ISSUE OBJECTIVES FOR THE 2002 G8 KANANASKIS SUMMIT
- International Financial System -

Introduction

Among the G7 nations, there is consensus that each country shall encourage their domestic financial and banking systems to adhere to more stringent money laundering and transparency rules in the conduct of their business. Yet, discussions after discussions in the international arena reveal that the International Monetary Fund (IMF) should take the lead in dealing with the various issues relating to the international financial system rather than the various individual nations. This report seeks to discuss three main areas within the International Financial System issue area that were highlighted during the past year and that will be addressed at the Kananaskis Summit later this month. First, the impact of the global financial system on emerging markets. Second, the attempts at reform within the international financial system, namely the creation of clarity and security within the system, and third, the movement to eliminate money laundering from within the current system.

1. Emerging Markets

In the aftermath of the Argentinean financial crisis, there has been widespread concern about the international financial system and the need to prevent and manage the cataclysmic crises which emerging markets are vulnerable to. Experts have expressed their frustration with the slow pace of global financial reform, and the lack of attention afforded to the concerns of developing countries in the debate surrounding the 'new international financial architecture'. The G7 Finance Ministers and Central Bank Governors meeting during February 8-9, 2002, focused on generating confidence in the current system. The Finance Ministers expressed concern for the emerging market economies because of the weak economic and financial market conditions in the G7 nations. The ministers stated that these markets should "continue to implement policies conducive to investment and economic growth. We welcome as steps in the right direction recent announcements by Argentine authorities. We encourage them to continue to work closely with the International Monetary Fund (IMF) and the international community on a financially and socially sustainable economic reform program that will enhance prospects for growth and future foreign investment. We recognize the difficult circumstances facing the people of Argentina, and that the way forward is for Argentina itself to develop a plan to build a credible and sustainable economic recovery."[1]

In April 2002, the G7 Finance Ministers adopted an integrated Action Plan to increase predictability and reduce uncertainty about official policy actions in the emerging markets. This Action Plan is part of an overall endeavor whereby the sovereign debt of all countries would ultimately be investment grade, a rating that every country could

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[1] http://www.g-7.ca/final_com_e.html

eventually achieve with the right policies. The Action Plan is designed to help prevent financial crises and better resolve them when they occur, thereby creating the conditions for sustained growth of private investment in emerging markets and helping raise living standards of the people in emerging market countries.[2]

The Action Plan is essentially a co-operative market-oriented approach to dealing with the sovereign debt restructuring process. It incorporates new contingency clauses into debt contracts in emerging markets and should describe as precisely as possible what would happen in the event of a sovereign debt restructuring: "The clauses should include super-majority decision-making by creditors; a process by which a sovereign would initiate a restructuring or rescheduling – including a cooling-off, or standstill, period; and a description of how creditors would engage with borrowers."[3] With this market-oriented approach to the sovereign debt restructuring process, the G7 countries have promised to limit official sector lending to normal access levels except when circumstances justify an exception.[4]

Emerging markets gained markedly from the low global economic recovery expectations in early 2002. In spite of continuing economic problems in Argentina, sovereign spreads in general narrowed in an environment of low industrial country interest rates. Some of the strongest performing stock markets were those of Korea, Mexico, and Southeast Asian countries, which were seen as having the most to gain from an economic rebound in the United States. The Russian equity market continued to rise at a blistering pace, with recent increases in oil prices adding impetus to an improving business climate.

Russia, whose financial markets were unfazed throughout 2001 despite falling global economic activity and oil prices, continued to boom in the first quarter of 2002. Shares on the Russian stock exchange have risen almost 60% this year, and the country's sovereign spread has dipped below 500 basis points, less than four years after its sovereign default. After their February 2002 Ministerial meeting the G7 Finance Ministers stated that they "welcomed Russia's strong growth and significant structural reforms, and encourage further progress in strengthening the financial sector, improving corporate governance and the investment climate, and combating terrorist financing. We agreed on the importance of Russia's early accession to the World Trade Organization (WTO)."[5]

In 2002, emerging markets were aided by both low level interest rates in developed countries and narrow sovereign spreads. The low interest rates in developed countries helped central banks in emerging markets to ease monetary policy without depressing exchange rates. Both Mexico and Korea were able to cut domestic rates and saw their currencies appreciate. In addition, low interest rates are likely to have lowered the perceived risks of investing in emerging market assets. While international issuance of debt securities by emerging market countries remained at the depressed level of recent

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[2] http://www.fin.gc.ca/activty/G7/g7200402e.html
[3] Ibid.
[4] Ibid.
[5] http://www.g-7.ca/final_com_e.html

years, Asian countries did begin to draw on bank credits from abroad, in both the fourth quarter of 2001 and the first quarter of 2002.[6]

The economic recovery that began during the first quarter of 2002 has brought improvements in financial market conditions. Mature equity and bond markets have further stabilized. Most emerging market countries continue to have access to international capital markets, and their bond spreads have declined. The near-term outlook thus appears largely free of imminent threats to global financial stability.[7]

2. Clarity and Strength within the system

The U.S. Securities and Exchange Commission (SEC) has issued recommendations that focus on disclosures regarding liquidity and capital resources, including off-balance-sheet arrangements; certain trading activities that include non-exchange-traded derivatives accounted for at fair value; and the effects of transactions with related parties and certain other parties. The accounting profession has announced initiatives to curb external auditors of publicly traded companies from also providing internal audit and consulting services to their clients. Possible regulatory measures are being explored and many other fundamental reforms are under development by private-sector organizations.[8] While most of these initiatives are related to the fallout from the Enron crisis, they do also improve the international system.

Over the past year and a half, the Bank of England and the Bank of Canada have been developing a new framework for the resolution of international financial crises. The new framework is designed to align incentives for all parties to deal with a crisis and thereby preserve the integrity of the international financial system. The framework is built on principles, not rules. It attempts to clarify the respective roles and responsibilities of the public and private sectors in the resolution of financial crises. A central element in shaping private sector expectations is knowledge that the official sector will behave predictably. Constraints on lending by the International Monetary Fund are a key step in that direction. They ensure that private sector involvement is a crucial part of crisis resolution, and they help encourage debtors and creditors to seek co-operative solutions to a crisis. Characterized by constraints, clarity, and orderliness, the framework has the potential to reduce the incidence and cost of financial crises.[9]

Recent statements by the German Government highlight the need for an international financial architecture that should be adaptable in line with changing circumstances, while maintaining stability in the international system. The German Government made it clear that they regard good governance as a key requirement for the creation of successful long-term economic development. The Federal Government pledged its support along

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[6] http://www.bis.org/publ/qtrpdf/r_qt0206a.pdf
[7] http://www.imf.org/external/pubs/ft/gfsr/2002/02/pdf/chp1.pdf
[8] http://www.federalreserve.gov/boarddocs/speeches/2002/200202282/default.htm
(Remarks by Governor Susan Schmidt Bies at the Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States, Rüschlikon, Switzerland February 28, 2002)
[9] http://www.bank-banque-canada.ca/publications/working.papers/2001/wp01-20.pdf

with other international financial institutions to pay increasing attention the underlying political causes of financial crises.

3. Money Laundering

One main focus for the G8 nations leading up to the Kananaskis summit, is the issue of money laundering within the financial system. After September 11, many countries took to the task of increasing security through multiple channels, including making the international financial system impervious to terrorist abuse. Attempts were made to shield both domestic and international financial sectors from fraudulent activities which terrorist groups may use to fund their activities, most notably money laundering. With an estimated $12.8 trillion dollars in circulation per year, money laundering is the world's third largest business. It adversely affects financial institutions and economies by creating unusual changes in the demand for money and exchange and by heightening interest rate volatility. Over the last year, members of the G8 have made substantial progress towards narrowing the channels of abuse for money laundering.

The G8 Nations have undertaken a number of collective initiatives towards reducing money laundering in their financial markets. Most notably, all G8 member nations sit on the Financial Action Task Force on Money Laundering (FATF). This independent body, whose secretariat is housed at the OECD headquarters, will soon release a new report outlining more stringent measures for the international reduction of financial abuse. There has also been a critical review of the "Forty Recommendations", a paper released earlier by the Task Force, which suggests increased activity of international financial institutions in preventing abuse, as well as increased involvement of member governments. Furthermore, at a meeting of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund (IMF), G8 nations pledged to strengthen the international financial system for developing and developed countries alike, and to take an active stance against international financial crimes including money laundering.

The G8 nations have also made individual efforts to combat international financial crime. Canada has taken the lead in many international initiatives towards preventing money laundering. Canada's anti-money laundering agency, the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC), was established in order to provide crucial support and information to law enforcement agencies to assist in the forceful implementation of anti money-laundering measures. In October of 2001, the Canadian government provided FINTRAC with $10 million, with a provision for $53 million over the next 5 years in order to facilitate these increased responsibilities. Furthermore, Canada has taken on the role of a key donor agency with the Financial Sector Reform and Strengthening Initiative (FIRST), which will help to address the problem of money laundering through specifically targeted projects between the donor and recipient nations.

The United Kingdom has also targeted the reduction of money laundering through its co-sponsorship of the FIRST initiative. In November of 2001, stringent new money-laundering regulation came into effect in the UK, giving Her Majesty's customs agents' power of inspection rights over cheque cashers and money transmission agents.

At the end of 2001, the United States launched a national money laundering strategy in association with the Department of the Treasury, the Department of Justice, and the Office of Enforcement. The goal of the strategy is to dismantle large-scale money laundering agents through the concentration of law enforcement officers in major financial centers domestically, as well as through cooperation with other governments on a global scale.

The European Union has continued to review and revise its existing "fight against fraud" legislation, while Japan is in the process of instituting anti-corruption measures within its corporate sector, in an effort to combat the economic difficulties that have been plaguing the country in recent months. Italy, Germany, and France have focused their attentions primarily on the financing of terrorism in the wake of September 11, and have consequently not launched ambitious individual anti money-laundering programs.[10]

Conclusion

The international financial system has been a focal point of recent Summits and will therefore not play a major role during the Kananaskis Summit later this month. Moreover, since September 11 and the Enron crisis, many initiatives are underway to improve transparency in the financial system. However, under the general issue area of terrorism, the G7/G8 leaders and ministers may discuss further initiatives to prevent terrorist groups from raising funds for their activities.

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[10] http://www.ustreas.gov/press/releases/docs/ml2001.pdf
http://www.reuters.com/news_article.jhtml?type=search&StoryID=1060360\
http://www.fin.gc.ca/budget01/bp/bpch5e.htm#sec1
http://www.newswire.ca/releases/May2002/07/c2515.html
http://www.newswire.ca/releases/April2002/21/c6653.html
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