

Reforming the International Financial Architecture After Ten Years

Barry Eichengreen

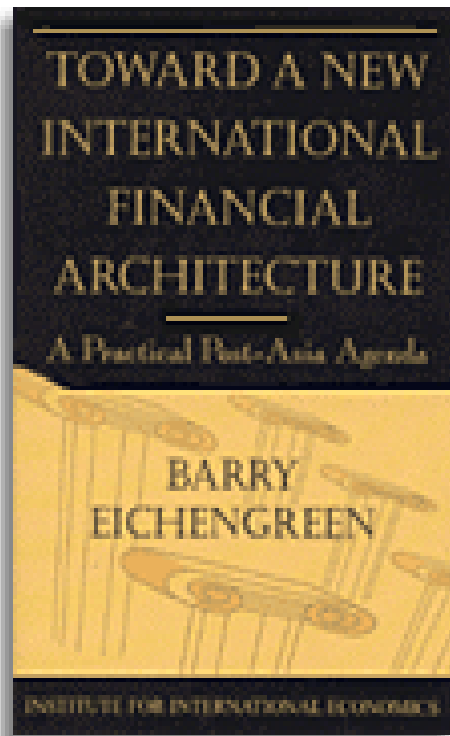
November 2008

- Like many things, this paper has been overtaken by events.
- I originally conceived it as a review of the debate over strengthening the international financial architecture that had been spawned by the Asian financial crisis.
 - Robert Rubin having coined the term exactly ten years ago.
- Since then, the global credit crisis has placed that debate in an new light.
- It has spawned a new debate using all the same language (the November 15th summit in Washington DC being intended, once again, to design “a new international financial architecture.”
- And there have been important changes in the architecture in recent days and weeks, ranging from a proposed new IMF lending facility to Federal Reserve swap lines for emerging markets to transnational bank bailouts in Europe.
 - Who can keep up?

I start the paper by reminding the reader of the priorities of earlier reformers

- **These included:**
 - Strengthening supervision and regulation of financial institutions and markets
 - Enhancing transparency
 - Reforming corporate governance
 - Rationalizing policies toward the exchange rate and capital account
 - Reforming the IMF

Perhaps a more accurate way of putting it is that this was my own agenda for reform 10 years ago



- These included:
 - Strengthening supervision and regulation of financial institutions and markets
 - Enhancing transparency
 - Reforming corporate governance
 - Rationalizing policies toward the exchange rate and capital account
 - Reforming the IMF
 - With hindsight, interesting as much for what it left out as what it included....

Standards and codes

- The main mechanism for ensuring progress on the first set of goals was the promulgation of a set of international standards and codes.
 - Morris Goldstein had done pioneering work on an international banking standard (1997).
 - The IMF and other multilaterals then generalized the idea.
 - The result was standards for not just best practice in banking supervision (“core principles”) but also securities market regulation, data disclosure, financial transparency, corporate governance, auditing and accounting, bankruptcy and insolvency procedures, etc. etc.

This approach was greeted skeptically

- (Not least in the IMF itself.)
- Standards, some complained, were weak soup
 - They were likely to be so general as to have little practical effect.
- Others complained that they would foist on emerging markets one-size-fits-all-advice.
 - (Notice the incompatibility of these two critiques.)
- Moreover, there was unlikely to be effective monitoring of compliance, it was objected, or application of sanctions against those who failed to comply.

And, indeed, there were problems

- The process of negotiation was long, complex and bureaucratic (recall Basel II).
- The IMF found it difficult to marshal the specialized human resources to monitor compliance with financial standards.
- It hesitated to issue blunt statements when compliance was inadequate.
- It was rebuffed by its shareholders (as when it tried to do an FSAP for the United States).

And yet there is some evidence of the desired effects

- Empirical work suggests that:
 - SDDS subscription and compliance with international accounting standards matter for credit ratings and spreads.
 - Undergoing a ROCS reduces spreads significantly.
 - Compliance with the Basel Core Principles is positively associated with financial-stability outcomes.

But other evidence is less positive

- There is the flawed Basel II agreement.
- There is the inadequacy of the OECD's corporate governance standard.
 - Common features of these problem areas include:
 - excessive confidence in market discipline,
 - acceptance of the premise that practice in the advanced countries is an adequate standard for emerging markets,
 - and the belief that markets necessarily process and assimilate information efficiently.

A second focus was a more measured approach to capital account liberalization

- The IMF had been pushing to make capital account convertibility an obligation of members in 1997 (!).
- The re-think was well underway by 1998.
 - Subsequent staff studies warned of liberalizing capital flows before moving to a more flexible exchange rate, before strengthening financial institutions and markets.
 - They warned of large current account deficits, excessive dependence on foreign funding, and currency mismatches.

This is progress

- Countries with large current account surpluses that have limited offshore bank funding and large currency mismatches have not been immune, but they have at least avoided the worst of the crisis.
- The problem is that not all countries took this advice to heart.
 - Not all of them prevented current account gaps from growing (Estonia...).
 - Not all of them limited offshore bank funding (Korea...)
 - Not all of them limited currency mismatches (Hungary...)
- And those that failed to do so are now paying the price.
- It's clear from recent weeks that the case for capital controls is back (Rajan, Cavlo, other names...)

- Related to this problem is the paucity of effective instruments for dealing with capital flow surges, currency mismatches and the like.
 - Controls must be applied with the delicacy, as Thailand learned in 2006 (not to say it can't be done – Indonesia, where I was day before yesterday, appears to be moving very cautiously in this direction).
 - Fiscal policy works, but flexibility is limited in democracies.
 - Greater exchange rate flexibility discourages currency mismatches, but governments have been reluctant to walk the walk (movement toward more flexible rates has halted in recent years).

Final agenda item was reforming the IMF

- Capital markets function was to be strengthened.
- Early warning indicators were to be built.
- Conditionality and lending functions were to be streamlined and updated.
- Governance was to be reformed.

Progress here is mixed

- Capital Markets Department receives mixed reviews (people are again calling for strengthening the Fund's surveillance of capital markets).
- There has been much investment in the construction of early warning systems (for which people like Gordon Brown are calling again) without, predictably, much payoff.
- IMF continues to face the dilemma of whether to call its members to task and risk provoking either the crisis is seeks to avert (Argentina in 2001) or provoking that member's ire (US and the TARP).
- There have been modest reforms of IMF governance since Singapore. But emerging markets are reluctant to borrow from the Fund (as in the case of Korea) or to recycle their reserves through it (as in the case of China), because changes in IMF governance have been largely cosmetic. Where are meaningful changes in Board composition? Where is reform of leadership selection?

The most significant innovation is probably the Short-Term Liquidity Facility

- This is a step in the right direction – if it has legs.
 - Responds to the need for something resembling an international lender of last resort.
 - Finesses some problems with the earlier Meltzer Commission proposal, CCL and RAL (doesn't require countries to apply)
 - There is little danger of stigma under current circumstances (lots of countries are suffering for reasons not of their own making).
 - But....

Problems with the Facility

- Its size is not clear (the Fund has not specified). Until there is meaningful governance reform, will China, Saudi Arabia and others agree to fund it?
- Will the IMF be able to sort countries into these two categories?
- Observers like Kemal Dervis warn that countries that are left out may be destabilized.
- They call for more general provision of liquidity (quick disbursing, five times quota).
- But if funds are also provided to countries like Indonesia, Turkey and Vietnam with structural imbalances, will loans through the new facility have to be conditioned?
- Are we then simply back in the old situation of every loan on its merits with its own particular conditions. (One suspects so.)

- Looking forward, a combination of new and old issues will dominate the agenda.
- So what follows is my agenda for the “new Bretton Woods Conference” on November 15th.

I would argue that the agenda should contain four items

- Immediately institute further policies to staunch the financial bleeding and get the patient's heart beating again.
- Strengthen existing financial institutions
- Think outside the box
- Finally, do no harm
 - [From the first and fourth item, you will see evidence that my wife is a physician...]

Immediate policies to staunch the bleeding and get the patient's heart beating again

- Much of the short-term action is taking place already, in other venues.
 - There are national programs to recapitalize banking systems and get the interbank market up and running through provision of guarantees.
 - There are the Fed's (and ECB's) swap lines for emerging markets.
 - There are IMF programs for crisis countries and the Short-Term Liquidity Facility for others.
 - There are fiscal initiatives at the national level
 - The US is now likely to do both a second and third round of fiscal stimulus (one during the lame-duck session of Congress, a second after the new president and Congress take office).
 - Japan has committed to significant fiscal stimulus, as you know.
 - Emerging markets with room for maneuver, such as China and Korea, have done likewise.
 - Europe is the main place where this response has been inadequate.
 - In all of the above, I believe that there is a need to do more.

But more needs to be done on November 15th

- Agreement on coordinated fiscal action is essential for correct this anemic response, since there is a big free-rider problem here (the effects mainly spill out internationally).
- While new interbank lending has been guaranteed in most countries for an interim period, the problem of who is responsible for new cross-border interbank claims remains.
- Similarly, some of the benefits of bank recapitalization are external to the country doing it – calls for coordination and concerted action.

Second, strengthen existing institutions

- Recognize that the IMF has inadequate resources.
 - Free IMF resources are only about \$250 billion, while 5 times quota (the STLTF limit for emerging markets implies demands as high as \$700 billion.)
 - If any of the larger emerging markets (Turkey, Brazil, Indonesia, Poland, or Korea) gets into trouble, \$250 billion will be gone before you can say 'Special Drawing Rights'.
 - An agreement to top up the IMF's resources by tapping reserve-rich countries on an exceptional basis would be the best solution.
 - There is no time, in my view, for agreeing on quota revision, SDR allocation, borrowing on the market.

This also means fixing Basel II

- Insofar as two of its pillars are credit ratings and internal models of VAR, Basel II is fatally flawed.
 - Interesting political economy question is how such a flawed standard could result from 10 years of deliberations...
- Some elements of reform are clear.
 - Financial institutions need to be made to hold more capital (8% is not enough).
 - Capital requirements need to apply across the board (to conduits and SIVs too – as in Spain).
 - Capital requirements should be a function of riskiness of banks' liabilities (funding) as well as assets (investments).
 - Capital requirements should be antecyclical rather than procyclical.
 - Capital requirements should depend on risks that a bank's portfolio poses for the financial system and not just for the individual bank (external effects should be taken into account).

Some modest proposals

- Key capital requirements to rate of growth and not just the level of bank assets (Goodhart).
- Compute required capital in the old Basel I way and new-fangled Basel II way and hold banks to the higher of the two (Eichengreen and SNB).

In this connection, rating agency problem must be addressed

- Bugbear of the Asian countries in 1997-8.
- Now that the crisis has hit home (hit the US and Europe), it is being taken more seriously.
- Ratings tend to be unreliable (models estimated on short time series).
- Agencies have conflicts of interest.
- What to do about this?
 - Certainly, reliance on ratings for gauging, inter alia, capital adequacy should be reduced.
 - Conflicts of interest should be addressed.
 - More competition is probably the most durable solution.

And counterparty risk must be addressed

- Solution is to force OTC transactions into a clearinghouse or organized exchange.
- Interesting political economy question is why this hasn't happened.
 - There are fixed costs.
 - Broker-dealers who would lose their hefty commissions lobby against.
 - This would require greater standardization of securities and make it more difficult to tailor contracts to need.
 - I don't regard any of these as compelling objections. This is what taxation and regulation are for.

Third, think outside the box (ponder new institutions)

- Here I see two places to start:
 - Form a new global steering committee
 - Take a global approach to the regulation of large internationally-active financial institutions.

A new global steering committee

- Asking China to top up IMF resources (“recycle some of its reserves through the Fund”) raises the question of what it can expect in return.
- Fundamental IMF reform (which I will discuss below) will take time.
- An immediate quid pro quo would be to reconstitute the G7 to make it a meaningful global steering committee for the 21st century.

A new global steering committee

- Asking China to top up IMF resources (“recycle some of its reserves through the Fund”) raises the question of what it can expect in return.
- Fundamental IMF reform (which I will discuss below) will take time.
- An immediate quid pro quo would be to reconstitute the G7 to make it a meaningful global steering committee for the 21st century.
 - This means: US, EU, Japan, China, Brazil, South Africa, Saudi Arabia (not exactly a “Club of Democracies”)

A Global Approach to Financial Regulation

- Actually, this was mentioned in the earlier debate, by Eatwell and Taylor, but dismissed out of hand. Now, clearly, it is back.
- But will there be a willingness of, inter alia, the United States to delegate regulation of its banks to a supranational body?
- Clearly not. At the same time, the problem of cross-border bank spillovers is too big to ignore.
- My own idea is the WTO model.

IMF reform one more time

- More fundamental governance reform will be required for the IMF to regain its legitimacy.
 - At a minimum, reform of Executive Board representation (a single European chair) and leadership selection.
 - A maximalist agenda would reform IMF governance so that it functioned more like an independent central bank (DeGregorio, Eichengreen, Ito and Wyplosz 1999, Mervyn King 2006, Gordon Brown 2008).

Finally, do no harm

- Don't kill financial innovation
- Don't resort to beggar-thy-neighbor policies, whether these take the form of trade restrictions or escalating deposit insurance limits.

- Thank you very much.