MINISTRY OF FINANCE

G-20 Leaders' Meeting on
Financial Markets and Global Economy

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Global financial governance
Brazilian proposal

Short-Term Actions

Although recent measures proposed by Governments are beginning to show positive and stabilizing short-term effects, the normalization of credit channels and financial flows still remain a challenge to be dealt with. Without tackling these problems, economic growth will be seriously impaired. Recovery of financial intermediation is a necessary condition to overcome the economic turmoil, avoiding further negative impacts on income, jobs, investment and growth. Short-term financial restraints must be confronted to avoid the resulting negative impact on credit for business, investment, consumption interbank operations.

The short-term economic agenda should be focused on countercyclical policies that boost aggregate demand and avoid excessive reduction of economic activity. The risk of long-lasting recession and of a global economic depression should be avoided. Governments must be proactive and perform pragmatically, rather than ideologically.

The successful implementation of short-term economic measures is a prerequisite for putting forth a more institutional and structural agenda covering on the core issues of financial governance.

The existing multilateral financial institutions and forums, as well as the current framework of regulation and practices have shown themselves to insufficient to the tasks at hand. In their present guise, they have failed the test of history. Negotiations to redefine the global financial system should, therefore, immediately begin. In order to be effective, these negotiations must be conducted within a reasonable time frame and, crucially, based upon a clear mandate, to be defined by world leaders. In short, a new Bretton Woods regime should be instituted to deal with 21st century realities, including legitimacy and representation principles.

Governance Proposals

General objectives

- The reform of international financial institutions (IFIs) in order to improve global financial cooperation. The new financial multilateralism should focus on rule, recommendations and incentives leading to the adoption of socially inclusive and sustainable macro-economic policies for the promotion of stability and economic growth.

- Greater legitimacy and representation should be the underpinning principles of IFI reform, so that they will better reflect present-day configuration of international economic relations. Emerging and developing countries, such as Brazil, should have their voice and representation increased and assume greater in IFI's decision-making and rule formulation processes.

- Seeing that insufficient national regulation and supervision allowed both financial agents and non-financial corporations to take excessive risks and unsustainable leverage levels, it is necessary to review the national regulatory, supervision and risk-assessment frameworks and develop multilateral normative references. These ought to be adopted nationally by all countries and be applicable to international transactions, imposing stricter disciplines on financial agents' performance, especially where it might affect the stability of the international financial system.

- Normative frameworks and crisis prevention mechanisms should be operated in a coordinated fashion by the various IFI's.

- Development of domestic instruments that minimize the costs of eventually needed intervention in financial markets by Governments with a view to protecting taxpayers from a harmful "profit privatization and socialization of losses" logic.

Based on this preliminary assessment, Brazil proposes a reform of the global financial governance, taking into account, among others, the following guiding principles.

Guiding Principles

a) *Representation and legitimacy:* Power-sharing arrangements, policy- and decision-making processes in international financial institutions and financial governance forums should be more adequately suited to the current economic international relations. In this context, IFIs should be open to further participation of emerging and developing countries;

b) *Effectiveness:* The set of rules and instruments of action of international financial institutions in the fulfillment of their specific mandates should be adapted and improved so that they may effectively respond to the challenges posed by financial globalization;

c) *Collective action:* Situations where risks and costs are collectively shared should evoke collective responses. Coordinated action must preside not only rule-making efforts, but also the implementation of mechanisms for the prevention of, and response to, financial crises, through the adoption of coordinated national policies.

d) *Good governance in the domestic markets:* Given the importance of credit and of financial intermediation in the world economy, and because of the growing risks and complexities involving these activities, regulatory, supervision, corporate governance and risk-assessment mechanisms should be continuously improved. This activity, in which the state necessarily performs a key role, should strike a balance between the efficiency of the financial markets, their continuous stability, and the promotion of conditions to generate economic development.

e) *Accountability:* On the international scene, each country´s policies should not lead to risk and/or cost transfers to other countries. Countries where these risks and costs originate should assume responsibility for them. At the domestic level, the sectors whose policies and actions expose society as a whole to disproportionate risks should contribute, both through their actions as well as financially, to the solution of the crisis and to restore market stability.

f) *Transparency*: Priority must be given to symmetry of information among economic agents. Private financial agents must comply with corporate governance rules and disclosure of relevant information to the market and society, especially those related to asset risks.

g) *Prevention:* National policies and international financial institutions should incorporate the notion of financial crisis prevention into their market supervision and monitoring mechanisms and policies.

Within the context of these general principles, Brazil proposes changes to the forums and international financial institutions, and to the supervision, regulation and domestic and international financial market risk-assessment mechanisms.

International Financial Institutions

a) G-7

- Insufficiency of the G-7 – The G-7 is not in a position to provide effective leadership on the main global issues, including economic ones. The current moment favours the creation of a new high level political discussion forum, especially on economic and financial matters, the format of which is left to be defined.

b) IMF

- Brazil wishes that the reform process within the International Monetary Fund continues. The IMF needs to adapt its governance rules, credit instruments and supervision mechanisms to the new international reality based on increasing financial globalization and the growing importance of emerging and developing economies at the global economic level. Once the 2008 reform package is ratified by Member Countries, 57.9% of the votes will belong to developed countries, and 42.1% to emerging and developing countries.
- ***The quota and vote reform in the IMF, initially scheduled for 2013, should be brought forward.***
- Brazil supports that the IFI´s top officials, including those within the IMF and the World Bank Group, be selected on an open and transparent process, with no restrictions in terms of nationality.

c) World Bank

- The World Bank also presents a legitimacy gap similar to the IMF's.
  The first reform moves of the World Bank were not sufficiently bold. Therefore, Brazil advocates the immediate resuming of the reform process of the World Bank at bolder bases, which should result in significant increase in the voting power of emerging and developing economies

d) G-20

- Brazil advocates the institutional strengthening and an improvement to the effectiveness of the G-20.
- Brazil proposes the following points for the G-20 reform:
  - Elevate the current G-20 status to a forum composed by Heads of Government;
  - Deliberations should aim at concrete results in terms of public policies.
  - Hold at least two G-20 meetings per year, before the IMF and World Bank spring and annual meetings, instead of a single one, in November; Cater for the possibility of convening extraordinary meetings, as needed, such as the one held in Washington last October 11.
  - Strengthen the G-20's ability to perform in terms of crisis management and prevention. The G-20 could set up a virtual "Situation Room" organised by the chairing country. The main goal would be to enable information exchange and coordination while favoring prompt crisis responses.

e) FSF

- In the present global financial crisis context, the role of the Financial Stability Forum (FSF) has increased in relevance and visibility. Several countries, including G-7, have proposed to strengthen the Forum and broaden its deliberation outreach. Although recognizing the qualities and virtues of the FSF, Brazil cannot support recommendations for strengthening the institutional role of a forum in which emerging and developing countries are not appropriately represented.

- Brazil advocates the expansion of FSF so that emerging countries' representation is considerably strengthened.

- The FSF should be represented by the Ministries of Finance and Central Bank governors and regulatory institutio***n***s' representatives, such as the current configuration of the G-7.

Propositions for the Regulation and Supervision of International Financial Markets

a) Crises prevention

- Monitoring of the systemic risks of financial markets by national Governments and multilateral agencies. Private institutions already have to conduct *stress* tests to learn their risk-exposure levels, but this is not currently done for the economy as a whole. Due to the complexity and secret nature of the information involved, only national and/or multilateral public institutions should be in charge of this task.

- Establishment of a risk alert mechanism (*Early Warning System*) – The IMF, or another global supervision agency to be established, should have mechanisms to monitor the evolution of finance-related systemic risks of potentially global impact. In this context, risk warnings could be issued, and crises prevention actions could be recommended and/or preemptively adopted, so as not to allow the deterioration of the relevant parameters involved.

b) Correction of insufficient supervision and regulation

- Identify and remove national and international deficiencies in regulation and supervision of the financial markets. Due to the growing globalized character of financial activity, the adoption of global regulatory and supervision standards could be achieved by defining minimal standards to be implemented by each country individually.

- The *shadow banking system* – the unregulated segment of the financial market – should be extinguished. In the context of the expansion of regulation on financial intermediation, a new agreement could be proposed to regulate actions of the financial agents whose practices are not covered by existing agreements, particularly those related to speculative funds. Equally, a proposal could be made for the regulation of securitization activities, with stronger capital requirements for securitization banking activities, as well as an increase in transparency, regulations and supervision of Governments in operations dealing with derivatives.

- *Standardization and registration:* One of the big problems of the current crisis is the existence of financial products whose pricing is difficult to gauge. Financial innovations are important for economic development, but they should not result in overly complex and risky products. Derivative contracts should be further standardized so that buyers know exactly what they are buying. Registration and follow-up of derivatives by the Government and international authorities is also critical, as the Government is uniquely placed to calculate the systemic risk of these instruments.

- Globalized and integrated financial markets may benefit from the establishment of a global supervisory agency, or the "supervisor of supervisors" (maybe, a reformed IMF.) Such a system would equally oversee the progress of the registration and standardization of financial operations and products at worldwide level.

- Worldwide financial institutions that are systemically relevant should be jointly supervised by various regulatory agencies and/or by a global supervisor. The information related to their activities should be available to all regulators, based on the principle of transparency. Global companies should be globally supervised.

- *Accountability* rules for risk-ranking agencies should be established. These rules should prevent the occurrence of vested interest assessments when ranking structured products, as well as encourage the improvement of information related to the characteristics of the risk. They should also strengthen the "*due diligence*" concept in the ranking process. These agencies should also be subject to the supervision of a worldwide supervisory agency.

- Coordinated action against tax havens should happen at the multilateral level. Ideally, the extinction of tax havens should be sought. The existence of tax havens undermines regulatory efforts and reduces the progressiveness of tax policies.

c) Macroeconomic instruments

- Any country, and not only advanced economies, may use countercyclical policies, without being stigmatized or suffering restrictions of an ideological nature. The IMF, for its part, should change its approach whenever requested to help countries in a crisis, by acknowledging the central role of countercyclical policies to overcome crises.

- Macroeconomic policy should avoid extreme formulations and ideological rhetoric. Good economic policy should be pragmatic, managing the *trade-offs* inherent to macroeconomics to reduce the volatility of growth and inflation patterns, while preserving the well-being of the population.

- Monetary policy should take into account both inflation control and economic development. As far as emerging-market countries are concerned, it is important that they preserve higher-than-average growth rates for long periods.

- Exchange-rate policy should combine floating rates with a low vulnerability to external shocks. Countries can avoid an excessive appreciation of their currency through the acquisition of foreign reserves. If the "surplus countries" commit to buying the currency of "deficit countries" in a system of coordinated macroeconomic policies, the international financial system would be less volatile and more conducive to economic growth.

- To avoid the risk of inflation, the exchange-rate policy must be complemented by fiscal responsibility and a system of inflation control. Fiscal policy should combine budget balance, which is crucial for macroeconomic stability, and social responsibility. In general terms, this means a stable fiscal outcome (deficit or surplus) as a percentage of the GDP, and stability of the debt-to-GDP ratio in the long run (average over the economic cycle.)

- Fiscal balance can be achieved at different Government sizes, and the needs of each economy must determine Government actions in democratic regimes. Emerging countries still have to build up a broad social protection network, as well as to invest heavily in the economic (power, transports etc) and social (housing, sanitation etc) infra-structure.

- Presently prudential rules are the same, both in boom and slump phases. This may encourage leveraging when the market is up (capital gains increase equity, promoting indebtedness), and deleveraging when the market is down. So, capital requirements, reserve funds central bank deposits should be countercyclical. These requirements for should be higher for periods of faster credit growth and higher risk, and lower for periods of market slowdown.

- Financial institutions should contribute more for credit guarantee during the moments of fast credit expansion and higher risk. In the moments of slowdown, these funds could have countercyclical functions. In the cases of a crisis, these funds could be used by Governments in market interventions without imposing an additional burden on taxpayers.

- Banks and other financial institutions should also be encouraged to "save" part of their additional earnings during the moments of fast credit expansion and higher-than-average profit. In an economic slump, with lower profit, they could use this capital for investment or dividend payout.

d) Transparency of balance-sheet rules

- The balance sheet of financial institutions (commercial banks, investment banks, hedge funds, and others) must be increasingly transparent. Financial institutions should issue full financial statements and accounting reviews, including detailed information on the level of risk exposure of off-the-balance-sheet operations. The current value of assets and risk exposure, including off-the-balance-sheet entries, should be effectively measured and demonstrated.

- Financial institutions should include middle-term risk perspectives in their balance statements. Risks should not be assessed by taking into account only the current prices of assets without considering their volatility or their behaviour over a longer timeline. In this context, the Basel rules should be amended in order to include asset and risk evaluations over longer periods of time.

e) Accountability

- The payment of high salaries and performance bonuses to executives of big financial institutions should be regulated to make the relevant remuneration policies compatible with sustainable levels of risk-taking, more transparent and less favourable to excessive speculation. Regulators should establish higher capital requirements for financial companies that offer compensation packages to CEOs that reward short-term returns associated with higher risks.

- Executives who are responsible for balance fraud and/or take excessive and disproportionate risks against the middle and long-term financial integrity of corporations should incur in both civil and penal liability.