structure and identity, however, resilience can be a negative. As this chapter illustrates, our system of global financial governance works to benefit the elites in international banks and developing countries at the direct expense of the common people in those countries. The system is deeply unfair and disfunctional and displays great negative resilience. This chapter analyses ways in which this negative resilience could be reduced.

# Resilience and global financial

### governance

#### Ross Buckley

(This chapter will appear in the forthcoming Resilience and Transformation: Preparing Australia for Uncertain Futures. Steven Cork (Editor). CSIRO Publishing, Melbourne.)

Resilience is generally seen as a positive attribute that should be enhanced. When a system is dysfunctional and needs to change its structure and identity, however, resilience can be a negative. As this chapter illustrates, our system of global financial governance works to benefit the elites in international banks and developing countries at the direct expense of the common people in those countries. The system is deeply unfair and disfunctional and displays great negative resilience. This chapter analyses ways in which this negative resilience could be reduced.

#### Introduction

A range of concepts is commonly used in analysing the global financial system, including stability, volatility, efficiency and others. Resilience is not among them. Yet we have a very resilient global financial system. It is unstable, volatile, narrowly efficient and highly resilient, principally in the negative sense of being resistant to change.

Resilience is the capacity of a system to withstand external shocks and retain its essential characteristics; its identity. Generally resilience is a positive feature. But when a system needs to change fundamentally and be

restructured, resilience can be a marked negative. The global financial system is somewhat functional from the perspective of OECD nations and the international commercial banks, and quite dysfunctional from the perspective of developing countries. It displays a high degree of negative resilience.

Even the global financial crisis (GFC) has so far led to little substantive change in the system that produced it. The GFC has led to higher capital requirements, particularly for trading, tighter liquidity controls, closer supervision and restrictions on bankers' bonuses, but none of these changes are fundamental. If one considers how profoundly different the global financial system is today from what it was 30 or 40 years ago, these changes are merely cosmetic. Even the macro-prudential regulatory function in which systemic risk across the financial system is to be assessed and monitored, which is to be carried out by institutions such as the new European Systemic Risk Board, is but a belated example of regulation beginning to catch up with market changes that are decades old.

The only real change to the system as a result of the GFC has been the handover of economic coordinating authority from the G7 to the G20 nations. Comprising 19 nations and the European Union, the G20 represents 85% of global gross domestic product (GDP), 80% of world trade and two-thirds of the world's people. In addition to the G7 nations, it includes Brazil, China, India, Indonesia, Turkey, Australia, South Africa and others. This is an important change. Brazil, China and India not having a voice in economic policy coordination was becoming increasingly ridiculous.

This change, however, is yet to result in any fundamental changes to the system, in part because the G20 is merely a gathering of national leaders; it is not a formally constituted international organisation and lacks the capacity to enforce its decisions.

So why is a system that, for so many of its participants, is deeply dysfunctional so resilient? The answer lies in whom the current system serves and the general paucity of knowledge, outside those it serves, about how it works and its effects.

# The strong negative resilience of the global financial governance system

Resilience science teaches us that strongly resilient systems have strong feedback loops. This concept of feedback loops, developed in analysing systems, explains much of the resilience of our global financial system. The feedback loops in global financial governance show that the system tends to reward the international commercial banks and the elites in developing countries at the expense of the common people in the debtor countries. A few examples will suffice.

After the debt crisis struck in 1982 a way was needed to allow many hundreds of creditors to negotiate with many hundreds of debtors in each debtor nation. The commercial banks appointed steering committees comprising representatives from six to eight banks to represent all creditors and persuaded the sovereign debtor to also represent all other debtors within its jurisdiction (including state governments, state-owned industries and private corporations). This was sensible. The banks, however, went further and persuaded the debtor nations to bring all debt incurred by all entities within their jurisdiction under their sovereign guarantee. This was completely

unnecessary and, from the perspective of the common people in the debtor nations, appalling. The inevitable, massive shortfall between what the sovereign now owed the bank creditors and what it could recover from the original debtors became a charge on government revenues. The people paid in reduced services so that the foreign banks could receive a free credit upgrade on most of their assets.

Likewise in Indonesia after the Asian economic crisis, the International Monetary Fund (IMF) and the foreign commercial banks insisted that the Republic of Indonesia assume the obligations of the local banks to foreign lenders and then seek to recover the funds from the local banks; by selling their assets if necessary. This again proved a difficult task and only about 28% of the total liabilities assumed have been recovered (Asian Development Bank 2009). Almost three-quarters of the costs of repaying those foreign loans has thus been borne by the Indonesian people. Yet there was no reason for Indonesia to assume responsibility for these loans. The market mechanism, if left to work, would have seen many of these Indonesian banks placed into bankruptcy by their Western creditors who would have received a proportion, presumably in the order of 28%, of their claims in the bankruptcy proceedings. Instead, insolvent local banks were put into bankruptcy by Indonesia, the creditors were repaid in full and the Indonesian people bore most of the cost of that repayment. The funds to repay the creditors came from the long-term loans organised by the IMF and invariably were described as bail outs of the debtor nations. Yet these loans were required to be used to repay outstanding indebtedness; so the bail outs were of

bepress Legal Repository

the foreign banks. In Indonesia, the IMF coordinated a restructuring that socialised massive amounts of private sector debt (Buckley 2002).

Similarly, the centrepiece of the G20 response to the GFC in April 2009 was a US\$500 billion additional credit facility for debtor nations. The conditions required to be eligible for these loans, however, exclude virtually all African and most Latin American nations. While it is not apparent on the face of the conditions, they are carefully crafted so that most of these loans will go to their intended destination; the East European countries. The German banks are heavily over-exposed to these countries. So this additional credit facility, in large measure, is designed to bail out the German banks. The funds lent come from the G20 nations, which know they will be repaid; official credit always is. The loss will fall on the people of these Eastern European nations, who will labour under massive debt burdens for decades to come.

Once again normal market processes, which in Eastern Europe would have led to German banks incurring large losses on their ill-judged, excessive lending to the region, are abrogated to prefer foreign banks at the direct expense of the people of the poorer nations.

The benefits of our system of global financial governance to the commercial banks are thus manifestly clear. The market is given full rein when yielding large profits to the banks, but is interfered with when it would yield large losses.

The benefits to the elites in developing countries are far less obvious, but are often very substantial and are the reason that voices well-placed to argue against the current system are rarely raised against it. An example is in the restructuring of Indonesia's indebtedness after the Asian crisis. When the

assets of the insolvent local banks were sold, who was best placed to bid for those assets? Who knew everything about the assets and precisely what they were worth? The families that had owned them and were the principal shareholders of the banks. So, in effect, these families were able to regain control of the assets they had owned before the crisis with their foreign debts discharged by their government, all for an average cost of 28%. Who would speak out against such extraordinary largesse? Would you if, somehow, you could repay your home mortgage for one-fourth of the debt owing? Our system of financial governance neatly transferred the real cost of the crisis, which should have been borne by borrowers and lenders that had engaged in imprudent borrowing and lending, onto the people of the debtor nations who had done nothing.

As Professor Luis Carlos Bresser Pereria, former Finance Minister of Brazil, testified before a US House Committee in the aftermath of the debt crisis, the elites in the debtor nations often profited from that crisis (Pereira 1990). Periods of great volatility and forced asset sales offer huge opportunities to those with access to better information, power and financial resources.

Overall, the system of global financial governance has displayed a quite remarkable degree of resilience. When one analyses whom it serves, this is unsurprising. Any system that rewards the powerful at the expense of the powerless is likely to prosper.

Yet the system was not designed to do this. Its architects were Keynes and White at Bretton Woods in 1944. Their primary goal was the promotion of global trade. Fixed exchange rates were to facilitate that trade. The IMF

was established to provide short-term loans and technical advice to nations to facilitate their management of these fixed rates. This fixed exchange-rate system ended in the 1970s as the US went off the gold standard and floated its currency and other developed nations followed suit. During the 1970s, the IMF's core mission ended.

Global institutions are, however, notoriously hard to kill. Witness the Bank for International Settlements, which Keynes and White had intended be closed but which lived on to become the most significant global banking regulatory institution.

So the IMF continued on until the debt crisis of 1982 gave it a new role. The commercial banks needed to keep lending to the sovereign debtors so they could service their debts, but they didn't want to advance more funds without changes to the policies that had led these nations to the brink of insolvency. Yet it was politically impossible for a Bank of America or J.P. Morgan to be dictating economic policy to a Brazil or Argentina. The IMF stepped in. As a supposedly independent international financial institution it was well-positioned to play the role of crisis manager of nations in trouble. It was well-positioned for the role but not staffed or equipped to discharge it. So the IMF performed poorly, with disastrous consequences for the human rights of poor people in poor nations. Yet it has continued to fulfil this function, with substantially unchanged policies, for over a quarter of a century – talk about negative resilience! Over time, as its litany of policy failures began to mount, the Fund attracted sustained, unrelenting criticism from both sides of politics in the US and from developing countries and it was allowed to shrink in size

bepress Legal Repository

Hosted by The Berkeley Electronic Press

from a total staff approaching 3000 to about 1700 (Vines and Gilbert 2004, Meltzer 2000).

Yet in 2009, another crisis rescued the Fund. The GFC meant the G20 needed an organisation through which it could channel most of its US\$1.1 trillion funding package, a bill the IMF fitted. And so, today, the credibility of the IMF has been somewhat restored by having a new role and its staffing levels are again climbing.

The IMF continues to exert control over the economic policies of developing countries in crisis some 35 years after the role for which it was established ended. It has proven to be a remarkably resilient institution, to the detriment of a substantial proportion of the people on the planet.

# Why such an unjust and dysfunctional system is not remedied

So why do the normal checks and balances of democratic systems not rein in and redirect the system of global financial governance if it so often implements ends that serve the rich at the expense of the poor? Part of the answer is that voters in rich countries cannot understand how international finance works and care far less about the problems of people in poor countries than they do about their own backyards. This lack of understanding is promoted by the media, which does a poor job of covering global financial governance. The media typically focuses on the most recent development and reports it, shorn of context. Its coverage is often inaccurate, promoted by the closeness with which information is guarded in this sector. The poverty of the media coverage means the powerful can continue to use the system in ways

that suit them free from countervailing pressures from civil society and democratic voters.

Two examples follow, although there are many others. In late 1997 the IMF-organised bail outs of Indonesia, Korea and Thailand were reported widely as if they were grants, not loans. Furthermore, the purpose for which the bail out funds could be applied was not reported in the media at all, as that was only to be found in the fine print which was not generally available. Yet the loans could only be applied to debt then due, which was mostly short-term debt. So the bail outs were essentially bail outs of Western banks, not East Asian nations and the bail outs rewarded the lenders who advanced the most destabilising form of loans – short-term ones – at the expense of those who had advanced less-volatile, longer term debt. Thus was perpetrated a disastrous policy that received no critical media coverage until it was old news, many years later.

In 2009 the G20's principal response to the GFC was a US\$1.1 trillion dollar funding package. US\$100 billion was additional concessional financing for poor nations. US\$250 billion was to support trade finance, financing for which had been severely limited by the GFC. Another US\$250 billion was an increase in Special Drawing Rights, the IMF quasi reserve-capital. And the final US\$500 billion was the additional credit facility. The first two tranches are readily understandable. The last two are not. Special Drawing Rights (SDRs) are based on a basket of four currencies – the US dollar, the pound Sterling, the euro and the yen – and are the ways nations make their contributions to the IMF. They are an excellent source of funding for poorer nations and the increase in them is a laudable response to the GFC. However,

SDRs can only be drawn down in proportion to a nation's quota. Accordingly, nearly two-thirds of the increase in SDRs is available to OECD nations, leaving US\$100 billion to developing countries, within which only US\$19 billion is available for low-income nations (Oxfam 2009; IMF 2009). So reporting the US\$250 billion increase in SDRs as a measure to assist poor countries, as was often the case, was quite misleading.

The US\$500 billion is, as we have seen, even more opaque. The principal destination of these funds is intended initially to be the Eastern European nations and ultimately the repayment of their loans to the German banks. The media has not, to my knowledge, reported the destination of the US\$500 billion additional credit facility because it cannot be divined from the terms of the facility. It is quite simply beyond the capacity of the media to cover such developments accurately, a state with which the powerful players are content.

So if the system exhibits such strong negative resilience, how might that resilience be lessened so that needed changes come about?

#### Steps needed to reduce undesirable resilience

Perhaps the initial principal step that needs to be undertaken to reduce the undesirable resilience of our system of global financial governance is to return the IMF to its original mandate, or what is left of its original mandate. The skills required to turn around poorly performing economies are utterly different from those typically held by central bankers and PhD graduates in macro-economics; the two most common backgrounds of IMF staffers. The IMF is the wrong organisation to set economic policy for nations in crisis.

Because the IMF is not equipped for the role it stumbled into, it has been open

to capture by the powerful in the international financial community and the poor countries and it should be removed from this role. If an international financial institution is required to play this role, a new one, with staff equipped with the right skills and attitudes and with the right culture needs to be established. This change would limit the IMF to data collection, technical surveillance and advisory roles.

The next step is to reform the governance of the IMF and the World Bank. There have been tiny reforms in the past two years but, essentially, most votes are in the hands of the US and the leading European countries. So these institutions, whose clients are the world's poorer countries, do the bidding of the richest countries. This is absurd. The principal clients of these institutions need a real voice in their governance.

The third step is to applaud the move from the G7 to the G20 and to strengthen further the G20. This could be done by increasing its size slightly by the addition of some regional representatives. While it will be difficult to remove the seat of any current nation, logically Italy should lose its seat, Argentina's seat should go to a regional grouping for Latin America, Saudi Arabia's to a regional grouping for North Africa and the Middle East and a seat should be given to a sub-Saharan African grouping. If the G20 were then expanded to a G22 and regional seats added for ASEAN and South Asia, the organisation would directly or indirectly represent the great majority of countries.

The final and most significant step to reduce negative resilience, or resistance to change, is to diminish the strength of the current feedback loops.

The best way to do this is to make the system more fair and balanced. The

strength of the feedback loops arise because of the degree to which the system currently favours the powerful among banks and within developing nations.

The system needs to change in fundamental ways and this is not likely to occur without these feedback loops being first weakened.

The UN established the Stiglitz Commission as part of its response to the GFC and the best way to disempower many of the feedback loops would be for the G20 to implement some of the Commission's recommendations. The Commission's three most readily implementable recommendations are that: (i) new financial mechanisms be introduced to mitigate risk, including international institutions lending in local currencies; (ii) highly indebted countries be given a moratorium or partial cancellation of debt; and (iii) new mechanisms be introduced for handling sovereign debt restructuring, such as a sovereign bankruptcy regime. The commission also recommended that the US dollar be replaced as the global reserve currency. There were other recommendations, but I will focus upon these four.

There are strong reasons why all reschedulings of rich country to poor country loans should be in local currency, as should all lending by international financial institutions such as the IMF and World Bank (Buckley and Dirou 2006). Our current system places the currency risk on the party least able to bear it; the borrower. This is illogical. Lending in local currency puts the currency risk on those best able to bear it and hedge against it, the lenders.

Likewise there are strong arguments for debt relief for more countries than currently receive it and for an orderly, rules-based approach to sovereign insolvencies (Buckley, in press).

A new reserve currency is needed because when one nation's currency serves as the global reserve currency the extra liquidity required to meet the global liquidity needs inevitably puts downward pressure on the currency's value thereby making it more volatile and less attractive as a reserve currency. This is known as the Triffin dilemma. It has required the US to run consistently massive trade deficits so as to inject sufficient dollars into the global system, which is not sustainable. Premier Wen Jiabao has said he is worried that China holds most of its reserves in dollars and well he might be, as the decline of the dollar in recent years has cost China a fortune. Twice in 2009 the governor of China's central bank called for a new reserve currency regime focused on Special Drawing Rights. China Inc. doesn't make such comments without careful consideration and is hard at work researching alternatives, such as denominating and settling its trade with Brazil in real and renminbi, not the US dollar.

#### Conclusion

The greatest reduction in negative resilience in global financial governance would be achieved if we were to promote lending to developing countries in their own currencies, grant more debt relief to more poor countries, stop the socialisation of private sector debt in debt restructurings, introduce a fair and independent arbitration process for sovereign bankruptcy and move towards a different global reserve currency, perhaps Special Drawing Rights or some other basket of currencies. These changes would go a long way to making the global financial system fairer, reduce the extent to which it favours the powerful and therefore disempower the feedback loops that make the current system so resistant to change. Of course, the negative resilience of the system

means that these changes will be strongly resisted by the system's powerful participants.

Ross Buckley is Professor of International Finance Law at the University of New South Wales, a Fellow at the Asian Institute of International Financial Law, University of Hong Kong and an Australia 21 Fellow.

#### References

Asian Development Bank (2009) Lessons from the Asian Development

Bank's Response to Financial Crises. Asian Development Bank, Manila,

<a href="http://www.adb.org/Documents/Evaluation/Information-Briefs/EIB-2009-02.pdf">http://www.adb.org/Documents/Evaluation/Information-Briefs/EIB-2009-02.pdf</a>>.

Buckley RP (2009) The Bankruptcy of Nations: An Idea Whose Time Has Come. The International Lawyer **43**, 1189-1216.

Buckley RP and Dirou P (2006) How to strengthen the international financial system by improving sovereign balance sheet structures. Annals of Economics and Finance 2, 257–269.

Buckley RP (2002) The fatal flaw in international finance: The rich borrow and the poor repay. World Policy Journal **19**, 59–64.

International Monetary Fund (2009) IMF Resources and the G20 Summit.

International Monetary Fund, Washington, DC,

<a href="http://www.imf.org/external/np/exr/faq/sdrfaqs.htm#q7">http://www.imf.org/external/np/exr/faq/sdrfaqs.htm#q7</a>.

Meltzer A (2000) Report of the International Financial Institution Advisory

Commission. United States House of Representatives, Washington, DC,

<a href="http://www.house.gov/jec/imf/meltzer.pdf">http://www.house.gov/jec/imf/meltzer.pdf</a>>.

Oxfam (2009) G20 Media Brief, Money for Nothing: Three Ways the G20 Could Deliver up to US\$280 Billion for Poor Countries. Oxfam, Oxford, UK, <a href="http://www.oxfam.org.uk/resources/policy/debt\_aid/money-for-nothing-g20.html">http://www.oxfam.org.uk/resources/policy/debt\_aid/money-for-nothing-g20.html</a>.

Pereira LCB (1990) Solving the debt crisis: Debt relief and adjustment.

Revista de Economia Política **10**, 147–154. <a href="http://www.rep.org.br/pdf/38-10.pdf">http://www.rep.org.br/pdf/38-10.pdf</a>>.

Stiglitz J (2009) Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System. United Nations, New York, <a href="http://www.un.org/ga/econcrisissummit/docs/FinalReport\_CoE.pdf">http://www.un.org/ga/econcrisissummit/docs/FinalReport\_CoE.pdf</a>>.

Vines S and Gilbert C (2004) *The IMF and its Critics: Reform of Global Financial Architecture*. Cambridge University Press, Cambridge, UK.

