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Global South Beyond Modern Money
Theory: Governance of a Complex
Global Financial System in the Age of
Global Instabilities**

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2 January 2024

Online at <https://mpra.ub.uni-muenchen.de/119650/>
MPRA Paper No. 119650, posted 15 Jan 2024 14:38 UTC

21st Century Accelerated Dedollarization, Multipolarity and The
Global South Beyond Modern Money Theory: Governance of a
Complex Global Financial System in the Age of Global
Instabilities
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January, 2024

* I would like to thank L.Randall Wray, Fadhel Kaboub, Tanweer Akram, Ilene Gabel, Izumi Otomo, Derek Sarchet, Aaron Schneider and the participants of my seminars at Korbel School, Rome, Naples, New Delhi and Tokyo.

Abstract

With the Global Financial Crisis of 2008-2009, the fundamental instabilities of global capitalism were exposed. Unfortunately, coordination failures and excessive risk-taking were not addressed---only the FIRE sector big players were bailed out. COVID-19 crisis exposed the failures even more starkly. It is high time that fundamental coordination and other failures of global capitalism are addressed so as to give the humankind a fighting chance to face pandemics, global warming and other looming crises and create a truly sustainable and just global economic order. I argue that there is a need to create monetary sovereignty for the global south in particular in line with the fundamental premise of *Modern Money Theory (MMT)* and *functional finance* to generate adequate *ex ante* public investment for full employment. The governments should also be employers of the last resort. Since all existing accumulated evidence since the 2008-9 crisis indicates that we are not near the inflationary barrier, appropriate full employment generating government spending for public investment is a sensible functional finance option (Kelton 2020; Wray 2012; Khan 2021a,b, 2020; Khan and Shabani 2021). For this to apply to the global south with any plausibility, first an appropriate global financial architecture must be created. This paper analyzes the problems of creating and expanding national macroeconomic policy space and economic governance for the global system which takes historical unevenness seriously and places both the developed and developing countries in the global system within a complex adaptive systems framework of overall global and regional financial architectures with special emphasis on the recent institution of a New Development Bank for the Global South, expansion of BRICS and the BRICS Contingent Reserve Arrangement (CRA). It develops a critical constructivist evolutionary theory of international financial institutions and arrangements within a framework of dynamic complex adaptive economic systems (DCAES), and applies this particularly to the current problems of developing countries. A mathematical model is also presented in the appendix.

More specifically, in terms of institutions of global economic governance with special emphasis on the task of regional institution building, reform of the IMF and creation of multi-regional

institutions to enhance the capabilities of ordinary people everywhere, particularly in the Global South. BRICS, the paper analyzes the following aspects in order to present the strongest justification for the creation of BRICS-like multi-regional financial architectures after the failures and crises in the 21st century so far :

- BASEL III reforms for more stringent capital requirements and their implications for the developing world in particular.
- BIS proposals for better regulation of financial derivatives, including commodities futures, by moving away from OTC transactions towards organized exchanges.
- The IMF's response to recent and emerging global economic and challenges, and the evolving nature of its role.
- The most appropriate role of regional arrangements in financial stabilization, based on experiences with such arrangements in this and prior episodes of crisis.
- In particular the roles of regional financial arrangements in Asia and the BRICS facilities announced in July, 2014 are analyzed as parts of the emerging RFA structures that could lead to a more efficient and equitable financing for development.

The Basel reforms and the BIS proposals for regulating the derivatives markets have many positive features. However, they have not been designed with the needs of DCs and LDCs in mind. The consequences of Basel I and II and proposed Basel III are analyzed from the perspective of the developing countries. It turns out that specific concerns of developing countries have not received adequate attention within the Basel Reform Initiatives and more can be and needs to be done.

Most importantly, the role of IMF under the present globalization arrangements and repeated financial crises is studied by following such a critical constructivist evolutionary theory of international financial institutions within a rigorous DCAES framework. Here, too, the key finding is that much more can be done to help the developing countries than has been done so far. Furthermore, the potential for such global reforms in the wake of the global financial crisis and the great recession is analyzed from a dialectical social constructivist viewpoint that combines the power of --sometimes conflicting-- norms and ideas with the underlying structural contradictions to produce a “critical-constructivist” analysis of the potential for change. It is shown that IMF must and can change in a direction which allows for greater national policy autonomy. It is also shown that the IMF needs complementary regional institutions of

cooperation in order to create a stabilizing hybrid global financial architecture that will be more democratic and pro-development in terms of its governance structure and behavior. Thus regional financial architectures will need to be integral parts of any new global financial architecture (GFA). The tentative steps taken towards regional cooperation in Asia since Asian financial crisis are discussed to illustrate the opportunities and challenges posed by the need to evolve towards a *hybrid* GFA. The opportunities and challenges arising from the current global crisis are also analyzed in this context. In this way, the strongest justification for the creation of BRICS-like multi-regional financial architectures after the failures and crises in the 21st century so far can be presented in the most even-handed and historically informed manner.

With the recent developments towards the further expansion of BRICS-plus already achieved, accelerated dedollarization and assertion of sovereignty by many countries of the Global South, the creation of an alternative less asymmetric non-IMF based architecture for global financial governance has become a more realistic institutional possibility.

Keywords: Multipolarity, The Global South, BRICS-plus, Accelerated Dedollarization, Modern Money Theory (MMT), Functional Finance in the Global South, dynamic complex adaptive economic systems, financial crises, global financial architecture, regional financial architectures, a *hybrid* GFA, regional cooperation, BASEL III reforms, the BIS proposals, Asia, BRICS Development Bank, BRICS financial facility, the IMF.

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LIST OF ABBREVIATIONS

AESAN	Association of Southeast Asian Nations
AFC	Asian Financial Crisis
ASA	ASEAN Swap Agreement
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BITs	Bilateral Investment Treaties
BOP	Balance of Payments
BRICs	Brazil, Russia, India, China and South Africa
CAR	Capital Adequacy Ratio
CCP	Central Counterparty
CDS	Credit Default Swap
CET	Constructive Evolutionary Theory
CFTC	Commodity Futures Trading Commission
CPSS	Committee on Payment and Settlement Systems
CRPRID	Center for Poverty Reduction & Income Distribution
CSO	Civil Society Organizations
DCAES	Dynamic Complex Adaptive Economic Systems
DHS	Demographic and Health Surveys
FCL	Flexible Credit Line
FTAs	Free Trade Agreements
FX	Foreign Exchange
FYDP	Five Year Development Plan
GDP	Gross Domestic Product
HDI	Human Development Index
HIPC	Heavily Indebted Poor Country
HDR	Human Development Reports
ICT	Information and Communication Technology
IGO	Inter Governmental Organization
IMF	International Monetary Fund
INGO	International Nongovernmental Organization
IOSCO	International Organization for Securities Commissions
IPS	Integrated Package Services
LDC	Least Developed Country
LIC	Low-Income Country
MAG	Basel Committee Macroeconomic Assessment Group
MDGs	Millennium Development Goals
MDGR	Millennium Development Goals Report

MDRI	Multilateral Debt Relief Initiative
MICS	Multiple Indicator Cluster Survey
MOF	Ministry of Finance
BOJ	Bank of Japan
MPND	Ministry of Planning and National Development
MPO	Management and Planning Office
MTEF	Medium Term Expenditure Framework
NAPEP	National Poverty Eradication Programme
NEEDS	National Economic Empowerment and Development Strategy
NGO	Non Governmental Organizations
NPC	National Planning Commission
ODA	Official Development Assistance
OTC	Over the Counter
PC	Planning Commission
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Papers
SBA	Stand-by Arrangement
SDR	Special Drawing Rights
SEC	Securities and Exchange Commission
SFT	Securities Financing Transactions
SIV	Structured Investment Vehicle
SPV	Special Purpose Vehicle
Stats SA	South Africa Statistics Office
TB	Tuberculosis
TWGs	Technical Working Groups
UNCT	United Nations Country Team
UNDAF	United Nations Development Assistance Framework
UNDG	United Nations Development Group
UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund
US	United States
VIE	Variable Interest Entity

1. INTRODUCTION AND BACKGROUND---COVID Crisis and Beyond : the MMT-consistent motivation for the creation of BRICS-like multi-regional financial architectures after the failures and crises in the 21st century so far

With the Global Financial Crisis of 2008-2009, the fundamental instabilities of global capitalism were exposed. Unfortunately, coordination failures and excessive risk-taking were not addressed--only the FIRE sector big players were bailed out. COVID-19 crisis exposed the failures even more starkly. It is high time that fundamental coordination and other failures of global capitalism are addressed so as to give the humankind a fighting chance to face pandemics, global warming and other looming crises and create a truly sustainable and just global economic order. I argue that there is a need to create monetary sovereignty for the global south in particular in line with the fundamental premise of *Modern Money Theory (MMT) and functional finance* to generate adequate *ex ante* public investment for full employment. The governments should also be employers of the last resort. Since all existing accumulated evidence since the 2008-9 crisis indicates that we are not near the inflationary barrier, appropriate full employment generating government spending for public investment is a sensible functional finance option (Kelton 2020; Wray 2012; Khan 2021a,b, 2020; Khan and Shabani 2021). For this to apply to the global south with any plausibility, first an appropriate global financial architecture must be created. The main purpose of this paper is to offer an evolutionary framework within a dynamic complex systems perspective for analyzing the prospects for creating global and regional structures of financial governance that can promote stability, growth and equity. The general theory and the model can be applied to the entire global system. However, the uneven development of this system is taken seriously. To this end, developments in Asia, Latin America and the BRICS receive special attention. Our analytical framework is erected against the background of recent financial crises. This is done in order to present the most reasonable justification for the creation of both a modified Keynesian global financial architecture (KGFA) with similar Keynesian Regional financial architectures (KRFAs) along with BRICS-like multi-regional financial architectures after the failures of global financial governance and global economic crises in the 21st century so far.

Despite the initial bafflement as the world economy was hit by the biggest financial crisis since the Great Depression, by now there is broad agreement on the underlying causes of the first global financial crisis of the 21st century: banks and financial institutions indulged in excessive leverage and excessive risk taking while regulators did not provide an adequate regulatory framework. In the US, the proximate causes also included the Fed policy under Alan Greenspan of supporting an artificial housing boom after the bursting of the stock market bubble through low interest rates and lax regulations in the housing and financial sectors in particular. Through various channels, the crisis was transmitted to other sectors of the economy and to nations across the world, leading to significant human development impacts on the poor and vulnerable. As the “Stiglitz Commission report”(the Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System), among other sources, emphasizes, the deeper causes relate to historic reversal of post-depression checks and balances of national and global economic governance.

As the Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System put it:

“...the standard policy nostrums—that countries should have sound macroeconomic policies strong governance, transparency, and good institutions – may be less than helpful. Countries that held themselves out as models of best practices have been shown to have had deeply flawed macroeconomic policies and institutions and to have suffered from major shortfalls in transparency.”

Against this backdrop, there have been many calls for changes in the global financial and economic governance architecture that would lead to a more stable and less risky international financial system. For example, internationally, there is momentum around BASEL III, a package of proposals to strengthen global capital and liquidity regulations. The United States government and various EU countries had introduced legislation aimed at reforming financial institutions under their jurisdiction.

While these processes are underway, the crisis itself continues to evolve leading most recently to an anemic recovery. Paradoxically, some emerging economies face concerns about excessive financial inflows and overheating of their economies. On the other hand, several

countries now face (or anticipate) debt sustainability issues of different degrees of severity. The prolonged crises in Southern Europe linger on.

Among the IFIs, the IMF has played a prominent role through several measures including the establishment of flexible credit lines, changes in conditions attached to emergency funding and, more recently, in its interventions to support the Euro-zone economies. At the same time, several regional arrangements, such as currency swap lines, have also been put into place. Whether global or regional mechanisms are more useful in preventing financial contagion and to what extent these complement each other, remain open questions.

Changes in the world financial and economic order have consequences for developing countries directly, through banking regulations and global/regional policies, and also indirectly through the impact on developed countries themselves, which can affect lending, foreign investments as well as international aid. In this context, it is possible to find the motivations for undertaking a study that will examine the principal changes that have taken place (or are likely to do so) as a result of the financial and economic crisis. These changes can also include alterations in financial and economic governance mechanisms and policies given the general economic context in which countries, in particular developing countries, are operating.

Particularly in this changing context in a complex global economic system, it is significant that the leaders of the BRICS countries (i.e. Brazil, the Russian Federation, India, China, and South Africa) approved in March 2013, during their meeting in Durban, the creation of a new Development Bank to finance investment in infrastructure and more sustainable development in BRICS and other emerging and developing countries. As the March 2013 Durban Summit Declaration and Action Plan states:

In March 2012 we directed our Finance Ministers to examine the feasibility and viability of setting up a New Development Bank for mobilising resources for infrastructure and sustainable development projects in BRICS and other emerging economies and developing countries, to supplement the existing efforts of multilateral and regional financial institutions for global growth and development... We have agreed to establish the New Development Bank. The initial contribution to the Bank should be substantial and sufficient for the Bank to be effective in financing infrastructure (BRICS, 2013: paragraph 9).¹

¹ See also Conway-Smith E (2013) Developing nations to meet at the BRIC beach party in South Africa. Global Post. Available at: <http://www.globalpost.com/dispatch/news/regions/africa/south-africa/130323/developing-nations-meet-bric-summit-durban>.

Economic Times (2013). BRICS may agree on 100bn currency fund during G-20 meeting. Available at: http://articles.economicstimes.indiatimes.com/2013-08-28/news/41538890_1_bricts-leaders-contingent-reserve-arrangement-new-fund.

This paper documents the nature and scope of these principal changes still evolving in the global economic governance system, and analyzes their consequences for developing countries in particular. The role of BRICS initiatives are seen in this systemic context. While recognizing that the capitalization is still insufficient and modus operandii are not completely laid out yet, it can be argued that in a complex system, small initiatives can lead to large changes in the future in the entire system. But this is not foreordained. In a related way, this paper also explores the important policy space for development issue by exploring analytically the conditions for their most effective responses. Without being exhaustive, the developments covered include:

- Proposed BASEL III reforms for more stringent capital requirements and their implications for the developing world in particular.
- BIS proposals for better regulation of financial derivatives, including commodities futures, by moving away from OTC transactions towards organized exchanges.
- The IMF's response to recent and emerging global economic and challenges, and the evolving nature of its role.
- The most appropriate role of regional arrangements in financial stabilization, based on experiences with such arrangements in this and prior episodes of crisis.
- In particular the roles of regional financial arrangements in Asia and the BRICS facilities announced in July, 2014 are analyzed as parts of the emerging RFA structures that could lead to a more efficient and equitable financing for development.

The methodological approach adopted here is a type of *constructivist* and *evolutionary* analysis of our complex international economic system and political economy. The technical work on aspects of this dynamic complex adaptive economic systems or DCAES in short, has been done in Khan(2004, 2011; Lin et.al. 2008) among other sources. The institutions I discuss and the alternatives I propose here are all path dependent, but in a non-deterministic manner . Social practices based on collectively held ideas by both elite and non-elite groups can matter in

Griffith-Jones S (2011). South-South financial cooperation. Background Paper No 2 to UNCTAD's *Least Developed Countries Report, 2011*. Available at: <http://www.stephanygj.net/papers/SOUTHSOUTHFINANCIALCOOPERATION2012.pdf>.

crucial ways. However, given the structural aspects of global financial and economic system and the conflicting ideas and norms, there are serious contradictions at all levels of the system. Recognition of such contradictions and conflicts at both ideational and material levels dialectically forms the “critical” part of my constructivist adaptive complex systems approach(Khan 2004,2006,2011).²

In analyzing the above in the context of the Developing Countries (DCs) in particular, the following features of DCs are highlighted among others:

- a. DCs have fewer resources for coping with financial crises, particularly one which is global in its scope;
- b. Most DCs lack automatic stabilizers due to the embryonic nature of their fiscal and social protection systems;
- c. They have limited ability of borrow in international financial markets and this limits their ability to pursue countercyclical policies;
- d. These threats are often exacerbated by global financial market integration and Free Trade Agreements (FTAs) and bilateral investment treaties(BITs). Many WTO commitments also affect the DCs adversely. IMF pro-cyclical Structural Adjustment Policies can also constrict the policy space.

The social and political construction of global and regional financial arrangements also depends critically on a supporting structure of complementary institutional network (CIN), norms, ideas and practices. Global financial architecture (GFA) and Regional financial architecture (RFA) both depend on their respective CIN within a global system of nation states and international organizations. Given the real interdependence within the system, all actors have some stake in sustained growth and stability with equity. At the same time part of the complexity of the global financial system arises from various contradictions and asymmetries in the system itself. Thus the central argument of this paper is that sustainable policies at the national level require a supporting network of GFA and RFAs that go some distance towards resolving the key issues

² At the same time corporate actors are legitimate under some conditions. In this my analysis is similar to Wendt's (1987, 1999) constructivist approach which does not contradict a deep and sophisticated version of Scientific Realism. Indeed, both Wendt and I build upon a scientific realist ontology avoiding narrow determinism. See also Khan (2003a,b; 2008c), Best(2010), Blyth(2002) and Abdelal (2007).

arising from such contradictions and asymmetries. Appropriate national policies in their turn can contribute to the sustainability of the GFA and RFA. It can be shown that following an evolutionary theory of international financial institutions, two broad types of possible Global Financial Architectures can be identified.³ In this paper, following Khan (2002c) the first is called an *overarching type*, exemplified by the classical gold standard and the defunct Bretton Woods system. The second is called a *hybrid form* that allows for the existence and coevolution of some Regional Financial Architectures as well. The changing roles of the IMF and national economic policies can be examined within these two possible financial architectures under globalization. The ongoing politics of re/construction of IMF along a more functional and equitable line is and will remain complex and require a separate treatment that is beyond the scope of this paper and therefore is not attempted here. However, the tentative steps taken towards regional cooperation in Asia since Asian Financial Crisis (AFC) are discussed to illustrate the opportunities and challenges posed by the need to evolve towards a *hybrid* GFA. The opportunities and challenges arising from the current global crisis are analyzed in this context.

In light of the above observations, in this paper I will discuss the problems of creating and expanding national macroeconomic policy space and economic governance for the developing countries in particular within a framework of overall global and regional financial architectures. The context of the current global financial and economic crisis gives such an exercise an undeniable urgency. However, the theoretical approach towards a type of constructivist analysis which respects the structural complexities of a global real-financial economy with serious asymmetries, problems of managing risk and uncertainty and uneven development may have broader applicability beyond the current crisis. Whether state capacities exist for formulation and implementation of national economic policies may depend in large measure on the kind of global and regional financial architecture in existence at any point in time---with or without financial crises.

The structure of the paper is as follows. In section 2, the proposed Basel III reforms and their implications for the developing world are discussed. Controlling portfolio capital flows,

³ For specific models and arguments see those developed in Khan (2001, 2002c, 2004 and 2005,2006) and Khan *et al.* (2008). Khan (2001; 2005) formalizes various types of path dependence. In Khan (2002c) a specific argument called “the extended panda’s thumb” is advanced to urge the utilization of the existing IMF with some modifications in a new, hybrid GFA. The arguments developed here also are consistent with Griffith-Jones(1998). See also Griffith-Jones et al.(2003,2006,2010 and 2013), Eichengreen(2013a,b;1999), and Eichengreen and Dincer(2013).

particularly in the form of derivatives are an important dimension of preventive measures which can overlap with a reregulated banking but still go beyond this. For this reason, section 3 takes up BIS proposals for better regulation of financial derivatives, including commodities futures, by moving away from OTC transactions towards organized exchanges in the context of the developing countries' special needs. Important as the issues in these two sections are, without a new and workable Global Financial Architecture, the prevention or even management of financial crises will very likely be impossible for the developing countries in particular. Therefore, the remainder of the paper until the concluding part concentrates on the problems of a new GFA and presents the case for a hybrid GFA.⁴The final section concludes.

2. Proposed BASEL III reforms for more stringent capital requirements and their implications for the developing world: limitations and need for hybrid financial architecture with BRICS-like multi-regional financial architectures

The banking and finance world is now witnessing a transition from Basel I and II to Basel III. Drafted in 1988, the Basel I Accord was the first to set minimum capital requirements for international banks. The goal was to stop international banks from evading national regulators. Equity capital and published reserves from post-tax retained earnings (Tier I capital) were required to be equivalent to 8% of risk-weighted assets. Tier 2 capital requirements (reserves to cover losses, subordinated debt holdings, gains from the potential sale of assets, etc. were set at the same levels for Tier I capital. Much of the accord focused on delineating the appropriate

⁴ Khan(2004, 2006, 2011 and 2013) presents arguments for investment and consumption demand led growth with investment receiving priority in a Kaleckian model. See also the model of a complex financial economy in the appendix which is inspired by Kalecki's approach. An excellent recent argument for investment-led growth is presented in Cozzi, G. and Stephany Griffith-Jones.2014. "Investment-led growth: a solution to the European crisis". Foundation for Progressive Studies.

risk-weights for assets. Risk weights were drawn to privilege sovereign debt, public sector entities and long term claims on other banks. Mortgage and private sector debt were weighted much higher (50% and 100% respectively). The 1998 accord allowed national supervisors to implement stronger/supplementary measures of capital adequacy for nationally chartered institutions.

Drafted in 2004, Basel II represented a significant revision of the 1988 accord. It expanded the scope of the 1998 accord to cover alternative approaches to a variety of topics. The goal of the accord was to promote the adoption of stronger risk management practices by the banking industry. The three pillars rationale (minimum capital requirements, supervisory review and market discipline) was developed as a conceptual framework on the revision of the initial accord. While many of the key elements of the Basel I were kept in place (general requirement for banks to hold capital equivalent to at least 8% of risk-weighted assets, 1996 Market Risk Amendment, and the definition of eligible capital), a major change in the way risk was assessed was put into place. It allowed risk to be assessed under Bank's own internal models, thus relying upon banks to largely self-monitor their own risk-taking strategies. National supervisors were to buttress internal risk assessments by assuring minimum compliance to national standards. And banks were required to provide more public disclosures related to its capital positions. The Basel II framework was more risk sensitive than the 1998 Accord. Operational risk and market risk were separated from credit risk.

Table 1: Key Features of Basel I and II

Key Features	Basel I	Basel II
<p>Capital Adequacy Requirements (CAR)</p>	<p>Tier I Capital Requirements:</p> <ul style="list-style-type: none"> • Equity capital and Disclosed reserves • Had to be held at 4% of risk weighted assets <p>Tier II Capital Requirements:</p> <ul style="list-style-type: none"> • Miscellaneous debt • Held at 8% - Tier I holdings 	<ol style="list-style-type: none"> 1. Tier I & II requirements were not changed. 2. Assets of holding companies were included into requirements of banks. 3. Capital Reserves = 8% * Risk Weighted Assets + Operational Risk Reserves + Market Risk Reserves
<p>Risk Weighting</p>	<p>Categories of risk weights:</p> <ol style="list-style-type: none"> 1. 0%--included cash, sovereign debt held in domestic currency, OECD debt 2. 20%--development bank debt, OECD bank debt, short term non-OECD debt 3. 50%--mortgage debt 4. 100%--private sector debt 	<ol style="list-style-type: none"> 1. Sovereign debt was weighted according to its credit rating. 2. Bank debt could be indexed to sovereign debt ratings or to their specific ratings. 3. Private corporate debt rated junk was weighted at 150%. 4. Home mortgages were risk-weighted at 35%; corporate mortgages 100%.
<p>Other Features</p>	<ul style="list-style-type: none"> • Promoted the harmonizing of national regulations • Allowed national regulatory specificities into capital requirements 	<p>Banks could choose between three approaches to risk weighting:</p> <ul style="list-style-type: none"> • Standardized Approach • Internal Ratings (IRB) Approach • Advanced IRB Approach <p>Operational risk and market risk was separated from credit risk.</p> <p>Bank disclosures were made public.</p> <p>Regulators were given additional powers:</p> <ul style="list-style-type: none"> • Creating capital buffers requirements • Intervene into internal risk modeling

Further Evolution: Going from Basel II to Basel III

Under Basel III, banks will be required to hold more capital against their assets than under Basel I and II. Among other things, this will have the effect of decreasing the size of their balance sheets and their ability to leverage themselves. The minimum amount of equity, as a percentage of risk-weighted assets, will increase from 2% to 4.5%. There is also an additional 2.5% buffer requirement, the so-called ‘capital conservation buffer’, bringing the total equity requirement to 7% [Caruana 2010, 4]. Total risk-adjusted capital requirements will remain unchanged at 8% [Demirguc-Kunt, Detragiache and Merrouche 2010, 4]. Deferred tax assets, mortgage servicing rights and other obscure forms of capital are now not allowed to be used to boost capital levels. Deployment of capital and payment of dividends will be constrained more. In effect, banks will be required to triple core Tier I capital ratios from 2% to 7% to hold against potential losses. They have until 2019 to implement these requirements [Masters, Hughes and Tait 2010].

There is also agreement on tough new liquidity rules. With the so-called “*liquidity coverage ratio*,” “for the first time that Basel rules have specified a notional global target for liquidity needs [Masters 2010]. The rule would require banks to hold enough cash and sovereign debt to survive at least a month-long market crisis. Banks will have to hold reserves equal to 100% of undrawn corporate borrowing lines. This could be potentially problematic for developing market banks in countries without liquid government bond markets. A second liquidity rule, the “*net stable funding ratio*,” would seek to reduce banks’ dependence on short-term funding. Like much of the agreement, there is considerable delay over when banks have to begin formally observing the rules. For the new liquidity rules, banks have until 2015 to put them into place [Masters 2010].

Basel III imposes tougher requirements on the bonds that banks can count towards their regulatory capital. So-called hybrid securities which sit between equity and debt and were intended to act as a buffer to soak up unexpected losses must now include a mechanism (so-called ‘bail-in’ mechanism) for taking losses. This would allow them to be converted into equity or written off [Hughes and Masters 2011]. This rule will have to be implemented domestically (through national regulatory laws) or individually (through each bond issue) by 2013. Hybrid forms of debt like this and preferred shares are used to bolster regulatory capital and are cheaper

to issue than equity. However, Basel III will force the phasing out of these types of protected forms of debt.

The Basel Committee has also proposed a countercyclical buffer that could be imposed when aggregate credit growth is rapid enough to build up system-wide risk [Caruana 2010, 5]. The buffer would be as large as 2.5% of risk-weighted assets and would be released on the judgment of domestic authorities to help absorb losses. Systemically important banks may also be asked to operate under more stringent rules. Capital surcharges, contingent capital, bail-in debt arrangements and peer reviews are policies that could be employed under rules delineated for these kinds of institutions [Caruana 2010, 5]. Basel III also embeds a reciprocity agreement into the operation of the agreement's countercyclical capital buffer:

“Consider the case of a country in the region receiving strong capital inflows and experiencing rapid credit growth and buoyant asset prices. Before Basel III, any tightening in capital required of locally incorporated banks would lead to the objection that foreign banks could lend to firms from offshore without being subject to the more rigorous capital requirements. With Basel III, however, internationally active banks would be required by their home regulators to calculate the countercyclical capital buffer add-on for exposures to the country whether booked in the local subsidiaries or offshore” [Caruana 2010, 5].

In 2008, the Basel Committee opened its membership to large emerging markets in the hope that a more globally relevant set of standards could be conceived [Taylor 2010]. In some ways, developing countries *were able* to help shape a couple of the rules. New capital rules would have penalized countries which require international banks to take on local partners by requiring these banks to strip equity held by local partners from their Tier I capital totals. However, in July of 2010, a compromise was agreed upon to the benefit of these emerging economies [Masters 2010]. For **key milestones** of Basel III upto 2018, the reader is referred to the **Appendix. As of July 22, 2013, the US and EU have accepted many provisions. For example, it was announced recently for the US:**

The federal banking agencies have just adopted comprehensive regulatory capital rules that will implement **Basel III** in the U.S. In turn, it is time for banking organizations to understand the new rules and bring themselves into compliance with them by the beginning of 2015 (2014, for the largest banking organizations). The new rules make important changes to the definitions and components of, and minimum requirements for, regulatory capital; revise the required regulatory deductions from, and adjustments to, regulatory capital; and create a new “standardized approach” framework for the risk-weighting of assets on the banking and trading books of U.S. banks. In addition, the federal banking agencies have made some important changes to the “advanced approaches” regulatory capital framework that applies to the largest U.S. banking organizations.

Topics of discussion will include:

- The revised minimum capital requirements, and the new definitions of capital;
- Required deductions from and adjustments to capital;
- The new “standardized approach” framework for the risk-weighting of on-balance sheets assets and off-balance sheet exposures;
- Changes to the advanced approaches capital framework;
- The major changes made in the final rules from the June 2012 proposed capital rules;
- The agencies’ proposed supplemental leverage ratio requirements for the largest U.S. banks; and
- Other recent and prospective regulatory capital developments.⁵

However, Andrew Cornford is on the mark when he states:

While the inclusion of the leverage ratio in Basel III is an attempt to strengthen the Basel capital framework, it only sets regulatory minima and is soft international law.⁶

Capital Adequacy Ratios (CAR) and Developing Markets

Stricter definitions on what constitutes core Tier I capital is of interest to developing market banks. Banks are going to have to hold much higher levels of common equity to satisfy their Tier I requirements [Caruana 2010, 4]. Resilience and capability will be judged, then, by the soundness and depth of equity markets in developing countries. No doubt, domestic debt and equity markets must be strengthened to provide space for banks to raise fresh capital. Improving the quality and depth of debt and equity markets in developing countries will be quite a task, especially for countries who currently have very limited markets.

Boosting capital adequacy requirements may indeed lead to institutions being perceived as safer, lowering their costs of capital. Larger banks would benefit most by being able to issue debt more cheaply. Banks and corporate firms that are guaranteed through large banks will probably see their costs of issuing debt decrease. This will occur, because bonds issued by these institutions will be an attractive investment for firms wishing to purchase assets that are lower risk-weighted.

⁵ See <http://www.lexology.com/library/detail.aspx?g=5afa5218-6a75-4801-9efa-90699fd7d2af>

Last consulted on Aug. 1, 2013

⁶ See the Triple Crisis Blog, <http://www.triplecrisis.com/> (last checked on Aug. 3, 2013) and also Cornford(2013) at the IDEAS site http://www.networkideas.org/news/jul2013/news19_Basel_III.htm (last checked on August 3, 2013)

The effects of higher CARs on banks are nuanced and difficult to tease out. Simulations done on the effects of Basel II and increased capital adequacy ratios on the Brazilian and Mexican economies showed that GDP in each country would be adversely affected [Barrell and Gottschalk 2010]. The analysis showed that a credit crunch would occur in each of these cases, and accompanied by an increase in lending rates. Although the Basel II reforms were never implemented fully, marginal changes in the nature of capital requirements will most likely not affect the results of the econometric analysis. If anything, tougher capital restrictions and more stringent ratios might affect GDP even more adversely.

From a different perspective, econometric evidence by Ediz, Michael and Perraudin (1998) showed that UK banks responded to regulatory pressures to add to their individual CARs not by lowering their risk or lending profile, but by actually increasing their capital provision. As a result, risky portfolios were complemented by raising new capital [Gottschalk and Sen 2010, 22]. In the wake of Basel III then, it might be more difficult to tease out how even the developed country banks could respond to more stringent capital requirements. That the success of raising capital in equity markets was buoyed in 2010 can be noted here. As regards developing countries, banks in search of returns may therefore not shy away from ramping up lending and investment operations. Indeed, it is feasible that the total amount of credit to developing countries may continue to increase. More important, where and to whom will that credit go?

This result should be compared against the finding by Montgomery (2005) which indicated that since Basel I was implemented, international banks based out of Japan reduced their risk profile. This was, in part, caused by regulatory pressures from the MOF and BOJ.

Econometric analysis on developing country banks showed that poorly capitalized banks reduced risk when under regulatory pressure (from Basel I and II regimes), as opposed to raising new capital [Gottschalk and Sen 2010, 23]. More stringent CARs under Basel III will force poorly capitalized banks in developing countries to make difficult choices over how they will provision capital and furthermore, how they will dole out credit.

Banks in large developing markets have had to hold CARs higher than the 8% minimum under Basel for some time now [Gottschalk and Sen 2010, 24]. This is a result of domestic regulatory regimes which were more stringent than Basel I and II regimes. As a result of these regulatory regimes, higher banking concentration occurred in Brazil. Credit to the private sector declined, and holdings of sovereign securities went up significantly [Gottschalk and sen 2010,

25]. This is directly related to the risk-weighting formula imposed by earlier Basel regimes. The same effects have also been seen in India [Gottschalk and Sen 2010, 28-29]. Increases in bank credit have notably lagged behind increases in deposits and holdings of sovereign debt by large Indian banks. Credit towards SMEs (as a percentage of total credit) fell by half between 2000 and 2007 [Gottschalk and Sen 2010, 29].

Credit Access under Basel III

New leverage requirements on Tier I and Tier II capital may mean that banks will be induced to reduce both their exposure to riskier assets to a significant degree [Gottschalk and Sen 2010, 20]. For developing economies, the implications are serious for much of the formal economy. Evidence of credit rationing from earlier Basel implementation is pertinent here. The introduction of Basel I in Brazil and India in the 1990s helped lead to a continual decline in total credit (as a percentage of GDP). Credit expansion in India slowed over the same period [Gottschalk and Sen 2010, 17]. Under Basel II simulations, access to household credit in large developing nations did fall significantly. However, higher interest charges vis-à-vis higher capital ratios would most likely lead to a decrease in household wealth and consumption [Barrell and Gottschalk 2010]. Basel II accords meant that domestic and foreign banks in emerging markets would have to ration credit away from SMEs and towards larger institutions (for standard risk and information-gap reasons) [Calice 2010].

Under Basel III, pressure from regulatory authorities may lead to further rationing in developing markets by commercial banks. Less credit to SMEs in the formal sector and to others in the informal sector will obviously play a role in reducing the overall economic activity of the country in question. Informal sector-formal sector linkages may further exacerbate the problem, as the SAM-CGE modeling in another context by Sinha and Khan(2010) shows.⁷

Developing World Banks and Competition under Basel III

Basel II had already presented tremendous implementation challenges for banks in developing countries [Gottschalk 2010, 3]. The challenges included the need to build large databases to run sophisticated risk models and to import the human capital necessary to assess,

⁷ See Anushree Sinha and Haider A. Khan, 2010. "The Gains from Growth for Women in India: A SAM- and CGE-based analysis," in Amelia Santos-Paulino and Guanghua Wan ed. *The Rise of China and India: Development Strategies and Lessons*, Palgrave/Macmillan,

monitor and act on such models [Gottschalk 2010, 4]. These costs were detrimental to competition against large foreign banks which had the resources to use these models to their advantage. Complying with Basel II meant that developing country banks had to divert resources away from activities that directly benefit economic growth and poverty alleviation in developing countries [Gottschalk 2010, 7]. Some of the PRSP documents allude to this problem. Clearly, this has implications for MDG goals and MDGRs that will need further exploration for which the LDCs in particular are poorly equipped.⁸

Technically, Basel III is going to be very difficult to implement for banks in the developing world. Proposals involve sophisticated stress testing that goes beyond the capacities of banks in developing markets [Taylor 2010]. While banks have until 2019 to meet Basel III requirements, domestic financial markets will face global concerns that will constrain their ability to meet requirements. Loose monetary policy in the developed world will continue to funnel cheap money to developing markets. Reigning in this money by meeting Basel III standards would be beneficial and relatively painless. Emerging markets, though, face pressure to continue to allow cheap credit to flow in and not risk alienating foreign investors [Taylor 2010]. The unevenness and asymmetry of the current global economy and finance is particularly striking in this context.

Because developing country banks are going to be held to the same risk and regulatory standards as banks in the developed countries, it will be critical to see to what extent developing country banks can realistically handle all of these new requirements.. The Basel Committee “has raised the bar for the supervisory review of risk management practices” [Caruana 2010, 3]. Areas that are more fully addressed in the new management rules include: firm-wide governance⁹, capturing off-balance sheet exposure risk and securitization activities, valuation processes for financial instruments, stress testing programs, risk concentrations and aligning risk and return incentives. Transparency is also being stressed. New rules from the Committee require that banks “disclose all elements of the regulatory capital case, the deductions applied and a full reconciliation to the financial accounts” [Caruana 2010, 3].

⁸ See Haider A. Khan, 2006b. “An In-Depth Review of the Country Millennium Development Goals Reports,”(submitted to UNDP) which anticipates some of these problems.

⁹ This was already an issue in the aftermath of the AFC for the Asian economies. See Khan (2004) chapter 6, pp.98-144 on corporate governance for a detailed discussion.

As regards capital requirements, leverage ratios for Tier I capital will not probably be of much relevance to developing market banks which rely mostly on equity, reserves and deposits. Their Tier I ratios are already high. Most big banks in China and India hold core Tier I ratios above 9% [Masters 2010]. A slowdown in the proliferation of financial products means less to these kinds of banks.

One of the major critiques against Basel I and II was its bias towards bank concentration and towards less diversity in financial sectors in terms of ownership, role and size. Financial innovation was also hampered [Gottschalk 2010, 4]. Unless developing market banks can, over this decade, bring up to speed the risk-management and supervisory capacity that exists elsewhere, they face serious competitive issues. Further liberalization of financial markets in accordance with the Washington consensus will only compound this issue. This has serious implications for borrowers who may get shut out if international finance comes to predominate in domestic banking systems. The most serious problems may arise in the SME financing for employment and development.

States as Collective Corporate Actors and Basel III

National regulatory authorities will have to begin incremental implementation of Basel III on January 1, 2013. Implementation will end on January 1, 2019 [Caruana 2010, 6]. To implement the new rules, authorities must be able to engage in an ongoing dialogue with senior bankers on business and risk models, have a more intensive and effective presence in the banking sector and be capable of developing the capacity to have broad power for early intervention and corrective action [Caruana 2010, 7]. Regulators will need clear mandates, independence, accountabilities, tools and resources adequate enough to do their job in using Basel III to strengthen domestic financial and banking systems. Risk management systems to be imposed domestically by Basel III face serious impediments in developing markets. Implementing and monitoring such systems require high levels of human capital and other things not readily available in emerging markets: independence, legal protections and integrity to challenge corruption at the State level [Taylor 2010].

Domestic banking systems which implemented Basel I and II saw a distinct trend towards higher banking concentration, more distinct division of labor between larger and smaller banks (and between foreign and domestic banks)' and changes in banks' portfolios away from credit to

the private sector and towards government securities. These systems also saw a trend away from corporate credit and towards consumer credit [Gottschalk 2010, 2]. Basel II had an implicit bias against SME borrowers towards larger corporations. As capital requirements and definitions are more stringent this time around, the major focus for States will be how to make up for the impending problem of credit rationing by domestic banks away from small but productive businesses in the economy.

To address this problem, some options do exist under Basel III. States in the developing world will see their ability to issue sovereign debt buoyed by Basel III. Because sovereign debt carries a very low risk weight, it will continue to be a preferred method of asset creation through loan expenditure by international banks. Developing countries must thus be wary of the attractiveness of its sovereign debt to banks that are looking to manipulate their capital and risk structures. Simulations done on the effects of Basel II on sovereign access to credit and spending showed that countries would be more likely to increase their spending and deficit levels [Barrell and Gottschalk 2010]. As we already know, Basel capital requirements have forced banks to disburse an increasing portion of priority credit towards more profitable, but not necessary productive, endeavors [Sen and Ghosh 2010]. These sources include many forms of consumer credit. “Social priorities of credit” have been negatively affected by the Basel regimes [Gottschalk 2010, 12]. Fiscal policy, whether direct or through policy banks may not be able to make up for the credit gap that forms as Basel regimes hit smaller banks in developing countries. The attractiveness of sovereign debt then could provide means for the State to channel more financing towards State development banks or to firms directly. As such, they must traverse a thin line between excessive and perhaps anti-developmental fiscal conservatism and one that promotes expenditures/lending for pro-poor and development activities without much fiscal prudence. Critical to this cause, the IMF and the World Bank must allow for countries to use their policy space to further promote growth and development priorities, especially under the new Basel regime.

Thus for developing market banks, States will have to find creative and reliable means for their banks to meet capital requirements more easily. For this purpose, the nurturing of nascent equity and bond markets will be critical. Developing new instruments and financial markets are tedious and time- and resource-consuming. If developing market banks are not able to increase their buffers through equity or bond markets, then they face serious competitive

issues from international rivals. This will especially be the case in countries that have liberalized their financial markets. The Basel Committee has sought to allay these worries by lengthening the time over which the developing country banks need to come into compliance. With that said, any push to strengthen financial market depth and maturity could lead to fewer resources going to generate sustainable growth and pursue poverty- reduction.

It must also be emphasized that inadequate regulatory capacity will make it difficult for developing markets to cope with financial innovation, and ultimately to keep the financial system stable. Multilateral institutions will have to be ready to provide technical support and resources to help countries deal adequately with the implications of Basel III on regulatory authorities. States will also have to find ways to hang onto the critical regulatory staff. Regulatory staff proficiency has been a recurrent problem in developing countries, because many competent staff are hired away into the private sector [Prasad 2010, 13].

Finally, the Basel Committee Macroeconomic Assessment Group (MAG) has produced an estimate of the implications of Basel III on the global economy. Its results show a maximum decline in the world's GDP of 0.22% over the next decade from its baseline forecast [MAG 2010, 2]. These estimates include the potentiality of spillovers across countries. Countries that rush to put Basel III in place may face relatively larger reductions in GDP and growth [Prasad 2010, 6]. Firms that are already well stocked with capital and/or are able to shift their risk profile towards safer assets will fare much better over the next decade. They will be able to offer debt more cheaply and avoid cutting back on lending volumes [MAG 2010, 2].

Lending volumes are projected to fall by 1.4% relative to baseline estimates over the next decade [MAG 2010, 5]. Lending spreads are projected to widen by 15.5 basis points during the same period. To ensure positive effects of spreads and lending volumes on future growth is critical. Based on the MAG models, tighter lending requirements in the face of Basel III could have a larger negative effect on world GDP than in models that weight the effect of credit spreads on volumes more heavily. Models also forecast that growth will be lower for countries that do not (or cannot) employ monetary policy to address the effects of higher capital requirements [MAG 2010, 6].

In light of these econometric estimates, further emphasis here is placed on the ability of States to use fiscal and monetary policy to support the growth of their economies. Because poor States are already fiscally constrained (whether through tax capacity, IMF/WB conditionality,

economic shocks/hardships), Basel III further complicates the growth and poverty-alleviation picture. Unfortunately, it means that these States will need to become more reliant on each other to implement the reforms and support regional development initiatives. Failure to do so will then mean that States will have to become more reliant on international technical expertise and resources. In this light that fact that the States have a full decade to delineate and implement a proper course is not as long a time horizon as it first appears to be. Even if the banking sector is adequately reformed, the proper use of financial markets will also require an enabling global financial architecture and an overall reduction of systemic risk. In the next three sections I take up these topics. The next section discusses risks arising from the OTC derivatives markets. The two sections following discuss the role of a reformed IMF and regional financial architectures in promoting financial stability for pursuing development policies leading towards equitable and sustainable growth and poverty reduction.

3. BIS proposals for better regulation of financial derivatives, including commodities futures, by moving away from OTC transactions towards organized exchanges. Pre-Crisis Buildup of Problems : limitations and need for hybrid financial architecture with BRICS-like multi-regional financial architectures

Recently BIS annual report summarized its current position as follows:

Since 2007, actions by central banks have prevented financial collapse. Further accommodation is borrowing time for others to act. But the time must be used wisely. The focus of action must be on balance sheet repair, fiscal sustainability and, most of all, the economic and financial reforms needed to return economies to the real growth paths authorities and the public both want and expect (Chapter I). After reviewing the past year's economic developments (Chapter II), the remaining economic chapters of the 83rd Annual Report cover the critical policy challenges in detail: reforming labour and product markets to restore productivity growth (Chapter III), ensuring the sustainability of public finances (Chapter IV), adapting financial regulation to ensure resilience of the

increasingly complex global system (Chapter V), and re-emphasising the stabilisation objectives of central banks (Chapter VI).¹⁰

The hallmarks of the global financial crisis were the contagion and counterparty risks taken on by financial institutions. Both of these arose at least in part from banks involving themselves in capital market activities for which they did not carry enough capital. Securitization and its warehousing on and off-balance sheets proved to be an intractable problem even for the firms involved. In the U.S., Variable Interest Entities (VIEs) to which banks are linked had to be consolidated onto balance sheets if banks became insolvent or if liquidity of funding became problematic. Capital regulations simply could not cope. Similarly, counterparty risk became a major issue with the failures of Lehman Brothers and AIG [Blundell-Wignall and Atkinson 2010, 5].

During the pre-crisis period, financial firms were able to increase the asymmetry of information and costs for consumers in the OTC and exchange-traded derivatives marketplaces through the internalization of information. This led to higher bid-ask spreads that benefitted financial firms' fee schedule. Customers were left in the dark on the intricacies of contracts, the risk of holding such contracts and were forced to pay more for the contracts than they would otherwise. Had these contracts been transparent and competitive, the price would have been much lower. This lack of transparency and a noncompetitive, imperfect market structure is coupled with sheer size of the derivatives industry. At its peak in June 2008, the outstanding notional amount of contracts stood at \$760 trillion, equivalent to the value of everything produced on Earth in the previous 20 years [Financial Times 2010].

Emerging Markets

Daily turnover in derivatives in emerging markets has expanded fourfold over the past decade, to over 6% of emerging market GDP [Mihaljek and Packer 2010, 44]. Daily turnover derivatives was about \$1.2 trillion daily last year [Mihaljek and Packer 2010, 44]. While this daily turnover is still less than a tenth of the turnover in advanced economies, the figures are notable. Since 2001, turnover has increased by over 300%, a faster rate than the increase in the daily turnover in advanced financial markets (~250%). Both OTC and exchange-traded

¹⁰ See <http://www.bis.org/publ/arpdf/ar2013e.htm>
Last consulted on August 1, 2013.

transactions are substantial. Most of these derivatives are foreign exchange derivatives (around 50% of the total daily turnover) [Mihaljek and Packer 2010, 45].

A growing majority share of these transactions are being completed cross-border and offshore. Counterparties to FX derivatives trades are increasingly doing cross-border business; cross-border shares have risen to 67% in 2010 from 59% in 2004 [Mihaljek and Packer 2010, 48]. This ratio now mimics that found in advanced economies. Offshore trading of currency has increased substantially as well. For example, more than 90% of trading in the Brazilian real, the Mexican peso, the Hungarian forint, the Polish zloty and the Turkish lira takes place offshore [Mihaljek and Packer 2010, 55].

OTC markets are more important for derivatives trading in emerging markets. Half of turnover occurs on OTC markets in these countries. In advanced countries, the ratio is more like 60/40 [Mihaljek and Packer 2010, 44]. Of the OTC derivatives transactions in emerging markets, nearly 90% are foreign exchange derivatives [Mihaljek and Packer 2010, 45]. This makes any proposals coming out of the BIS on OTC reform especially important for derivatives markets that are maturing in emerging economies.

The financial crisis did not work to reverse the proliferation of OTC and exchange-traded derivatives in emerging markets, unlike in advanced economies. The total daily turnover of derivatives (both markets) increased by a quarter from 2007 to 2010 [Mihaljek and Packer 2010, 46]. Notable and expected, lightly-regulated traders (pension, insurance, hedge funds) have increased their share of total turnover by nearly a third during this time period as commercial and investment banks have had to slow operations. Reporting dealers constituted only 43% of daily turnover in OTC FX trading in 2010 [Mihaljek and Packer 2010, 49]. This could be particularly problematic as reform on these transactions goes further.

As countries continue to develop their financial markets and their economies grow, the proliferation of OTC and exchange-traded derivatives markets will occur making the institution of a proper regulatory structure a clear imperative [Mihaljek and Packer 2010, 55].

Financial Derivatives

World OTC derivatives markets have seen shrinkage in volume during the last couple of years. Despite the proliferation in OTC markets in emerging markets, the value of outstanding contracts fell by about 4% in the BIS latest figures. Most of the shrinkage has been in the market

for credit default swaps, as companies and countries have largely (save Europe) been able to recover from the financial crisis.

Leading regulatory figures have stressed that derivatives markets must become more transparent, not only amongst themselves, but with the public as well. In the wake of the crisis, firms which have large derivatives trading desks have had to vastly increase the information they provide to regulators about their positions [Mackenzie 2010]. More is going to be asked of these traders in the future. It is hoped that greater transparency will allow customers to both have more knowledge of these products and be able to demand smaller bid-ask spreads [Mackenzie 2010]. As part of new Basel III proposals, banks will be required to apply tougher and longer margining periods as a basis for determining regulatory capital when they have large and illiquid derivative exposures to a counterparty [Blundell-Wignall and Atkinson 2010, 9].

Commodity Futures

Financial market dynamics have played a part in fuelling the most recent commodity-boom. Regression analysis has shown that commodities are uncorrelated or negatively correlated with traditional asset classes of equities and bonds. Such analysis has allowed investment portfolios to hold commodities to reduce risk and enhance returns. More non-traditional players have entered the market as the financial crisis deepened and spread.

Global turnover in commodity derivatives has grown significantly over the past several years but remains volatile. According to BIS statistics, the notional value of OTC commodity derivatives contracts outstanding reached \$6.4 trillion in mid-2006, about 14 times the value in the late 1990s [Domanski and Heath 2007, 53]. By the middle of last decade, the share of commodities in overall OTC derivatives trading reached nearly 2% [Domanski and Heath 2007, 53]. Outstanding commodity derivatives contracts peaked in 2008 (\$13.3 trillion notional amount outstanding) and have declined rapidly in the wake of the crisis. In June 2010, the notional amount outstanding was around \$3 trillion [BIS Quarterly Review 2010, A121]. Compared with physical production, the volume of exchange-traded derivatives was around 30 times larger for major minerals in 2005 [Domanski and Heath 2007, 54]. At that time, 90% of swaps and options trading in oil was done in the OTC market. Speculation on U.S. commodity exchanges now probably constitutes the majority of all interest/positions on these markets.

Fund managers and other investors have also piled money into commodities markets. During asset bubbles or even during a partial downturn, the return on going long in these markets is compared with many other asset classes [Domanski and Heath 2007, 55-56]. High commodity prices will continue to shape manufacturing decisions and future trade flows. Elevated shipping costs and scarcity in some commodities markets raise the stakes on ensuring that exchanges and markets in the future are conducted in a fair and licit manner. Needless to say, prolonged political turmoil can inevitably complicate the picture. The volatility of prices is both a cause and an effect of this turmoil. Thus we are indeed dealing with a complex dynamical system.

Thus commodities markets now are very similar to mature financial markets and exchanges. The BIS admitted as much in a paper on financial investors and commodity markets back in 2007 [Domanski and Heath 2007, 54]. The increasing diversity and complexity of financial instruments in commodities markets demand an increasing need for infrastructure and regulation to protect actual supply and demand interests [Kiang 2008, 2]. The 2007 BIS paper acknowledged that evidence pointed to price levels and volatility in commodities markets that could not be justified by economic fundamentals [Domanski and Heath 2007, 61-62]. Prices were supporting speculative investor/ interests, as opposed to sound commercial interests.

Organized Exchanges for OTC transactions

Counterparty risk arising from the use of OTC derivatives was one of the key hallmarks of the crisis. Regulatory arbitrage and shifting promises was an important contributor to the explosion in credit default swap(CDS) use. Tax arbitrage too has allowed promises to be transformed with strong implications for bank on- and off-balance sheet activity. In 2009, key regulatory officials from the BIS and around the world sought to discuss and then formulate ways to regulate OTC markets. As it stands, the interest rate swap market is the only OTC derivatives market in which actors and financial institutions rely on central clearing mechanisms in any way. Forty five per cent of this market is based in London. The uses of clearing houses for other OTC transactions are virtually non-existent [Cecchetti 2010]. Currently, only less than 20 per cent of positions have been shifted to CCPs, exchanges or clearing houses .

The BIS has specifically called for the requirement that all standardized OTC derivatives be cleared through central clearing houses [BIS 2010, 61]. In their “Review of the Differentiated Nature and Scope of Financial Regulation,” the BIS stressed that these CCPs impose robust

margin requirements, necessary risk controls and minimize the use of customized OTC derivatives [BIS 2010, 61]. It also stressed that unregulated traders in these markets (hedge funds, SPVs etc.) ought to be placed under a regulatory architectures, especially given their proliferation in CDS and insurance markets in the past several years [BIS 2010, 70]. Collateral requirements on derivatives exposure (even for firms with high credit ratings) is another option being debated within the BIS.

The chief economist at the BIS and the US Fed Chairman Bernanke both have spoken about the need to require corporate derivatives users to rely on central clearing houses. Encouragement would come through requiring additional capital for contracts not cleared through a CCP [Cecchetti 2010; French *et. al.* 2010]. CCPs would have to be very well designed (strong operational controls, appropriate collateral requirements, sufficient capital, etc.) to guard against the issue of concentrating risk onto the clearing houses. Officials also spoke of the need to encourage market participants to create standardized exchange traded derivatives for all risk types currently handed in OTC transactions. Non-standardized contracts would then be place higher capital requirements on financial institutions. In the future, more serious consideration could be given towards the introduction of product registration and ‘consumer’ protection for financial innovations, products and contracts. This kind of consumer protection, product registration scheme would be akin to a “pharmaceutical style warning system” [Financial Times 2010].

Another goal of early discussion would be to increase transparency in the CDS(Credit Default Swap) market so as to improve the ability of market participants to identify potential problems [Cecchetti 2010]. Increasing transparency would have to involve targeting the “index and single-name CDS contracts that are relatively liquid and standardized...[and] introducing trade-reporting similar to that in the TRACE system, which provides post-trade price transparency for US corporate bonds” [Cecchetti 2010].

U.S. And EU legislation will require financial institutions to trade through CCPs, but many market participants would be exempt from any legislation. Regulators are pushing for a narrow exemption rule to be into place that only allows non-financial end-users to be exempt from having to clear through exchanges or clearing houses [Mackenzie 2010]. Dodd-Frank Act’s further implementation will mean that many of the world’s largest derivatives traders will be subject to have transactions cleared through CCPs and other types of exchanges . Specific rules

for firms doing business within the U.S. have been set but further discussion is ongoing. Dodd-Frank will place two agencies, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC), in charge over directly overseeing these OTC markets [Van Duyn 2011]. Delineation of rules by these agencies will certainly play an important role in how the BIS and other regulators will oversee these markets in the years ahead.

Critical to the BIS proposal to move OTC transactions onto organized exchanges, banks under the new Basel III regime will qualify for a 2% risk weight for counterparty risk exposure if they deal with centralized exchanges (that meet regulatory criteria). Qualifying CCPs will receive a low risk weight (2%) [BIS CCP Proposal 2010, 1]. Default fund exposures to a CCP will be capitalized according to the estimated risk from such a default fund. This proposal creates incentives to use these centralized exchanges since higher risk weight charges will apply for bilateral OTC derivatives:

As part of the Basel III reforms, the Committee has materially changed the CCR regime. These changes significantly increase the capital charges associated with bank OTC derivatives and SFTs and thereby create important incentives for banks to use CCPs wherever practicable. [BIS CCP Proposal 2010, 2].

Rules arising from the consultation on the BIS proposal have been finalized following an impact study. CCPs will ultimately be under the regulatory reach of the CPSS-IOSCO. Any CCP that does not qualify under CPSS-IOSCO rules will force any financial institution to hold significantly more capital to protect against default of that CCP [BIS CCP Proposal 2010, 6]. The use of trade repositories (TRs) will also be boosted. TRs for CDS and interest rate derivatives already exist. They feature electronic databases of open OTC positions and publish statistics on volumes and market activity. Very little of this information is available, however [Cecchetti 2010].

In addition, the CPSS-IOSCO has issued recommendations on improving the accessibility and capacity of trade repositories. Augmenting trade repositories would provide much greater transparency to OTC derivatives markets by making available data on open trades available to the public [CPSS 2010]. Repositories standardize and make information widely accessible to all market actors.

It should be emphasized that the pervasive discussions and many proposals on OTC markets, commodity rules and CCPs are in their relative infancy. Most of the specifics are still in the consultative phase. It is hoped that by 2015, a more thorough regulatory regime will be

developed. There are many controversial areas as Blundell-Wignall and Atkinson (2010) and others have pointed out. According to the former:

Prior domestic and international regulatory regimes were unable to properly gauge to what extent securitization dampened (hid) balance sheet credit growth in the past, leading to false signals that there were no leverage problems. The same could very well occur in Basel III, where future developments in the shadow banking system could lead to similar distortions that would be impossible for supervisors and other policy makers to identify.

They also claim:

Measures/proposals from Basel and the BIS to get more OTC derivatives onto exchanges should create more reliable traded price data and improve the modeling of some of these exotic instruments. Firm-specific requirements of non-financial and financial firms for tailor-made derivatives suitable to individual needs, however, will likely contribute to the already large size of the OTC market. Individual derivatives (continually innovating) are neither conducive nor really able to be traded on exchanges. This presents a significant regulatory problem in the future [Blundell-Wignall and Atkinson 2010, 11].

The argument that there may be over-regulation of securities and derivatives markets has also been advanced. The OECD points to the activity of hedge funds, who act like “capital-market oriented banks” [Blundell-Wignall and Atkinson 2010, 13]. They are lightly regulated, issue securities in their own name and invest with leverage on behalf of investors. Market discipline in the absence of public guarantees help keep leverage ratios significantly lower for these institutions. If regulations on banks are ramped up (especially on diverse, exotic transactions), there will be a corresponding shift in the quantity and nature of business conducted within the shadow banking system [Blundell-Wignall 2010, 14].

Despite the proposal to move OTC transactions onto exchanges, Basel III “does not deal with the most fundamental regulator problem identified: that the ‘promises’ that make up any financial system are not treated equally – in particular banks can shift them around by transforming risk buckets with derivatives (particularly credit default swaps) to minimize their capital costs – including shifting them beyond the jurisdiction of bank regulators – e.g. to the insurance sector in a least regulated jurisdiction. The extent of activities in the shadow banking system also a part of the problem related to how similar promises are treated by regulators. This has many implications for the reform process” [Blundell-Wignall and Atkinson 2010, 21].

It has also been claimed that increasing capital requirements on counterparty risks provides a strong incentive to push OTC transactions onto CCPs and other exchanges. It is likely

that a significant amount of activity will be pushed here, concentrating risk onto members of the clearing houses and onto the clearing houses themselves. The total risk might be lower overall, but its concentration introduces new systemic concerns over the integrity of exchanges [S&P 2010, 6].

Furthermore, questions can be asked about the ability of CCPs and other exchanges to effectively manage the centralization of risk onto their books. Lack of availability of prices, limitations of market liquidity and product differentiation is going to make it hard for any exchange to model and contain risk. Lack of liquidity within these markets may arise if capital requirements on counterparty risk are increased. This could adversely affect the integrity of the clearing system. Tighter derivatives markets may be good for the future of the entire financial system, but it will certainly have a short- to medium-term impact on real economic activity.

As Das thoughtfully remarks:

The credit quality of the CCP is crucial. Currently, private clearing houses are contemplated. The CCP's capitalisation and financial resources as well as the risk management systems will be important in ensuring its credit standing. Commercial motivation (for market share and profit) may conflict with risk management requirements. It is not immediately apparent how these competing pressures will be accommodated. The US believes that privately-owned clearing houses are the solution. The CCP is designed to reduce systemic risk but in reality, the CCP may become a node of concentration. The heavy investment required to establish the infrastructure to clear contracts through the CCP will mean that a few large derivative dealers (probably US and European) will quickly dominate the business. Other dealers will inevitably be forced to clear and settle trades through these dealers creating different counterparty credit risk and perversely increasing systemic risk. Maximisation of benefits of central clearing requires a single clearing house. Currently, multiple CCP appear likely, as different commercial clearing houses compete for the latest frontier land grab in financial markets. National prejudices, inherent mutual distrust, promotion of national champions as well as feared loss of sovereignty and control of financial markets will mean multiple CCPs located in different jurisdictions. This will require, if feasible, inter-operability, cross margining and clearing arrangements between exchanges and jurisdictions. Instead of decreasing risk, this may create new and complex exposures. For example, international regulators are yet to agree on the definition of a standardised contract or the market participants required to transact through the CCP. It is also not clear who will regulate and oversee the system, especially where it transcends national boundaries.

From the perspective of DCs and LDCs these controversies point to an increasing need for multilateral solutions within a global framework. This leads us to a consideration of the need for a new GFA and its possible structural requirements. In the following two sections, first, in the next section, the discussion leading to a somewhat novel analytical

framework is motivated by looking at some aspects of the AFC. Following through, we can then view *the current IMF reforms* underway within the analytical framework that is developed. Section 5 then presents a more in-depth analytical look at the role of a reformed IMF along with appropriate RFAs in managing crises in a way that will recognize the problems of development and be beneficial to the developing countries.

4. Towards a Workable Development-oriented Global Financial Architecture with an Enabling Role for Regional Financial Arrangements : need for hybrid financial architecture with BRICS-like multi-regional financial architectures

4.1 A Constructive Evolutionary Theory (CET) of GFA: two evolutionary types of GFA---AFC as a Critical Case for a CET of GFA

It should be mentioned at the outset here that the Constructive Evolutionary Theory (CET) of GFA developed here is an example of evolution within a dynamic complex adaptive economic system that operates globally. The dynamic instabilities in such a system can arise in both the real and the financial parts of the system and in interactions between them. In my earlier work in the bounded rationality context using neuro-fuzzy models I was able to show the crucial role of social learning in order avoid to at least the possibility of deepening the crises if not entirely averting them. However, given the endogenous role of uncertainty and lack of coordination in a complex capitalist economy, crises can not be completely averted. The pragmatic question is how to ensure that they are not deep crises.

Malthus, Sismondi and Marx in the 19th century and Keynes and Kalecki in the 20th century analyzed some aspects of the possibilities of crisis without formalizing the complexity as such. Both Keynes and Kalecki presented models of aspects of endogenous crises from the real side. But these did not formalize complexity as such. Keynes had crucial insights about the fragile nature of a monetary economy and the role of uncertainty as opposed to insurable risk in making private and socially uncoordinated investment decisions crisis-prone, leading to periodic deficiencies in effective aggregate demand. Minsky pioneered modeling financial fragility and many of his followers have done the best work in advancing the modeling of financial fragility in a complex monetary economy.

In order to motivate the discussion that follows empirically, we can revisit some aspects of AFC before discussing the current reform moves within the IMF. In distinguishing among the countries that managed to survive the AFC and those that did not, John Williamson, one of the proponents of the “Washington consensus,” pointed out that whether or not these countries had liberalized their capital accounts could be construed as crucial. Those that had not, survived.¹¹

All Asian crisis countries had accepted the IMF’s Article VIII obligations, as evident from the historical documents. But as some¹² have pointed out, liberalizing trade and liberalizing financial sector have different policy implications. In line with the discussion in the previous section, theoretically, one should carefully distinguish the welfare impacts of financial market liberalization in an uneven world from such impact in a smooth world of equals with information symmetry. Indeed, next to unevenness, the most critical element is the role and the presence of *asymmetric information*. In a financial market, gathering, selecting, using and providing information are central to its proper functioning, yet it is precisely here that market failures from asymmetric information can arise.¹³

But the constructive evolutionary theory with appropriate attention to structure goes further than simply cataloguing moral hazard and adverse selection problems. On the *explanans* side are also *the asymmetries in the size, structure and capabilities of the economies and polities*. These asymmetries constrain some polities, particularly the economically disadvantaged ones from developing as quickly as possible in an equitable manner. The UNCTAD reports on the poorest underdeveloped countries point this out empirically.¹⁴ The theoretical significance of these features of the real world is that no uniform set of rules can work for all the economies and polities in the world. *A fortiori*, it follows that for GFA and RFAs to serve these poor countries as well as the rich countries equally well, special provisions should be in place.

It may appear that the least developed countries are only a special case. But that is not the whole truth. The NIEs, the European social democracies, Japan etc. each in its own way is also different. This poses the real theoretical challenge: how can we even attempt to theorize in the face of such diversity? The way out is through a consideration of the basic needs of the system

¹¹ John Williamson (1998), *passim*.

¹² See for example, Bhagwati(1998).

¹³ Stiglitz has been one of the pioneers of such “information theoretic” approach. For further analysis, see Stiglitz (1994).

¹⁴ See UNCTAD(2002,2003 2007).

and asking if these can be satisfied better under arrangements that are different from the old IMF and the “Washington Consensus.”

Further work by Barry Eichengreen and others¹⁵ show that it is possible to move beyond the post Bretton Woods and pre-(global)crisis situation. In contrast with the conservative Meltzer report after the AFC, all of these authors emphasize the need to strengthen the IMF in certain dimensions. However, not all of them recognize the crucial need also for the RFAs and the role they can play in creating an enabling environment for the state to implement beneficial economic policies. A completely constructive evolutionary theory of GFA recognizes the need for RFAs from both an *evolutionary* and a *structural* perspective. Given the lack of political resolve, a point made forcefully by Eichengreen among others, there is little chance of creating *institutional structures* in the manner of the 1944 Bretton Woods agreement. The recent path of the world economy does not lead to this immediately. At the same time, the recent path does not lead to only neoliberalism. It is possible to both reform the IMF, as Eichengreen suggests, and to create new RFAs to complement such reforms. Thus this theory leads to the question of identifying a spectrum of GFAs. Most important among these are those that combine the GFAs like a reformed IMF with appropriate RFAs.

Formally, the heuristic argument presented above can be established via a careful consideration of *path dependence* during evolution of the GFA. In order to do this in a conceptually rigorous manner, the concept of *path dependence* itself has to be refined and formalized in a specific way. I have developed this idea elsewhere, and will only sketch the

¹⁵ See in addition to Eichengreen (1999) cited earlier, Azis, Iwan J (1999) *Do We Know the Real Causes of the Asian Crisis?* Global Financial Turmoil and Reform: A United Nations Perspective, The United Nations University Press, Tokyo.

Khan, Haider A. 2004 *Global Markets and Financial Crisis: Towards a New Theory for the 21st Century* Palgrave/Macmillan.

Sachs, Jeffrey D., A. Tornell., A.Velasco. (1996) *Financial Crises in Emerging Markets: The Lessons From 1995*, Brookings Papers on Economic Activity, No 1.

Sachs, Jeffrey D, and Wing Thye Woo (2000). *Understanding the Asian Financial Crisis*, in Woo, Wing Thye, Jeffrey D. Sachs, and Klaus Schwab (eds), The Asian Financial Crisis: Lessons for a Resilient Asia, The MIT Press. Summers, Lawrence H (2000). *International Financial Crises: Causes, Prevention, and Cures*, American Economic Review, Vol 90, No.2.

Tobin, James., and Gustav Ranis (1998). *The IMF's Misplaced Priorities: Flawed Funds*, The New Republic, available online at the following address: <http://www.thenewrepublic.com/archive/0398/030998/tobin030998.html>

Yoshitomi, Masaru and Kenichi Ohno (1999), "Capital Account Crisis and Credit Contraction: Towards a Better Management of Systemic Currency Crisis", Paper presented at ADB Annual Meeting, 29 April 1999, Manila.

conceptual path to be followed briefly.¹⁶ Briefly, there can be completely deterministic (CD), completely stochastic (CS), and partially deterministic (PD) characterizations of path dependence. Eschewing the formal apparatus of graph theory and neural network dynamics which can be used to describe these rigorously, we can simply say that in deterministic path dependence there is only one choice of path. Everything is as it should be, since there are no bifurcations at any point in history. In fact, we can make a stronger statement. At *no* point in history is there even a *possibility* of even a bifurcation. Most people will see this as an extreme, and in case of human institutional design, perhaps as an unrealistic case.

The purely stochastic case is all *random mutation*. Again, there is no way that conscious choice can play a role here either. Blind chance determines the outcome. The last type of path dependence, i.e., the PD variety leaves some room for evolution to be a result of at least some kind of bounded rational human activities. In this case, a complex set of human activities including learning and improving policy making capabilities can influence which network of paths are followed over time. While the number of available paths at any point in history may be large, they are never infinite. Therefore, combinatorial mathematics will in most cases show the existence of the most likely evolutionary outcome. However, the caveat that large, seemingly random fluctuations (e.g., a war) can throw these calculations off is always a (rare) possibility.

Fortunately, barring such events as wars, revolutions, complete meltdowns of financial systems etc. there are not at present an unmanageably large number of outcomes that are possible for the GFA. In fact, if we are willing to assume a continuum with nothing but an overarching *global* architecture for international finance with regional impurities added as another type we have just two types of possible evolutionary outcomes for the institutional history of GFAs from a theoretical point of view.

The first type, which can be created at special evolutionary moments, can be called *Overarching GFAs*. Gold standard under the UK hegemony and Bretton Woods under the threats of a postwar depression are two examples. Recent history does not support the hope that such events are about to happen again. Therefore, a second type of evolutionary path resulting in a hybrid form should be recognized. This is the hybrid coexistence of a GFA together with one or many RFAs. We can call this type a *hybrid GFA* for shorthand reference. Once again, Asia after the AFC is a good place to begin the analysis.

¹⁶ See Khan (2001 and 2002c)

In the Asian case, as many have observed, the financial sector liberalization followed the pre-AFC neo-liberal GFA by default. There were some short-term gains of the policy, but ultimately it resulted in severe instability. More generally, as Kaminsky & Reinhart¹⁷ show, based on the episodes of 76 currency crises, of which 26 are also characterized by banking crises, financial sector liberalization can result in a boom-bust cycle by providing easy access to short-term financing. Proponents of liberalization suggested some sort of micro sequencing in order to prevent such adverse consequences. With some variations, the most commonly suggested sequence was: improve the quality of regulation, make sure they are enforced, and then improve the supervisory mechanisms. Once the markets are liberalized, the level of bank's minimum capital requirements could then be brought closer to what the *Basel Accord* required.

As one author,¹⁸ who, of course, does not use the same terminology as developed here, nevertheless points out, there is a contradiction in this type of GFA arrangement.

But when the Asian crisis countries liberalized the financial sector in 1980s, the aforementioned preconditions (assumptions) were not in place. Yet, they were rushed to liberalize by the IFI. Ironically, when at the early stage the policy showed favorable impacts, e.g., higher economic growth; greater access to financial services, the IFI applauded it. But when the crisis hit, the very same countries previously praised were swiftly placed into the category of those with misplaced development strategies. All of a sudden, nothing was right with these countries. When confronted with such an embarrassing contradiction, the international institutions are quick to claim that they actually *saw* the faults, and *already reminded* the governments about the existing flaws (e.g., weak banking system, unsustainable exchange rate system, and widespread corruption).¹⁹

IMF recommendation during this period led to the increase in interest rates. Because of the common prescription under the GFA this occurred in all Asian crisis countries. Such high rates created more moral hazard and adverse selection problems, thus showing that the incentive system has indeed been altered, and led to the undertaking of bad risk by the banking sector²⁰. As Azis correctly points out:

Under these circumstances, the amount of investment credits going to risky sector rose (adverse selection), the incidence of bail out in the absence of free-exit scheme also increased (moral hazard),

¹⁷ See Kaminsky and Reinhart (1999).

¹⁸ Azis (2002c).

¹⁹ Azis(2002c) p.3

²⁰ See Hellman, Murdock and Stiglitz (2000)

and the subsequent banks' franchise values (expected returns) declined. All these are precisely what the "pre-conditions prior to liberalization" are expected to avoid. Thus, the implicit logic is inherently self-conflicting, i.e., expecting bank's prudent behavior while allowing 'franchise value' to fall. The suggested preconditions, although seemingly logical, simply do not match with the prevailing institutional conditions.²¹

Azis points out further:

The IMF persistently argued for liberalizing the sector and meeting the pre-conditions simultaneously. A study by the Fund on the sequencing of capital account liberalization using the case of Chile, Korea, Indonesia and Thailand, for example, stresses the importance of proper sequencing if benefits from the liberalization are to be achieved and the risks to be minimized. The study also argues that financial sector liberalization, especially capital account liberalization, should be a part of a coordinated and comprehensive approach, in which the sequencing of regulatory and institutional reforms is critical. The design of macroeconomic and exchange rate policies should also play a vital role (Johnston, Darbar, and Echeverria, 1997). While intuitively making sense, such conclusions are too broad, far from being practical. No one would argue against the importance of making liberalization policy (or any policy for that matter) consistent with the prevailing macroeconomic policy. But how do you do it, remains unanswered. The information contained in such a study is of limited value to policy makers. Yet, while many countries still had problems to meet the stated preconditions, they were pushed to accelerate the liberalization policy by recommending one or two new measures to safeguard. More often than not, these measures are based on the practice of developed countries that have different institutional conditions.(emphasis mine)²²

Here the author correctly pinpoints the failure to recognize unevenness as a key feature of the failure of the IMF to prescribe the correct medicine. In fact, IMF did much worse--- it prescribed the wrong medicine, a set of measures that worsened the impact of the AFC. This situation illustrates the danger of being in the grip of a (pseudo-) universalistic theory that simply cannot be applied in the real world of unevenness without serious distortions that may cause great harm. An alternative is to work with our type two hybrid combinations of GFA and RFAs. Again, Asia can be used as an illustration.

Prior to AFC, the borrowing in short-term market and the increased flow of foreign capital both occurred almost simultaneously in these countries. As the real exchange rate appreciated, competitiveness suffered, and vulnerability to sudden reversals of capital flows increased. It must be emphasized that these were systemic features that went largely unnoticed by the IMF or the private sector. As is well known, in a nonlinear system the vulnerability to sudden shocks is a logical possibility. In case of Asia, this became an empirical reality of nightmare proportions.

With most debtors being in the corporate sector during the AFC, the capacity to invest became severely constrained. The debt-deflation scenario became the reality because the price

²¹ Azis(2002c) p.3

²² Azis (2002c) pp.3-4

effects of depreciated exchange rates did not occur until much later, if at all. Hence, the initial currency crisis became first a more general financial crisis and then a full-blown economic crisis. In Indonesia it also became a social and political crisis

The Asian crisis showed that, the composition of capital flows matters. The fact that there were sudden reversals of capital flows during 1997 and 1998 led many to believe that most capital flows in the region were of portfolio investment type. Reversals of such capital can strain the region's financial system sufficiently to cause or exacerbate its collapse²³. However, while it is true that portfolio investment was on the rise, data indicate that foreign direct investment (FDI) remained the largest in all Asian crisis countries. In all Asian crisis countries foreign debts increased persistently until the onset of the crisis. These were debts of the private sector from foreign private lenders. Regional monitoring with the help of a theory such as the one proposed here could have caught the problem and a regionally, ultimately globally, coordinated solution could be attempted. But this was never a possibility under the then existing circumstances. We now know that financial and balance-of-payments crises became interlinked precisely because of the existence of foreign-currency-denominated liabilities (foreign debt) in the domestic financial system.²⁴ This hindsight can be used to develop RFAs in Asia, Latin America and a few other regions.

In Asia, a "Washington Consensus" policy mix of monetary tightening and fiscal restraints was imposed as part of the IMF conditionalities. The experience during the Mexican crisis in 1995 had convinced the Fund that such a policy mix was appropriate for Asia as well, despite the fact that the pre-crisis conditions in Asia were quite otherwise.²⁵ Another element emerged in Asia that was indeed new, the IMF suggested a rather radical and fundamental change in the countries' institutional structure.²⁶ In the event, neither set turned out to have been well-conceived.

As already observed, the Fund's insistence on severely tightening the monetary policy by raising the interest rates turned out to be incorrect and counterproductive. Its arguments for

²³ See for example, Rodrik and Velasco (1999)

²⁴ See Krueger (2000)

²⁵ James Tobin and Gustav Ranis (1998) were among those who believed that the IMF programs in Asia were based on the Fund's experiences with Mexico in 1994.

²⁶ Azis (2002c) suggests: 'The experience with policy adjustments of this kind in Eastern Europe and the former Soviet Union (from communism to market economy) had inspired the Fund to do the same thing in Asia.' (p.7)

remaking many institutions in Asia did not make evolutionary sense although all would agree that ending corruption, curtailing special business privileges, and imposing the practice of good governance, including good corporate governance were good overall goals.²⁷ But quite apart from the well known fact that this falls outside the Fund's mandate, such adjustments at the time could result in further instability. In the words of Morris Goldstein, an ex-IMF staff member: "...both the scope and the depth of the Fund's conditions were excessive...They clearly strayed outside their area of expertise...[I]f a nation is so plagued with problems that it needs to make 140 changes before it can borrow, then maybe the fund should not lend."²⁸ Although not a conscious advocate of the evolutionary theory advanced here, Goldstein's long experience and solid sense of institutional matters led him to the right conclusions in this matter.

Before leaving the question of the analytical distinction between the two types of GFAs it is instructive to ask whether the theory of the second best is relevant in making this distinction. Although the language of evolutionary theory is different, this can be done in a way that throws further light on why the hybrid form is important. In a first best world without frictions, information problems and market imperfections an overarching GFA is indeed optimal. However once we depart from any of these we are in the second best world. Interestingly, given these imperfections, at least along some dimensions, a hybrid architecture with RFAs can (locally) improve upon the surveillance problems that an overarching GFA will face. As long as local information gathering and monitoring can be improved under a (local) RFA, there is an advantage to having an RFA. In the world of second best this can be called "the principle of localism".²⁹

4.2 Towards a Workable Hybrid GFA: RFAs, the IMF and National Policy Management under Fractured Globalization

But how is the transition towards a hybrid GFA to be effected? What conceptual modifications are necessary in the way to which we have become accustomed to thinking under the present institutional order? The present and following sections are all intended to answer these questions. The present section will consider steps taken by the IMF during the global crisis and some general issues and the possible formation of RFAs stemming from the AFC and the

²⁷ See Khan(1999a, b; and 2001) on Asian corporate governance reform, and the sketch of an evolutionary theory.

²⁸ New York Times, October 21, 2000.

²⁹ I am grateful to Barbara Stallings for very helpful discussion on this point.

current crisis, while sections five and six will address more rigorously how the IMF needs to be modified and what such a modified IMF together with several RFAs could do. I do this strategically by discussing the counterfactual of what a hypothetical RFA in Asia could have done to handle the situation before, during and after the AFC. This turns out to have broader applicability in the 21st century global crisis management. But in order to build the argument for a hybrid GFA fully, first the recent tentative but potentially important reformist steps of the IMF deserve consideration.

4.2.1 The IMF's Response to the Global Economic Crisis and its Evolving Role

The IMF's loss of stature after the Asian financial crisis

After the Asian financial crisis, the Fund lost much of its credibility with developing countries. As a result, the Fund's program portfolio diminished significantly for much of the last decade. Prior to the most recent crisis, demand for the Fund's resources was at an historic low. Major borrowers had repaid their outstanding debt to at the time of the most recent crisis, leading the Fund to contract its staff by around 15% [Grabel 2010, 3; Kapur and Webb 2006; Thomas 2009]. The Fund's loan portfolio shrunk from \$105 billion to less than \$10 billion in the space of five years (2003-2007) [Weisbrot, Cordero and Sandoval 2009].

Many have pointed to the Fund's continued insistence on using *ex ante* and *ex post* conditionality as a major reason as to why countries shied away from going to the institution for help. The historical use of conditionality within IMF programs meant that developing countries had to acquiesce to dominant Western thinking on correct fiscal and monetary policy formulae. Embarrassment at having to ask the IMF for assistance during crises also played an important role in dissuading developing countries from ceding control over their fiscal and monetary policy over to the Fund. Over the past decade or so, developing countries were able to resist relying upon the IMF through:

- The over-accumulation of reserves
- International private capital flows
- Bilateral swap arrangements
- Regional banks and financial arrangements
- South-South financial assistance.

4.2.2 Regaining Relevance

In December of 2008, the IMF was thrust into the global financial crisis through its stand-by arrangement with Iceland. The Fund package with Iceland totaled \$2.1 billion, with over \$800 million made available immediately for the country [Anderson 2008]. IMF policy prescription was used to explicitly stem the fall of the Icelandic krona to ward off the potential of massive defaults in foreign denominated currency. Monetary and fiscal policy space was left largely open by the Fund. The IMF also provided assistance in the restructuring of the entire Icelandic banking and financial structure.

Since providing assistance to Iceland, the Fund has been very active in providing financial assistance to member states all over the globe. Notably, the global nature of crisis has meant the Fund is being seen in areas of the world (most especially Europe) for the first time in quite a while. With that said, the majority IMF's response to the crisis was built around a sharp increase in the amount of concessional lending to low- and middle-income countries.

Lending to low-income countries during the crisis period was 4 fold larger than historical levels [IMF 2009]. In late 2009, concessional resources for low-income countries to meet projected demand were increased to nearly \$17 billion through 2014 [IMF 2009]. Relief on interest payments by LICs to the IMF through 2011 has been approved. Additionally, LICs now can access double normal limits on annualized draw-outs from the Fund. The IMF approved a \$250 billion allocation of SDRs that will be distributed to all of the member countries at the Fund according to their quota levels. As such, more than \$18 billion will be available to LICs to augment their foreign exchange reserves to alleviate financing and BOP constraints [IMF 2009].

In the wake of the global financial crisis, the Fund has become relevant again. It is also trying to regain credibility in global financial governance---an effort that actually started with the AFC (Khan 2002c, 2004, 2006; Best 2010). It has served as a "first responder" to financial crises in countries throughout the globe [Grabel 2010, 3]. The restoration of the Fund to its 'proper place' in the international financial system was seen in its speedy response to the Icelandic crisis and from the boost it received from G-20 nations. Indeed, the G-20 meeting in April 2009 reaffirmed the Fund's mandate and provided new and large amounts of funding commitments (\$1.1 trillion for the crisis; \$750 billion through the IMF) to support the institution's efforts [Grabel 2010, 3]. Even China and Brazil, notable critics of the Fund's governance policies, committed new

resources and lending to the institution. These new commitments will facilitate greater interaction and sharing of resources between the IMF and regional development banks.

The G-20 has backed the partial devolution of funding commitments from the IMF to regional development banks to allow resources to be available in a more timely fashion to countries in need. This kind of development speaks to a small, but growing, consensus that the IMF might be better served in the future to serve as a central figure in a network of intergovernmental finance with regional development banks and institutions [Vols and Caliarì 2010].

In 2009, the IMF also began issuing its own bonds to boost its available resources. \$90 billion of the \$500 billion in new resources for future IMF lending will come from BRIC countries and South Korea [Grabel 2010, 4]. The development is important in two ways:

1. Lenders from emerging and developing markets can use their new lending capacity to exert greater influence over policies of the Fund.
2. Buoyed by new commitments from the BRIC reaffirms the central role the Fund will continue to play as a lender of last resort.

4.2.3 Current Arrangements

As of January, 2011, the Fund had 19 Stand-by Arrangements with different member countries. These arrangements involved the potential draw-out of over 70 SDR billion, of which nearly 35 SDR billion had already been delivered. These arrangements included member states from Africa, the Caribbean, Europe, Central America, Central Asia, the Middle East, and South Asia. The Fund also had four extended arrangements with member states, with nearly 20 SDR billion in resources were being utilized through these facilities. Three countries (Colombia, Mexico and Poland) had already begun taking advantage of the IMF's new Flexible Credit Line facility. These three arrangements had already seen nearly 48 SDR billion in BOP assistance being given out by the Fund. The above arrangements, totaling over 125 SDR billion, were all relatively recent; all of these facilities were initiated in the last three years [IMF Financial Activities Update 2011].

In addition, the Fund as of February 2011 had 28 Extended Credit Facility Arrangements on its books. The value of these arrangements was around 2.5 SDR billion, a billion of which had already been drawn upon. Over the past decade, the Fund had committed over 6 SDR billion in

debt relief through its Heavily-Indebted Poor Country (HIPC) and Multilateral Debt Relief Initiative (MDRI) programs. These programs had involved arrangements with over 60 countries [IMF Financial Activities Update 2011].

Changes in the IMF's conditionality regimes

In the wake of the global crisis, the IMF has introduced a number of new financial programs aimed at allowing countries to have more agency in delineating their loan/policy structures. The IMF has stated that these facilities “will be more flexible and tailored to the increasing diversity” of member countries [IMF 2009]. New instruments include:

- Extended Credit Facility – medium-term support and flexibility program
- Standby Credit Facility – addresses short-term and precautionary needs
- Rapid Credit Facility – emergency support with limited conditionality
- Flexible Credit Line – support for BOP pressures for countries with strong macroeconomic track records; no ex post conditionality [IMF 2010d]
- Precautionary Credit Line – lower standards of qualification than for the FCL; less ex ante qualifications, but stronger ex post conditionality

Each facility and credit line has its own conditions, term structures, borrowing capacity and availability. The IMF has strongly pushed to make its credit facilities more low-cost for member economies. Conditionality is being streamlined to “focus on core objectives” [IMF 2009], and applies primarily to structural reforms. Conditionality is not supposed to affect countries’ fiscal policies that directly target poverty alleviation, growth and pro-poor spending. Programs now are supposed to accommodate larger fiscal deficits, looser monetary policy and increased inflation targets. Additionally, countries will not need to seek waivers for access to funds if reforms are not completed by a specific date.

In addition to paying lip service towards granting more policy autonomy to countries with IMF facilities, the Fund has softened its stance on capital controls and other macro-prudential measures [see, Ostry, *et. al* 2010]. The Fund, and its sister organization the World Bank, have indicated that the targeted and temporary use of capital controls can be an effective way for countries to defend themselves against exogenous financial shocks and preserve monetary policy space [Beattie 2010; Ostry, *et. al* 2010]. This is a far cry from the Fund’s reaction to the controls put into place by Malaysia during the Asian financial crisis. As part of

the Iceland's 2008 Stand By Agreement (SBA), the IMF explicitly advocated the use of such controls [Anderson 2008]. Nonetheless, one of the Fund's most recent papers on economic liberalization [Shah and Patnaik, 2011] indicts the use of controls in India for their ineffectiveness in shielding the economy from exogenous shocks and their bias against small- and medium-sized private firms.

In reality, a close study of conditionality 'reforms' confirms that they are more *ad hoc* and piecemeal than might otherwise appear. Many of the recent studies of SBAs and other facilities negotiated during the crisis have shown that the IMF has continued to promote pro-cyclical macroeconomic policy targets or structural adjustments [UNICEF, 2010; Van Waeyenberge, Bargawi and McKinley, 2010; Muchhala, 2009; Solidar, 2009; Weisbrot et al., 2009]. Questions have already arisen as to what fiscal programs count as targeting 'poverty alleviation, growth and pro-poor spending'. Does the subsidizing of basic energy inputs for the poor (kerosene, heating oil, etc.) count under these spending exceptions? The evidence emanating from the IMF is mixed at best. Public outcries in Pakistan and the Kyrgyz Republic over the ending of energy input subsidies are important examples of how IMF policy prescription can directly lead to public unrest. In the midst of the crisis, the Hungarian government's public spat with the IMF over program conditionality was especially notable, illustrating the unease within governments to work under the Fund's rules [Bryant 2010].

4.2.4 Governance Reforms at the IMF

The IMF has recently seen a change in the share of voting quotas. In November and December of 2010, IMF member countries agreed to an unprecedented doubling of quotas to SDR 476.8 billion [IMF 2010a]. This doubling of quotas was complemented with changes in the quota shares amongst the members. As a result, more than 6 percent of quota shares will be shifted to "emerging market and developing countries" and away from over-represented European countries. The shifting of shares will not impact the voting power of the Fund's poorest members. Starting from 2012, the Fund's 10 largest contributors and quota shareholders have begun to more accurately reflect the countries' contributions to world GDP. The total shift in voting share to developing countries, when combined with the 2008 quota reform, is now about 5.3% .

Changes to the IMF governance structure will also come via the Executive Board. The size of the Board will remain at 24 members. However, advanced European countries will reduce their contribution to the Board by two. Developing countries will up their contribution by the same amount. Further, from 2012, the Executive Board will consist only of elected Executive Directors, “following entry into force of the proposed amendment of the Fund’s Articles of Agreement, end the category of appointed Executive Directors (currently the members with the five largest quotas appoint an Executive Director)” [IMF 2010c].

4.2.5 Supervisory Role in the World Economy

Key leaders at the Fund have acknowledged that the institution has not done a good enough job at understanding the effects of financial flows on the financial system, and in particular, the effects of flow velocity on contagion and crisis. While not a self-indictment per se, the Fund has been very vocal about the ways in which it can better serve the international financial system. Generally, the Fund has communicated that it must clarify the Fund’s mandate and improve the role of the Fund in promoting global stability. On three issues in particular (cross-border research on capital flows, systemic changes in financial regulatory structure, taxes on flows), the Fund has focused a large amount of attention.

Fund Directors have noted that volatile capital flows played an important role in the transmission of shocks towards the depth of the current crisis. As it is the Fund’s mandate to oversee international monetary stability, the institution acknowledges that it must strengthen its ability to “advance in bilateral and multilateral surveillance and policy advice for member countries, based on extensive analytical work and taking into account country specific circumstances and relevant experiences” and “develop a coherent Fund view and inform policy guidance on capital flows” [IMF 2011]. The Fund has initiated work on *Cross-Cutting Themes from Recent Country Experiences with Capital Flows* as a starting point from which it can further elaborate its views on how to deal with cross border flows. In particular, the Fund has highlighted the need for its research and surveillance to focus on the potential spillovers of capital flows and the implications for the international monetary system as a whole.

The Fund has been very vocal on the need for global policy cooperation in the international monetary and financial system [IMF 2010b]. Directors at the Fund see it necessary that, for the global recovery to accelerate, cooperation on financial regulatory architecture must

be prioritized. The Fund is currently working hard with member states to guard against protectionist and mercantilist policy measures. In doing so, the Fund plans on delivering spillover reports for the world's major economies that assess the impact of domestic policies of systemic countries beyond their own borders [IMF 2010b]. Part of this larger surveillance effort involves an enhanced understanding of macroeconomic and financial risks and their associated linkages. Similarly, the Fund has also produced research and policy proposals on the resolution of cross-border banking institutions [Hagan and Vinals, 2010].

IMF directors have stressed the need for member states to develop a global financial safety net to protect against the threat of future shocks. Much of this discussion has centered around the ways in which such a safety net could be initiated. The Fund has been at the fore in assessing the potential regulatory and tax policies that could be used to develop such a safety net.

After losing much of its relevance after the Asian financial crisis, the IMF has suddenly become the most important financial and monetary institution in the world economy (save perhaps the Bank of International Settlements). Its loan portfolio has swelled to historic levels. New commitments from member states and direct borrowing by the Fund have meant that available resources are also at an all time high. Dozens of countries from every continent on the globe have credit arrangements with the Fund currently. The Fund's geographic reach has put it in a unique position to monitor financial and economic developments. Critical research and surveillance by the Fund can help us better understand the linkages between financial flows and policies within and among member states. Greater voice has even been given towards the use of the Fund's SDR as future reserve currency.

Such importance and responsibility requires that the Fund seriously consider the weight of its continued use of conditionality on member states. No doubt, the Fund is carefully considering the viability of its lending model along with the potential easing of terms and conditionality in its programs. Recent quota and governance reforms indicate that the Fund is at least beginning the process of granting more agency to developing countries on the appropriateness of fiscal consolidation and tight monetary policy.

As the crisis comes to an end, it will be important if reforms to the Fund's governance and program/facility structure will be long-lasting or *ad hoc*. Indeed, countries have been granted more autonomy over their decision making in the wake of the crisis. Only time can tell whether or not such change is really serious.

4.2.6 Some Key Propositions

If the argument—motivated and illustrated by both the AFC and its aftermath and the recent global crisis and its aftermath, particularly the still ambiguous but nevertheless serious reform-talk at IMF itself--- presented so far is valid, then several propositions can be accepted. First, there may be more than one evolutionary possibility; so there may not be a unique, global optimum set of institutions. Second, the goal of achieving stability and sustainable growth in a world of scarce resources leads to exercising prudence as a principle, particularly when costs are distributed unevenly over space and time. Third, a combination of global institutions with regional and national level institutions may provide more public good than focusing simply at the global level. The case for RFAs has so far rested implicitly on the third proposition. I now wish to elaborate more on this point and link it to the formulation of national economic policies and institution building at the national level as well. It is best to focus again on a concrete case such as the post-crisis Asia to give substance to the formal argument.

After the AFC, and again after the recent global crisis, the IMF, the World Bank, BIS and the national policy making bodies were in intense consultation. The current discussion regarding reforms in some ways mimic the individual East Asian economies responses after the AFC in that they took numerous measures such as improving bank supervision, allowing greater exchange rate flexibility etc. to inoculate themselves against future capital account shocks. However, individual countries now just as the Asian economies after the AFC are still vulnerable to large negative capital account shocks. The national strategy of having a very large stock of foreign reserves to deal with large capital flight may work but it is an extremely expensive strategy. As the recent global crisis shows, no one can foretell how frequent such crises may be, and how expensive; but if the past is any guide, even infrequent crises can be quite expensive to manage in this manner. This is not to say that such measures should not be taken. On the contrary, these measures are and should be a part of the transitional national management strategy. However, more is clearly needed. It seems that following this logic, an increasing number of developing country policy makers are realizing that although they may not have the capacity to change the international financial architecture immediately, creating a regional financial architecture may be an attainable goal. There can be a whole range of regional financial cooperation policies leading to more permanent institution building. These could begin with a

peer review process such as the G7 or preferably, the G20 process. Using this as the reference point, a move to mutual liquidity provision and some form of enforcement mechanism could be adopted. These could be enhanced through exchange rate coordination and enhanced surveillance process. Ultimately, such a process could evolve into an RFA that could have its own institutional and organizational structure.

In the Asian case, such an evolutionary process had already started after the AFC. The most important steps taken then were: the Manila Framework Group Meeting, the ASEAN Surveillance Process, the ASEAN+3 Surveillance Process, and the Chiangmai Initiative-related Surveillance Process.

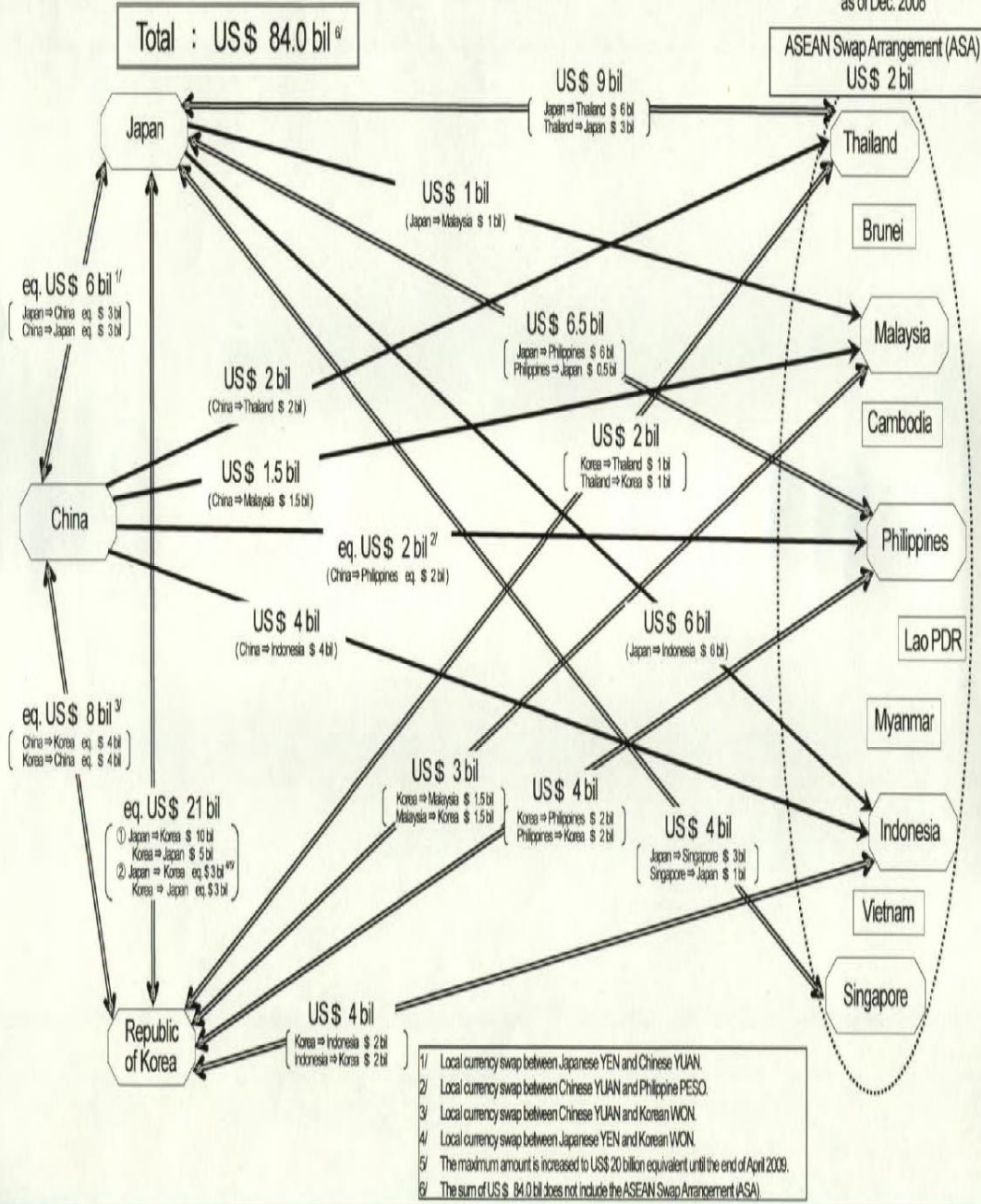
It has to be said that the performance of Manila Framework Group as a mechanism for regional financial cooperation and regional financial surveillance has not yet reached its potential. The reasons are related to institutional incapacity which has prevented the parties from specifying clearly the objectives of information exchange and surveillance. Consequently, no priorities, targets, and rules have been set for the process of information exchange and surveillance. Most importantly, there is no actual peer review process; the surveillance process seems to be simply general discussion of the global and regional economic outlook. Finally, there seems to be no attempt to formulate any country-specific or region-wide recommendations for policy actions--- a point to which I will return at the end.

The other processes also have much room for improvements and the actual prospects for improvement, as shown by the Chiangmai Initiative-related Surveillance Process. In addition to an expanded ASEAN Swap Arrangement (ASA) that includes all ASEAN members and a network of bilateral swap agreements among ASEAN countries plus China, Japan and South Korea, the initiative has opened the door for further discussion about concrete policy coordination and institution building. In so far as the swap arrangements are concerned, currently 10 percent of the swap arrangements can be disbursed without the IMF involvement. Figure 1 below shows the network of ASA during 2008.

Figure 1: Network of Bilateral Swap Agreements under CMI
Source BOJ

Network of Bilateral Swap Arrangements (BSAs) under the Chiang Mai Initiative (CMI)

as of Dec. 2008



Even with this modest beginning, there is now a need for the swap-providing countries to formulate their own assessments about the swap-requesting country. Costs of such information gathering can be economized through regional cooperation. Such a move will also make it possible to pre-qualify members for assistance if and when the need for such assistance arises. This will also help fight contagion and prevent capital flight when actions are taken promptly before a crisis point is reached because of avoidable delays. Acting in accordance with the principles of prudent management stated earlier, there could be a regular policy dialogue at the deputy minister level. Finally, at the organizational level, the evolutionary approach could lead to the establishment of an independent surveillance unit to serve as the core of an RFA, and to lead the policy dialogue. The proposed policy dialogue process should pay particular attention to the root problems in East Asia's weak financial systems (e.g. prudential supervision, risk management, and corporate governance), and actively promote the development and integration of long-term capital markets. At this point, it is not essential to pinpoint any further the precise organizational blueprint for such an RFA; but the point that the process underway can result in an appropriate institutional structure with proper organizational design is important to grasp. A critical constructive evolutionary economic theory suggests that an open architecture will be better able to absorb future shocks, learn from them, and modify itself.³⁰

In light of the foregoing analysis of AFC and subsequent attempts at an incipient Asian RFA, at a concrete policy making level, one could make the case for Asian countries lobbying for the formalisation and regularisation of ASEAN Chair's and ASEAN Secretary-General's participation in the G20 Summits. There is also a regional logic for holding policy dialogue meetings of an "expanded" ASEAN+3 (regular 13 members plus India, Australia and New Zealand) in general but particularly before the G20 Summits for coordinating policies and developing common positions to support the ASEAN representatives at the G20 Summits. Furthermore, supporting and joining the informal Global Governance Group (3G) convened by Singapore under the auspices of the United Nations to coordinate Asian position with developing countries in other regions of the world. Another regional institution building possibility is that once the ASEAN+3 Macroeconomic Research Office (AMRO) is established in Singapore (by May 2010). AMRO can coordinate the policy dialogue meetings of the

³⁰ Although the terminology used is different, Kuroda and Kawai (2002) describe the case for strengthening regional financial cooperation in East Asia in terms that lend support to the "open architecture" view with a regional component advanced here from an evolutionary perspective.

“expanded” ASEAN+3 overall. Specific moves could include designing coordination in order to support participation of the ASEAN Chair and the ASEAN Secretary-General in the G20 Summits.

There are two key aspects of such an interrelated architecture that will crucially affect the workability of a possible RFA in Asia or in any other region. First, the willingness of a reformed IMF to permit the RFAs to have a certain degree of regional autonomy. For this the complementarily and burden sharing aspects of the GFA with RFAs need to be recognized. This is a special case of complementary institutional network (CIN). Second, and another instance of CIN, is the viability and cooperation at the national level. A slogan accompanying globalization is that the nation state can no longer act on its own. This may be true in certain areas of macroeconomic policy, but on a wide range of issues from tax policies to environmental policies the national governments can within limits formulate and implement policies. In the area of finance, even under WTO rules, there are possibilities of not only policy maneuvering but also of institutional reform and new institution building. In addition to addressing such matters as prudential supervision, risk management, and corporate governance the need for building other institutions for risk sharing, human development and policy dialogues within the nation loom large as tasks during the transitional management at the national level.

One final observation regarding the creation of an RFA within Asia is necessary before moving to a discussion of the future of the IMF in the next section. To put it in the most concrete and perhaps provocative way, could the Chiang Mai initiative foreshadow an East Asian Monetary System?

The AFC led to a collapse of the dollar pegging most of the economies in East Asia had before the crisis. The East Asian economies prefer a certain amount of exchange rate stability due to their trade multilateral dependence. They also see some advantages to be gained from coordination against speculative attacks, and preventing competitive devaluations in the region. However, fixing rates with respect to one another like the EMS earlier also carries dangers. Furthermore, the US dollar is still the most important vehicle currency in the region. Therefore, whether something like a yen bloc or even an Asian Currency Unit (ACU) can be created in the near future is doubtful.

At the same time, the experience of the AFC points towards closer coordination and a concerted effort to reduce volatility in the currency and financial markets. Since there are

asymmetries among the countries in the region, the more advanced countries need to take the lead and ensure that in times of asymmetric shocks, the less advanced countries will have resources to call upon. Thus any kind of steps towards an RFA will have to involve adequate reserves and the ability to provide liquidity and other resources to countries that need these in times of crisis.

4.2.7: New South-South Initiatives—BRICS and BRICS-Plus

In this context, the July, 2014 initiative by the BRICS group of countries to create a new financial facility for development was a noteworthy attempt. Although at a capitalization of 100 billion dollars it is far short of the actual needs, it is a good start in the right global direction. The key roles played by China and India from Asia together with Russia, Brazil and South Africa can give it a multi-regional---indeed eventually a hybrid global-regional character emphasized in this analysis--- dimension and capabilities.

Recently, the imposition of massive sanctions by the US and the collective west started a process of delinking from the collective west. This also accelerated the moves towards dedollarization. With the recent developments towards the further expansion of BRICS-plus already achieved, accelerated dedollarization and assertion of sovereignty by many countries of the Global South, the creation of an alternative less asymmetric non-IMF based architecture for global financial governance has become a more realistic institutional possibility.

Officially designated as the Contingent Reserve Arrangement (CRA), this fund is intended to serve as “a self-managed contingent reserve arrangement to forestall short-term balance of payments pressures, provide mutual support and further strengthen financial stability.” Thus it is still in the nature of financing a temporary BOP disequilibrium. Therefore, the question of funding more medium to long term development projects needs to be put on the table. Perhaps parallel facilities can be set up for these purposes with longer time frames and more explicit

developmental goals. In this context, Stephany Griffith-Jones's(2014) discussion of the BRICS Development Bank and future possibilities holds out hope for the future. Financing medium to long term development projects can be discussed in this context with a view to wider South-South cooperation.

As of July , 2014, according to the treaty, China will contribute 41 percent, Brazil, Russia, and India 18 per cent each, and South Africa 5 per cent. The CRA is to be governed by two boards. First, there is the *Governing Council* with five members, one each from the five BRICS countries. The next is the Standing Committee for operational matters. The Standing Committee will have five directors, one each from the five member countries. The Governing Council can only make all the fundamental decisions *by consensus*. This is an important difference in governance compared to that of the IMF. New countries can join the CRA if there is consensus. There is no effective veto power as in the IMF.

The Standing Committee will make executive and operational decisions---particularly decisions regarding seek funding support. Providing Parties will decide on funding requests based on simple and transparent majority voting. At present, according to the article 4, it appears that there are two kinds of financing instruments: (i) "A liquidity instrument to provide support in response to short-term balance of payments pressures"and (ii) "A precautionary instrument committing to provide support in light of potential short-term balance of payments pressures". Again, the goals are short-term relief. There are specific details underlined in the text of the treaty regarding proceures and limits to funding.

It does not appear now that the CRA will fundamentally alter the dependence of the developing countries on the IMF; but it can lessen such dependence and through a combination of short-term BOP lending and other measures can help the developing countries in increasing their policy spaces. But the CRA can only be seen as a start in the right direction. There is much more to be

done. A good first step will be to hold an intellectual summit with committed experts from developing countries for a deep and serious discussion regarding the future courses of action.³¹

As mentioned earlier, the BRICS development bank can serve in a complementary fashion the need for sustainable development finance. However, there are several issues to consider in making the bank an efficient instrument for sustainable development finance.

It must be emphasized that the scale of lending of the BRICS bank should be large enough to make an intersectoral impact(see the mathematical model in the appendix). As in all finance, the impact of the BRICS bank would be magnified through its capacity to leverage as well as through its ability to arrange for co-financing of projects with the relevant parts of private and public sectors. A related and important issue will be the quality of the loans made. Without careful and close monitoring and evaluation, there is a danger of a bad trade-off between the pace of growth of a portfolio of loans and the quality of loans. Thusnt, a high quality of loans needs to be made an operational priority in order to maximize the development impact of the projects financed while minimizing the risk of default. In the neuro-fuzzy model developed and applied in Khan(2004) such monitoring and inductive learning is crucial.

Another related issue is the degree of financial “sophistication” of the instruments used(Khan 2004, chs. 8 and 9). As is well-known , the “plain vanilla” loans can be made much faster than more complicated loan structures. Transactions involving equity take much longer (though they have desirable features, such as capturing part of the “upside” if projects are very profitable). As a rule, the more complex the products, the longer they take to be designed and implemented. Here, complexity without proper regulation and oversight, as the first half of this paper has been at pains to argue, can lead to crisis. Investing in an open, transparent and concessionary manner in very poor countries through simple instruments will be the way to proceed---at least for a time while training of personnel and supervisory capabilities are developed both within the bank and in debtor countries.

³¹ For details one can consult the text of the treaty. For an illuminating brief, please see, Montes, Manuel F. 2014. Initial Comments on BRICS Contingent Reserve Arrangement (CRA),The South Centre, Geneva, Switzerland. July

5. The Changing Role of the IMF within a Hybrid GFA and the Need for Emerging Countries' Voice and BRICS-type financing facilities: Beyond the IMF? A Bifurcated Hybrid Financial Architecture?

In this section I want to address what is perhaps the most important institutional and policy question that arises from the proposal for a hybrid GFA. What will be the role of IMF, and how will this new role differ from its present or neoliberal role? As mentioned already, the handling of the AFC by the IMF had raised important issues of global governance. The Fund had been criticized by the left, the right, and also the center. The global financial crisis has elicited mixed

but on the whole potentially constructive responses from the IMF. I have already alluded to some of the ways in which the IMF will need to change its ways if the hybrid form of GFA I am suggesting here is to become a viable option for institution building. Elsewhere³², I have pointed out the need for adhering to some basic principles as the IMF transforms itself consistent with a critical social constructivist approach. Chief among these principles are the principle of symmetry and the principle of burden sharing. These are described briefly below:

1. *The principle of symmetry*, i.e., the surplus and deficit countries should be treated equally.

However, it was not realized in the past; nor is it likely to be realized in the near future.

However, there are various ways to pursue this as a goal even under the current set up of the IMF. If serious efforts are made to follow this principle by a reformed IMF, that will be an important step towards a new and better GFA.

2. *The principle of burden-sharing*, i.e., during episodes of crisis management the IMF will share the management burden with the RFAs and through them also with the affected countries and their neighbors.

It should be kept in mind that in keeping with the critical constructivist argument developed so far both the principles recognize the practical impossibility of the IMF being transformed into a global central bank in the near future. What the IMF cannot do now and will not be able to do in the foreseeable future is to follow Bagehot's dictum to lend freely against good collateral at a high interest rate in time of crisis. Unless SDRs become the commonly accepted and easily expandable means of settlement, this role will remain foreclosed. It is unlikely that the principal shareholders of the IMF will allow such a change to occur.³³ Also, compared to a national central bank dealing with a problematic domestic financial institution the IMF has a limited ability to force corrective action. Yet, there will clearly be a role for IMF lending, and the consequent moral hazard will need to be recognized. But just as the moral hazard from having fire fighters ready to fight fires does not compel thoughtful communities to abolish fire stations, the global community also cannot abolish the IMF, or reduce its resources simply because there is a moral hazard problem associated with such institutions. The second principle above, the principle of

³² See Khan (2002c).

³³ However, this should not be ruled out completely. Pressures for increased supply of SDRs will be beneficial in specific ways as argued below.

burden sharing with the RFAs, national governments and the private sectors should go some distance towards both increasing the overall resources available, and mitigating the moral hazard.

While the Fund cannot now, or even in the near future be expected to act as a global central banker, pressures for increasing the net supply and poor country allocations of SDR will have beneficial effects. Even if the increases are not significant in the short run, the tendency will keep alive the eventual goal of forming a global central bank, as Keynes had envisioned. More practically, putting pressures on the IMF to emit new SDRs in order to finance the stabilization of primary (and perhaps other) commodity prices will lead to benefits for both the developing and the developed countries in the intermediate run. The stabilization of these prices will help many developing countries avert BOP disasters. Furthermore, to the extent that the unusual price increases, such as the oil price increase in the 70s, create general inflationary pressures such pressures can also be averted. A smooth international transactions pattern will thus be consistent with domestic price stabilization as well.

In addition, the Fund can make a concerted effort to manage the private creditors. Most important from the point of view of managing crises will be the incorporation of new provisions on loan contracts so that orderly work out procedures become feasible. The Fund can also lend into arrears as a means to provide debtor-in-possession financing. Such a provision, along with more direct measures vis-à-vis the creditors, can help to bring the creditors to the bargaining table during a crisis.

Such measures to manage the creditors should also be complemented by increased surveillance of financial markets. Strengthening supervision is one aspect. Arriving at independent assessments of financial risk is another, related aspect of moving in this direction. However, it is important to realize that even after adopting this stance, the risk of crises will still remain. Not all crises can be foreseen, much less prevented. The best that can be done is to draw the countries, the private sector and the RFAs together in an effort to strengthen the financial structures, including information gathering and processing capabilities. A cooperative structure where the Fund recognizes the need for hybridity will also help to reduce the reaction time.

Reducing the reaction time can help only if the policies undertaken cannot do much harm even if they are not successful in achieving their positive aim. The IMF has been correctly criticized for suggesting a “one-size-fits-all” policy package. Here again, a changed institutional structure with a more flexible IMF will mean a case-by-case approach where the RFAs will play

a significant role. National economic policies such as requiring borrowers to unwind positions in increasingly risky situations, curbing excessive foreign borrowing, limiting portfolio investment, cautionary policies towards derivatives and off- balance sheet items may need to be examined as serious policy options. Tobin tax, or individual country taxes of the Chilean variety should also be given serious consideration. The *mantra* of free capital movements together with the refrain that there is no alternative needs to be revised appropriately to incorporate the available tools that the Fund can help countries use to mitigate the risks arising from such capital movements.

It is not clear that the Fund can do much in instituting a more stable exchange rate regime. The pegged rate system, advocated among others, surprisingly by the Wall Street Journal, will create one-way bets for speculators. Free floating, on the other hand, can lead to disasters when exchange rates collapse suddenly instead of finding a new stable equilibrium. Such perverse dynamics was observed during the AFC, particularly in the Indonesian case. The inability of Greece to use exchange rate policy during its own crisis shows how the EU and particularly the ECB may not be a model to emulate for creating future RFAs. Neither currency boards nor perfect flexibility can prevent vulnerable currencies from collapsing. Rather a managed float before any signs of crisis appear together with a prudent management of the financial and real sectors would seem to be both pragmatic and feasible at this point. Strengthening the capacities of central banks will have better pay off here than urging the IMF to twist the arms of the countries through conditionalities.

In Asia, in addition to the high interest rate standard recipe, the IMF seized the crisis as an opportunity to dismantle what remained of the particular mix of institutions that had historically evolved to create the so-called “Asian Model of Development”. Widespread and massive bank closures, enterprise restructuring, opening up sectors to foreign ownership, tearing down labor institutions in the name of flexibility, and attack on living standards seemed to be a part of an overarching agenda. This type of radical restructuring under duress is not the way to apply the principles that are being advocated here.

In spite of widespread criticism from many quarters, the IMF still remains committed to capital account liberalization as *an ultimate* goal. The AFC and similar crises have merely given it pause to consider proper sequencing before liberalization. The critical constructive evolutionary theory developed here, point to a more nuanced, less global approach. Some economies may be ready for capital account liberalization; others are not. The IMF needs to

distinguish among them carefully, and not adopt capital account liberalization as a principle enshrined in its revised articles of agreement.

It goes without saying that proper sequencing, better monitoring and management of debt, greater transparency in both the government and private sector operations, more effective regulation of domestic financial institutions are all desirable policy goals. Also desirable are domestic tax policies that do not encourage excessive reliance on short-term capital inflows. However, in a world of unevenness some countries may also require temporary capital controls through various means. The IMF, instead of taking a dogmatic approach that says “no” to any form of capital control should set up facilities for examining the impacts of different alternatives. In doing so, it should also pay attention to the principle of symmetry so that the borrowing countries do not always and everywhere have to take the initiative. At the same time both capital inflows and outflows need to be controlled to some extent

A reformed IMF together with the RFAs could take the leadership in providing the overall framework within which individual countries could pursue policies most advantageous from a systemic point of view. For example, as alluded to already, the hybrid GFA could have a framework agreed to by the member countries of the IMF so that when a crisis hits lenders would be subject to credit standstills and orderly workouts. This would clearly force the creditors to shoulder some of the responsibility for the crisis. Such an arrangement, in all likelihood, will also reduce the need for large IMF loans. Another part of the new IMF responsibilities could be the collection of a global Tobin tax. Although no panacea, such a tax would almost certainly reduce returns to very short-term capital movements. A further consequence of a Tobin tax could be a somewhat more stable exchange rate system. Adoption of a securities transactions tax is also not a far-fetched idea. Even Lawrence Summers wrote academic articles before he joined the government advocating modest taxes on these transactions.³⁴ As any international monetary economist knows, the “impossible trinity” of international capital mobility, fixed exchange rate system and an independent monetary policy can not all be pursued together although Mundell’s carefully specified context for “the assignment problem” and his solutions may be applicable in specific instances. Slowing down short term capital movement need not prevent long term capital from flowing across borders. However, fixed exchange rates must be given up if countries are

³⁴ See Summers and Summers (1989).

still to pursue independent monetary policies. Thus, a return to the old IMF is neither necessary nor desirable. The transformation of the IMF as a handmaiden of the neoliberal agenda in the 1980s shows that something like a constructivist process was already at work in the post Bretton Woods system IMF. Given sufficient political wisdom and will that process can be reversed towards creating a transformed IMF that can serve the cause of financial stability for global prosperity much better than it has done during the last decades of the twentieth century. This new IMF will adopt a more flexible approach towards national policies. It will recognize that in periods that seem to be leading towards a crisis there may need to be policy shifts such as a shift towards some types of capital controls. The present articles of the IMF actually allow some forms of capital controls when countries are in distress. Instead of dismantling, these provisions have to be made realistic and applicable whenever the financial system seems vulnerable. Thus flexibility and context-dependent policy making will be the key features of a hybrid system. To begin with, debt rescheduling, moderation in fiscal-monetary policy mix with an expansionary bias for most economies and gradual restructuring of corporate sectors with strengthening of standards and corporate governance are steps that IMF can encourage the economies to take without interfering directly with the policy making in specific countries.

Other measures that the IMF can allow or even encourage national governments to pursue could include requiring lending institutions to hold different levels of provisions for countries with different estimated levels of riskiness measured by such factors as the state of the banking system and the level of reserves relative to short-term debt. As many have observed, risk assessment by the credit rating agencies also leaves much to be desired and could be improved if IMF provided some guidance and input. Another, more practical measure would be to impose different levels of taxation on earnings from overseas investments with different maturities. Although as stated in the previous sentence, it will not be so sensitive to individual country risk; it will nevertheless curb some of the tendencies towards short-termism. It should be mentioned that the Basel Committee regulations in effect during the AFC may have been a culprit in this respect. These regulations gave a lower weight to short-term foreign lending (20 per cent) for capital adequacy purposes than for loans with a maturity period of over one year (100 per cent). A new IMF could make such rules less biased by coordinating its guidelines with BIS, and being guided by a better theory than the one underlying the Washington consensus. Here some of the

Basel III guidelines, if they check the currently systemic dysfunctional pro-cyclical tendencies can be helpful.

But the prospects for delinking from the US-led order loom large in the 3rd decade of the 21st century. Indiscriminate use of sanctions by the collective west including financial sanctions against central banks of other countries and coercive diplomacy have already made the US-led system weaker and more unstable than at any time since 1945. In terms of complex systems dynamics this will most likely lead to a bifurcated global financial architecture. The further expansion of BRICS-plus has been accelerated as has been the dynamics of dedollarization. The assertion of sovereignty including monetary and financial sovereignty by many countries of the Global South will hasten the creation of an alternative less asymmetric non-IMF based architecture for global financial governance. This alternative now looms as a distinctly realistic global and regional institutional possibility.

6. Summary and Conclusions

As is now painfully clear, with the Global Financial Crisis of 2008-2009, the fundamental instabilities of global capitalism were exposed. However, these coordination failures and excessive risk-taking were not addressed properly---only the FIRE sector big players were bailed out. We have seen that the COVID-19 crisis has exposed these failures even more starkly. Even more starkly, it showed the complete lack of any type of global governance that addressed the needs of the people, particularly in the Global South. It is high time that fundamental coordination and other failures of global capitalism are addressed so as to give the humankind a fighting chance to face pandemics, global warming and other looming crises and create a truly sustainable and just global economic order. I argue that there is a need to create monetary sovereignty for the global south in particular in line with the fundamental premise of *Modern Money Theory (MMT) and functional finance* to generate adequate *ex ante* public investment for full employment. The governments should also be employers of the last resort. Since all existing accumulated evidence since the 2008-9 crisis indicates that we are not near the inflationary barrier, appropriate full employment generating government spending for public investment is a sensible functional finance option. For this to apply to the Global South with any plausibility, first an appropriate global financial architecture must be created.

It is now clear from the available data that the emerging and developing countries have the necessary savings and foreign exchange reserves in hard currencies and can finance a new development bank that could contribute to investment for sustainable development. In this context, it is encouraging that the leaders of the BRICS nations have committed to the creation of a new Development Bank for infrastructure and sustainable development . As our analysis makes clear, this bank would be a complement, not a substitute, for existing financial institutions both in the public and the private sector and thus contribute to development and financial stability as part of a multiregional facility in a hybrid global financial architecture. No doubt such BRICS-like facilities need to be developed further since such institutions will strengthen the voice of developing and emerging economies in the development finance architecture that is still evolving.

It is encouraging that BRICS leaders have also proposed the creation of other institutions, such as the Contingency Reserve Arrangements (CRA), amongst BRICS countries, which would provide official liquidity in times of need. The history of financial crises shows that they cannot be prevented once and for all in a globalized monetary economy with unpredictable ebbs and

flows in capital movement. This history also shows that financial markets have short memories and limited long-term learning capacity. Thus there needs to be--- within the limits of human fallibility--- a well-designed set of institutions capable of dealing with the tendencies towards financial instability and crisis. Thus both the steps following from the Chiang Mai initiative in Asia and the more recent BRICS CRA are wise responses by policy makers who wish to see and go further than the last crisis. A similar initiative in Latin America by widening and deepening the Bank of the South--- Bancosur, founded in 2009--- idea can strengthen further these moves in the right direction.

Furthermore, as the first BRICS summit hosted by the Russian Federation in Yekaterinburg in 2009 emphasized and the more recent summits have reemphasized, there is a pressing need for the global economy to move away from too much dependence on the US dollar. Inter alia, the Yekaterinburg summit highlighted the lesson that is emphasized in this paper regarding the problems created by dollar-denominated loans and assets. Both the Asian Financial Crisis of 1997-1998 and the global financial crisis that began in 2007-2008 point towards the need for a more rational global currency basket including an expanded role for the SDRs. Most importantly, as this paper highlights, such a world of multiple currencies and SDRs will need to have a transparent and democratic system of financial governance. Here technical economic arguments regarding efficiency and stability work in tandem with political and political economic arguments regarding equity and democratic rights in a world of uneven development and opportunities.

Given the unevenness in the structure of the global economy, the developmental consequences of financial crises are particularly important to analyze when designing institutions to contain and manage such crises. In this paper, particular attention has been given to the fact that the negative consequences for output growth, employment, income distribution and poverty reduction are relatively more severe for the DCs and LDCs. At least partly this occurs because of the following characteristics among others:

- a. DCs and LDCs have fewer resources for coping with financial crises, particularly one which is global in its scope;
- b. Most DCs and all LDCs lack automatic stabilizers due to the embryonic nature of their

- fiscal and social protection systems;
- c. They have limited ability of borrow in international financial markets and this limits their ability to pursue countercyclical policies;
 - d. These threats are often exacerbated by global financial market integration and Free Trade Agreements (FTAs) and bilateral investment treaties (BITs). Many WTO commitments also affect the DCs adversely. IMF pro-cyclical Structural Adjustment Policies can also constrict the policy space.

In areas such as the derivatives markets and portfolio capital flows, the shortfall in regulatory capacities for these countries can leave them vulnerable. Even in banking, the well-intentioned Basel regulations can either not be implemented, or worse, as this paper illustrates, there are aspects of Basel II and Basel III that can harm the developmental processes. Thus a careful rethinking of these issues and further capacity building for DCs and LDCs will be necessary. In light of the econometric estimates discussed earlier, this paper emphasizes the need for enhancing ability of DCs and LDCs to use fiscal and monetary policy to support the growth of their economies. Because poor States are already fiscally constrained (whether through tax capacity, IMF/WB conditionality, economic shocks/hardships), Basel III further complicates the growth and poverty-reduction picture.

The analysis here leads to the conclusion that these States will need to become more reliant on each other to implement the reforms and support regional development initiatives. Failure to do so will then mean that these States will have to become more reliant on international technical expertise and resources which may or may not be forthcoming. This may be the time for multilateral agencies to devote significant resources towards building capacities in DCs and LDCs with the help of experts with combined technical and area specializations.

In this light, the fact that the States have a full decade to delineate and implement a proper course is not as long a time horizon as it first appears to be. Even if the banking sector is adequately reformed, the proper use of financial markets will also require an enabling global financial architecture and an overall reduction of systemic risk.

As earlier papers (Khan2009; 2023a-f; 2021a-c) showed, analyzing the challenge of meeting the MDGs which justifiably, has high priority in both the UN and the affected countries

presents us with the fact that some important gaps still remain.³⁵ In one way or another, these all involve problems of capacity building and cooperation among national, sub-national and international actors both at the governmental and civil society levels. Related to this, the interests of those who live in rural areas, more remote regions and are disadvantaged for that reason would need greater representation. The combined disadvantages of gender, location and ethnic identification raise particularly salient issues for widespread deliberation. Concrete step-by-step plans of action with identifiable outcomes need to be communicated clearly, and followed through properly. All these are made much more difficult if not impossible to achieve specially for LDCs during times of crisis and global contraction.

In times of crisis, there are well-meaning suggestions of radical institutional restructuring that fade away when the immediate crisis is over. Only a few farsighted or worrying types may still voice lingering concerns. Following this literature, but more importantly, the recent global crisis and the history of the AFC motivate my proposals for moving away from an *overarching type* of GFA--- to use the terminology developed here.

Given the features of the real economic world, an evolutionary approach admits of multiple evolutionary equilibria, and a need for realistic institutional design that recognizes path dependence and the role of alternative theories and interpretations without the disabling and in most cases incorrect slogan that there is no alternative. Although social and political construction of new institutions and arrangements are difficult, except for rare circumstances, there are usually more than just one possibility. Real struggles among competing ideas, norms and politics at different levels are necessary aspects of the process of choosing among these possibilities. Such a critical constructivist approach applied to the recent international financial and economic history leads to the identification of two broad categories of global financial architectures. The *hybrid* variety advocated here on the basis of both realism and systemic efficacy and equity will nevertheless involve much institution building that is always fraught with the danger of politics-gone- awry.

The dismantling of Chilean capital controls in 1998 is a case in point. In this particular instance, a balance of payments crisis prompted the loosening of capital controls instituted earlier (Agosin 1998). It can be argued that the situation of policy and institutional reversal

³⁵ This applies particularly to those countries targeted to receive Integrated Package Services (IPS).

occurred because the interest groups favoring liberalization following a particular world view were strengthened. Such interests in Chile included at that time holders of foreign exchange, exporters, foreign creditors and investors, and the IMF and other international financial institutions. Thus the political problems of coalition building and ensuring the least cost cooperative outcome need attention. The limited achievements and remaining problems that can be seen from the Asian example discussed here should provide concrete motivation to think further about such problems of designing institutions in the real world currently.

Even under a far-from-complete RFA in Asia, the current global financial crisis has made the benefits of having an RFA structure obvious to the Asian central bankers and other players. All the surplus countries carry too much hard currency reserves which is costly. In particular the developmental opportunity costs from foregoing developmental projects are deemed to be quite high, as critics from China in particular stress. It is to be kept in mind that these foregone projects are not just in the reserve country, but in many DCs and LDCs outside of the borders of the Asian surplus economies. Thus the developmental opportunity costs of the current excess reserve-holding system are quite high indeed.

One way to assess the utility of an RFA for Asia is to raise a counterfactual question. From the policy perspective, it is interesting and important to know if the existence of an Asian RFA would have helped in any way during the AFC. The counterfactual question then asks: suppose there existed an RFA for Asia during the AFC, how would it have responded to the crisis that would have been different?

In contrast with the behavior of the IMF, within the proposed hybrid GFA, a regional financial architecture, had it been present could have done at least the following on the basis of applying an evolutionary theory of financial instabilities under globalization:

1. Through constant regional monitoring it would have sensed the danger ahead of time. Even a regional monitoring unit alone would have been able to do better than the IMF team in Asia.
2. Through constant formal and informal contact with the officials in member governments and the private sector, it would have sized up the possible extent of the problem earlier and better than did the IMF.

3. Through prompt and early action it would have provided liquidity to the system, and punished bad management in coordinated measures with the national governments.
4. It would have been able to start regional discussions about bankruptcy and work out procedures by keeping in close touch with the history and legal issues facing particular countries.
5. It would have been in a position to use both moral suasion and toughness to keep both regional creditors and debtors in line.

The fundamental requirement for this, however, was an actually existing RFA with enough liquidity and technical expertise. The Asian Development Bank provided quite a bit of liquidity to Korea in particular, but did not even have a monitoring unit when the crisis broke out. Furthermore, the autonomy and integrity of any future RFA, in Asia and elsewhere are issues that need discussion. The relationship between the RFAs and the IMF also needs to be further specified. These are matters that are of necessity evolutionary by nature. In this paper, I have tried to specify some principles that may help in selecting the more beneficial evolutionary path.

Once there is a full-fledged regional financial architecture for Asia, for instance, it could be a regional lender of last resort. It could also perform effective surveillance functions. In addition, it could promote financial and corporate restructuring that is necessary, but almost impossible for the IMF to do. Finally, in the event of a future global or regional crisis, a more timely response could come from such an RFA already in place. In addition to East Asia such useful RFAs could be constructed in South Asia, the MENA region, Sub-Saharan Africa and Latin America. In EU, ironically, a deconstruction towards a more flexible RFA through a reform of ECB and a construction of a more benign federalist revenue-sharing fiscal structure may be what is needed.

The critical constructivist argument developed so far points to the possibility of using our knowledge, interpretative flexibility within reasonable limits and political skills and ingenuity to utilize existing institutions together with some new ones to achieve desirable goals of global financial governance. In case of GFA, this argument strengthens the case for developing the hybrid variety. Using both the existing global institutions such as the IMF, albeit in a modified form, and building upon existing regional initiatives may offer a better chance of creating a beneficial makeshift hybrid GFA than the textbook type pie-in-the-sky schemes correctly dismissed by Eichengreen. However, Eichengreen does not consider the role of RFAs in his

otherwise excellent analysis. One way to read the present paper is to see it as filling this gap by using an evolutionary constructivist argument for a hybrid GFA. A set of realistic reforms of the IMF together with the formation of RFAs will offer the best chance for the global economy to achieve stability and prosperity with equity. The BRICS initiatives though small in scale are welcome moves as a multiregional RFA within the hybrid GFA, and have the potential to move the complex global financial system in the direction of optimality under post-crisis conditions.

Finally we need to emphasize in this 3rd decade of the 21st century the increasingly accelerating prospects for delinking from the US-led order. As pointed out in this paper, indiscriminate use of sanctions by the collective west including financial sanctions against central banks of other countries and coercive diplomacy have already made the US-led system weaker and more unstable than at any time since 1945. In terms of complex systems dynamics this will most likely lead to a bifurcated global financial architecture. The further expansion of BRICS-plus has been accelerated as has been the dynamics of dedollarization. The assertion of sovereignty including monetary and financial sovereignty by many countries of the Global South will hasten the creation of an alternative less asymmetric non-IMF based architecture for global financial governance. This alternative now looms as a distinctly realistic global and regional institutional possibility. In this sense, the Global South is already moving beyond the Northern architecture-biased MMT towards a world ultimately beyond Northern-dominated finance capitalism.

Appendix 1
Basel III Key Milestones
Capital requirements

Date	Milestone: Capital Requirement
2014	Minimum capital requirements: Start of the gradual phasing-in of the higher minimum capital requirements.
2015	Minimum capital requirements: Higher minimum capital requirements are fully implemented.
2016	Conservation buffer: Start of the gradual phasing-in of the conservation buffer.
2019	Conservation buffer: The conservation buffer is fully implemented.

Date	Milestone: Leverage Ratio
2011	Supervisory monitoring: Developing templates to track the leverage ratio and the underlying components.
2013	Parallel run I: The leverage ratio and its components will be tracked by supervisors but not disclosed and not mandatory.
2015	Parallel run II: The leverage ratio and its components will be tracked and disclosed but not mandatory.
2017	Final adjustments: Based on the results of the parallel run period, any final adjustments to the leverage ratio.
2018	Mandatory requirement: The leverage ratio will become a mandatory part of Basel III requirements.

Liquidity requirements

Date	Milestone: Liquidity Requirements
2011	Observation period: Developing templates and supervisory monitoring of the liquidity ratios.
2015	Introduction of the LCR: Initial introduction of the Liquidity Coverage Ratio (LCR), with a requirement of 60%. This will increase by ten percentage points each year until 2019.
2018	Introduction of the NSFR: Introduction of the Net Stable Funding Ratio (NSFR).

Appendix 2:

A Simple Model of a Complex Financial Economy with Multiple Equilibria with Possibilities of Crisis and the Role for BRICS-like Financial Facilities

In order to give the reader some idea of the problem of formalizing global and Regional complex financial cum real economic systems (GRFS and RRFS) we summarize here the basic structure of a 'simple' non-linear model embodying distinct financial architectures which can be applied to analyze the BRICS-like financial facilities. At any single point in time, the model can be presented as a Social Accounting Matrix (SAM) and flow-of-funds representation of the

socio-economic system. We will indicate the first m sectors as real and the next n as financial. There are p households and q other institutions including global and regional governance institutions.

The key distinction here is the explicitly non-linear nature of the economy-wide functional relationships. The key theorem shows the existence of multiple equilibria. Some further considerations of complexity and increasing returns prospects for development show that multiple equilibria are indeed the “natural” outcomes in such models. Thus, there would seem to be some role for domestic policy in guiding the national economy to a particular equilibrium among many. Likewise, such policy space in an RRFs within a GRFS can only be possible under some hybrid GFA of which BRICS-like multi-regional financial architectures can be an integral and desirable part.

The virtue of a global economy-wide approach to technology systems is the embodiment of various inter-sectoral linkages within and across regions. In a SAM, such linkages are mappings from one set of accounts to another. In terms of GRFS and RRFs, the production activities can be broken down into a production (sub-) system and a set of institutional innovative activities leading to the creation of BRICS-like multi-regional financial architectures .

Although the existence theorems for these global cum regional multisectoral models provide some structure for the equilibria as sequences of fixed points in the socio-economic structure with evolving technology systems, it is not specified a priori which equilibrium will be reached. The problem of equilibrium selection thus remains open and depends on global, regional and national institutions. The idea behind a BRICS-like multi-regional financial architectures can now be stated somewhat more formally. It is to reach a sequence of equilibria for developing economies so that in the non-linear models of the entire economy the maximal fixed points that are attainable are in fact reached through a combination of market forces and policy maneuvers over time. It is also to be understood that path-dependence would rule out certain equilibria in the future. Thus initial choices of projects and institutions can matter crucially at times. It has been argued in the paper that BRICS-like multi-regional financial architectures matter precisely in this way.

3. C. The Model on a Lattice

Define X as a vector lattice over a subring M of the real field R .Let $x_+ = \{x \mid x \in X, x \geq 0\}$

A non-linear mapping N is defined such that $N : X_+ \rightarrow X_+, N_0 = 0$. Given a vector of exogenous variables d , the following non-linear mapping describes a simultaneous non-linear equations model of an economy, E :

$$x = Nx + d \tag{1}$$

for a given $d \in X_+$.

This non-linear system represents a socio-economic system of the type described previously. In order to specify the model further, the following assumptions are necessary.

1. X is order complete
2. N is an isotone mapping
3. $\exists \hat{x} \in X$ such that $\hat{x} \geq N\hat{x} + d$

In terms of the economics of the model, the non-linear mapping from the space of inputs to the space of the outputs allows for non-constant returns to scale and technical progress over time. The 3 assumptions are minimally necessary for the existence of equilibrium. Assumption 3, in particular ensures that there is some level of output vector which can be produced given the technical production conditions and demand structure.

Existence of Multiple Equilibria:

Theorem: Under the assumptions 1 - 3, there exists $x^* \in X_+$ so that x^* is a solution of

$$x = Nx + d$$

Proof: Consider the interval $[0, x] = \{\hat{x} \mid \hat{x} \in X_+, 0 \leq \hat{x} \leq x\}$ where \hat{x} is defined as in assumption

3. Take a mapping F .

$$F : x \in X_+ \rightarrow Nx + d$$

F is isotone and maps $[0, x]$ into itself.

Define a set $D \equiv \{x \mid x \in [0, x], x \geq Fx\}$.

By assumption 3, D is non-empty.

We now show $x^* \equiv \inf D$ is a solution to $x = Nx + d$. $x^* \equiv \inf D$; therefore $x^* \leq x, \forall x \in D$. F is isotone; therefore $Fx^* \leq Fx \leq x$ for each $x \in D$ implying.

$$Fx^* \leq x^*$$

From (2) we have $F(Fx^*) \leq Fx^*$. Thus $Fx^* \in D$; hence $x^* \equiv \inf D \leq Fx^*$ so, $Fx^* \leq x^* \leq Fx^*$.

Therefore $x^* = Fx^*$.

This is an application of Tarski's and Birkhoff's theorem. The key feature to note here is that the equilibrium is not necessarily unique. It should also be noted that under additional assumptions on space X and the mapping N the computation of a fixed point can be done by standard methods (e.g. Ortega and Rheinboldt).

3.D. Multiple Equilibria on Banach Space:

In this section the results for multiple equilibria are extended to functionals on Banach Space. We can define the model again for monotone iterations, this time on a non-empty subset of an ordered Banach space X . The mapping $f : X \rightarrow X$ is called compact if it is continuous and if $f(x)$ is relatively compact. The map f is called completely continuous if f is continuous and maps bounded subsets of X into compact sets. Let X be a non-empty subset of some ordered set Y . A fixed point x of a map $N : X \rightarrow X$ is called minimal (maximal) if every fixed point y of N in X satisfies

$$x \leq y (y \leq x)$$

Theorem: Let (E, P) be an ordered Banach space and let D be a subset of E .

Suppose that $f : D \rightarrow E$ is an increasing map which is compact on every order interval in D . If there exist $y, \hat{y} \in D$ with $y \leq \hat{y}$ such that $y \leq f(y)$ and $f(\hat{y}) \leq \hat{y}$, then f has a minimal fixed

point x . Moreover, $x \leq y$ and $x = \lim F^k(y)$. That is, the minimal fixed point can be computed iteratively by means of the iteration scheme

$$\begin{aligned} x_0 &= y \\ x_{k+1} &= f(x_k) \quad k = 0, 1, 2, \dots \end{aligned}$$

Moreover, the sequence (x_k) is increasing.

Proof: Since f is increasing, the hypotheses imply that f maps the order interval $[\bar{y}, y]$ into itself. Consequently, the sequence (x_k) is well-defined and, since it is contained in $f[\bar{y}, y]$, it is relatively compact. Hence it has at least one limit point. By induction, it is easily seen that the sequence (x_k) is increasing. This implies that it has exactly one limit point \bar{x} and that the whole sequence converges to \bar{x} . Since f is continuous, \bar{x} is a fixed point of f . If x is an arbitrary fixed point in D such that $x \geq \bar{y}$, then, by replacing y by x in the above argument, it follows that $\bar{x} \leq x$. Hence \bar{x} is the minimal fixed point of f in $(\bar{y} + P) \cap D$. It should be observed that we do not claim that there exists a minimal fixed point of f in D .

We can also show that if $F : x \in X_+ \rightarrow Nx + d$ is an intersecting compact map in a non-empty order interval $[x, \hat{x}]$ and $x \leq Fx$ and $F\hat{x} \leq \hat{x}$ then F has a minimal fixed point x^* and a maximal fixed point x^{**} . Moreover, $x^* = \lim F^k(x)$ and $x^{**} = \lim F^k(\hat{x})$. The first of the above sequences is increasing and the second is decreasing.

Complex Dynamics and Out-of-Equilibrium Behavior:

As is well known, nonlinear dynamic systems can display a wide range of dynamic behaviors. As Keynes perspicuously pointed out in the General Theory during the great depression, the capitalist economies with complex financial systems are unstable but within limits. However, as we know, dissipative systems with a big enough perturbation can move to a new basin of attraction with much disorganization during transition. Also, even with bifurcations, we do not know for certain which path it will follow. Furthermore, catastrophic singularities are also possible.

My argument can now be summarized in terms of , dissipative systems dynamics in a world of multiple equilibria none of which may be reached. Instead, a neoliberal global economy may simply go through cycles of instabilities. A large part of my argument, therefore, has been that the recent global crisis is an example of a large accumulated perturbation that has created instabilities giving us a foretaste of what may become a pattern in the 21st century unless a new flexible hybrid GFA with sufficient liquidity and enforcement power is constructed soon. The BRICS bank and financial facilities are moves that can possibly dampen further instabilities in the global financial system and help promote growth with equity particularly in the poorer countries in the global system. With the creation of enough BRICS-like multi-regional financial architectures after the failures and crises in the 21st century, the world will have a fighting chance to pursue appropriate capabilities-enhancing development strategies along with a deepening of civilized social democratic structures in the core countries.

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