

# *Building an International Monetary and Financial System for the 21<sup>st</sup> Century: Agenda for Reform*

## *REINVENTING BRETTON WOODS COMMITTEE*





***Building an International Monetary  
and Financial System  
for the 21<sup>st</sup> Century:  
Agenda for Reform***



**eBook published by the  
Reinventing Bretton Woods Committee**

**Proceedings of the conference  
organized by the Committee in  
New York City, November 24–25 2009**

**Marc Uzan  
Founder and Executive Director  
[www.rbwf.org](http://www.rbwf.org)**

## ***The Way Forward***

Over the last fourteen years, The Reinventing Bretton woods Committee has closely been involved in the debate of improving and reforming the global financial architecture. Our name speaks for itself. In 2008, call for a new Bretton woods, Bretton woods 2 has been mentioned by Prime Minister Gordon Brown, President Nicolas Sarkozy among others.

Since the heads of State Summit in Washington in November 2008, the global economy is decelerating at an unprecedented level and a sense of disarray, and a loss of confidence world wide is now spreading. This crisis is not any more a crisis of the center versus the periphery, it is a global crisis, economic, financial and political. This crisis is our collective failure not to have taken decisions to improve and change the paradigm during the period of emerging markets crisis of the 1990's and during the debate of the best way to resolve the global imbalances in the world. In fact, the external imbalance and the internal imbalance of major countries in the world between surplus countries and deficit countries are at the origin of this debacle. So how to explain that Heads of state mention a new Bretton woods where at the end, there is no mention at all not even the word exchanges rates or currencies in the G20 heads of state communique? Are we missing something? Maybe we are realizing that the world is not ready for globalisation. Markets went ahead believing that the political structures will follow.

In fact, this crisis demonstrate more than ever that national level is the only level that matters. No one is ready for a global financial regulator, for a global central bank, for a global single currency. So we will need to live with a patchwork of cooperation which are going to be more and more complicated to manage. That transition will be complex as we don't really have a global financial macro theory to understand the episode of the last 12 months.

From our perspective,

1. On the architecture, G20 should serve as the forum formally for countries to agree to adopt best practices/international standards. The IMF should provide its advice, support to the G20. The Financial Stability Forum should be made into a permanent body, with a broader membership, reporting to G20.
2. On lender of last resort functions, regulators should rethink the global approach to liquidity management and develop guidelines for lender of last resort policies. There is an urgent need to clarify and institutionalize central bank swap arrangements.
3. On bank regulation, a complete revision of Basel 2 is needed, including tighter leverage ratios, and the regulatory arrangements must be made compatible with incentives to private actors to discipline the market better.
4. On exchange rates, work should begin immediately on how to restore discipline in the international monetary system.

If this is deemed to be “unrealistic”, then we have to face the fact that the world faces a succession of crises, each one worse than its predecessor, and that these are beyond our scope to manage with existing instruments. At present the stark choice is between another Great Depression, another bigger New Asset Bubble, and a return to International Socialism, including rigid controls on international exchanges and bank credit. The only way to preserve freedom for a liberal financial and trading order is to build a new financial architecture.

Marc Uzan

Founder and Executive Director  
Reinventing Bretton Woods Committee



# ***Building an International Monetary and Financial System for the 21<sup>st</sup> Century: Agenda for Reform***

## **Contents**

### Conference Summary

Edited by Sandrine Merckaert . . . . . 1

### Avoiding International Financial Crises

Mark Allen . . . . . 11

### *Building an International Monetary and Financial System for the 21<sup>st</sup> Century: Agenda for Reform*

Sven W. Arndt . . . . . 21

### *Could Another Currency Provide Liquidity To Financial Markets?*

Christopher Avenarius . . . . . 25

### *Responding to the Financial Crisis: An Agenda for Global Action*

Amar Bhattacharya, Kemal Dervis

and José Antonio Ocampo . . . . . 29

### *The Past and Future of IMF Reform: A Proposal*

Michael Bordo and Harold James . . . . . 43

### *A New Bretton Woods?*

Lawrence J Brainard . . . . . 75

### *Building an International Monetary and Financial System For the 21<sup>st</sup> Century: Agenda for Reform*

Martin Castellano . . . . . 83

### *Improving the International Financial Architecture*

Richard N. Cooper . . . . . 93

### *How to Prevent Future Crises: Create a World Financial Organization*

Barry Eichengreen . . . . . 101

<i>International Financial Architecture</i>	
Erich Harbrecht .....	107
<i>The Icelandic Banking Collapse: A Story of Broken Promises</i>	
Tryggvi Thor Herbertsson .....	115
<i>Building an International Monetary and Financial System for the 21<sup>st</sup> Century: Agenda for Reform</i>	
Olivier Jeanne .....	127
<i>Solutions to Restore International Financial Stability</i>	
Dino Kos .....	133
<i>A New Bretton Woods?</i>	
Ronald McKinnon .....	141
<i>Financial Disaster Recovery</i>	
Ira Millstein and George Vojta .....	151
<i>After the Turbulence – Where to next for Emerging Markets?</i>	
Jens Nystedt .....	161
<i>South Centre calls for Revamping the Global Financial Architecture</i>	
José Antonio Ocampo and Board Members of the South Centre .....	173
<i>Will the Crisis Trigger a Revival of the IMF?</i>	
Jean Pisani-Ferry .....	183
<i>Ten Fundamental Issues in Reforming Financial Regulation and Supervision in a World of Financial Innovation and Globalization</i>	
Nouriel Roubini .....	197
<i>Global Financial Crisis and Restructuring the International Monetary System</i>	
Li Ruogu .....	213
<i>Restoring International Financial and Monetary Stability</i>	
Jeffrey Shafer .....	223
<i>Stable Money Is the Key to Recovery</i>	
Judy Shelton .....	233

*Restoring International Financial Stability: Five Guidelines for  
Regulatory Reform*  
Alexander K. Swoboda . . . . .245

*International Financial Institutions Reform Proposals*  
George Vojta . . . . .255

**APPENDIX**

*CFA Institute Memorandum to the Treasury Select Committee:  
Accounting and the Banking Crisis*  
CFA Institute. . . . .263

*Proposals on the Financial Crisis*  
Club Praxis . . . . .283

Conference Agenda. . . . .293

List of Authors . . . . .297

List of Participants . . . . .301

Sponsors . . . . .309



# ***Building an International Monetary and Financial System for the 21<sup>st</sup> Century: Agenda for Reform***

## ***Conference Summary***

***Edited by Sandrine Merckaert***

What we are witnessing today is not just a crisis in the system, it is a crisis of the system. The global financial framework is broken, and the level of trust in capital markets is at all time lows. As a new step in the globalization process, there should be a focus on enhancing world trade and financial flows, in a way consistent with sustainable economic growth. On November 24-25, 2008, the Reinventing Bretton Woods Committee held a conference in New York City aimed at addressing solutions and proposals to restore international financial and monetary stability. The following summary of the conference emphasizes three fundamental points: 1) financial regulation, oversight and role of the Financial Stability Forum (FSF); 2) emerging economies, lender of last resort; and 3) global imbalances, exchange rate regime.

## ***International Coordination on Financial Sector Regulation***

Participants welcomed the decision to shift discussions from the G7 to the G20. The latter could play the role of an umbrella authority for groups of countries coming together on different issues. With a more policy-oriented approach and a clear focus on financial stability, the G20 should not only recommend, but also monitor implementation of the recommendations. It was proposed that the G20 serve as a forum for countries to formally set an agreement about their commitment to adopt best practice and international standards. The idea that the International Monetary Fund (IMF) provide analysis and recommendations

to the G20 was also put forward during the conference.

The question was raised whether some form of global authority is needed to look after the stability of the financial system as whole, the same way national regulators look after the safety and soundness of their own system. One speaker proposed the creation of a World Financial Organization, analogous to the World Trade Organization. However, participants mostly viewed a global regulator as too ambitious. On the other hand, the idea of making the FSF into a permanent organization was welcomed. As one panelist pointed out, the FSF, which is a body without statutes, staff, procedures, and formal decision-making powers, has emerged as a powerful organization and has been able not only to design but also to monitor the implementation of some early responses to the crisis. The focus remains on giving more legitimacy to the FSF, which will have the task of producing recommendations, while the IMF will be responsible for implementation. There was a large consensus to broaden the membership of the FSF. Participants encouraged the G20 to follow through on its communiqué and appropriately expand the Forum to include emerging market economies.

In a world of nation-states, there is a legitimacy of national decisions which does not exist at the supra-national level. As one speaker highlighted, the current crisis has demonstrated the limitations on global coordination and global cooperation for the regulation and supervision of the financial system, making decisions by nation-states more critical. The IMF was cited as a possible facilitator for cooperation between colleges of supervisors. While a global regulator is neither desirable nor feasible, purely national regulation is also inadequate due to cross-border spillovers and negative externalities. The challenge lies in finding the right balance.

### ***Financial Market Policy***

Officials should focus on stabilizing markets and economies by countering the acute liquidity squeeze. It was recognized that there is now more than ever before a much tighter connection between funding liquidity and market liquidity. In order to make

the financial system less crisis prone, one panelist emphasized the importance of providing systemic liquidity in situations of stress. In this regard, regulators should rethink their global approach to liquidity management by developing protocols for liquidity provisions. Financial institutions should further ensure they use improved risk management models. One speaker made the case for some form of international prudential taxation. The possibility to raise the reputational costs for countries with inadequate domestic regulatory practices was also mentioned.

Progress has been made in the area of OTC credit derivatives markets, convergence of global accounting standards, credit rating agencies oversight, and bank capital requirements. Revisions to the Basel II framework are needed in the area of capital requirements and liquidity cushions. A likely development is for central banks and regulators to demand higher and comparable capital standards, as well as tighter leverage ratios from banks. Some participants argued that Basel II had enhanced pro-cyclicality and that the three pillar system (minimum capital requirements, supervisory review, and market discipline) was inadequate. In this regard, prudential regulation should become anti-cyclical rather than pro-cyclical. Another speaker stressed that the real challenge lied in the pro-cyclicality of banking, not in the pro-cyclicality of the capital regime.

The question was raised whether prudential authorities should be involved in accounting standards setting. Comparable accounting rules and regulatory flexibility, including how to treat market-to-market pricing, are crucial factors. As one panelist indicated, the purpose of financial reporting is not to ensure the safety and soundness of financial institutions, but rather to provide transparent information to regulators, investors, and financial companies for the evaluation of their peers and competitors. It is also important that accounting rules do not lead to arbitrage between countries and different geographic regions. Whether we are talking about country conditions, ratings, implementation of best practice standards, risk management practices, and the state of the financial system, the linkage between disclosure, oversight, and implementation is crucial for investors to make informed decisions.

## *Financial Regulation/Oversight*

Weaknesses in the private sector have resulted from weak governance of risk measures, the failure to demand better disclosure of asset values in the large institutions, and the lack of communication between risk takers and risk managers. Gaps and overlaps in the coverage of regulation and supervision across financial institutions, but also across jurisdictions, have led to regulatory arbitrage. Compensation practices, moral hazard problems, pro-cyclicality of regulation, and maturity mismatches are other important factors to take into account. The challenge today is to enforce prudential regulation over a highly liberalized and largely integrated global financial system by linking financial regulation with macroeconomic development. There has been a consensus that corporate governance weaknesses, particularly in terms of risk management, have represented a major failure at the institutional level. In this context, there is a need for increased transparency, enhanced risk management practices, and better information provided to the markets. Participants recognized that improved market oversight will have a substantial return in the financial system.

In terms of global exposure, both regulators and banks will need to refer to standards and regulation in other jurisdictions to ensure consistency in the decision-making process. Participants debated whether national regulators should aim at separating the international and domestic operations of banks, and only backstop domestic operations which cater to the domestic economy. The creation of an international bank charter for banks engaged in cross-border activity was suggested. One speaker stated that the proposals put forward would continue to lead to systemic crises unless there was a general overhaul of the financial regulatory system. Other participants felt it would be advisable to enforce the regulations that are already in place, as opposed to introducing new regulations. Finally, there were concerns about the risk of regulatory over-reaction.

Financial system regulators need a much wider mandate than they had in the past. One panelist noted that the approach to regulation for the past few years, particularly in the U.S., has

been to strongly rely on self-regulation. The demise of the shadow banking system could subject systemically important non-bank institutions to the same regulatory umbrella as banks. The regulation of the hedge fund industry is an open question. There is a lack of information on activities of hedge funds, which play a key role in the financial system. Hence, some form of disclosure of the operations of hedge funds and private equity funds may be required in the future. It was proposed that in each major jurisdiction an agency be given the authority to designate institutions, markets and infrastructures as systemically important.

One important lesson from the subprime crisis pertaining to business conduct is that market practices require more regulation and oversight than they have received in recent decades. Consumer protection, investor safeguard, and prevention of abusive trading practices must all be effectively implemented in upcoming financial regulatory systems. Participants stressed moral hazard as a rationale for safety and soundness regulation. Finally, with regards to market stability, it is critical to develop more fully the information requirements, analytical tools, and instruments for the proper conduct of monetary policy in order to avoid recurring crises.

### ***Stake for the Emerging Economies***

Over the past decade, there has been a major shift of power in the global economy from the old industrialized countries to the big emerging market nations. In this context, a new governance framework should be formalized to incorporate these countries into the decision-making process and policy discussions. As the financial crisis developed, a substantial number of emerging markets built up classic vulnerabilities. In addition, the low-income countries under stress, also known as the bottom billion, together with the least developed countries, are arguably the most badly affected by the current global shocks. As a result of substantial capital outflows from emerging markets with large current account deficits, public funding or IMF-type liquidity resources will be needed to stabilize the situation. It was suggested that the IMF provide a coordinated liquidity

access package, or some form of currency swaps, to countries with a good track record and decent macroeconomic policies. There is also a need to institutionalize swap arrangements. The lack of clarity in terms of central bank swap lines may cause reluctance from nations to approach the IMF if they believe that an alternative unconditional measure exists. Another proposal involved resuscitating export/import banks.

The IMF's new short-term liquidity facility was seen as a step in the right direction. It is crucial that the facility be easily accessible and readily available to distressed members. Another suggestion was for central banks to invest part of their external liquidity in IMF securities, as a way of transferring excess savings to those economies that need the funding the most. In the medium term, this would require the institutionalization of global mechanisms for liquidity provisions. According to the panelists, the challenge now lies in the effective implementation of the G20 Action Plan.

### ***IMF Restructuring***

Panelists questioned what reform of the IMF would have enabled it to better mitigate the financial turmoil. Overall, participants agreed that the Fund had demonstrated new flexibility in responding to problems in the current crisis, and should be given additional resources. In particular, wealthier countries should provide adequate funds to backstop the IMF. Additional funding to the IMF would require further justification according to others. Several speakers shared the view that global macroeconomic policy coordination should be done through the IMF. The creation of more regional reserve funds was also deemed necessary. Since the IMF has a macroeconomic mandate but not a microeconomic one, it is limited in its actions because it cannot perform its surveillance function over the private sector. The suggestion of converting the Fund into an effective regulatory institution by extending its regulatory function to financial institutions was deemed unrealistic in the near future. In this regard, micro-prudential regulation must involve collaboration between national regulators and standard setters. Financial market analysis should also be better integrated into

the surveillance function of the IMF. Other participants believed that the Fund should retreat to its core area of expertise and responsibility including data standards, liquidity management and surveillance.

The IMF lacks credibility and legitimacy in the eyes of the emerging world. There has been support for giving greater weight to emerging markets in the Fund, as reflected in the quota reform debate. One proposal was put forward to institute a separate and parallel voting system based on reserve assets deposited at the IMF. Calls have also been made to streamline the Fund's large executive board without shrinking emerging market and developing country representation. Another debate highlighted the need for governance reforms in the IMF to address potential conflicts of interest. One participant noted that the multilateral assessments needed to do a better job of assessing cross-border spillover effects. While member states are required to have a consultation with the IMF, they are not obliged to take into account the Fund's recommendations. Finally, the issue was taken up whether the IMF has the political independence to take on its large shareholders when their national practices are judged to be inadequate.

In terms of crisis management, the IMF has helped members dampen spillover effects and contagion by providing financing. However, the controversial issue of conditionality remains. Distressed member states tend to come to the Fund as the very last resort. One idea was discussed to prequalify countries to avoid having them go through the process of requesting access to an agreement. The IMF could also act as a global lender of last resort in periods of crisis by supplementing international reserve assets with a new SDR allocation. Since SDRs are confined to governments and other selected institutions, there is the issue of broadening the reach of SDRs to include private institutions. These instruments could also potentially include new currencies or be traded directly in the markets. This would, however, require major amendments to the articles of agreement.

## ***Global Imbalances/International Monetary System***

Macro-imbalances and the search for higher returns on financial assets have been important triggers of the crisis. There is a strong acknowledgment about the need over the medium and longer term to continue making progress in unwinding persistent global macroeconomic imbalances. It was stressed that proper due diligence of the micro-problems taking place within financial instruments was essential in addition to macro-policy initiatives. While broad agreement was reached on the importance of fiscal stimulus and fiscal policy cooperation, there were divergences regarding the coordination of fiscal policies (i.e. balanced fiscal expansion). It was suggested that countries with a large current account surplus and large reserves take the lead in helping deficit countries restore their trade balances. The idea of charging fees for excess reserves was also introduced.

Regarding the role of central banks, it was noted that they should be endeavoring to burst bubbles or prevent bubbles from getting too large before they burst. One speaker stressed the importance of ensuring that institutions are robust enough to protect themselves against bubbles, rather than trying to combat a bubble by means of tightening monetary policy. Another participant insisted on the notion that there is no empirical connection between a successful inflation targeting strategy and bubbles. The curbing bubbles verses robustness issue is analogous to the difference between the systemic stability function and the safety and soundness function. Central banks do not have sufficient instruments to match the mandates assigned to them. Participants agreed on the need for alternative instruments, including fiscal instruments.

Inconsistency in the monetary system and big swings in the exchange rate were seen as important contributors to the current financial crisis. It was thought that developing countries would benefit greatly from stability in the major currencies. Debates took place regarding the appropriate exchange rate regime, in particular fixed exchange rates verses floating exchange rates. For some, there was no single currency regime that was right for all countries at all times. Others questioned the viability of a fixed

rate regime without capital controls. The idea of a commodities basket or a global reserve unit with the major currencies fixing their exchange rate was also put forward. The current paradigm leaves for conflict between different conceptions about how monetary policy should respond to credit crunches and credit crisis. Since these conflicts have an international dimension, there was a general consensus on keeping the economies and trading systems open to avoid protectionism and beggar-thy-neighbor policies.



# ***Avoiding International Financial Crises***

*by Mark Allen<sup>1</sup>*

Greedy bankers provide an easy target of blame for the current financial crisis, and some of the spectacles of the last few years on Wall Street and the City have been unedifying indeed. But the responsibility to avoid systemic meltdown is that of the policy-makers and regulators, not of individual financial institutions. If greed is part of human nature, a well-run international financial system should be able to cope with it. This paper looks at some of the things policy-makers and regulators might do to reduce the likelihood of the events of 2007-8 occurring again, and focuses on some of the international dimensions of the problem.

If the experience of previous crises is anything to go by, it will be several years before there is broad agreement on the underlying causes of the present crisis and on what lessons should be drawn from it. Bretton Woods took place a decade after the events that made a new international financial order necessary. Indeed, debate on the causes of the crash of 1929 and the Great Depression have continued up to our day, and will only stop now because attention is diverted to a similar but more recent disaster. While it will take time for wisdom to emerge on the causes of the crisis, thinking about a better system is urgent, as the spur to action may well fade.

<sup>1</sup> Former Director of Policy Development and Review, International Monetary Fund. The author can be contacted at [marklegrosallen@gmail.com](mailto:marklegrosallen@gmail.com)

### ***Responsibility lies with regulators and policy makers***

Those who have most to answer in the post mortem on this crisis are the regulators and policy-makers, as well as bodies charged with overseeing international stability. Banks and other financial institutions should be expected to run themselves so as to cope safely with normal storms. But they cannot be responsible for keeping their institutions seaworthy when swamped by a systemic storm. If they were to do so, it would mean that they would have to run their institutions so conservatively as to harm growth. The responsibility for ensuring that the systemic storm does not develop is that of the regulators and the policy makers. They are responsible for maintaining economic conditions favorable to growth, and also for the public purse. And given the huge costs of a systemic crisis to the taxpayer and to economic prosperity, their job is to regulate the system so as to ensure that the systemic crisis does not occur.

This means that regulation based on the promulgation of best industry practices, while useful, is bound to be insufficient. If the job of the central banker is to take away the punch bowl just as the party is getting started, then that of the regulator is to prevent institutions from taking some risks that they are willing to take. Only the regulator internalizes the cost of systemic meltdown; the individual banker just wants to be sure that he doesn't fail in an unconventional way. Of course the regulator needs to have a clear view of the practices that have the potential to cause systemic catastrophe, but he should be focused as much on the properties of the financial system as a whole as on the activities of individual banks. Complex systems have properties that are not apparent in the behaviors of their individual constituents. But this special responsibility for systemic stability means that there will inevitably be a conflict between regulators and those they regulate, since the latter are being deprived of profit-making opportunities. And one of the public policy challenges over the longer run is to ensure that the regulators receive the political support they need to do this job.

The argument that industry best practice cannot be the sole basis for regulation can be extended from the national to the

international level. National regulators and their authorities do not internalize the total costs of a systemic meltdown in their national financial markets. There is no particular reason to why they should take full account to the costs to others of international spillovers, and there is evidence in the handling the present crisis that they do not. The current crisis shows very clearly that we are in a highly interconnected international financial system. Some framework needs to be in place to guard against international systemic meltdown, and logically this will require national authorities to be more constrained in the supervision of their own markets and institutions than they would be if they consulted solely their own interests.

### ***What gaps are there in the international supervisory framework?***

Following the Asian crisis, policy makers in the G7 considered what needed to be done to prevent another crisis, one that might have broader ramifications than the Asian Crisis. They judged that, with the growing complexity of the international financial system and the growing diversity of institutions involved, there needed to be a forum where the regulators and financial policy makers met and considered matters that fell between their various jurisdictions. Such a forum would keep the minds of policy makers focused on emerging systemic threats, and prompt the various regulators to do more to combat them. Thus was born the Financial Stability Forum.

If any body was assigned the responsibility to warn of impending systemic crisis and to catalyze action, it was the FSF. If we are to draw lessons on how to avoid the next crisis, we need to ask whether the FSF and others saw the danger signs clearly. If they did, did they raise the alarm with sufficient vigor? And if they were open and forceful about the risks, what inhibited policy-makers from taking action? It seems likely that the FSF, the IMF's Global Financial Stability Report, and the host of financial stability reports produced by central banks did point to a lot of the elements that turned out to trigger or exacerbate the crisis. But somehow these analyses did not combine into a forceful warning that the stability of the system was in danger,

let alone catalyze action.

It may be that our analytical tools are not very good at establishing the state of the system as a whole and the likelihood of systemic collapse. Certainly a lot of risky practices were identified in these various reports, and action was initiated to deal with some of them. This should allow a consensus to emerge rapidly on corrective actions in such areas as the need for larger capital buffers, the control of liquidity risks, the accounting perimeter of firms, the treatment of tail risks, the originate-to-distribute model of securitization, the infrastructure of the CDS and other derivative markets, transparency, credit rating agencies, incentive structures in financial institutions, and international supervisory coordination. These are all important repairs to the structure of the stable while the horses are temporarily elsewhere. But the fear is that the next threat to the stability of the system will come from a different set of factors that need to be identified and corrected in a timely way.

***Can a framework be established that will constrain national regulators and authorities to take action that is needed to prevent future systemic meltdowns?***

This is the challenge posed by those calling for Bretton Woods II. It bears a strong resemblance to the challenges faced at the first Bretton Woods and again at the negotiations of the Second Amendment of the IMF Articles in 1974-6. During the first Bretton Woods conference, a framework was established to deal with issues of exchange restrictions and competitive devaluation that had plagued the interwar economy and inhibited recovery from the Depression. Recognizing that these were matters that spilled over from one country to another, it established obligations on member countries, a system of financial support for those facing difficulties (including those arising from the implementation of these obligations), and an institution with the authority to supervise compliance with the agreement. The negotiations around the Second Amendment of the IMF Articles were about the obligations and constraints on countries' policies required to ensure that a system of floating exchange rates was a stable one. Again, the focus was on an agreed set of obligations

and a mechanism whereby an institution would hold countries to account for implementing those obligations.

This is not the paper in which to discuss in detail the record of success of the IMF in these areas: the achievements have been many, but it shares with others the failure of not inducing action to head off the current crisis. Observers generally agree on the need for rules constraining some aspects of individual country macroeconomic behavior, the importance of enforcing those rules, the need for a financial safety net to preserve the achievements of an open system, and the importance of a strong and independent secretariat.<sup>2</sup> For an institution to be effective in managing the international system in the macroeconomic area--and this analysis can be extended to the international financial system--it needs to be able to do high-quality analysis, it needs to have the courage to speak truth to those in power, and it needs to mobilize peer pressure to reinforce its recommendations. Even with these in place, its effectiveness will be limited in a world of nation states cautious of surrendering sovereignty, and keen to regain any sovereignty surrendered in the wake of a crisis.

<sup>2</sup> For an interesting analysis of the persistence of support (*faute de mieux*) of IMF surveillance, see Louis W. Pauly, "The Institutional Legacy of Bretton Woods: IMF Surveillance 1973-2007" in David Andrews, ed., *Orderly Change: International Monetary Relations Since Bretton Woods*, Ithaca, NY: Cornell University Press, 2008.

High-quality analysis of the problem at hand is essential. A secretariat that has thought through the problem and its ramifications in more depth and with a broader perspective than can national governments has considerable authority. It should focus that analysis on the main task at hand, dangers if any to international financial stability. It is vital if a consensus is to be formed on the need for action and to mobilize the peer pressure that may be needed to push action. Scrutiny of national supervisory systems and financial markets by such a secretariat can provide a relatively objective and internationally consistent judgment on shortcomings in national systems and emerging risks.<sup>3</sup> Nevertheless, doing such analysis can be difficult, beyond the inherent difficulty of the subject matter. Firstly, there is the problem of the inconvenient truth: national policy-makers are often not keen to have problems identified if they reflect badly on the policy-makers or risk upsetting the policy-makers' own priorities. Secondly, reports will inevitably have something of an alarmist character about them, particularly if action is called for, and the more successful they are in averting crises, the less effective they are as early warning devices.

The more serious problem is probably the first one, that of having the courage to speak truth to power. International institutions that are owned by the major shareholders and which require their support and cooperation for myriad activities are very susceptible to pressure from governments to tone down any unwelcome criticism. There is no easy answer to this problem. It requires intelligent management devoted to the broad purposes of the institution and support from the rest of the membership in the exercise of peer pressure. But it has been frequently observed that peer pressure can easily turn into peer protection, and then the ability to do independent analysis and to call systemic risks is seriously compromised.

### *Persuading the Politicians*

But even had such an analysis been available in the current crisis,

<sup>3</sup> In principle, the Financial Sector Assessment Program reports of the IMF could perform such a function. At present they suffer from being voluntary and insufficiently resourced.

and argued cogently, would politicians have listened? Would action have been taken to curb the excesses and to moderate behaviors? It is not obvious that this would have been the case. Many risks to the system were identified in the period preceding the crisis, including the housing bubble and the explosive growth of derivatives, but little action was taken. Indeed, on housing bubbles, one of the best analyzed features of recent developments, many central banks argued that monetary policy should not seek to prevent such bubbles emerging -- and was indeed powerless to do so -- but should be prepared to help clean up in the aftermath.

Financial crises tend to occur after booms and after lending practices and risk management have deteriorated. All are manifestations of the same over-exuberant animal spirits. The apparent prosperity associated with these booms creates a strong and broad constituency in their favor. It also concentrates a lot of wealth that may be reinjected into the political system. Both factors make it hard for politicians to act.

And then there is the political problem of dealing with long-range contingent events. The sort of crisis that we are now in the midst of appears to be the once-in-a-hundred-years event. It requires a very confident politician to take unpopular action against an event that is likely to occur so rarely, even if its consequences are so dire. The likelihood is that, if the event occurs at all, it will be during the term of office of some successor. With a normal electoral cycle of four years, the average time horizon of the politician will be only two years. And it is a well-known political maxim that action usually has worse consequences than inaction. In such circumstances, it is hard for a politician to use political capital to take the necessary measures.

There are ways to help the well-minded politician to take the longer run view head off crises. One is a precommitment device that will bind them to taking identified action. Within the national context, governments can be obliged to react to the recommendations of those entrusted with identifying the action. At the international level, a treaty binding the country to take action in response to representations or fall foul of its obligations

has a similar effect. Credible analysis can help the politician who wants to do the right thing to deal with domestic criticism. And similarly, peer pressure from politicians and regulators in other countries concerned with the possible spillover on their economies and financial systems can also give backbone.

### *International Solutions*

While vivid memories of the current events may persist for twenty or thirty years, this gives us a chance to do something now. But the challenge is to put something in place that will work in eighty years time, when human memory will have faded, and preferably for longer. The problems we are dealing with are those of stability of the international financial system, one in which all countries have an interest. If we are not to go back to isolated and less efficient national financial systems, all countries need to have confidence in the management of the system as a whole. It will be vital that a broad range of countries participate in any structure of rights and obligations that emerges, so it will be important that they participate fully in the design of the system and in its supervision.

This paper has argued that an international body charged with holding countries to account for their actions to preserve the stability of the international system offers one of the more promising ways to promote the necessary action. And the wider the engaged membership of such a body, the more it is likely to exhibit the analytical independence and political courage that are needed to forestall the next once-in-a-hundred-years event.





# ***Building an International Monetary and Financial System for the 21<sup>st</sup> Century: Agenda for Reform***

*by Sven W. Arndt*  
*Claremont McKenna College*

These brief comments are organized around the questions raised by Marc Uzan in his invitation letter.

1. Yes, this is a different crisis in many respects. While there is always debate over the extent to which history merely repeats itself in varying guises and while this crisis contains many familiar elements, it is also new and surprising in important ways. But in my view, that is not the central question and I hope that we do not dwell on it.
2. The crisis occurred in a world of highly linked markets, especially financial markets, with large and persistent payments imbalances among countries, and rapidly rising U.S. international indebtedness. The role of national markets and institutions in global financial intermediation has risen sharply in recent years. In part, this has been the result of underdeveloped national financial intermediation in many countries, which has forced them to resort to international channels. Any meaningful reform of the system must, therefore, address this issue.
3. The crisis has laid bare the futility of one of the most cherished tenets of U.S.-style capitalism: markets can be relied upon to maintain discipline by punishing private behavior with failure. We should now know that there are

many institutions in and beyond the financial sector that are too big to fail. Indeed, in the process of managing this crisis, we have ensured that the surviving institutions will become even bigger. This should be a key element in any approach to reform.

4. For the world we live in, existing regulatory approaches and structures are inadequate. We know, for example, that market efficiency depends on timely and accurate information. There are too many information asymmetries in the current system. Indeed, the cherished notion of trade secrecy, bank secrecy and private information as defined today is incompatible with “too big to fail.” If the public is the protector of last resort, then it will have to have greater access to relevant information. If this does not happen, it will be the patsy of first resort.
5. In the existing system, some crucial markets did not exist at all, including markets for credit default swaps. It is, in any case, worth asking to what extent the commercial activities among Wall Street’s main financial institutions may be called a market.
6. In a world of large firms and institutions, the nature of incentive structures is far more important than in a more atomistically competitive, impersonal market environment. The current system is riddled with principal-agent issues, not only between managers and owners, but between private and public interests, particularly in view of too big to fail.
7. Global imbalances per se are not the issue. There will always be savers and investors, lenders and borrowers. But savers around the world need better information about the use to which their resources are put and better protection from abuses.
8. It is clear that central banks have not adequately “taken into account sufficiently the effects of the huge expansion ...of liquidity and credit...” In fact, they have supported it. An interesting question for large countries in this context is:

what should be the domain – national or broader – for the conduct of monetary policy? If broader, what is the role – if any – of cross-country coordination? This should be an important aspect of reform at the level of the multilateral institutions. If there ever was doubt, the current crisis makes clear that the distribution of power in those institutions needs to be revised in more than cosmetic ways.

9. The old Bretton Woods was, of course, a system of managed exchange rates. Contemporary discussions of a new Bretton Woods tend to focus more on institutions than on exchange rates, but the question of beggar-thy-neighbor exchange-rate policies needs to be examined.



# ***Could Another Currency Provide Liquidity to Financial Markets?***

*by Christopher Avenarius, Credit Suisse*

After risky investment banking strategies and flawed national regulations have discredited major international credit institutions, it is legitimate to award the mandate to restore confidence and trust in global financial markets to a supranational organisation. As almost any sovereign state seems to have supported real estate investments, a global solution to the mortgage crisis would be adequate. Not by challenging Sovereigns, but ultimately by pooling their strengths the IMF could become an additional money printing authority.

At times when people are confused about the evolution of the global credit system it is essential to reinforce the platforms that are necessary to entertain our global exchanges, also by embracing publicly credit trading. The Bretton Woods Institution seems to be in a position to stabilize the global credit system, which has grown largely through asset backed securitizations and the alternative investment industry far above the individual capability of most developed nations.

Financial institutions turn in general to central banks for liquidity. Today, several banks are proven to be too big for one single country in a liquidity crisis. These banks should be able to directly approach the IMF for credit facility providing their structured financial products as collateral at book value. Subsequently, the IMF should auction these products without naming the original bank. The price difference between the booked and the auctioned price will be a currency deficit (or surplus) that is asset linked. The achieved auction price would set the exchange rate for that new currency. The IMF would effectively launch a currency by providing credit to international

credit institutions like commercial banks.

Currencies have been introduced to facilitate frequent exchanges of assets and the introduction of a new asset linked currency may help to trade specifically the complex financial structures that have turned illiquid. The main mandate of the IMF has always been the ultimate liquidity provider in crisis situations.

Without establishing a lower floor for distressed assets through real transactions, confidence in banks is hard to be established. A prolonged period of business contraction will be the likely outcome. Because single Central Banks have already started to accept credit structures at face value without establishing their market value, they are also risking losing their clients' trust and large FX moves.

Once a bank has approached the IMF as a client, confidentiality is a must. But certainly the IMF had subsequently the authority to take an activist approach on banks with large deficits. The IMF may suggest to wind down certain banks or to propose mergers with other banks or with real asset managers like state pension funds or sovereign wealth funds. Ultimately, the idea is to give incentives to large institutional asset managers to engage in the credit system other than through government bonds.

The present credit crisis has reached a scale due to the real estate backed lending in the private sector that perhaps only a new currency can tackle the structured credit market. Next to the SDR, a further IMF currency for globally active banks should be an acceptable price for sovereign states in today's globally interconnected financial world.





# ***Responding to the Financial Crisis: An Agenda for Global Action***

*by Amar Bhattacharya, Kemal Dervis and  
José Antonio Ocampo<sup>1</sup>*

Prepared for “Global Financial Crisis Meeting”  
Columbia University, New York, November 13, 2008

Sponsored by Friedrich Ebert Stiftung (FES) and  
Co-hosted by FES and the Initiative for Policy Dialogue (IPD)

The financial crisis that has now enveloped the world has sparked a vigorous debate about the causes of the crisis and the fundamental reforms that are needed in the regulatory and institutional regimes of financial markets. Beyond financial markets, there is debate on how better to coordinate macroeconomic policies. The way forward on such reforms will be an important element of the discussions at the meeting of the leaders of the G20 countries that President Bush will be hosting at the White House on November 15<sup>th</sup>. But an even more urgent concern, which will figure prominently at the meeting of G20 Finance Ministers in Sao Paolo this weekend and that leaders will have to address at their November 15 meeting, is how to organize an immediate

<sup>1</sup> Amar Bhattacharya is the Director of the G24 Secretariat; Kemal Dervis is Executive Head of the UNDP and former Minister of Finance of Turkey; José Antonio Ocampo is Co-Director of the Initiative on Policy Dialogue at Columbia University and former Minister of Finance of Colombia. The views expressed in this paper are those of the authors and not necessarily those of the organizations they represent.

response to the widening financial and economic crisis. Much of the focus until now has been on mature markets and the response of industrial countries. It is now time to broaden the focus of discussion and action to include emerging markets and other developing countries.

### ***Impact of the Crisis on Emerging Markets and Developing Countries***

For the first year after its onset, emerging markets were relatively unaffected by the subprime related crisis on the basis of their generally strong economic fundamentals and lack of exposure to the toxic financial products that undermined the balance sheets of financial institutions in advanced countries. But since August of this year, and with increased intensity in recent weeks, they have come under severe pressure. Access to international credit has dried up, and bond spreads have spiked by more than 500 basis points in the last two months (Figure 1). Their currencies have depreciated on average by 20 percent and stock markets have tumbled by 30-50 percent since August (Figure 2). While some emerging markets have been affected more than others, these changes have been broad-based and larger than what has been suffered by industrial countries despite the fact that the crisis did not originate in emerging markets (Table 1). Nor can these difficulties be attributed to any significant changes in economic fundamentals; most emerging markets entered 2008 with sound fundamentals and good financial cushions, and have continued to maintain relatively strong fiscal positions. The primary factor behind recent pressures was investor fear and herding and the withdrawal of credit by the internationally active banks.

In the past two weeks there appears to have been some easing of pressures on emerging market currencies and stock markets, but volatility remains very high and with it the prospect of sharp reversals in flows. Access to financing remains highly constrained with spreads that are still prohibitive for many countries. Of equal concern are the real effects that the crisis is now beginning to have on developing countries. Demand for exports of developing countries has sharply decelerated, and

domestic demand is facing a downward spiral because of the more uncertain prospects and difficulties in access to financing. The dramatic change in global growth expectations has also led to a reversal in commodity prices following the very sharp increases of the past two years (Figures 3-6). Oil prices are less than half the level of the peak reached this past summer and almost back to where they were in January 2007. Prices of many minerals have fallen by as much as 30-60 percent from their peaks earlier this year. Food prices have also moderated but remain high by historical standards.

Against this backdrop, concerted actions are needed on three fronts to help emerging markets and developing countries withstand the spillover effects of the recent crisis: *actions to deal with the systemic liquidity crunch; measures to sustain demand and growth momentum; and steps to ease financing strains on low-income countries that will suffer indirectly from the fallout of the crisis.*

### ***Responding to the Systemic Liquidity Threat***

In response to the liquidity pressures on emerging markets, the IMF has announced a new facility, the Short-Term Liquidity Facility (SLF), to channel funds quickly to eligible emerging markets with track records of sound policies, access to capital markets and sustainable debt burdens, evidenced by very positive policy assessments by IMF staff in the most recent Article IV discussions. The Federal Reserve has also just announced new swap facilities which Brazil, Mexico, Singapore and the Republic of Korea will be able to access. These are welcome steps that need to be built upon and applied with flexibility and agility. In particular, the success of the arrangements to deal with the systemic liquidity threat now facing emerging markets will depend on: how eligibility is determined for the IMF's new SLF instrument and related swap facilities; whether access and conditions applied to the IMF's normal credit facilities are sufficiently flexible and streamlined; and whether there will be enough resources to meet the potentially large liquidity needs over the coming year.

Setting the eligibility bar for the SLF at a very high level would

create difficult tensions and is unlikely to be tenable. As Kemal Dervis has argued in an op-ed article in the Washington Post published on November 2<sup>nd</sup>, “Emerging markets cannot be easily and simply divided into two categories: those with good and those with bad policies. There are degrees of strength in existing policies and prospects, and a comprehensive approach will have to recognize the continuum rather than oversimplify and open the way for dramatic and politically very sensitive all or nothing choices. Selecting only a few countries for access to the new liquidity arrangements and asking many others to engage in protracted negotiations with the IMF will create great stigma for these others and may in fact push them into crisis even faster. It will also make it politically very difficult for governments to decide to engage in these negotiations while other countries have easy access to the SLF, central bank swaps or both.” It will be best to enlarge access to the SLF to a fairly large number of countries with reasonably good economic policies over the last few years and a clear forward-looking commitment to a strong macroeconomic framework. The relatively short maturities of the liquidity arrangements (three months for each purchase under the SLF) provide adequate safeguards against policy slippages. Such an enlarged coverage for the IMF liquidity facility, with the explicit aim of avoiding stigma, is the only way forward that can reach a sufficient number of countries quickly and effectively. Even with this more inclusive approach to the SLF, many countries may need recourse to normal IMF facilities where macroeconomic risks are clearly significant and longer-term financing is warranted from the outset. Some countries that draw on the liquidity facility may also need to enter into a regular IMF program if circumstances warrant a longer-term financing arrangement. In both sets of cases, a more streamlined and flexible approach than in the past is called for, so that the amounts of financing provided are adequate to cover financing shortfalls with conditionality that is focused on the key risks and that does not potentially amplify the contractionary effects of the shocks.

The IMF has total available resources of about \$250 billion of which it has earmarked \$100 billion initially to the SLF. If the liquidity crunch persists, much larger levels of resources will

be needed to meet the scale and scope of potential demand. IMF resources will therefore have to be complemented with central bank credits, not only from G7 countries but perhaps including credits from China and some of the Gulf States. Since fundamental governance reforms will take time, it may be desirable and indeed necessary to design immediately decision making mechanisms that would allow China and others who contribute large amounts to participate more directly in the decision making than just through their place at the Board. A counter-cyclical issue of SDRs or borrowing from the market could also be considered to augment the IMF's lending resources. Ultimately a substantial increase in IMF quotas is warranted if the IMF is to play its proper role in today's global financial environment.

### ***Coordinated Macroeconomic Policy Response***

A second priority for action is coordinated macroeconomic policies to sustain growth. While the focus in the recent past has been in shoring up demand in the advanced countries, there is a need for more aggressive and coordinated actions to respond to falling demand in emerging markets and other developing countries for two reasons. First, because these countries are more vulnerable to a sharp slowdown in aggregate demand; and second, because they are now the dominant engine of global growth and hence key for an early worldwide recovery. There are increasing signs that retail sales are falling sharply in many developing countries. External demand is also decelerating sharply with the slowdown in world trade growth. World trade growth is expected to be negative in 2009 for the first time since 1982, affecting many developing countries that have relied on export markets for their vigorous growth. Another important source of demand contraction will be a potentially sharp contraction in investment. The driving force underpinning the growth of demand and output in developing countries in recent years has been the sustained expansion in investment (Figure 7). With investment rates that are much higher as a percentage of GDP in many emerging markets than in advanced countries, a sharp contraction in investment because of the huge rise in uncertainty and difficulties in borrowing or raising capital,

could lead to a large negative Keynesian multiplier as was the case in the aftermath of the financial crises of the 1990s. A sharp deceleration in demand and growth in emerging markets would not only have an adverse effect on the populations in the developing world but also on global prospects given their contribution to global growth (Figure 8). In many ways China is a special case given the size of its foreign exchange reserves and the surplus in foreign payments as well as its strong fiscal position. China is not in need of liquidity or investment financing. On the contrary it could provide some of both to other developing countries. It is worth noting, however, that China too is affected by the worldwide slowdown and whatever it can do to boost both its domestic demand—as it announced recently—and support other developing countries will benefit both China and the world economy.

There is an urgent need for an internationally coordinated macroeconomic response that encompasses emerging markets and other developing countries. Given the credit squeeze, and the prevailing investor mood, it is unlikely that monetary policy alone will be effective in stimulating domestic demand. What is needed is a coordinated and effective fiscal stimulus which can offset the decline in private demand. The ability of countries to expand public expenditures will vary given their underlying economic conditions and debt sustainability. But the risks of being too conservative and fragmentary in fiscal policies are greater to the world economy than from a mutually supportive fiscal stimulus. Such increases in fiscal expenditures could be targeted to enhanced social protection and priority public infrastructure investments critical for growth or longer-term sustainability including investments in clean and low-carbon technologies. It is important that short-term financial concerns not be allowed to crowd out the measures and policies needed to fight climate change within the UNFCCC framework.

While many emerging markets have significant scope for mobilizing additional domestic financing to cover the larger deficits, longer-term external financing can alleviate financing constraints in both the public and private sectors and boost market confidence. Public external financing can also play an

important role in countering the curtailment of commercial credit available to exporters, which can undermine an essential mechanism through which countries can recover from crises. Fortunately, the World Bank and the regional development banks are well positioned to expand their lending to developing countries given net repayments from them over the past several years. Altogether the multilateral development banks have headroom of around \$200 billion to expand their lending.

The multilateral development banks can therefore play an important complementary role to the IMF and Central Banks in providing longer-term financing to enhance the scope for countercyclical fiscal policy and help cushion the social impacts of the crisis. In order to do so effectively, the World Bank and the regional development banks will have to be prepared to provide support rapidly and on a scale commensurate with the needs and size of these economies. This in turn will entail more aggressive use of their balance sheets than in the past. Finally, this is clearly not the time to engage in 1930s-style beggar-thy-neighbor protectionist policies. Restrictions that may look attractive to individual countries in the short-term would be disastrous for world growth and therefore backfire very quickly on everyone. Trade, like macroeconomic policies, deserves coordinated international support.

### ***Easing Financing Strains on Low Income Countries***

A third pillar for international action is to assist low income countries, who are far from the epicenter, but will be strongly affected by the indirect effects of the crisis and the rise in food and fuel prices that preceded it. The World Bank estimates that the increase in food and fuel prices raised the number of malnourished by 42 million in 2008 to a total of 967 million. Although food prices have moderated in the wake of the economic downturn, they remain very high at the retail level and continue to pose a significant burden on food-deficit countries and the poor within those countries. The \$1.2 billion rapid financing facility launched by the World Bank to help poor countries cope with the food crisis is a welcome step, but more is likely to be needed. On the other hand, while beneficial to fuel-importing countries, the sharp decline in the oil price since August and

in minerals threatens many commodity-exporting low-income countries.

More generally, low-income countries and sub-Saharan Africa in particular, are likely to be affected simultaneously by a decline in demand for exports, a contraction in remittance flows from rich and middle-income countries and restricted private sector financing. These strains come at a time when sub-Saharan Africa had for the first time in decades built a solid growth momentum of 6 percent per year, and was well positioned to accelerate progress towards the millennium development goals agreed upon at the various UN conferences. It is imperative therefore that the donor community meets its previous commitments to increase aid including to sub-Saharan Africa in line with the targets set in 2005 so that these countries do not suffer a further setback in their quest to meet the millennium development goals. Official development assistance amounts to just over \$100 billion, a tiny fraction of the fiscal cost likely to be incurred in the financial sector clean-up in advanced countries. Even with the present fiscal pressures, the rich countries can and should live up to their aid commitments and to provide the promised additional financing needed to cushion the poorest countries from the effects of higher food and fuel prices as reaffirmed at the recent UN Summit.

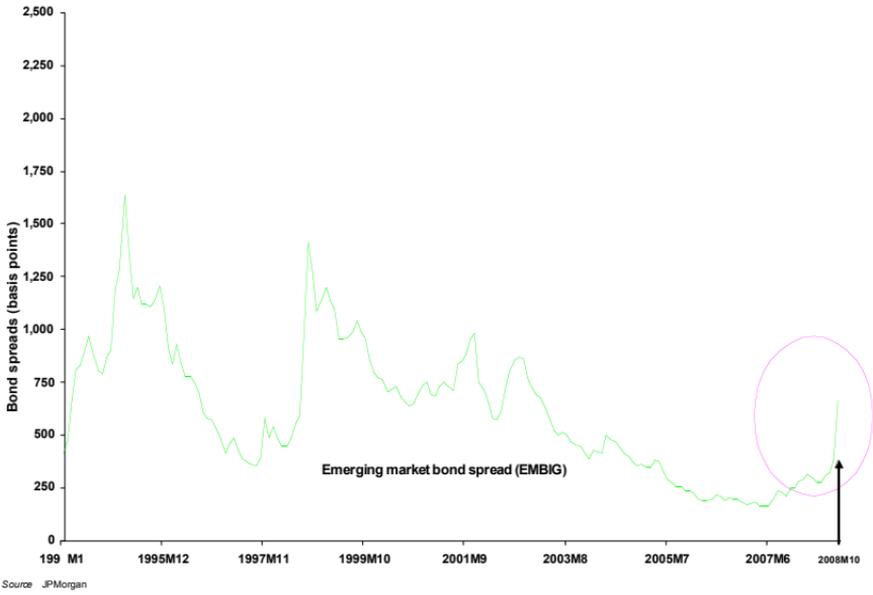
The world has changed dramatically since the onset of the financial crisis. Although developing countries appeared in the beginning to be relatively insulated from the crisis, they could now potentially be the most affected in terms of growth and loss of employment. Vigorous actions on the three fronts highlighted in this note will help ensure that the populations in the developing world, who had no role in the crisis and are the most vulnerable, are protected as much as possible from its effects. These actions will also ensure that the global downturn does not turn into a global depression, benefiting the world as a whole.

	Exchange Rate		Sovereign Spreads			National Stock Markets	
	(local currency/USD)		(basis points)			(local currency)	
	Percentage Change <sup>1</sup>		Change			Percentage Change	
	Oct 12-07	Aug 8-08	Oct 12-07	Aug 8-08	Current Spread	Oct 12-07	Aug 08-08
	Aug 8-08	Nov 4-08	Aug 8-08	Nov 4-08	(Nov 4-08)	Aug 08-08	Oct-27-08
<b>Latin America</b>							
Argentina	-3.3	8.4	379	935	1664	-21.5	-50.9
Brazil	-10.9	31.3	72	209	439	-9.4	-45.8
Chile	4.1	25	60	179	356	-13.2	-20.9
Colombia	-8.7	29.5	68	297	514	-15.4	-25.3
Ecuador	--	--	92	2406	3080	5.6	-1.8
Mexico	-6	23.4	68	185	352	-16.4	-37.4
Peru	-5.3	7.6	67	294	484	-43.9	-49.4
Uruguay	-13.5	21.3	125	476	794	--	--
Venezuela	0	0	327	730	1407	1.9	-7.4
<b>Asia</b>							
China	-8.7	-0.3	63	175	322	-55.9	-33.9
India	6.8	13.5	--	--	--	-17.7	-43.9
Indonesia	0.9	19.2	154	398	743	-16.8	--
Korea	11.9	25.3	--	--	--	-22.6	-39.7
Malaysia	-2	7	55	285	438	-18.5	--
Pakistan	19.8	12.1	537	1173	2006	30.1	--
Philippines	0.7	9.2	103	145	404	-29	--
Taiwan Prov. of China	-4.5	5.4	--	--	--	-24.1	-39.4
Thailand	8.5	3.7	--	--	--	-22.1	-43.9
Vietnam	29	1.8	240	504	881	-59.8	--
<b>Europe</b>							
Bulgaria	-5.9	15.6	150	370	597	-48.2	
Czech Republic	-16.4	14.4	--	--	--	-23.5	-51.9
Hungary	-10.8	26.3	73	267	417	-25.8	-48.7
Poland	-16.9	24.8	66	248	380	-32.7	-39.8
Ukraine	-8	25.3	300	1437	1942	-42.9	--
Romania	-0.1	20.6	--	--	--	-34.8	--
Russia	-2.8	10.6	86	417	622	-20.4	-68.1
<b>Middle East and Africa</b>							
Egypt	-4.6	4.7	115	186	401	-1.9	-46.3
Jordan	0	0	--	--	--	34.4	--
Morocco	-4.9	12.8	--	--	--	8.4	--
South Africa	14.3	25	119	364	590	-14.3	-31.4
Turkey	-0.5	24.8	118	298	611	-29.5	-40.6

TABLES I: IMPACT OF CRISIS ON EMERGING MARKETS

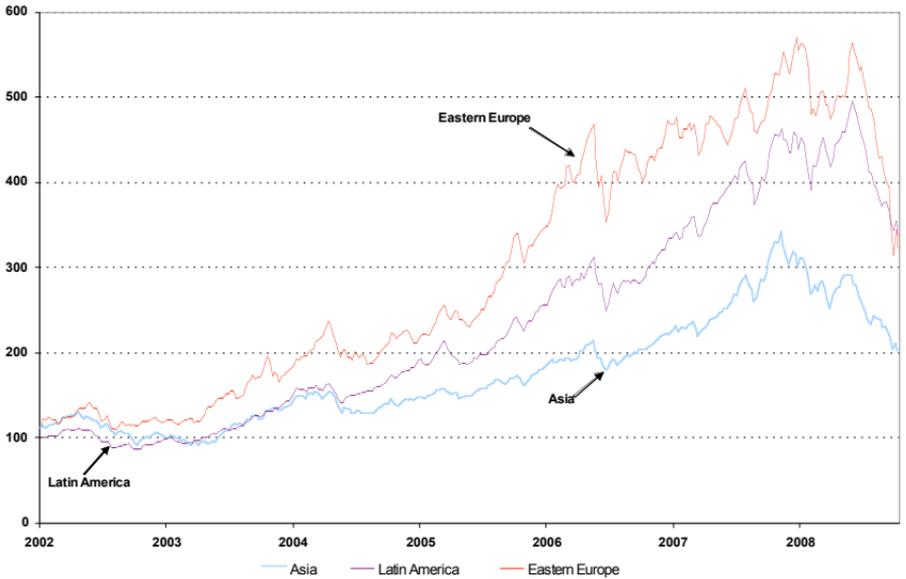
<sup>1</sup> Increase indicates depreciation *Source:* Bloomberg and JP Morgan EMBI Spreads

**Figure 1: Trends in Emerging Markets Bond Spreads, 1994-2008**  
(basis points)

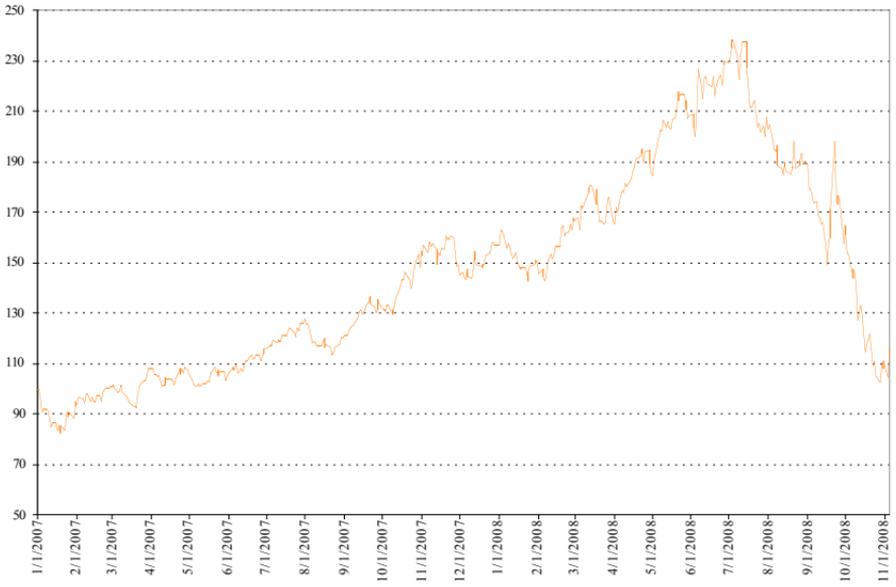


**FIGURE 1: TRENDS IN EMERGING MARKETS BOND SPREADS, 1994-2008**  
(BASIS POINTS)

**FIGURE 2: TRENDS IN EQUITY MARKETS OF DEVELOPING COUNTRIES, 2002-2008** (2001=100, NATIONAL CURRENCY)



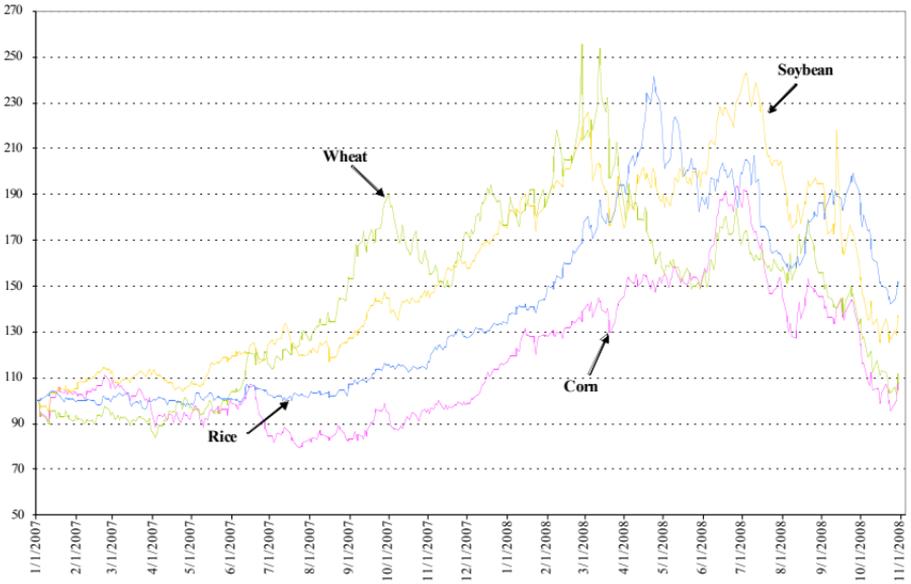
Source: World Economic Outlook, IMF



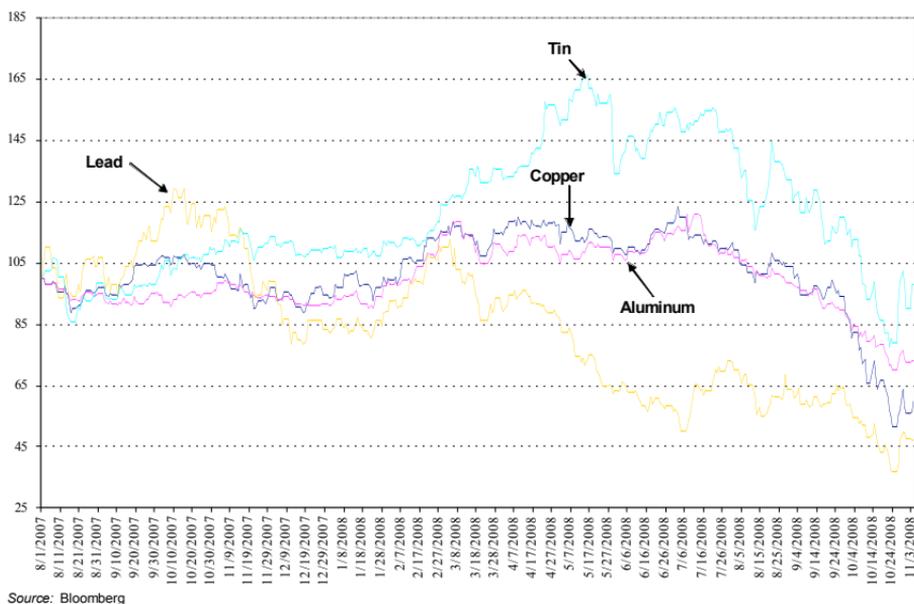
Source Bloomberg

**FIGURE 3: COMMODITY PRICES - CRUDE OIL**  
 ((INDEX 01-01-2007=100))

**FIGURE 4: COMMODITY PRICES - FOOD**  
 ((INDEX 01-01-2007=100))

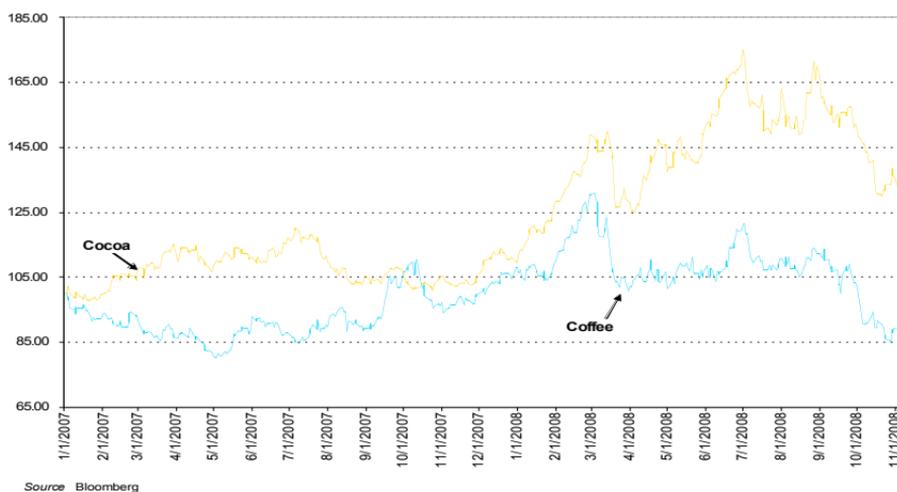


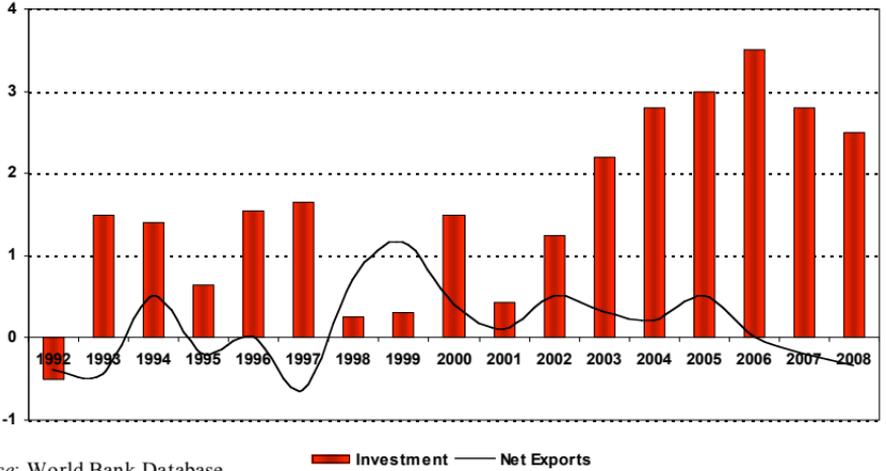
Source Bloomberg



**FIGURE 5: COMMODITY PRICES – METALS**  
(INDEX 08-01-2007=100)

**FIGURE 6: COMMODITY PRICES– BEVERAGES**  
(INDEX 01-01-2007=100)

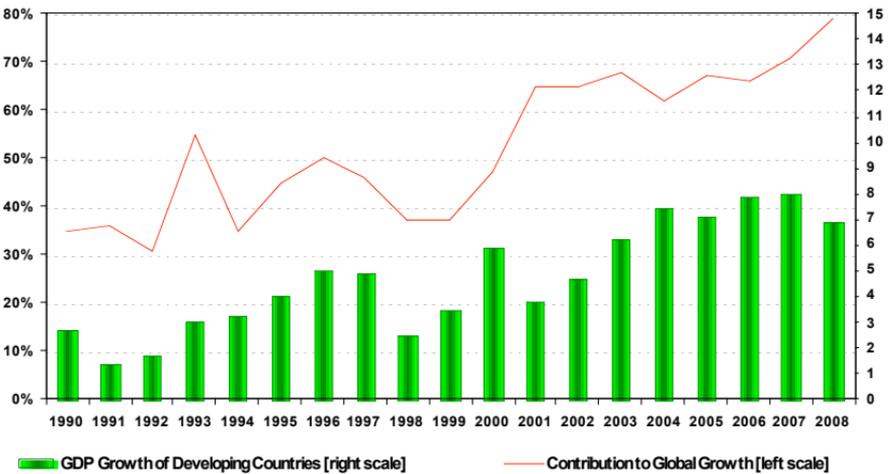




Source: World Bank Database

**FIGURE 7: THE CONTRIBUTION OF INVESTMENT TO GROWTH IN DEVELOPING COUNTRIES, 1992-2008 (PERCENT OF GDP GROWTH)**

**FIGURE 8: CONTRIBUTION OF DEVELOPING COUNTRIES TO GLOBAL GROWTH, 1990-2008 (PERCENT)**



Source: World Economic Outlook, IMF



# ***The Past and Future of IMF Reform: A Proposal***

*by Michael Bordo (Rutgers University and NBER), Harold James (Princeton University and European University Institute)*

## ***Abstract***

This paper examines changes in the role of the IMF since its inception in 1944, in response to the breakdown of the par value system, the liberalization of capital movements, and financial deregulation. In the 2000s, as IMF lending contracted, the role of the Fund has become less controversial but also less important. A need for public goods provision arises, however, out of the major new problems of the twenty-first century: controversies over exchange rates, over the management of reserve assets, the politicized debate over sovereign wealth funds (SWFs), and the management of financial globalization. The paper suggests a new role for the Fund as an asset manager that would offer a more stable and less politicized alternative to the SWFs. Such a role would be predicated on governance reform.

## ***The Past and Future of IMF Reform: A Proposal***

After over sixty years of existence, in the course of which there have been numerous ups and downs, there is probably today less conflict about the role and importance of the IMF than in previous eras. This is largely because the IMF has been almost completely sidelined from many of the major governance issues of the international financial system. Is there any need for an institution such as the IMF? This paper argues that there may be a case for reviving some part of the original vision of the 1944 Bretton Woods conference; and in particular that the IMF

might play a central and useful role as a manager of reserves.

The original mandate of the Fund, as laid down in the Bretton Woods Articles of Agreement, was very general: to promote international monetary cooperation, facilitate the growth of world trade, promote exchange rate stability, and to help to create a multilateral system of payments. In order to achieve these objectives, the Fund was supposed to provide short term balance of payments support to countries in need of additional reserves. The best way of thinking about the IMF's functions during the early period, the so-called Bretton Woods system (1945-1973) is not so much as an institution, but rather as the embodiment of a system of rules as laid out in the Articles of Agreement. But in the early 1970s the core of the rule-based system, the requirement on member countries to adopt a par value, disappeared.

The IMF's evolution since the 1970s has reflected both the demand for its services in the light of new and perceived market failures and its willingness to provide those services. There has been a fundamental change of environment: the breakdown of the par value system, and the new mobility of capital, and financial deregulation. Capital flows have taken a role that no-one expected at the time the IMF was created. The international political system has changed too: there are many new countries, with quite new problems, and the Soviet bloc collapsed economically and politically.

The IMF developed in response to these external challenges. There was an expansion of the scope of policies considered as part of the surveillance exercise. The number and length of duration of stabilization packages increased, but these were only successful in a few cases. In the 1990s, in responses to crises in a globalized capital market, the IMF engaged in liquidity crisis management. A response to the new politics of the 1990s involved an expansion into non-macro-economic policy areas, such as criticisms of military spending, corruption, and non-democratic practices. After the Asian crises in 1997 and since, the IMF also discussed areas such as corporate governance and accounting practices that traditionally lay outside its purview.

## *The Situation at the Millennium*

Eight years ago we summarized the outcome of the post-1973 order as follows (Bordo and James 2000). IMF surveillance produces highly useful general reports (World Economic Outlook, Capital Markets); but Article IV consultations have a questionable use in that they frequently lack bite when the country concerned is not engaged in an IMF program. In particular, they seem largely irrelevant for most of the advanced industrial countries. A perceived over-extension of the IMF into new areas of policy concern involves unpopular interventions into national sovereignty. The poorer clients of the IMF often become trapped in a welfare dependency. The management of liquidity crises has contributed to moral hazard and at the same time has not stopped crises spreading.

In 2000 we argued that markets are powerful mechanisms for discipline, but that they can be usefully supplemented by IMF policies and advice. In general, the historical record suggests that the IMF should operate as a traffic policeman as much as a fireman: anticipating and preventing disasters rather than dealing with their painful aftermath. Such a mission would involve:

- a commitment to improve the reliability and timeliness of statistics.
- independence from politics (since the political instrumentalization of the IMF conflicts and harms its core mission, which is aimed at macro-economic stability).
- transparency of operations.
- the establishment of as many rules as possible which are contingent and incentive-compatible. This would enhance transparency. Pre-qualification for crisis lending is desirable, and may become a powerful instrument to achieve better national policies. However, there will then still remain the possibility of crises with potentially damaging systemic effects arising in non pre-qualified countries. A further problem is that a country might cease to pre-qualify, and that such a development would set off an investor panic, and thus frustrate the whole pre-qualification strategy (Cordell

and Levy Yeyati 2006; Kenen 2007). In these cases (in order to avoid moral hazard as far as possible) there may be a case for creative ambiguity, in which the IMF would need some room for discretion, and may not be able fully to announce likely policy responses in advance.

- the willingness to link lending to policy conditionality. Such conditionality, in the past an essential part of the IMF's mode of operations, has been severely criticized by the Meltzer commission in 2000, and it has been too complicated and remains potentially politicized. But it at present still remains the principle lever through which the IMF can effect improvement of members' policies. Its complete abolition would only make sense if the IMF was restricted to strictly rule-based pre-qualified crisis assistance: but such a situation is unlikely in the immediate future.

In general, it was clear that the IMF is best equipped to handle a more limited range of tasks that lie closer to its historical mission. Such a realization implies a retreat to its core area of expertise and responsibility. Such a core includes data standards, liquidity management, and surveillance (the provision of information that markets cannot provide). Longer term concessional lending to very poor LDCs does not fit well into this core, and might be handled better by the World Bank.

Such proposals were consistent with the IMF's mandate. To go further than this could not have been achieved at the insistence of one country alone, even of the most powerful economy in the world. Rather it would have required a new and constructive Bretton Woods conference, which is truly unlikely in the conditions of the early twenty-first century.

### *The Post-Millennial Debate*

Since 2000, the debate has shifted considerably. Many of the issues that generated ferocious controversy in the early years of the new millennium have slid into historical oblivion.

1. There is no longer much debate as to whether the IMF should

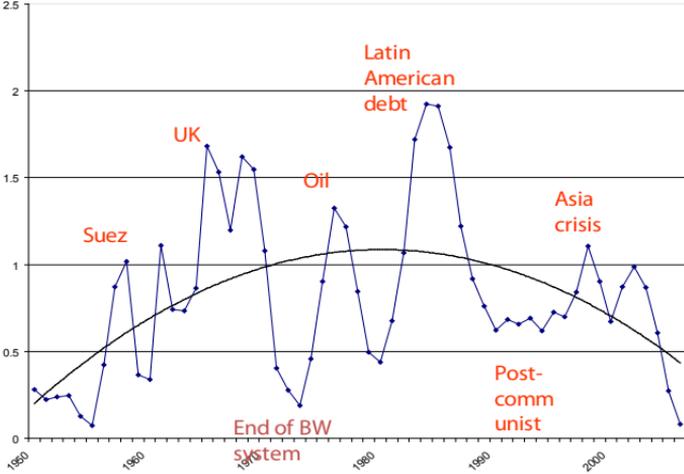
take on an analogous function to a bankruptcy court in domestic law and be able to supervise an orderly reduction of claims while a borrowing country restructures its financial obligations. Such proposals, originally set out by Jeffrey Sachs (1989) and others, were taken up in a modified form by the IMF's Deputy Managing Director, Anne Krueger as the Sovereign Debt Reduction Mechanism (SDRM) (Krueger 2001). They were widely opposed, by banks but also by the U.S. administration.

2. The alternative discussion of collective action clauses in bond contracts, as championed in academic discussions by Peter Kenen (2001) and Barry Eichengreen (2003), and as taken up by the U.S. administration, fared better, but has not really been tested in a large-scale emerging market crisis.

3. The debates about whether IMF conditionality was excessive have also faded, because of the dramatic reduction in the volume of IMF lending.

4. Joseph Stiglitz (2002) and others accused the IMF of being run to bail out the financial system and in particular the big banks. The Fund had been captured in his view by Wall Street. But in 2007 and 2008, as investment banks in advanced industrial countries began to demand new forms of bailout it was clear that the Fund was not suited to such an operation, and that national

IMF Drawings as Proportion of World Exports 1948-2006



fiscal authorities in the big industrial countries would be the last stop of the financial system.

5. In 2003 and 2004 it was often argued that the IMF was inadequately funded to manage big emerging market crises of the future. The coincidence of crises in Argentina, Turkey and Brazil had led to an overstretching of the Fund's financial resources. Commentators saw the likelihood of future crises in some big emerging markets, such as India or China, and concluded that the Fund would be unable to manage. But the growth of emerging market country reserves has made the prospect of such a crisis decreasingly likely. Most countries self-insure against crises, with the result that reforms such as the Contingent Financing Facility became a practical irrelevance.

In general, then, the decline of the IMF's lending activities led to a decline in controversies about the Fund. From the post-millennial perspective, we can clearly see some long-term trends in IMF lending: relative to world exports, drawings on the Fund increased, reaching a high point in the 1980s Latin American debt crisis. Since then there has been a decline, interrupted by a surge of lending in the wake of the 1997-8 Asia (and Russia and Brazil) crises. But since 2003, the outstanding drawings have been repaid, and there was almost no new lending (Figure 1). Such low levels of lending had been seen before, in the mid-1950s and the early 1970s, but a rather dramatic trend now seems unmistakable.

Decreased lending has also led to a debate about the funding of IMF operations, since the day to day activities have largely been paid through charges applied to borrowers. Following precedents from the 1970s (when there had also been a sharp decline in Fund lending and income), the IMF's Executive Board in April 2008 set out a new income model including an endowment funded by IMF gold sales.

The question then arises of whether the IMF can be relevant again. There are issues relating to the IMF's performance and role that are still alive, as well as a new type of problem. At the end of the 1990s, concern with governance issues was not

IMF Drawings as Proportion of World Exports 1948-2006

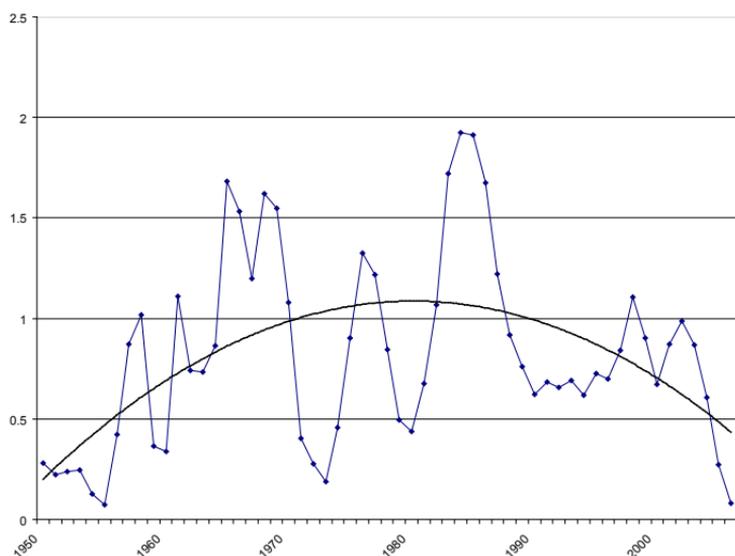


FIGURE 1:  
TRADE FROM INTERNATIONAL FINANCIAL STATISTICS.  
SOURCE: IMF ANNUAL REPORTS.

usually presented as a central part of critiques of the IMF. De Gregorio Eichengreen Ito and Wyplosz in 1999 called for a structure that resembled more of an independent central bank, but this demand was generally regarded as politically infeasible and also undesirable, in that it would remove any element of accountability (while central banks are subject to national legislation). In the course of the 2000s, criticism mounted in two influential critiques from the Bank of England and the Bank of Canada (Dodge 2006; King 2006; see also Santor 2006).

Two parallel problems are critical for the governance debate: first, the issue of the degree of control of the staff and management by the Executive Board that represents the member states; and secondly, the out-dated basis on which shares and votes are determined, and which has only been slowly modified in the light of persistent critique of the over-representation of Europeans and the under-representation of Asian emerging market economies. This paper will propose a solution that would both make the IMF more representative and more flexible, through the addition

of a separate and parallel voting system based on reserve assets deposited at the Fund. The Fund's ownership would thus reflect the international distribution of reserves.

There may on some occasions be a conflict of interest between a staff that sees itself as dedicated to furthering global public goods, and an Executive Board that is dominated by the political agendas of member states, especially the more powerful states with the larger quotas. The Managing Director is poised between the staff and the Executive Board. Critiques of the Fund have pointed out how a Managing Director might feel under pressure to satisfy the large shareholders who appointed him. The First Deputy Managing Director is by convention a U.S. appointee and on occasions appears to follow the general lines set by the U.S. administration. But on some prominent issues, most recently over the question of the IMF's involvement in debt reduction, the U.S. administration shot down initiatives that came from the staff and the FDMD.

One of the most persistent problems of the IMF in the past decade has arisen from the belief of rapidly growing Asian members that they are relatively neglected. In 1997, there was even a short-lived discussion of the idea of establishing a separate Asian Monetary Fund, which was aborted by the United States. Since then, Asian countries have cooperated in establishing an Asian bond market; and some also discuss the prospect of closer currency cooperation in a manner analogous to Europe's slow evolution of monetary union. The IMF by contrast has always insisted that its task is a global one, and that regional institutions are less well equipped to handle global questions of confidence and liquidity.

At the moment, the U.S. has 16.79 percent of the votes in the IMF, which because a majority of 85 percent is required for many crucial decisions, can constitute a veto on Fund policy. The European Union has 32.09 percent of the votes (and members of the Euro currency zone 22.57 percent), so that if either the EU or the Eurozone were a single member, it would be the largest member. By contrast, China has 3.68 percent of the votes, Saudi Arabia 3.18 percent, Russia 2.70 percent,

India 1.89 percent, and Brazil 1.39 percent. The politics of recalculating quotas has meant that the process of rebalancing the Fund is excruciatingly slow. It took very long negotiations for China to be awarded a “special” quota increase when it reabsorbed Hong Kong, even though it was already abundantly clear that China was a systemically important country. In spring 2008, the Board of Governors agreed to a process of modest but continuing reform, which would eventually reduce the U.S. vote being reduced slightly to 16.73 percent, while increasing that of China (3.81 percent) and India (2.34 percent) but reducing that of the Russian Federation (2.39 percent).

At the same time as the old issues are fading from debate, the IMF has become very vulnerable because its financing model depends largely on revenue generated by its lending activity, which is also fading fast. In consequence, questions about the IMF’s viability and role are being asked with much greater urgency.

Three big issues have developed instead as focuses of international debate: the design of the exchange rate regime and the appropriateness of exchange rates; the question of reserve management; as well as the management of financial globalization. The first two (but not the third) of these topics had been major elements of the initial Bretton Woods vision. But none of these issues has been at all central to the recent focus of the IMF.

### *1. Exchange Rates*

With the reemergence of large U.S. deficits, corresponding to surpluses in emerging Asia and in the oil producers, a discussion emerged as to whether Asian economies were artificially holding down their exchange rates in order to achieve rapid export-led growth, and to absorb large quantities of discontented rural labor. The so-called Bretton Woods II thesis (Dooley Folkerts-Landau Garber 2003) saw China and other Asian states behaving in a fashion analogous to Germany and Japan in the 1960s, which had also had export-led growth and big surpluses, and had been highly resistant to proposals for parity changes. Concern about currency manipulation emerged in a political form as a potent

source of new trade protectionism, as when Senator Charles Schumer proposed to subject Chinese goods to a special tariff as a compensation for the exchange rate manipulation.

In the global imbalances debate, it was always unclear where the adjustment should take place. Some commentators, notably Cheung Chinn and Fuji, have produced arguments that would support the Chinese position, namely that in the light of a number of institutional factors, including the large extent of non-performing loans, public sector corruption and inefficiency, the renminbi is actually not overvalued. However, no one in China is likely to make explicit their support for this interpretation, and no one in the U.S. is likely to believe such an argument given the size of the bilateral trade deficit. Since a large part of the problem lies in the U.S. current account deficit, it is equally plausible to argue that the correction should lie in U.S. adjustment. Such adjustment, which has been taking place since 2005, is however likely to depress world economic growth.

In a few isolated historic cases, the IMF had taken up exchange rate issues and in “special” consultations issued rulings against Korea and Sweden for exchange rate dumping. Some other Scandinavian countries had complained about the extent of the Swedish devaluation of October 1982; and in 1987 the United States criticized the large current account surplus of Korea which it attributed to the undervaluation of the Korean won. But in the 1980s, while the IMF was prepared to deal with Korea, the Fund shrank from involvement in the much more highly politicized question of the Japanese exchange rate. Clearly in the 2000s, there is no mechanism that would simply require China to adopt a new exchange rate policy at the demand of importing or competing countries. The issue of the Chinese exchange rate does appear in Article IV consultations, where the topic is dealt with in a sane and largely unpolitical way. The advice given may have convinced Chinese officials to embark on a limited move to more exchange rate flexibility since 2005. But the IMF has no greater standing in these Article IV reports than the coherence of its intellectual case. In this sense, the Fund is no more powerful than some of the eminent academic economists such as Ronald McKinnon, Robert Mundell and Jeffrey Frankel, who have

offered (contradictory) opinions on the appropriate course of Chinese currency policy.

A more promising vehicle is the multilateral surveillance mechanism agreed by the International Monetary and Financial Committee in April 2007 as a way of addressing the global imbalances issue. Kenen (2007) went much further and proposed that the IMF staff should be given greater latitude to publish specific country recommendations without the endorsement of either the Fund Executive Board or of the International Monetary and Financial Committee. Such a development would clearly be an important step in the establishment of a more autonomous or apolitical Fund.

There are some indications that the new approach may be effective. China has certainly responded to the debate about its exchange rate policy, although it is unclear how much if any of the new flexibility is the result specifically of a need to deal with the new Fund mechanism, and how much it has simply followed from general developments and in particular from the rapid depreciation of the dollar (and the fact that the dollar has depreciated less against the renminbi than against other currencies such as the euro). In the course of the initial negotiations, China agreed to a statement that: "The exchange rate formation mechanism will be improved in a gradual and controllable manner. Exchange rate flexibility will gradually increase, with attention paid to the value of a basket of currencies. Efforts will be made to cultivate the foreign exchange market and deepen reform of foreign exchange administration. Restrictions will be further relaxed on holding and use of foreign exchange by enterprises and individuals." And in the course of March and April 2008, it appeared that the Chinese authorities were prepared to see much greater flexibility in the dollar-renminbi rate.

As to the United States, adjustment is taking place but not as a consequence of any policy initiative generated through discussions with the IMF or through Fund surveillance. Since 2005 a surprisingly orderly depreciation of the dollar has taken place, latterly speeded up by the loose U.S. monetary policy

response to the sub-prime crisis and to fears of U.S. financial instability and possible recession. The U.S. adjustment might well be interpreted as a testimony to the ability of markets to self-correct.

But there is a difficulty in the way of the market-based view. Large emerging markets have acquired such high levels of reserves that any changes in their reserve holdings may dramatically affect market expectations. In this sense exchange rate issues have become ever more closely bound up with the controversial topic of reserve management.

## *2. Reserve Management*

One way of understanding the interwar situation, to which Bretton Woods was the policy response, is of a world in which reserves were highly unstable because of the substitution of a gold-dollar standard for a pure gold standard. The Fund as a kind of credit cooperative (in an analogy popularized by Peter Kenen) was a solution to the reserve problem. Its lending facilities could be a substitute for absent reserves.

The world of the early twenty-first century is also characterized by instability and worries about reserve positions. On the face of it, the new development of very substantial international reserves is a signal that something was wrong in the international economy long before the present outbreak of credit market panic. John Maynard Keynes and the other makers of the 1944 Bretton Woods conferences had seen central bank management of reserves as a significant part of the instability of the pre-1939 system, and proposed to replace reserves by collective assets or quotas held at the new institution, the International Monetary Fund. Today's greatly increased reserves held by single countries can be understood either as a misallocation of assets, or alternately as the use by financially under-developed economies of the United States as a global financial intermediary (analogous to the banking role of the U.S. described by Despres Kindleberger and Salant 1966). In this view, emerging market savings are successively recycled through their central banks, then the U.S. bill market, U.S. banks, U.S. corporations back to emerging

markets. Such complex financial intermediation is costly and potentially destabilizing.

The rapid growth of reserves of emerging markets since the turn of the millennium – one of the major policy developments of our time - presents a puzzle. Between 2002 and 2006 they have more than doubled in terms of SDRs, the IMF's international unit of account, and almost tripled in dollar terms. Reserves are supposed to facilitate international transactions, in that they help countries deal with unanticipated declines in export revenues, or increases in import prices, or sudden withdrawals of foreign credits. Since there are continuously local shocks, and ups and downs in the international economy, the size of reserves should also be expected to fluctuate (as the length of a cab rank grows and falls as new taxis arrive and lined up taxis are hired).

In the global economy of the last decade, world reserves did not really fluctuate but instead moved in a mostly linear direction. Industrial countries needed reserves less, while poorer and emerging countries wanted them more. The United States never had or needed very extensive foreign exchange reserves (in April 2008, the level stood at just \$75 bn. while China had \$1760 bn. and India \$313 bn; by contrast the European Central Bank held \$63 bn. and the Eurosystem as a whole \$542 bn.) In particular, the bad consequences of not having reserves in a crisis had appeared in 1997-8 in the Asia crisis. The crisis was a cruel reminder of the vulnerability of very dynamic economies with big capital imports and inadequate foreign reserves. China, and other Asian economies, then tried to ensure that they would not be vulnerable again. The costs of the crisis were so great that countries (especially poorer countries) were powerfully motivated to build additional reserves. But then they went on and on accumulating. In the 1960s, the distinguished international economist Fritz Machlup formulated a different view of reserves, which he called the theory of "Mrs. Machlup's wardrobe." Mrs. Machlup apparently always liked to buy new dresses, while resisting giving away old ones: so the stock of dresses went on increasing. Since the millennium, the reserves of Japan, Taiwan, Korea, and Malaysia have all more than doubled, while that of China more than quintupled. Are the reserves really needed and

when is the optimal point reached? One Korean central bank official said that: “There is no limit to the amount of reserves that are needed.” (Cheung and Qian 2007) Asian reserves now look more like Imelda Marcos’s shoe collection than Mrs. Machlup’s wardrobe.

Because reserves are held mostly in short dated and very low risk securities (traditionally treasury bills issued by a few industrial countries), the world pile up of assets has driven down short term interest rates, and prompted a global expansion of liquidity that then helped to power asset price bubbles, especially in the housing markets of countries with current account deficits and higher interest rates, especially the United States, Australia, or the United Kingdom.

The rapid accumulation of reserves follows from high savings rates, both in the private and the public sector, in oil producing and emerging Asian economies. While overall savings in non-industrialized countries have fallen, the countries classified by the IMF as “developing Asia” have had big increases in savings: from 32.9 percent in the 1990s to 42.2 percent in 2006. Especially quickly growing but politically unstable and insecure countries experienced dramatic rises in the savings rates, as citizens felt unsure about their future and were unable to rely on state support mechanisms. The private choices are a response to the unavailability of insurance for old age and sickness, and the rapidly increasing cost of education: individuals need to save so much because they are dependent on their own resources. The paradigmatic case again is that of China, where consumption rates have actually fallen as incomes rose: by 2005, Chinese households consumed less than 40 percent of GDP, and Chinese households moved to very high savings rates (of around 30 percent). With simultaneous high saving by the government and by enterprises, the outcome is a large amount of capital in search of security. But the savings surge, and the accompanying positive current account balance is not just a Chinese peculiarity, but can be found in most Asian, South Asian and Gulf States economies. For the Middle East, the savings rate rose from 24.2 percent in the 1990s to 40.4 percent in 2006. In the latter case, the surge in oil prices has been responsible for the growth in

savings, but in Asia it reflects the combination of stronger growth and increased precautionary saving (IMF, World Economic Outlook April 2007, Table 43). Reserve growth represents one way, though not a particularly cost effective one, of investing the savings generated, in more apparently secure (and foreign) economic and political settings.

The surprising savings behavior is not just the outcome of private decisions. Public policy has played a central role. The emerging market states have chosen to build up large levels of reserves, in part to avoid an appreciation of their currencies that would make their highly dynamic export sector less competitive.

But the countries that are building up these enormous reserves are setting themselves a new kind of trap that relates to their composition, in terms of choice of currency but also of the class of securities chosen. The accumulations are so large that even the announcement of a small shift in assets, for instance, a declaration that there may be a shift to more euros and fewer dollars, is enough to move markets and to cause disruptions and panics. In the past, reserve regimes in which there was a choice of assets brought an inherent instability. For instance in the interwar period the world had a choice of the dollar, the pound and gold and reserve currencies, and was deeply destabilized by the sudden loss of confidence in the pound in 1931. In the run up to the financial crisis, private speculators, but also other central banks, rapidly tried to convert pounds into dollars or gold. After the pound was decoupled from gold, speculation turned against the dollar, until Franklin Roosevelt followed Britain and left the gold standard. This feature of the old order reserve system was exactly why Keynes and his Bretton Woods colleagues were suspicious of the prewar order, and felt that it led to the possibility of devastating speculative attacks on central banks, who could only defend their currencies and their reserves by taking measures that would be highly damaging to the domestic economy.

There are also problems relating to the management of the domestic economy. Reserves are often sterilized to prevent an impact on the domestic money supply and inflation. But there

is a limit to such sterilization, as governments cannot issue debt indefinitely without crowding out private sector investment. In consequence, the outcome of rapid reserve accumulation is often inflationary, as it was in Germany and Japan in the 1960s; and as it appears to be in China's recent past (Sohmen 1964; Yongding 2007; Humpage and Schenk 2008).

In recent times, a number of solutions have been put forward to the threat to stability posed by the big build up of reserve assets. The most obvious is to follow the path of central banks in the rich industrial countries and look for a broader range of reserve assets. Why should central banks only hold low yielding Treasury bills? Why should they in effect subsidize the U.S. government by holding its debt liabilities? The emerging Asian economies have indeed gradually looked to longer term assets in place of short Treasury bills, and have also moved to buy other government agency securities, and even some corporate bonds. Asian governments are also tempted to look to equities as a way of obtaining higher yields, but by doing this they expose themselves to more volatility.

In practice, the attempts by the new surplus countries to look for alternative reserve assets have been highly problematic. Most of the attention has been fixed on China's more than one trillion dollars in reserves, and its nervous search for ways of maintaining the value of those assets. Diversification from U.S. Treasury bills by investing some \$3 bn. in the Blackstone private equity fund this summer was swiftly followed by an embarrassing collapse in value.

### ***The Search for Alternative Institutions of Asset Management***

When assets are managed in an alternative way, through sovereign wealth funds (SWFs), there are even greater difficulties. On the receiving end, industrial countries' governments are increasingly anxious that SWFs will be used strategically, rather than simply following the logic of the market. They might be used as a way of gaining control of key sectors of the economy, especially since the credit crunch has made the world's largest banks look for new

injections of capital. In November 2007, Abu Dhabi recapitalized Citigroup with \$7.5 bn., and in December the Government of Singapore Investment Corporation took a CHF 19.4 bn. (\$17.2 bn.) stake in the Swiss bank UBS. The more activist Singapore institution, Temasek, has acquired stakes in Standard Chartered, Barclays, Bank of China, and the China Construction Bank. Since the second quarter of 2007, SWFs have put at least \$46 bn. into financial companies in developing countries (Financial Times 2007). Other investments have attracted substantial attention: such as the failed attempt of Dubai Ports World to buy the British company P & O which managed six major U.S. ports; or the blocked bid in 2005 of the China National Offshore Oil Company for the Californian oil company Unocal. Even the highly successful model for the sovereign wealth funds, Singapore's Temasek, which for a long time went largely unnoticed, is now attracting an attention which from the point of view of its owners and managers is highly undesirable and has announced that it intends to avoid stakes at "iconic" companies. It is possible to imagine a voluntary code of good management by SWFs, in which they apply a self-denying resolution not to purchase commanding shares in key industries, but even that will not be enough to satisfy the nerves of the old industrial countries. Norway has adopted such a code, but few recipient countries are likely to see Norwegian investment as a threat. The IMF has recently tried to formulate a new role in creating a code of conduct, but the debates are highly contentious.

Even without the politics, the simple size of the SWFs makes them a major actor in financial markets. With a capital of at least \$2.5 trillion, they are larger than the world total of hedge funds, and are large enough to move global markets. They have in part funded the big expansion of global stock markets over the past five years. The total world stock market capitalization was only \$20.4 trillion in September 2002, but is currently \$63 trillion (October 2007) (World Federation of Exchanges 2007). In effect, the flow of savings from emerging markets has driven the global equities boom that followed the collapse of the dot.com bubble (Bernanke 2005).

The capital markets are no longer effectively an arena in which

outcomes result from the interplay of millions of independent guesses, decisions or strategies. Instead the central banks of emerging markets and new sovereign wealth funds provide so much of the market that they might dominate it. When entities of such a size make decisions, they are bound to act in a strategic way. All the parties begin to suspect political manipulation.

Both the problems of the owners of the new assets and the targets of ownership can be resolved, and the political venom inherent in the accumulation of strategic ownership interests neutralized, through the operation of institutions that have a commitment to and an interest in an overarching general good. They should not be in a position where they may be suspected of a particular strategic manipulation.

### *The IMF as an Independent Asset Manager*

What kind of institution is committed to the overall good? It was such an aspiration that drove the establishment of the IMF immediately after the Second World War. In the past, IMF surveillance of individual countries had teeth because the IMF also had financial power, and because countries taking its advice were borrowing from the Fund or might need to borrow in the future (James 1995). Unlike the OECD, it could put its money where its mouth was. At its most effective moments, the IMF had a powerful leverage over countries whose behavior was vital to the health of the international monetary system.

The IMF originally supervised the rules of the par value system under the Bretton Woods order, which disintegrated in 1971. It was initially envisaged as a sort of rotating credit cooperative, which would support member countries in need of resources to deal with short-term balance of payments problems. It was also intended to have some leverage over perennial surplus countries, through the “scarce currency clause”, though this provision of the original agreement was never acted on. In the first instance in the 1950s, such action would have required taking measures that penalized the U.S.

The effectiveness of multilateral surveillance as it developed in

the 1960s within the context of the G-10 and OECD's Working Party Three was linked to the IMF's presence as a really major financial intermediary as its lending expanded (see Figure 1). The major problem at this time involved the chronic strain and frequent eruption of crises in Britain's balance of payments, while the U.S. regarded Britain's role as a reserve center as a central part of the international order and as an outer perimeter defense of the dollar. At this time the IMF went well beyond its own quota-based resources, and its financial power was enhanced by a new ability to raise additional resources through the General Arrangements to Borrow (concluded in 1961). Its ability to give powerful advice to the systemically important countries, such as the United Kingdom, was enhanced by the dependence of those countries on IMF resources. It was the financial power of the IMF that gave it real analytical bite and real powers of persuasion.

In the years after the collapse of Bretton Woods, the IMF reinvented itself as a principle vehicle for the management of the surpluses of the time. It borrowed from the new surplus countries, especially Iran, the Gulf States, and Saudi Arabia, who in this way in part managed their new assets through the intermediation of the IMF. As a consequence, it was able to lend (through the newly introduced Oil Facilities) to those countries which suffered shocks as a result of the increase in petroleum prices.

In principle, any very large financial actor can have a similarly stabilizing role through its ability to take positions against speculative attacks. In the more distant past, market expectations were stabilized during panics by the counter-cyclical behavior of very large private institutions. The multinational house of Rothschild made the first half of the nineteenth century more stable, not only by lending in crises, but also by combining its assistance with a policy conditionality intended to ensure that the credits were more likely to be repaid. Niall Ferguson's survey of the Rothschild history (1999) makes clear how much this central role allowed the expansion of financial activity, and hence also of economic and industrial activity. In the great waves of panic of 1893-6 and 1907, U.S. financial markets were calmed by J.P.

Morgan (Strouse 1999). At the time of the Great Depression in the 1930s, there was no house of equivalent power: Morgans failed to calm the U.S. market in 1929; and when the Swedish financier Ivar Kreuger tried to stabilize European markets in 1932, his financial empire collapsed. In 2007, there are some signs that Goldman Sachs feels a duty to lean against the wind in order to stabilize markets. It presents itself, like the Rothschilds or Morgans of the past as having both a more cautious approach to risk as well as the massive financial firepower that enables it to act as a stabilizing force.

It is therefore quite conceivable that emerging market economies could simply turn to some large private sector western financial institutions to manage their assets. They might hope that there would be a large benevolent and foresighted private sector player that might serve as an international lender of last resort, and stave off panics. But the problems raised by the delegation of the control of emerging market government assets remain quite intractable.

There is an unpleasant choice implied by tying a powerful emerging market country to a large private sector actor in a different country. If the emerging market governments take a major equity stake, as in the case of Citigroup or UBS, they may be accused of trying to exercise some form of political strategy involving taking control of some commanding heights of the industrial economies and then holding those traditional powers to ransom. If, on the other hand, they do not attempt to assert any control on the governance of the financial institutions they are buying, they will have lost control and may be more vulnerable to loss. Moreover, the benevolent hegemonic private sector actor is usually treated with considerable suspicion. In the domestic market and political context of the U.S. one century ago, rivals and critics turned on J.P. Morgan after the rescue of 1907. The ensuing public debate led to Morgan's embarrassment before the Pujo Committee, and to an early death; and also led to the establishment of a public stabilizing institution, the Federal Reserve System. An analogous debate after the Second World War applied on the global rather than the national level, and led to the idea that an international institution was a crucial part of

the world's financial architecture.

The IMF could again become a very powerful financial stabilizer if it managed a significant part of the reserve assets of the new surplus countries. It would be in a powerful position to take bets against speculators. The stabilizing action would ultimately benefit both the world economy and the interests of the owners of the reserve assets, who have (simply by the fact of the accumulation of the surpluses) a similar interest in world economic and financial stability. At the same time, the management of reserve assets by an internationally controlled asset manager would remove suspicions and doubts about the use of assets for strategic political purposes.

In the course of developing new functions, it would be important to distinguish between routine day-to-day transactions and crisis management (in the same way as central banks and national regulators do in their management of domestic affairs). The large stock of assets under the routine management of the IMF would in the first place represent a large *masse de maneuver* that would frighten off speculative attacks or irrational panics. The Fund would be in a situation to intervene preemptively, possibly but not necessarily at the request of the target of the speculative attack; so that the speculation would become impossibly costly. The enhanced asset base of the IMF would also give it the possibility of switching into crisis mode without long discussions and formal negotiations. There could be very quick responses; and, as the shifting of assets by asset managers, they would also be noiseless. One of the problems of IMF functions in the past – whether it was in trying to define “scarce currencies” in the immediate postwar period, or asking whether there was a sufficient world supply of liquidity – was that these determinations had to be made in such a formalized way that there could in practice never be an agreement on the issue. Operating as an asset manager, the IMF would be able to affect currency exchange rates without requiring authorization through a formal decision.

The IMF in this new role could directly provide crisis-stricken countries with very large amounts of support: a sort of revival of its traditional role. It is also conceivable that it might intervene

directly in currency markets, in cases where its management was satisfied that the crisis was entirely or predominantly speculative in origin and did not correspond to fundamental problems. This would be a decision not directly controlled by governments or by the Executive Board, but at the same time informed by the process of multilateral surveillance. And ultimately, the management would bear the responsibility for mistakes and would be accountable to the board and the governments which own the IMF.

Asset managers are conventionally held to performance benchmarks and other comparative criteria. In evaluating the IMF's performance as an asset manager, and in particular of its crisis response functions, it would be inappropriate to take short-term benchmarks, since such a criterion would require the IMF to "follow the herd" in a panic and liquidate assets in a crisis-stricken country, thus intensifying the crisis. But a multi-year framework would offer an appropriate basis for performance evaluation, since crisis countries supported by the IMF would be expected to undertake reform, and to bounce back from the speculative attack.

### ***3. The Management of Financial Globalization***

As part of the response to the new problems and threats posed by liberalized global capital markets, the IMF established a Capital Markets Division in 1999, which has produced high quality semi-academic reports on major developments. These reports gave warnings about the potential for destabilization from financial innovation, and saw hedge funds as a source of potential threat.

In responding to the 2007-8 financial crisis, the IMF's new Managing Director, Dominique Strauss-Kahn, has complained that the IMF has been effectively sidelined. In particular, the US never signed onto the joint IMF-World Bank initiative of 1999 (Financial Sector Assessment Program) designed to alert countries to financial vulnerabilities. Strauss-Kahn was quoted as saying that "What is interesting is that ... the United States had refused to have an FSAP. We can't be responsible for lack

of supervision... owing to the fact that our main instrument to make that kind of supervision was not used in the country.” (Financial Times, 2008). The FSAP mechanism was largely intended, as might be deduced from the date of inception, to deal with ways of examining the financial sectors of emerging market economies, which had been one of the central problems in the 1997-8 Asia crisis. Strauss-Kahn’s comment sounds rather like a rather regrettable instance of international institutions trying to build legitimacy by sounding a cheap anti-American note. But the IMF is completely right to think that it is largely on the sidelines as far as financial stability issues are concerned. It never evolved in the direction of the “large IMF” sketched out by one of the authors in 1996 (James 1996, pp. 618-619), and instead remained resolutely a “small IMF”. The major institutional involvement of the Financial Stability Forum is with the BIS. Given that the major task is to formulate monetary policy as well as regulatory responses to financial developments, it is appropriate that financial stability issues should be handled by an institution that is owned by central banks, rather than by governments (as is the Fund). Indeed the strikingly rapid growth of capital markets was in general a development that had not been predicted at Bretton Woods, and had not been desired by the makers of Bretton Woods, who wanted to move away from the interwar world of central bank-based international cooperation. At that time they had seen central banks as insufficiently committed to mandates to achieve macro-economic stabilization and growth.

#### ***4. Reform of IMF Governance***

For some time, there has existed a substantial consensus, even from fundamentally sympathetic critics, that IMG governance is out-dated and in need of reform (for sober assessments see Van Houtven 2002; Woods 2005; Kenen 2007). The rise in reserves in many Asian countries was a deliberate response to the 1997 Asia crisis, in which there was a substantial disillusionment with the IMF. A precondition of the IMF acting as a global reserve manager would be a governance reform in which the new surplus countries were able to exercise a substantive influence through the IMF. They would need to feel absolutely secure that they were not being the subject of some politically motivated

manipulation. In particular, if the IMF were to be in a position of an asset manager who could shift assets from one market to another, it would need to be at a longer distance from U.S. influence and attempts at control: otherwise, it would be seen as a device for propping up the dollar for political rather than economic reasons.

In the past, the IMF has frequently run into precisely this sort of difficulty. In the early 1970s, the IMF's Managing Director Pierre-Paul Schweitzer was thought to be pressing for a devaluation of the dollar, and the U.S. insisted on removing him. In later high profile country cases, involving countries such as Egypt or Russia or even Argentina where the U.S. saw a strong security interest, the U.S. pressed against the advice of technical experts from the IMF (see Blustein 2001; and Blustein 2005).

Above all, while reports of the IMF on aspects of U.S. economic and financial management were often critical, the IMF has no real leverage over the U.S. Unlike in the case of Great Britain in the 1960s and 1970s, it is unable firmly to press American governments for policy reform or fiscal adjustment. But part of the theory of the usefulness of international institutions involves the ability of a commitment via an externalized and depoliticized process to act as a lever for policy reform that brings long run collective benefits, even though there are short term political costs associated with adjustment. Reference to the external pressure – as in the relation of member countries to the European Union – can be a very effective way of overriding the shorter run political opposition in order to bring about the needed economic adjustment.

In a revised approach, votes would be allocated or “bought” to a large extent through the assets held at the IMF. The proportion of votes determined in this way might be as high as 50 percent, in a new Reserve College, while the rest would be allocated in the traditional way in the existing Membership College. There is an analogy to this double determination of voting power in the U.S. Constitution, according to which all states have an equal share of Senate votes, but very different numbers of seats in the House of Representatives, where their differing population is

reflected. As in the U.S. Congress, a concurrence of both houses or Colleges would be required.

Reserve positions in the IMF would be established, as they are now, by deposits in convertible currency of another member country. The voting in the Reserve College would follow the reserve positions held in the IMF. Voting might only be possible with some time delay (as is often the practice with votes in the stock of private corporations), so as to make sudden reserve deposits (and withdrawals) with the object of obtaining some particular political objective (such as the selection of the IMF's Managing Director) an unappealing option.

Traditionally, the counting of votes has not been very important in shaping particular Fund policy, as the institution and the Board largely operates on the basis of consensus. The eventuality of a vote taking place nevertheless helps to shape the way in which consensus is arrived at, and the extent to which diverging interests are respected and heard. Requiring majorities (with specially qualified votes as in the current voting system of the Fund's Board of Governors) in both houses or Colleges might appear to make likely the possibility of stalemates arising; at the same time, it might be argued that such a threat of stalemate would create additional incentives for cooperation and consensus-building.

How would such a system look? It is obviously hard to estimate in advance what share of reserves member countries would actually choose to invest through the new mechanism. In addition, reserve position share likely to move. The following examples thus provide only an extreme outlier of the maximum effect that would be produced by the investment of global reserves at current levels, and in that sense is deliberately unrealistic. In the unlikely event that every member country decided to put all its existing reserves into the new Fund mechanism, and not to find additional reserves, the weight of voting in the Reserve College would allocate 25 percent to China, 14 percent to Japan; 9 percent to the European Central Bank and the Eurosystem, 4 percent to India, and only 1 percent to the U.S. Such a large allocation would of course not be necessary for the system to work, or even

desirable: the figures are only presented to give some sense of the upper bound possibilities. It might also be conceivable that the U.S. would want to make supplementary reserve deposits to bring up its voting share. But overwhelmingly, the Reserve College would be an institution which gives a powerful voice to emerging market economies.

Making a substantial part of Fund voting a reflection of the reserve positions held in the IMF would allow very quick adjustments to new international realities. It would make the IMF more of a market institution, in much the same way as the changing ownership of joint-stock companies can shift quickly and noiselessly. There would be no need for constant and cumbersome processes of quota renegotiation and revision. A revision of the voting system that meant an automatic reflection of reserve assets held in the Fund would at a stroke eliminate political complications and make the IMF appear much more like a market-oriented organization: in short, the type of credit cooperative that Keynes and the other makers of the postwar monetary settlement envisaged at the 1944 Bretton Woods conference.

### *Conclusions*

In the 1970s, the IMF's engagement with large industrial countries came to an end, and in the 1980s and 1990s it became principally an institution engaged in emerging market economies (as well as in very poor countries). The problem with the new mission is that by the 2000s, the emerging markets also graduated, and look as if they no longer need the IMF (although it is quite possible to imagine new emerging crises arising that might require the more traditional fire-fighting functions of the Fund). As a consequence, all that is left of the original mission of the Fund is the poor country issue (where the micro-economic nature of many of the problems makes the World Bank look like a more suitable agency); and surveillance. But surveillance without the association of financial power that characterized the IMF's modus operandi in the 1960s and 1970s is likely to be rather toothless. The involvement of the IMF in reserve management would provide a powerful set of new

financial teeth.

In order to reorient the focus of the IMF in this manner, some simple principles would need to be followed:

First, the IMF's new function as an asset manager would need to be handled separately from the much smaller traditional quota resources used to provide the classical balance of payments assistance through the so-called "General Department" of the Fund. Some portion of the new assets could perhaps be invested adventurously in long-term infrastructure projects for poorer economies, not simply as a public good but in the expectation of long-term returns. The management of assets could be subject to specific guidelines as to which assets might be inappropriate for investment by the IMF. But the fundamental aim of the new Asset Department would be to generate satisfactory and stable returns that would make the reserve assets financially more rewarding (and actually less risky) than under the current system as it is emerging with the problematic growth of SWFs. The Asset Department would thus be subject – like other asset managers – to a clear financial measure of its performance.

Secondly, but only in exceptional circumstances of a generalized threat to global financial stability, the IMF's new resources would be used to stake out positions to defeat speculative attacks in situations where the fundamental position might be judged to be sound. Like a traditional lender of last resort in a domestic context, it would then lend against collateral at a normal, non-crisis, valuation. But, as in its traditional mission, it might also impose policy conditionality in the case of crisis lending to governments.

Third, the new operations would be separated from the existing regular assessment of country policy (the so-called Article IV consultation process or surveillance). Otherwise there would be the suspicion that judgments are influenced by the financial stance of the IMF. This is of course a problem that private sector institutions also face, and which they deal with by establishing "Chinese walls" between research and investment banking activities.

Fourth, in order to carry out this completely new task, the IMF would need to regain the trust of its members. This would require a reform of IMF governance, and in particular of the highly contentious issue of the voting arrangements.

## ***REFERENCES***

- Bernanke, Ben, 2005. “The Global Saving Glut and the U.S. Current Account Deficit”, speech to the Virginia Association of Economics in Richmond on March 10, 2005: <http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/default.htm>
- Blustein, Paul, 2001. *The chastening : inside the crisis that rocked the global financial system and humbled the IMF*, New York : Public Affairs.
- Blustein, Paul, 2005. *And the money kept rolling in (and out) : Wall Street, the IMF, and the bankrupting of Argentina*, New York : Public Affairs.
- Bordo, Michael and Harold James, 2000. “The International Monetary Fund: Its Role in Historical Perspective”, U.S. Congressional International Financial Institution Advisory Commission.
- Cheung, Yin-Wong and XingWang Qian, 2007. Hoarding of International Reserves: Mrs. Machlup’s Wardrobe and the Jones, CESifo WP 2065, July.

Cordella, Tito, and Eduardo Levy Yeyati, 2006. "A (New) Country Insurance Facility," *International Finance* 9, 1-36.

de Gregorio, Jose, Barry Eichengreen, Takatoshi Ito, and Charles Wyplosz, 1999. *An Independent and Accountable IMF*, International Center for Monetary and Banking Studies.

Despres, Emile, Charles P. Kindleberger and Walter S. Salant, 1966. "The Dollar and World Liquidity: A Minority View," *The Economist*, February 11.

Dodge, David, 2006. "The Evolving International Monetary Order and the Need for an Evolving IMF." Speech to the Woodrow Wilson School of Public and International Affairs, March 30.

Dooley, Michael P., David Folkerts-Landau, Peter Garber, 2003. "*An Essay on the Revived Bretton Woods System*," NBER WP 9971 .

Eichengreen, Barry J. and Mody, Ashoka, 2004. "Do Collective Action Clauses Raise Borrowing Costs?" *Economic Journal*, Vol. 114, No. 495, pp. 247-264, April.

Eichengreen, Barry, 2003. "Restructuring Sovereign Debt," *Journal of Economic Perspectives* 17:4

Ferguson, Niall, 1998. *The house of Rothschild : money's prophets 1798-1848*, New York : Viking.

*Financial Times*, 2007. "\$46 bn. invested in Western Institutions," December 12, p. 16.

*Financial Times*, 2008. "IMF rejects criticism over foreseeing global turmoil." April 11, <http://www.ft.com/cms/s/0/35236db8-075f-11dd-b41e-0000779fd2ac.html>

Humpage, Owen F. and Michael Shenk, 2008. "Chinese Inflation and the Renminbi," <http://www.clevelandfed.org/research/trends/2008/0208/01intmar.cfm>

James, Harold, 1996. *International Monetary Cooperation Since Bretton Woods*, New York: Oxford University Press.

- James, Harold. 1995. "The Historical Development of the Principle of Surveillance," *IMF Staff Papers* 42/4, pp. 762-91.
- Kenen, Peter B., 1986. *Adjustment and the International Monetary Fund*, Washington DC: Brookings.
- Kenen, Peter B., 2001. *The International Financial Architecture: What's New? What's Missing?* Washington: Institute for International Economics
- Kenen, Peter B., 2007. Reform of the International Monetary Fund, CSR 29, Council on Foreign Relations.
- King, Mervyn, 2006. "Reform of the International Monetary Fund." Speech to Indian Council for Research on International Economic Relations, New Delhi, February 20.
- Krueger, Anne O. 2001. "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring," Address at the National Economists' Club Annual Members' Dinner, American Enterprise Institute, Washington DC, November 26, 2001, <http://www.imf.org/external/np/speeches/2001/112601.htm>
- Sachs, Jeffrey, 1989. "Efficient Debt Reduction," in *Dealing with the Debt Crisis*, Ishrat Husain and Ishac Diwan (eds.), A World Bank Symposium, Washington, DC.
- Santor, Eric, 2006. "Governance and the IMF: Does the Fund Follow Corporate Best Practice?" Bank of Canada WP 2006-32.
- Sohmen, Egon, 1964. *International Monetary Problems and the Foreign Exchanges*. Special Papers in International Economics, Princeton: International Finance Session
- Stiglitz, Joseph E., 2002. *Globalization and its discontents*, New York: W.W. Norton, c2002
- Strouse, Jean, 1999. *Morgan : American financier*, New York : Random House.
- Van Houtven, Leo, 2002. *Governance of the IMF: Decision-Making, Institutional Oversight, Transparency and Accountability*, IMF Pamphlet Series No. 53.

Woods, Ngaire, 2005. "Making the IMF and the World Bank More Accountable," on (ed.) Ariel Buira, *Reforming the IMF and the World Bank*, London: Anthem, Press.

World Federation of Exchanges, 2007. *Annual Report*.

Yu Yongding, 2007. "Global Imbalances and China," *Australia Economic Review*, March.



# ***A New Bretton Woods?***

*by Lawrence J Brainard*

With pundits as diverse as France's Nicolas Sarkozy and the editorial writers of China's People's Daily calling for a redesign of the postwar global financial architecture, can reform be far behind? Actually, despite all the ink spilled on calls for a new Bretton Woods, there is remarkably little agreement on what needs fixing and how best to go about it.

## ***The twin crises***

The best way to think about our present predicament is that it represents a crisis of the international financial system as well as a crisis in that system.

The systemic crisis is that a relatively small financial shock, that of subprime mortgages in the US, has led to a global financial breakdown with wide-ranging negative consequences for the real economy of countless nations. As Holman Jenkins of the Wall Street Journal noted on 03 December<sup>1</sup>: "...the entire stock of subprime mortgages could have been bought for about half of what was spent last week to prop up Citigroup and spur consumer and mortgage lending."

The crisis in the system is a crisis of large, internationally diversified banks and in the shadow banking system (non-bank financial intermediaries). This crisis reflects two fatal weaknesses in the behaviour of participants in the system:

<sup>1</sup> <http://online.wsj.com/article/SB122826676533474525.html>

- **Complexity**—banks have originated and hold large volumes of assets whose value the banks themselves cannot determine. This opacity of bank balance sheets means that bank managements are “flying blind” in controlling the risks imbedded in their asset exposures.
- **Homogeneity**—nearly everyone in finance was employing the same strategies in recent years, with the result that a small shock to the system was amplified many fold, causing a collapse. Banks with their originate/distribute fixation and the shadow banking system built with massive leverage on minimal capital are to blame.

### *Why this is a systemic crisis*

The systemic crisis facing us today reflects the culmination of years of gradual evolution of international finance from the original Bretton Woods arrangements, where the US dollar was fixed to gold and all other currencies were pegged to the dollar. Following the US break with gold in 1971 the system has gradually evolved to what we have today, a mostly floating rate system where the dollar and the Euro provide the “anchors” and float against each other and most other currencies float more or less freely.

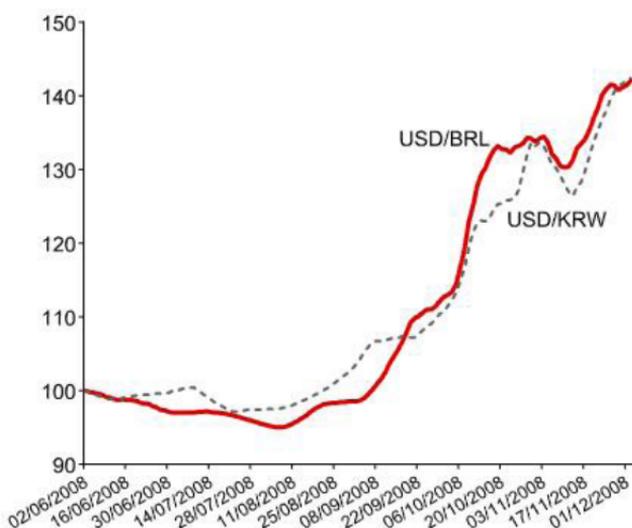


CHART 1: INDEX OF BRAZILIAN REAL AND KOREAN WON VS US DOLLAR, 10 DAY MOVING AVERAGE, 02 JUNE=100

What's wrong with this system? Most economists would argue that nothing fundamental is wrong, apart from the need to police the behaviour of its participants through better regulation. While popular, this view ignores the evidence that the floating rate system we have today is inherently dysfunctional and prone to instability.

The relatively free movement of capital into a number of emerging markets has brought a level of financial integration that is sorely testing countries' abilities to deliver economic stability. Take Brazil and South Korea. Since the beginning of the crisis this summer both countries have experienced extreme currency volatility, with their currencies plummeting nearly 50 per cent in a matter of 3-4 months (Chart 1).

This level of currency volatility is far beyond what proponents of flexible exchange rates ever envisioned. While some degree of currency flexibility can be desirable, currency swings of this magnitude are not—such volatility will have a significant knock-on effect on the real economy, negatively affecting both consumption and investment. This is why most emerging markets would welcome a more stable exchange rate system.

What options do countries have to preserve some degree of economic stability given the volatility they are exposed to in the current system? Most emerging markets have opted to build up large international reserve holdings as a form of “self-insurance”; both Brazil and South Korea for example have amassed over \$200 billion in reserves. But even such relatively impressive reserve holdings have failed to protect them from the fallout of the crisis.

This partly reflects the reluctance of policy makers to actually draw very much from reserves for fear this could destabilise expectations and spur even greater capital outflows. In Brazil, FX reserves have actually risen over \$20 billion since end-June, as the Central Bank has primarily intervened in the futures market selling dollars, not the cash market. In Korea, reserves have fallen nearly \$60 billion over the same period to reach \$200 billion at the end of November. During this period foreign ownership of

Korean equities has dropped from 48 per cent to 27 per cent of the total.

If we are to judge by these two examples, then even \$200 billion in FX reserves are too few to provide an effective degree of “self-insurance.” Reserve levels of closer to \$1 trillion would seem necessary to give policymakers the necessary degrees of freedom to intervene at will.

But this is clearly a result that makes no sense for the overall system—a further massive increase in FX reserves in the hands of major emerging markets would far outstrip the available stock of international reserve assets. Further, it would require countries supplying these reserves (i.e. the US, EU and Japan) to run huge current account deficits, exacerbating global imbalances. Stability requires a reduction of global imbalances, not further increases.

So the pragmatic policy of creating a self-insurance backstop is not a viable longer-term option for emerging markets, with the notable exception of China who has already amassed some \$2 trillion in reserves.

This leaves countries two possible options. One is to impose selective restrictions on capital inflows and outflows, drawing on the relative success of Malaysia’s capital restrictions during the 1997 Asian crisis as a template. The other is to create an international lender of last resort, something on the order of a super-IMF that would have the billions in funding necessary to provide the credible backstop that would be needed.

Neither of these two options is particularly appealing. Many emerging markets would be reluctant to roll back financial globalisation, given the benefits that open capital markets have brought in the form of major inflows of fixed income and equity investment.

This is why the idea of an international lender of last resort is gaining support as the best way forward. The problem with such an initiative, though, is that it is not clear how such an institution

could find adequate funding. This is particularly the case since the biggest surplus country—China—is unlikely to sign onto such a scheme, since it plans to focus on its own internal needs and will not be available “to save the world.”

### *Reforming bank behaviour*

Though we are left without a clear conclusion of how best to reduce systemic risk, a number of feasible and practicable steps can be taken to address dysfunctional behaviour by the financial system’s participants. Unsurprisingly, there is broad consensus in both developed and emerging markets that financial sector regulation needed to undergo a major overhaul.

With the benefit of hindsight provided by the current crisis, the defects of today’s financial regulation are blindingly obvious. A system designed to protect banks from adverse developments in the real economy utterly failed to anticipate that the real economy needed to be protected from a financial sector crisis. We are now paying the price for this oversight as the original financial crisis morphs into a broader crisis in the real economy.

Further, the widespread use of financial ratios, such as minimum capital requirements, and formulae for measuring such capital created a system that was not only dangerously pro-cyclical, it was also subject to abuse. One need only to point to AIG Financial’s writing of some \$300 billion in credit default swaps to help European banks evade restrictions of various capital ratios—instead of diversifying balance sheet risks, the result concentrated these risks in one, undercapitalised, lightly-regulated institution.

The way forward is satisfying simple: replace static measures of capital adequacy by dynamic, counter-cyclical guidelines, penalise institutions that create systemic risk (such as too-big-to-fail banks), and increase international coordination on financial sector regulation. Although some might wish to see the creation of a supranational regulator, this seems beyond the realm of possibility at the present time. A near-term solution

is to strengthen national regulatory authorities while deepening cross-country coordination.

### ***Where is global finance heading?***

The current crisis represents a major turning point in the evolution of the international financial system since the 1980s debt crises. After a period of rapid growth in international capital flows and of innovation in non-bank financing, we are now heading back to a system dominated by banks.

A relevant question is whether the coming wave of re-regulation, hopefully better designed and implemented, will lessen the evident shortcomings of the floating rate system that we now have. On the positive side opaque financial instruments, excessive leverage and facile assumptions about the market's ability to price risk and provide liquidity will be relegated to the proverbial dust-bin of history.

These developments will do much to lessen systemic risks, but it should also be clear that fundamental contradictions of the system will persist. Put simply, a partially reformed system cannot guaranty exchange rate stability so long as global imbalances persist and capital is free to respond to misalignments in national monetary policies that generate leveraged “carry trade” opportunities, including so-called hot money flows.

The bottom line is that there is still a lengthy research agenda that should focus the attention of financial market participants of every stripe—investors, banks and countries, both developed and emerging.

### ***The way ahead***

One issue high on this agenda is the implications of a return to a bank-dominated financial system for growth in developed economies as well as in the emerging markets. At a minimum the scale of devastation of bank capital in the US and Europe poses major challenges to raising the funds needed to support economic recovery. In this regard the fact that most banks in

the BRICs have escaped with minimal damage to their capital suggests that these economies are better placed to take the lead in the hoped-for global economic recovery.

A second critical issue concerns the future evolution of China's relationship with the US. It is difficult to image that any major reforms to the international financial system will be able to move forward without the Chinese being on board. Thus, while the G7 has been thrown out as arbitrator of future reforms in favour of the G20, what really counts is the G2, i.e. the US and China.

To get this relationship back on track will require an end to China bashing on the part of US politicians as well as the abandonment of Secretary Paulson's short-sighted harping on secondary issues such as China's exchange rate. There is hope on this score, given that Tim Geithner, the Treasury Secretary designate, has lived in China and apparently understands the culture much better than the outgoing occupant of the Treasury hot seat.

Without exaggeration, the success of this relationship will be pivotal to success or failure not only of the new administration but also of the hoped-for global economic recovery.



# ***Building an International Monetary and Financial System for the 21<sup>st</sup> Century: Agenda for Reform***

*by Martin Castellano*

Every crisis brings about the flaws in the system. It is important to improve market functioning in ways that do not set the seeds for the next crisis. This is not a crisis of the international financial system per se. We simply face a new stage on a welcomed globalization process. The focus of this new phase must be placed –with no biases– one enhancing world trade and financial flows in a way consistent with sustainable economic growth.

The regulatory framework both at the national and supra-national levels must be rebuilt taking into account this new (and improved) focus. It is evident that the world is in need of international financial institutions to set common rules for financial markets and, perhaps most importantly, to effectively implement them. There is also need of an effective global liquidity provision mechanism.

First, I will briefly describe how emerging markets are dealing with the crisis. Then, I will discuss a few ideas on the role multilaterals should play both to handle the current situation and to prevent future ones.

This event finds developing countries in a position that differs from other episodes in the past: instead of causing the crisis, they are the ones suffering its impact. And this straightforward point is not a minor one given our history of economic instability. We perfectly acknowledge the economic and social pain that crises entail. Latin America in particular ranks the highest in terms of the average number of episodes per country, as well as recurrence over the last 30 years.

Taking into account both the magnitude of the event and the current global growth dynamic, a first order condition is to minimize the effects on the rest of the world. Not only for the benefit of emerging markets but also for the much-needed smooth ride of the world economy. We must recall that 75% of global economic growth between 2003 and 2007 (measured at purchase power parity) is explained by developing countries. Actually, in 2009, the whole (very modest) expected global growth rate will be explained by the emerging world.

For the first time in decades, Latin America, in particular, is reasonably (and relatively) well-prepared to face the crisis. A combination of policies aligned with the goal of reducing macroeconomic volatility and a favorable international context has placed the region in this position. The outcome has been based upon several pillars with anti-cyclical components:

First, many years of fiscal surpluses: a distinctive feature from a record of overspending and over indebtedness. This is combined with better liability management, which reflects in a reduction of net foreign debt and currency mismatches.

Second: more flexible foreign exchange regimes. They provide additional degrees of freedom to deal with highly volatile financial flows. The crisis also proved that there is no “one-size-fits-all” exchange rate policy. Blaming or assessing the merits of an exchange rate regime without taking into account the consistency with the whole set of economic policies, the power of monetary policy instruments or the particular phase the country is going through, means losing sight of the core problems. In the case of Argentina, with a history of several years of fixed exchange rate regimes, high inflation, devaluation and dollarization processes, small and segmented capital markets with limited access to hedging, a managed floating exchange rate regime makes sense.

Third, external strength due to mainly trade dynamism (a diversify base of destinations and products) and FX accumulation. Over the last years building an external liquidity policy at the country level has been the common pattern in the emerging world.

Fourth: well-regulated financial systems. In general, in Latin America, financial systems are highly capitalized and less exposed to public sector debt; another key sin from the past together with dollarization. Not long ago, we used to have not only central banks but also the banking system financing the treasury with no limits whatsoever.

The health of the financial systems in Latin America is relevant in the light of what is going on in the rest of the world. Regulation is tight, which reflects in well-matched, liquid and solvent systems. With more traditional credit products, banking systems in general are not exposed to assets of dubious quality. Leverage (overall, in the economies) is low. The impact of a sudden reversal in foreign capital flows is limited due to sizable external and fiscal buffers. The credit cycle is less exposed to the real estate sector and the mix between national, transnational, state-owned and private-owned institutions is balanced.

In this context, an issue of concern is the ability of less sophisticated investors exposed to emerging markets to properly understand that those capital outflows from global banks were just the response of margin calls or capital adequacy actions in developed countries (instead of outflows as a result of fundamentals deterioration in the domestic market). This flight to “safer heavens” could trigger a run against the local banking system or currency, given a “natural tendency” towards financial instability in our economies.

Despite the progress made, the magnitude of this crisis affected significantly our countries both through the trade and financial channels. Everything revealed short when matured financial markets are under stress. And, emerging economies have a narrower capability to embrace monetary and fiscal policy.

It is difficult to think about an emerging economy increasing base money in a 35% in less than two month or reducing target interest rates close to zero with no adverse consequences on inflation expectations or the sustainability of the exchange rate regime. It is also hard to imagine a developing country launching

a rescue package of 7% of GDP, with no harm on the perception about the inter-temporal fiscal solvency.

Emerging countries are also more prone to suffer contagion. In most of the episodes financial crisis are accompanied by balance of payment distress (given the tendency of agents to withdraw deposits and use the proceedings to buy FX) and fiscal constraints (because of the potential impact on government accounts of financial bailouts, or an FX depreciation in a context of currency mismatches on public debt).

These limitations together with second round effects on developed economies due to their exposure to emerging markets (both on the real and financial sides), make a strong case for a global mechanism of liquidity provision. Otherwise, countries might be tempted to address the shocks in an uncoordinated way probably by taking measures to close the economy thus hampering the recent progress made. The backfire could be seen either on financial integration (by controlling capital outflows), or on trade policy (rising barriers on imports). We have to avoid that the positive aspects of integration are overcome by the flaws of the system. It is also worth noting that self-insurance via international reserve accumulation or fiscal funds seems not to be enough when confronted to the magnitude of the de-leveraging process taking place at a global level.

The appropriate response should materialize on short-run and medium term solutions: the urgent tasks and the fundamental ones. The former is to take quick and definite actions to avoid the crisis continues to propagate to developing nations by making better use of actual resources and the set of institutions that are already in place.

Both the fed and IMF actions to provide timely liquidity to the emerging markets are welcomed but need further work.

The currency swap mechanism launched by the fed could be permanently in effect (not just during times of crisis) and extended to the several countries that show a high volume of cross-border operations.

In the case of the IMF's short term liquidity facility, a more efficient process for accessing the window is a step in the right direction. However, the devil is in the details. It is important to make it easily accessible and readily available. A possibility is to establish short-term credit lines in the form of swaps (against U.S. treasuries or even certain domestic securities) to avoid liquidity shortages, which would allow easing conditions without putting at risk the fund's resources. When designing this kind of instruments, an appropriate matching between duration and requirements to meet borrower's ability to stabilize the system and to pay in due time must be weighted.

Also, the fund is letting aside most vulnerable economies, a situation that should be taken into account because other way those countries could be in the front line of speculative actions. The creation of outsiders and insiders could unintentionally worsen the domestic situation in country, yielding additional systemic risks.

In the same line, the IMF can work as a provider of collaterals for sovereign issuance in a move to help less integrated countries to access financing at a lower cost. These guarantees can also be used as collateral of central banks credit lines between institutions with excess liquidity and those requiring funds.

This, of course, would require proper capitalization; an issue which has not been fully explored in the recent G-20 meetings. IMF's resources vis-à-vis private capital flows are minimal as reflected by the ratio of each member's quota to its foreign reserves.

If capital contributions are expected to be voluntary there should be enough incentives in terms of increases in quotas and voting power for surplus emerging markets.

A right scheme could trigger the needed adjustment in the balance of power inside the fund that most of the emerging world has been calling upon for many years.

Also, raising capital through the market should not be ruled out. It could prevent political implications of a quota and vote realignment. In fact, central banks or governments might be interested in having part of its external liquidity invested on IMF securities, which would become a way to transfer excess savings to those economies that need funding the most.

In the medium term we need to take steps towards two issues: 1) institutionalize the global mechanisms for liquidity provision; 2) design and implement a regulatory framework for financial markets.

Regarding prudential regulation and supervision there is a variety of institutions and committees where participation of the emerging world is almost non-existent. So the discussion about how to improve the framework must go hand-in-hand with progress in terms of representation and legitimacy within these organizations. And, in the business of supervising and preserving financial stability, all members should be equally important.

Here the G-20 can play a key role as a “global coordinator” of the current network of institutions that build the international financial architecture. The rationale for this is based upon a combination of representation and efficiency that places the group in a unique position to foster political will. First, it is a matter of legitimacy. In terms of representation the group compares highly against any other. Second, the degree of interaction and frankly exchange of information and experiences is also at the forefront compared to other for a. The outcomes achieved are a process of ample participation of the members throughout the work done all over the year. This expeditious way of making decisions also ranks high against other groups with greater representation such as the U.N.

With a more policy-oriented approach and a clear focus on global financial stability, the group should not only recommend but also systematically monitor implementation. It is important how the next G-20 meetings handle the degree of progress made.

Effective implementation of the regulatory changes proposed is the next immediate challenge. National authorities are responsible for the adoption of the agreed standards in their respective jurisdictions.

The adoption varies depending national priorities, the legal framework and so on. In that sense, the G-20 could serve as a forum for countries to formally set an agreement about their commitment to adopt the proposed standards. The process in order to be successful must acknowledge that there are different ways and paces of putting into practice the adequate policies. They should involve domestic consensus to be carried out based on “conviction” rather than on “need”.

The current crisis has shown the need to complement the traditional micro-prudential approach with a greater weighting for macro-prudential measures. A macro-prudential approach will be fundamental to understand the interaction that exists between the financial system and the real economy.

A macro-prudential approach should take into account analysis of the macroeconomic vulnerabilities that could subsequently impact on financial system liquidity or solvency. It is normally suggested that deviations be analyzed in relation to the long-term trends for certain variables, such as, for example: the credit to GDP ratio, prices of various assets (residential and commercial property, shares and government securities, and currencies), and the equilibrium rate of exchange (real/effective), among others. The difficulty in determining long-term levels has become a challenge for those defining economic policy around the world. Specifically in emerging countries, fiscal dominance over economic policy generates the need to include other key variables in the analysis, such as levels of exposure to the public sector, or public sector borrowing requirements in foreign currency.

This approach recommends the introduction of stress test techniques not only at the level of each individual financial institution, but also at aggregate level along with systemic early-warning systems.

On the pro-cyclical nature of financial systems, proposals such as time-varying capital requirements or capital insurance as additional elements in the regulation toolkit should be further explored. In addition, in times of hardship it proved very useful to have in hands criterions to temporarily apply “reduction ratios” to adjust capital requirements for the instruments most affected by the crisis resolution mechanisms. This scheme should be put in place based upon the existence of systemic risks, which are somehow involuntary for the institutions operating under these conditions. This approach buys the system some time (a relatively less scarce resource in times of hardship) while minimizing the need for government bail-outs. In the case of many emerging countries, the traditional liquidity requirements, while costly, keep having a crucial role as a both prudential and monetary policy tool.

In a nutshell, countries in the world face significant challenges. In a context of an unprecedented crisis of confidence at the global level, which its impacts are yet unknown, for us, emerging markets, challenges are magnified: we have to catch up with growth and, most importantly, build institutions and credibility at the same time. Therefore, in today’s world, to develop a framework that minimizes the impact on emerging markets has benefits that go well beyond the domestic or regional level.





# ***Improving the International Financial Architecture***

*by Richard N. Cooper  
Harvard University*

The most salient issue of those concerned with the international financial architecture in mid-2007 was “governance,” in particular governance of the International Monetary Fund (IMF). This involved among other things selection of future Managing Directors (by convention since 1946 always a European), representation on the Executive Board (which is responsible for the operating decisions of the IMF), and voting rights, which were based on out-dated formulae. The “legitimacy” of the IMF was said to be in doubt. This concern with governance was against a backdrop of excellent performance of the world economy since 2002, high and widespread growth, low inflation but rising commodity prices, which helped exporters of primary products. The IMF had made no significant loans since 2003, many countries had repaid their outstanding debts to the IMF (down from \$107 billion in 2003 to \$15 billion in 2007), and with low interest income the IMF was anticipating difficulty in meeting its normal operating expenses.

True, there were signs of difficulty in the US subprime mortgage market, where defaults had begun to rise and construction of new residences had declined from their peak in 2005. This even had a modest international impact, as two French mutual funds suspended trading because they could not properly value some of their securities backed by US mortgages. But all this seemed to be mainly a US problem, no doubt manageable.

That was then. Much has happened since mid-2007, often rapidly and dramatically: the seizing up of asset-backed commercial

paper markets in August 2007, requiring large injections of liquidity both by the European Central Bank and by the Federal Reserve; the failure and government takeover of Northern Rock, a major British mortgage firm; the takeover of Bear Stearns, America's fifth largest investment bank, by JPMorganChase with strong financial assistance from the Federal Reserve; government financial support to two large US mortgage institutions, Fannie Mae and Freddie Mac; unusual support to AIG, the world's largest insurance company; the failure of Lehman Brothers, the fourth largest US investment bank; and by September 2008 a general flight to safety and aversion to risk among most financial institutions.

By the fall of 2008 the IMF was back in the lending business, with loans to Iceland, Hungary, Ukraine, and Pakistan, and more in the works. Governance issues had receded in deference to more operational concerns – not only for the IMF, but also for other parts of the international financial structure, such as the several committees of the Bank for International Settlements charged with improving financial regulation, the Financial Stability Forum, and of course for governments and central banks as the world seemed to be sliding into recession, or worse. There was much talk of the need to reform the international financial system, and calls for a second Bretton Woods, recalling the international meeting in 1944 that agreed on the main features of the postwar international monetary system and led to the creation of the IMF and its sister institution the World Bank.

A key unasked question lay behind these calls: if the international financial architecture had been plausibly different, would the origin or the magnitude or the international ramifications of the evolving financial and economic crisis have been markedly attenuated? My tentative answer is negative.

Edwin Truman and I put forward a proposal in February 2007 to reform the governance of the IMF, addressed to the issue of legitimacy (“The IMF Quota Formula: Lynchpin of Fund Reform,” PB07-1, Washington: Peterson Institute). Briefly, our proposal called for revising the formulae by which IMF voting

rights (and borrowing rights) are established, giving modestly greater weight to all small countries, substantially greater weight to many rapidly developing countries (so-called emerging markets), less weight to medium-sized European countries; reducing the number of Europeans (nine of 24, counting Russia) on the Executive Board; and increasing IMF quotas by about 50 percent both to accommodate the rising value of world trade and to avoid any reduction in quota that otherwise would have occurred with the re-weighting of voting rights. (The last quota increase was in 1998.)

The IMF addressed the issue of governance in a report of March 2008 to its Governors. The proposal would reduce the voting share of the 26 industrial countries by 2.6 percentage points, and Europe's share by 1.6 percentage points, compared with 14 percentage points and 11 percentage points, respectively, in the Cooper-Truman proposal. Thus the Fund remains dominated by Europeans, both in votes (31 percent) and in Board representation. Whether this modest agreed change (but not yet fully implemented, since amendments to the Articles requires parliamentary ratification) responds to calls for greater legitimacy remains to be seen.

One can nonetheless play a thought experiment: suppose the Cooper-Truman proposal had been adopted in 2002. Would the IMF responses in 2007-2008 have been markedly different from what they were? Would the IMF have significantly attenuated the international crisis? I believe an honest answer must be negative.

Part of the reason for this answer is that the key central banks, including most notably the US Federal Reserve, responded vigorously to the emerging financial crisis with a speed, magnitude, and unorthodoxy – providing general liquidity in abundance, supporting specific institutions whose failure would have threatened much wider damage, and extending swap lines to selected foreign central banks in excess of \$700 billion – that it would be difficult to imagine coming from the IMF as an international organization under any plausible set of governance arrangements.

The IMF is not a regulatory agency, and is not staffed adequately to be a regulatory agency, although it occasionally gives advice to member states on desirable financial regulation. The Bank for International Settlements in Basel, Switzerland, however plays host to several international committees that are concerned with financial performance and regulation: committees on banking supervision, on the global financial system, on payment and settlement systems, on markets, and on counterfeit deterrence. These committees regularly brought together relevant officials from national capitals to discuss common problems and to identify potential problems. The best known product is agreement on the so-called Basel II risk-based capital requirements for banks that are heavily engaged in international activities. For large banks, it placed reliance on sophisticated individual bank risk assessment models, models that apparently failed signally during the recent financial turmoil.

In addition to the BIS committees there is the Financial Stability Forum, created with 12 member countries in 1999 to assess risks and vulnerabilities affecting the international financial system and to encourage and coordinate action to address them. In April 2008 the FSF submitted a report to the G-7 finance ministers that called for action in five areas: strengthened oversight of capital, liquidity, and risk management; enhanced transparency and valuation; the role of credit ratings; strengthened official response to risks; and arrangements for dealing with stress in the financial system. It built on earlier work, but obviously action was too late to avoid the financial meltdown of September 2008.

The bottom line: there has been no shortage of fora for discussions among relevant national regulatory authorities about potential financial problems. But they evidently were deficient in imagination and/or unable to convey effectively their concerns to the national political authorities who alone could have taken effective action.

The key problem is this: in a period of economic euphoria, when everything seems to be going well, no one wants to take away the punch bowl, to use the colorful metaphor of former

Federal Reserve chairman William McChesney Martin. As time goes on, personnel in financial institutions change, and each new generation of traders and financial managers believes it is intellectually and technically superior to its predecessors and has nothing to learn from their experiences, particularly their unhappy experiences. Their world is different from that of their elders. In addition, the system of rewards in the private financial community has placed a premium on short-term performance and has neglected long-term risk.

Under these conditions, it is difficult to imagine structural changes at the international level that would either have prevented the financial crisis or substantially ameliorated it.

However, the crisis is not yet over, and as the world economy slides into recession the IMF can play an important role in mitigating the damage, particularly to countries heavily dependent on inflows of foreign capital that have now diminished or even dried up. The Short-term Liquidity Facility (SLF) of \$100 billion created by the IMF in October, with its relaxed lending conditions, is a partial response, but with limitations both in magnitude and in coverage. Moreover, the total resources of the IMF, at about \$250 billion, are hardly adequate to deal with a financial crisis of the current magnitude. Hungary alone, a country of 10 million people, will absorb \$15 billion.

One can imagine a much bolder version of the IMF, a true lender of last resort. Since the late 1960s the IMF has had the capacity to create international money, called SDRs, for Special Drawing Rights, but that term is not helpful in understanding them. Financial journalists dubbed them “paper gold,” since they represented a functional substitute for monetary gold, exchangeable among official monetary authorities and other designated institutions such as the BIS and the World Bank for national currencies. SDRs were created to help satisfy the long-run liquidity needs of the world economy. (SDRs are now defined as a weighted average of four currencies: the US dollar, the euro, the British pound, and the Japanese yen, so has an exact value that changes from day to day with market exchange rates among these currencies.) They were issued on only two

occasions, in 1970-72 and 1979-81, in total amount of SDR 21.4 billion (roughly \$32 billion today). With the huge growth in international reserves, to over \$5 trillion, they now play a negligible role in provision of international liquidity, and then mainly for transactions with the IMF itself. But the SDR could become an important source of liquidity during periods of financial crisis, such as the present.

The IMF's Articles of Agreement could be amended to allow the IMF to create SDRs not only to satisfy long-term official demands for international liquidity, but also to respond quickly to periods of intense increase in demand for liquidity, with tight terms of reference such that when the period of crisis passed the liquidity would again be mopped up, i.e. repaid to the IMF. But during the crisis there need be no limits on the issuance.

Under current arrangements the SDR can only be held by monetary authorities of countries that are members of the IMF (such as their central banks) and other designated institutions. Thus to deal with a market crisis the SDRs would have to be converted into the national currencies relevant for dealing with the financial crisis, which the relevant central banks could do. A more ambitious change would be to allow SDRs to be held by private financial institutions, or even by any private party. They would become a kind of global money, at least for large institutions, and could coexist with national monies, which people would continue to carry in their pockets.

A compromise proposal was made some years ago by Professor Peter Kenen of Princeton University, whereby a special clearing house would be established that was allowed to hold SDRs, and commercial banks would be able to deal with this clearing house in transactions denominated in SDRs but actually executed in national currencies.

This enlargement of the potential use of the SDR would give the IMF the financial capacity to deal with crises large in magnitude. Of course it would have to develop the procedures to use the funds effectively when necessary, which would require giving appropriate authority to the Executive Board, which

resides in IMF headquarters in Washington; or (with modern technology) convening as necessary their superiors, ministers of finance (including the US Treasury Secretary) around the world. While the IMF is not suited to be a regulatory agency, it could and should beef up execution of its periodic surveillance of the macroeconomic conditions of member countries to include greater focus on the soundness and potential risks attending the practices of their financial institutions, and in particular compliance with international best practice as determined in other fora. Coordination of regulatory policies would remain in the hands of the various Basel-based committees.

This proposed change would require amending the IMF's Articles of Agreement, requiring parliamentary ratification around the world. Thus would be too late for the current crisis. But it is not too early to think about how to prepare ourselves to deal effectively, at the global level, with the next major financial crisis.



# ***How to Prevent Future Crises: Create a World Financial Organization***

*by Barry Eichengreen*

In the wake of the “Second Bretton Woods Conference,” expectations have fallen to earth. It should now be possible to discard overheated rhetoric about the end of Anglo-Saxon capitalism and get to work. The work in question should center on strengthening the financial system. The G20 summit on November 15th and even more the crisis that caused that summit to be convened remind us that purely national regulation is inadequate. The cross-border spillovers and negative externalities thrown off by subpar (one is tempted to say “subprime”) regulation are simply too great. At the same time there is no appetite for a global regulator, as President Bush and a series of “unnamed Treasury officials” reminded us in the run-up to November 15th. We will get a global regulator at about the same time we get a global army and a global police force.

Given that neither national nor supranational regulation is feasible, the challenge is to carve out something in between. This is where the intellectual challenge and interesting issues lie. What has been done along these lines to date – the Basel Committee of Banking Supervisors and the Financial Stability Forum – is not enough or we wouldn’t be in the current mess. Nor is it obvious that a College of Supervisors along the lines suggested by the members of the European Union will differ significantly from the status quo. The idea and its name will make the academics among us think of department meetings in our own colleges where every member of the faculty gets a say and at the end of which nothing much is decided.

At least as important as exchanging ideas and information and harmonizing regulatory practices, which are the putative goals of the Basel Committee, the Financial Stability Forum and the College of Supervisors, are actual consequences for countries that fail to meet the standards they prescribe. How do we go about getting them?

At the more ambitious end of the spectrum, Stijn Claessens has proposed creating an international bank charter for banks engaged in cross-border activity.<sup>1</sup> Internationally active banks would have to receive a charter from an international College of Supervisors, and they would be subject to its supervision. When the members of the College determined that banks were in violation of its charter, it could impose cease-and-desist orders, limit the operations of said institutions, and require remedial action. This would be a great outcome were it only feasible. Unfortunately it is not. U.S. officials and politicians, among others, would clearly regard it as a bridge too far.

Somewhat less ambitious but more politically realistic, I would argue, is my proposal for a World Financial Organization analogous to the already-existing World Trade Organization.<sup>2</sup> Membership would be obligatory for all countries seeking freedom of access to foreign markets for domestically-chartered financial institutions. The WFO would define obligations for its members; the latter would be obliged to meet international standards for supervision and regulation of their financial markets and institutions. It would appoint independent panels of experts to determine whether countries were in compliance with those obligations. Importantly, it would authorize the imposition of sanctions against countries that failed to comply. Other countries would be within their rights to restrict the

<sup>1</sup> In his chapter in Barry Eichengreen and Richard Baldwin (eds), *What G20 Leaders Must Do to Stabilize our Economy and Fix the Financial System* (VoxEU, 11 November 2008).

<sup>2</sup> Barry Eichengreen, “Not a New Bretton Woods but a New Bretton Woods Process,” in Barry Eichengreen and Richard Baldwin (eds), *What G20 Leaders Must Do to Stabilize our Economy and Fix the Financial System* (VoxEU, 11 November 2008).

ability of banks and nonbank financial institutions chartered in the offending country to do business in their markets. This would provide a real incentive to comply.

The move to a WFO would presumably occur after some years of satisfactory experience with a GATT-like predecessor if the history of the WTO is any guide. It will be objected that the United States, among others, would never let an international organization dictate its domestic regulatory policies. The rebuttal is that the WFO would not dictate. The specifics of implementation would be left to the individual country. There would still be scope for the U.S. and other members to tailor supervision and regulation to the peculiarities of their national financial markets.

But those regulatory specifics would have to comply with the broad principles set down in the WFO charter and associated obligations. We already do the equivalent for trade. Dispute settlement panels already determine whether, *inter alia*, U.S. tariffs on timber imports from Canada are in compliance with our WTO obligations. If not, we have the choice of whether to change those laws or face sanctions and retaliation. If the U.S. and other countries accept this in the case of trade, why should they not accept it for finance?

Least ambitious of all would be to simply try to raise the reputational costs for countries whose domestic regulatory practices are not up to snuff. Proposals for the FSF and the IMF to provide firmer surveillance of national regulatory practice move in this direction. Gordon Brown, for example, would have the Financial Stability Forum define acceptable practice and the IMF determine whether national regulation meets that standard.

But is the Financial Stability Forum adequately legitimate and accountable, given its membership? (We will have to see whether the G20 follows through on its November 15th communiqué and appropriately expands the FSF.) Does the Forum have adequate staff? Does the IMF, for its part, have the backbone to take on its large shareholders when their national practices are not up

to snuff? Doesn't this proposal presuppose a more politically independent IMF? You will forgive me: this is a case that some of us have been making for going on ten years. It is hard not to have mixed feelings on hearing prominent politicians like Horst Koehler now endorse this idea when they have not exactly stuck their necks out in the past.

The weakest step of all, if the conclusion is that all of the above are impractical, is to create an independent commission to provide an annual evaluation of the adequacy of regulatory practice. Some will dismiss even this out of hand. But think of it as analogous to the European Commission evaluating the adequacy of national budgetary practice in the context of the Growth or Stability Pact, where experts are allowed to tell countries "your budget is recklessly out of control." Why couldn't a similar Commission similarly tell national governments "your financial supervision is recklessly out of control?"

The answer, presumably, is that the members of the European Union, because their internal market is so integrated, recognize fiscal spillovers to be of first-order importance. Well, we now all recognize that cross-border financial spillovers are of first-order importance, so what is possible in Europe should be possible globally. Another answer is that the European Commission has the legitimacy needed to undertake this task, embedded as it is in the larger process of European economic and political integration. Well, if this is the answer, then we need to endow our multilateral financial institutions with comparable legitimacy.

Barry Eichengreen is George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley.





# ***International Financial Architecture***<sup>1</sup>

*by Erich Harbrecht*

## ***1. Key Issues***

The turmoil and large losses experienced by the international financial system have put policymakers under a lot of pressure to act. In the short term, they must therefore be able to present results. The series of high-level meetings that has just started must meet this political necessity without setting the wrong course in terms of contents or policies, duplicating work or establishing superfluous new structures or committees. At the same time, distinct objections need to be raised against anti-market proposals, which are currently spreading at a worrying speed. Those responsible must speak out clearly in favor of a market economy and against protectionism, as the G20 leaders did in their declaration after the Summit on Financial Markets and the World Economy.

Recent proposals for enhancing the international financial architecture deal with questions relating to the governance framework of the international financial system (crisis management, intensity of regulation, supervision) and the need to reform the international institutional set-up (particularly the IMF, FSF, G7/G20). Given the urgent need for action, the summit has taken first high-profile decisions, with the

<sup>1</sup> Erich Harbrecht; Head of International Financial System Division. This paper represents the author's personal opinions and does not necessarily reflect the views of the Deutsche Bundesbank.

strategic direction initially set at the G20 meeting in São Paulo. Prior to this, on 7 November, the EU had established a common position on important questions.

Debate on the governance and regulatory framework should concentrate on giving more political weight to the recommendations made during the analysis of the crisis so far, particularly by the Financial Stability Forum (FSF), and to implementing them. Reforms should be based on the recommendations which the competent committees have been working on for months. The global financial summit has lent its political support to this.

However, caution should be exercised when looking at far-reaching proposals to reform the international financial architecture (some of which are discussed in the “Early warning system” section). These proposals cannot be justified by the financial market crisis alone. Their aim is to give the IMF a sole leading role in monitoring and safeguarding the stability of the international financial system. Such a role would reduce the powers of the FSF and standard-setters. Moreover, it is doubtful whether the international community would be willing to provide the IMF with the necessary mandate to enforce compliance with rules.

Instead, the goal should be to improve cooperation between the relevant committees and the bodies representing their areas of responsibility on the ground. The IMF continues to exercise the important role of monitoring the implementation of standards and risks to financial stability through Article IV consultations and the Financial Sector Assessment Programme (FSAP). Reforms to the international financial architecture require careful and in depth debate. Hasty decisions should be avoided.

What are needed are clear signals that, financial crisis notwithstanding, a market economy is still the economic system of choice, as it ensures maximum freedom and prosperity. Protectionism must not undermine wealth and the mutually beneficial cooperation of nations.

It would be desirable for the world trade round (Doha round)

to be brought to a rapid conclusion. We need signals in favor of financial globalization, which must be accompanied by an appropriate governance and regulation framework.

On this, the summit has delivered and can now be taken as a point of reference.

## ***2. Crisis management***

Overall, crisis management and cooperation have worked well when institutions have run into difficulties. The international coordination of national rescue packages has proven successful – though it got off to a bumpy start. At the international level, further improvements are being discussed; no further initiatives are necessary at present. At the EU level, cooperation within cross-border financial groups is currently being strengthened (supervisory colleges and cross-border stability groups).

Deleveraging in the international financial system will take longer and is likely to involve some friction. On top of genuine difficulties in the financial system, there are also the repercussions of the global economic downturn for the financial system to contend with. Crisis management is therefore likely to remain a necessity, though flexibility will continue to be required.

## ***3. Governance and regulatory framework***

The FSF, commissioned by the G7, has, since October 2007, been carefully analyzing the causes of the crisis and the weaknesses it has uncovered and has used this as the basis on which to issue (67) concrete recommendations. All of the important players (G7 countries, standard-setters, international organizations) have been involved.

The competent bodies are making progress on implementing these recommendations (FSF progress report to G7, October 2008), a process which must continue apace. Greater explicit political support (G7, G20) would be helpful – as would a name-and-shame policy. Within the EU, the competent authorities have, since October 2007, been analyzing the crisis on the basis

of the ECOFIN roadmap, and good progress is being made. These processes do not need re-enacting; events have come to a head during the crisis, but no substantial new insights have been made into existing shortcomings.

Further improvements to the regulatory framework are possible and would be welcome. The G20 leaders identified five regulatory areas, where they requested additional recommendations: procyclicality, accounting, transparency, compensation practices, and the scope of regulation. Work in all these areas is already underway in competent authorities, mostly in the FSF. The leaders' request does not require another major international stand alone process. Instead, these issues should be dealt with in existing processes at the international (or EU) level.

#### ***4. "Early warning system"***

On the necessity of an early warning system: There were indeed warnings, some very stark, of risks (from the BIS, FSF, central banks). These were not, however, heeded and/or had no political and/or supervisory consequences. Moreover, the IMF's early warnings were comparatively muted.

The usefulness of institutionalized early warning systems is frequently overestimated. In fact, contrary to what it might suggest, the term "early warning system" has primarily been used to refer to ideas for the institutional set-up employed to monitor the international financial system, rather than to concepts for improving the monitoring of the stability of the financial system.

#### ***5. Fundamental institutional aspects***

Before the institutional set-up is changed, its deficits must be convincingly demonstrated.

Contrary to what is currently being suggested by some, the crisis cannot be attributed to weaknesses in the institutional status quo at the international level. Rather, the root causes were weaknesses in the regulatory framework and supervision at the national level.

Viewed dispassionately, the crisis is not, therefore, a reason to reorganize the landscape of international bodies and institutions. One should also bear in mind that the crisis originated (and had the greatest impact) in the major industrialized countries, which were, from the start, involved in the analysis of the crisis within the competent bodies. However, the fact that the crisis has spread to the emerging market economies lends weight to their calls for greater involvement that have now sunk in with the leading economies.<sup>2</sup> As G20 leaders also requested comprehensive reform of the IFIs, the debate on the institutional set-up will go on.

## ***6. Fundamental institutional aspects: the IMF going forward***

The IMF should act within the confines of its current mandate. In particular, its involvement in global crisis management should focus on its mandated tasks; any assumption of central bank tasks and/or regulatory functions, which it cannot fulfill, should be strictly rejected.

The tasks and responsibilities of the most important IMF management bodies (IMFC, board, management) are still appropriate. There have been calls for a council of ministers to be set up. That would eliminate the IMF executive board's powers in conducting IMF business policy and thus de facto allow the IMF's management to make policy decisions independently of its shareholders, who would, however, continue to be responsible financially.

IMF lending without collateral (i.e. without the conditionality appropriate to the situation) – as specified in the new short-term liquidity facility (SLF) – is highly problematic as it sets the wrong incentives for dealing with public monies and results in a discriminatory two-tier system within the IMF.

IMF liquidity is not tight and appears to be sufficient. The IMF has liquidity of US\$190 billion, which could be complemented

<sup>2</sup> In addition to the financial reserves held by major Asian countries and oil-exporting countries, which might be asked to make a greater international financial commitment.

by US50 billion in funds from New and General Arrangements to Borrow (NAB, GAB). If required, bilateral loans can be mobilized, which were recently coordinated via the BIS (Brazil). The IMF can and should only act as a catalyst in crisis funding.

## 7. “*Early warning system*”

Closer cooperation, which is desirable and explicitly demanded by the G7 and the G20, should be based on a dual leadership role for the IMF and FSF, where each is able to bring to bear its core competences.

The IMF’s main task would be to analyze the interaction between the real economy and the financial system, and monitoring, particularly when implementing supervisory standards and stability risks in the context of Article IV consultations and the FSAP. However, the IMF should not become involved in micro prudential analysis or monitoring individual financial institutions. The FSF and the standard-setters involved should maintain their leadership role in regulatory questions, with the IMF participating through its membership of the FSF. To place the FSF and standard-setters under the umbrella of the IMF would be counterproductive.

Increasing the number of FSF participants would start to compromise effectiveness. However a moderate expansion of the FSF (and potentially other standard-setters), as now envisioned, would be acceptable, but might require new thinking about its working modalities. This should be done without changing the FSF’s mandate, ability to function, informal character and distinguishing feature (namely, cross-departmental involvement of systemically relevant countries – with central banks, finance ministries and supervisory authorities – cross-sector involvement of regulators/standard-setters, international institutions).

Several countries are demanding that the IMF take on a sole leadership role for the international financial system in future. However, there are important grounds to reject such a step, namely the IMF’s lack of influence over its members’ policies and financial supervisory regimes, its deference to major shareholders

and its patchy track record.

The incorporation of the FSF into the contractual structure of the Bretton Woods institutions, as proposed by some, would also have undesirable consequences which would negate the improvement in financial governance this consolidation seeks to achieve. The international organizations BIS, OECD and the international standard-setters, i.e. virtually all non-sovereign FSF participants, have no reason to defer to the IMF. There is nothing to suggest that they would agree to the partial loss of independence this type of institutional restructuring would bring with it. If their status were forcibly changed in this manner, their willingness to cooperate within the FSF would in all likelihood suffer significantly. This would not only thwart the FSF's successful approach, it would also be likely to diminish its smooth functioning and clout.



# ***The Icelandic Banking Collapse: A Story of Broken Promises***

*by Tryggvi Thor Herbertsson<sup>1</sup>*

## ***Abstract***

This is a dramatic title but after all this is a dramatic story. The total collapse of a country's financial system and in the wake its currency is no small matter. This is the story of the Icelandic banking crisis: An unprecedented event that occurred in Iceland the last days of September and the first of October 2008. At the time of writing, it looks as this is going to be the most costly financial crisis for a sovereign industrialized country ever. The estimated direct cost that the public will be responsible for is today estimated to be around 85% of the country's GDP. This short paper gives an account of the events the lead to the collapse, discusses how it was handled, and what the future holds for the country.

Keywords: Financial Crisis, Iceland

<sup>1</sup> Contact: tryggvi@askar.is. This paper was prepared for: 1) The 5th International Financial Forum: 30th Anniversary of China's Reform and Opening-up, Beijing, China, November 14-16 2008; and 2) The Reinventing Bretton Woods Committee conference, Building an International Monetary and Financial System for the 21st Century: Agenda for Reform, New York City, November 24-25 2008. I would like to thank, without implicating, Thrainn Eggertsson, Pentti Kouri, Jon Steinsson, Halldor Thorbergsson, and Miranda Xafa for useful comments on earlier drafts.

## *Introduction*

The two single biggest mistakes in current financial crisis were to let Lehman Brothers and the Icelandic system banks go under. September 15 2008 will mark a similar event for World financial markets as September 11 2001 for World peace. History will view the decision of the Federal Reserve System not to save Lehman at least as big a mistake as the Fed not providing enough liquidity for the American economy at the onset of the Great Depression. The decision of the international financial system to starve Iceland of funds is a mistake of similar magnitude.

The event of September 15 resulted in absolute mistrust in the financial community – almost all funding lines of the Icelandic banks were cut and they were faced with severe funding problems. The usual route – to use the central bank as a lender-of-last-resort – was not possible as the needs of the banking system dwarfed the capabilities of the Central Bank of Iceland (CBI). The reserves amounted to about half the country's GDP but the banks' balance sheet was about ten times GDP. There was a total systemic failure and the three largest banks were taken over by the Icelandic authorities. The crisis led to a complete deterioration of the country's capital account and a full-fledged currency crisis. Moreover, the event triggered a complete mistrust in emerging market economies around the World and a renewed role for the IMF. Following the fall of Iceland, Hungary, Ukraine, Serbia, and other countries applied for help from the IMF.

Direct costs for the Icelandic taxpayer associated with the demise of the banks are estimated, at the time of writing, to be around 85% of the country's GDP. This cost estimate includes the equity injected into the new banks, about 30% of GDP. Cost in terms of lost output remains to be seen but the first estimate of the IMF is that GDP might contract by 10%. For comparison, it was estimated that the total cost of the most expensive financial crisis to date, the crisis in Indonesia in late 1990's, was around 40% of GDP and a little over 10% in Finland in the early 1990's.

This short paper is organized in the following manner. First it gives a brief background on the developments that lead to the

collapse of the Icelandic banks. Secondly the takeover process is described. Thirdly some policy mistakes that lead to the result are identified and finally the outlook for Iceland is discussed.

## ***Background***

For Iceland It all began by reports published by Royal Bank of Scotland and Dresdner Kleinwort Wasserstein late November 2005. The focus shifted to Iceland and people in the market started to pay attention to how leveraged the financial system of the country was. Stories of participants shorting the Icelandic banks, companies, and even the currency began to surface. CDS spreads started to widen.

In the coming months and especially in March 2006 Iceland was the talk of the town. Research departments of all major banks paid disproportional attention to Iceland and issued reports on the country's financial system – the bloodier the better.

In March 2006 CDS spreads shot to 110 bp and Iceland was generally viewed as a risky place in the wholesale market. In May I and Rick Mishkin published a report on Iceland concluding that this was a misconception, as the country was fundamentally in a very good state and that generally the outlook was good.<sup>2</sup> However, we warned that there was a probability of multiple equilibria incidences. We concluded by saying that we believed that if our policy recommendations were followed, confidence of the international financial community in the Icelandic economy would be regained. But we did not foresee the current international financial crisis that eventually toppled the banks.

Yet another report was published in the summer of 2006, now by Morgan Stanley. The tone was much more positive and they concluded by saying that after reviewing our report, they were confident that there was almost no danger of a financial crisis in Iceland and recommended investors to invest in Tier I capital of the banks.

<sup>2</sup> Trygvi Thor Herbertsson and Fredric S. Mishkin (2006). *Financial Stability in Iceland*, Icelandic Chamber of Commerce, see [www.chamber.is](http://www.chamber.is).

The Icelandic banks used this mini-crisis to get their act somewhat together. Cross-holdings were reviewed and some dissolved, the funding structure was changed, transparency increased, and much more emphasis put on deposits as a source of funding. Late autumn 2006 Landsbanki introduced the infamous IceSave internet accounts in their London branch and later Kaupthing their Edge accounts in a subsidiary. The system slowly gained confidence and continued growing. The rating agencies complemented Landsbanki for their internet accounts and the market rewarded the bank with the lowest CDS spreads of the three banks.

The current crisis is marked by events surrounding the fall of the Bear Stearns hedge funds in the summer of 2007. Wholesale funding became gradually more difficult. Finally at the start of this year, Iceland was more or less closed off from the wholesale market. As a reaction even more focus was put on deposits and old private placement contacts were renewed. The funding situation became grimmer for the banks.

### *The Collapse*

Current events in Iceland started with a 600 million euro equity injection by the CBI into Glitnir, the third largest bank of the country on Sunday the 29th of September. The week before credit lines had been cancelled as a consequence of the fall of Lehman Brothers. Glitnir was scheduled to meet a 750 million euro payment on the 15th of October and with the dry-up of liquidity they saw no other way than to go to the CBI and take out an emergency loan in order to meet the upcoming maturity. The plan provided by the CBI was that instead of the loan the CBI would inject 600 million Euros into the bank and in exchange get 75% of the equity of the bank. Shareholders would practically be wiped out. The following morning the share price of Glitnir fell by 75% in matter of minutes. At the same time the value of the (unlisted) holding company Stoðir that owned the biggest share in the bank fell even more dramatically. The next day Stoðir applied for a moratorium. Majority of Glitnir's stocks had been pledged in Kaupthing and Landsbanki and with the fall of Glitnir's stock prices stockholders were subject to

margin calls, which they could not meet. The collateral became practically worthless. It became apparent in the following days that liquidity in the country was fast disappearing and that the situation with Glitnir was deteriorating. Also the domino effect from the fall in the banks stocks was emerging. Slowly it emerged that more had to be done as the grave situation with Glitnir was starting to affect the other banks, especially Landsbanki.

The following days a plan emerged on how to take the banks over one-by-one if needed. It was apparent that the CBI could not come to the rescue as the size of the banks was absolutely disproportional to the capabilities of the sovereign. It was decided a blanked guarantee should be given to depositors in local banks and that depositors should come first in line as claimants on the assets of the banks. Unlike the Nordic countries, which provided a blanket guarantee to the creditors in their crisis in the 1990s, Iceland only guaranteed deposits. The Icelandic banks have now defaulted on their senior debt. Emergency laws giving similar powers to the financial supervisor as the FDIC has in the US were ratified the following Monday and Glitnir was taken over the following night, Landsbanki two days later and, finally, Kaupthing on Friday after the UK had used their terrorist act to freeze all assets of Landsbanki in the UK.

Figure 1 depicts a stylized schematic representation of the plan that was followed in the takeover process.

In the first phase various ministries and the Icelandic Financial Supervisory Authority (FME) drew out the plan on how to take over the banks. This included writing up the legal framework and organizing the architecture of the new system. The second

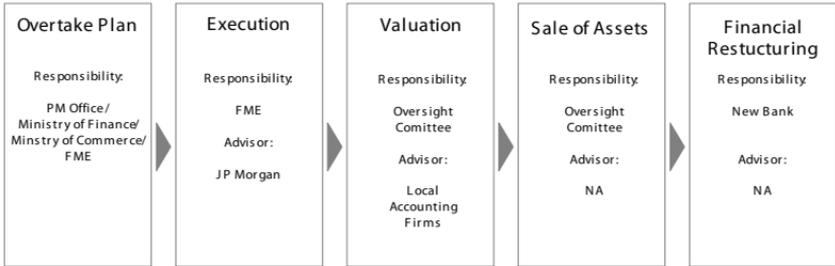


FIGURE 1. SCHEMATIC REPRESENTATION OF THE TAKEOVER PLAN

phase was to execute the plan which was the responsibility of the FME. The third phase was to value the assets, which was the responsibility of an Oversight Committee, one for each bank, appointed by the FME. The fourth is to sell assets that had to be sold quickly in order for their value not to deteriorate. And the fifth phase was to restructure the banks financially which is obviously the responsibility of the new banks. A sixth phase can possibly be added – re-privatization of the banks but no such decision has been taken yet.

New Bank	Old Bank
Revalued Assets  Deposits Note to Old Bank  New Equity	Revalued Assets  Note on New Bank  Claims

FIGURE 2. BALANCE SHEET OF THE OLD AND NEW BANKS

In each case a new bank was formed and all deposits directly guaranteed by the sovereign transferred there, see Figure 2. A preliminary evaluation of the assets was carried out and assets amounting to deposits moved to the new banks. The state finally injected capital into the new banks supporting a CAD ratio of 10%.

What remained in the old banks were all assets that had not been moved to the new banks, a bond issued by the new banks for the assets they took over, and claims of creditors (such as deposits in branches outside of Iceland and claims of bondholders).

The capital contribution of the Icelandic government amounted to 380 billion ISK or almost 30% of GDP. The new system is about three times the country’s GDP compared to almost ten times before the crisis, now fully financed in ISK.

## *The Sources of the Collapse*

This decade has been unusually favorable to Iceland. The liberalization of the economy has made the country the fifth richest of the member countries of the OECD living standards next to non according to the UN. Output, consumption, and investment, both FDI and domestic, grew rapidly the last decade. At the same time public finances were in a very good shape. Taxes were lowered and the economy flourished. As a matter of fact government debt was almost non-existent at the onset of the crisis, less than 7% of GDP. Also implicit debt was none-existent with pension wealth amounting to almost 1.5 times GDP and a very favorable demographic composition of the population. There was no unemployment and almost 10% of the labor force were migrant workers, mostly from Eastern Europe. Favorable fundamentals justified optimism. Iceland was the "Nordic tiger".

The Icelandic banking system was more or less government owned until the turn of the century.<sup>3</sup> It was a simple depositary system with a balance sheet approximately amounting to the country's GDP. The loan portfolio was mostly domestic, fairly low risk, and credit losses were small. However, Iceland had already deregulated its financial market at the time of privatization being a member of the European Economic Area and by adopting the European Financial Directive in the early 1990s.

After privatization of the banks, the flow of foreign credit increased rapidly. Domestic liquidity fuelled an investment boom and later an asset price bubble. International creditors were willing and able to lend what seemed like limitless amounts to Iceland. Housing prices rose dramatically with easier excess to capital and the stock market boomed. It could be said in retrospect that a Ponzi-game was played in the stock market. One could start with a certain amount, buy stocks, pledge the stock in the bank and use the money to buy more stocks and thereby increasing the price, pledge the increase and buy more stocks, etc. This pumped up the stock market and created a bubble.

<sup>3</sup> Glitnir (formerly Islandsbanki) was, however, always a private bank.

Monetary policy was changed from a fixed exchange regime in 2001 to a floating exchange rate and inflation targeting. The first 3-4 years this new policy fared well. However, because of the carry game that both households and firms played they were more or less immune to hikes in the policy rate and in fact the higher the rate more you gained on the carry trade. Monetary policy soon became almost impotent. The exchange rate was targeted to keep import prices at bay, which encouraged further international investors, firms, and households in the carry game, fueling increased demand and an illusionary wealth effect. The sustained strong exchange rate helped to maintain investor confidence and created an illusion of low exchange rate risk in foreign currency borrowing. Both households and firms borrowed heavily in foreign currency, which became a major problem when the ISK started to depreciate.

This policy turned out to be almost deadly for the monetary regime as inflation targeting is non-linear. When the policy rate is sufficiently close to, for lack of a better word, World interest rate the monetary transmission mechanism works fine. As the policy rate moves further away its effects on demand diminish in a small open economy as the carry trade sets in, the currency appreciates, and demand increases because of illusionary wealth effects. Moreover, the targeted price index included an asset price – housing prices – and there was a structural change in funding of housing that lead to rapid increases in housing prices and consequently inflation. The banks started to lend foreign currency dominated mortgage loans to households. The current account started to deteriorate and the deficit became monumental – peaking at over 20% of GDP.

Gradually the banking system turned from being a fairly simple depositary system to full fledge international financial intermediation, with its operations all over the World. The banking system was, however, not supervised prudently enough. The banks, the FME and to some extent the CBI did not have the knowledge to understand fully the systemic risks that had built up in the system. The focus was too much on CAD's and formalities but not on systemic risk and funding. One of the policy measures put forth by Mishkin and myself in our report

was to consolidate the financial stability mandate of the Central Bank and the banking supervisory functions of the FME in the Central Bank and thereby put more emphasis on actual risks but not only on regulation. Also, in a country of only 320 thousand inhabitants there must be economies of scale in overseeing the financial system. Not following this advice lead to the same mistake as we saw in the Northern Rock incidence in the UK – a detachment of lender-of-last-resort and supervision responsibilities.

After the 2006 incident the Icelandic banks did react in an encouraging manner but they should have done more. In retrospect it was obvious that the system was far too big for the currency. The banks were too myopic and risk seeking. Funding the leverage game of Icelandic and foreign entrepreneurs turned out be very risky. The banks might possibly have understood their own risk but they hardly understood the systemic risk their collected action imposed on Iceland. The banks should have deleveraged and de-risked and they should have been required to do so. In less than eight years the balance sheet of the banks had grown from one times the country's GDP to almost ten times. With the fall of Lehman Brothers and the size of Iceland's financial system the banks had almost no chance of surviving. Investor confidence in Iceland was none.

## ***Conclusions***

So what is the future for Iceland? The request of the UK government to compensate depositors in the IceSave internet accounts far beyond what the European Deposit Insurance Directive requires amounts many times German reparations under the Versailles agreement, in relative terms.<sup>4</sup> It could be the straw that would break the camel's back. Further, it is not at all clear if small states like Iceland can have their own independent currency in a new World order. It could be done if the country would go back to basics. Where exports would equal imports and capital movements were restricted and the financial

<sup>4</sup> A point made by Thrainn Eggertsson in *Morgunblaðið*, Iceland's major newspaper.

system would be a simple domestic depositary system. But that is not a future that can be offered to young people who need opportunities, opportunities that only free markets can offer.<sup>5</sup> Therefore the route is possibly to join our neighbors in Europe – join the European Union and adopt the Euro. That way Iceland would give away the flexibility that comes with an independent currency but would gain the stability that comes with a credible fixed exchange rate instead.

On a more positive note, unlike most other countries that have survived a financial collapse, the fundamentals are strong in Iceland. The export industries, fisheries, heavy industries, energy, and tourism, are in a healthy state. The country has abundant human capital and favorable demographics. Public finances are more or less in order, although the crisis will put a burden on Icelandic taxpayers in the near future. And after all, there are positives about reducing an oversized financial system to a more manageable size in only one week.

What Iceland has to worry about is unjust redistribution of wealth, corruption, and crony capitalism during the restructuring of the system. The experience of Finland in the 1990s in terms of redistribution of wealth was not good. The outcome still is a matter of controversy. Lots of good assets, such as big chunks of Nokia, were sold to foreigners at distressed prices.<sup>6</sup> Also the chaos that surrounds transformations on this scale gives rise to corruption.

<sup>5</sup> A point made by Ned Phelps in *Morgunblaðið*.

<sup>6</sup> I owe this point to Pentti Kouri.





# ***Building an International Monetary and Financial System for the 21<sup>st</sup> Century: Agenda for Reform<sup>1</sup>***

*by Olivier Jeanne*

I would like to present some (rather speculative) thoughts on whether and how the current global financial crisis may change our views about the long-run future of the international monetary and financial system. I will organize my remarks under two headings: first, money and exchange rates (the international monetary system), and second, financial regulation (the international financial system).

## ***International Monetary System.***

If one tried to define an underlying paradigm for the modern international monetary system, it would probably be a set of inflation targeting areas linked by floating exchange rates. This is of course not a realistic description of the system as it stands now, but it may be a good model for the end point toward which the system is thought to be converging. By contrast with the Bretton Woods system, nominal anchors are provided by independent central banks that (implicitly or explicitly) target the inflation rate, rather than nominal exchange rates.<sup>2</sup>

<sup>1</sup> Conference organized by the Reinventing Bretton Woods Committee, New York City, November 24-25 2008.

<sup>2</sup> See Rose (2007), "A Stable International Monetary System Emerges: Inflation Targeting is Bretton Woods Reversed," *Journal of International Money and Finance* 26, 663-681.

Will the current crisis change the paradigm? I don't see any reason to think so---in particular, I do not think that the current crisis will put fixed exchange rates back in fashion.<sup>3</sup> But I think that the current paradigm leaves scope for conflict between different conceptions about how monetary policy should respond to a credit crunch. And these conflicts have an international dimension that is problematic and might lead to protectionism. So while we do not need a new paradigm for the international monetary system, we may need to think of a system to mitigate those conflicts.

Let me explain. There is a good economic case for increasing the rate of inflation to say, 5 or 6 percent, in a credit crunch with a large overhang of debt. First, this is a relatively efficient way of deleveraging the liabilities of debtors, by reducing the real burden of their debt or equivalently inflating their nominal equity. Second, as the literature on the Japanese liquidity trap has shown, the best way to avoid a liquidity/deflationary trap is to credibly commit to a positive level of inflation (what Paul Krugman, called "committing to being irresponsible")<sup>4</sup>. And third, the alternative policy mix of fiscal stimulus with low or negative inflation has not worked well in Japan.

However, I do not expect a consensus on the view that inflation is an acceptable way of getting out a credit crunch. Actually, I would expect many people in this room and outside to strongly

<sup>3</sup> It may be too early to tell but recent developments do not seem to revive the case for managing the exchange rates between the three main currencies. As for the exchange rate regimes of emerging market countries, it is interesting that two of the first three countries to apply to an IMF package had inflation targeting regimes, not fixed peg (Iceland and Hungary, the third country being Ukraine). This being said, I would be very surprised if the crisis put fixed pegs or target zones back in fashion. Most likely, when the dust settles we will have observed again that countries with fixed pegs tend to have more severe problems of currency mismatches in their balance sheets, so their crises are likely to be deeper and more difficult to manage. The crisis may reinforce the view that emerging market countries should resist appreciation and accumulate reserves in an international credit boom, but even a country like China presents exchange rate flexibility as its long-run objective.

<sup>4</sup> Krugman, 1998, "It's Baaack! Japan's Slump and the Return of the Liquidity Trap," *Brookings Papers on Economic Activity* 2, 137-87.

disagree with this prescription. First, many people will point to the risk of losing credibility, i.e., the risk that nominal expectations lose their anchor and long-term interest rates increase to levels that hurt the very borrowers that we want to help. I personally think that the credibility problem can be managed in the context of a credible flexible inflation targeting framework,<sup>5</sup> but there is room for reasonable disagreement on this. Furthermore, actively pushing up the inflation rate might be inconsistent with the strict inflation targeting mandate of many central banks.

But my point is precisely that there is room for disagreement over what inflation targeting means in a severe credit crunch. This might lead to conflicts will not stay below the surface for long if the credit crunch is protracted. The conflicts may occur between the monetary authorities and various domestic constituencies, but also between countries. For example, imagine what the protectionist pressure would be in Europe if the U.S. adopted a strategy of higher inflation which would depreciate the dollar (even though dollar depreciation would not be the primary purpose of U.S. monetary policy).

One may draw a parallel with the interwar monetary problems. The old view was that the interwar monetary instability was due to beggar-thy-neighbor competitive devaluations. A new view holds that the problem was more fundamentally with the deflationary effects of the interwar Gold Standard system<sup>6</sup>. The depreciations were simply the reflection of the fact that countries unshackled themselves from the constraints of the Gold Standard, and should not have led to protectionism. Shall we reenact a modern version of this drama, with the role of the Gold Standard played by strict inflation targeting?

What can we do to mitigate such a risk? I do not think it would

<sup>5</sup> The central bank would have to explain that inflation increases temporarily and will go back to the target as the credit crunch is resolved. See Jeanne, 2008, "What Inflation Targeting Means in a Credit Crunch", available at <http://econ.jhu.edu/people/Jeanne>.

<sup>6</sup> See Barry Eichengreen's *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939*, Oxford University Press, 1992.

be realistic to expect international agreement on the optimal rate of inflation (lack of agreement is precisely the issue), but it would be good to limit the risks of protectionism by having at least an “agreement to disagree” allowing for some measure of experimentation with the rate of inflation. The new process of multilateral consultations under the auspices of the IMF could be a good vehicle for discussions about such an agreement. Why not have a new round of multilateral consultations between key members of the IMF on how monetary policies should respond to a credit crunch and the risk of a deflationary/liquidity trap?

### ***International financial system.***

The question here is how we can reform the “international financial architecture” to avoid the repetition of a global credit and asset price boom-bust episode of the scale that we are observing now. The crisis generates short-term political demands for far-reaching reforms. However, those reforms are not urgent, since clearly the priority now is to deal with the crisis, not avoid the next one. Reforming financial regulation also involves very technical and complicated issues, so why not take our time and rely on orderly discussions between experts? Well, one reason is that the Basel 2 process is not very encouraging for the view that international discussions between experts lead to a relevant and timely outcome. But are there basic principles that political decision-makers could agree on soon in a forum like the G-20 to put the technical discussions on the right tracks?

Rather than addressing this question, I will instead use my privilege, as an academic, to put forward a proposal whose main merit is logic rather than practicality or political feasibility. I will make the case for an international agreement for the countercyclical prudential taxation on systemically risky financial instruments. Or to put it more shortly, some form of “international prudential taxation” (IPT). I present the general case for prudential taxation elsewhere<sup>7</sup> and will simply summarize the logic here.

<sup>7</sup> See Jeanne, 2008, “Dealing with Credit Booms and Busts: the Case for Prudential Taxation,” available at <http://econ.jhu.edu/people/Jeanne>.

First, let us take a step back and look at the anatomy of credit booms and busts. Clearly, some financial instruments contribute more to systemic risk than others. Some complex instruments may come to mind, but there is no need to go further than debt versus equity. The vicious circles in which fire sale of assets and deleveraging feed each other rely on debt---they would not work with equity. So plain vanilla debt is an example of what I have called “systemically risky financial instrument.”

Systemically risky instruments have negative externalities in a crisis. Public economics 101 tells us that sources of negative externalities should be taxed. But systemically risky financial instruments should not be taxed in the crisis, when they have been already issued. They should be taxed preventively in the boom, to avoid an excessive build-up of systemic risk. And the tax rate should be higher if the boom is more likely to turn into a bust, i.e., the tax should have countercyclical component. I think it should be possible to base this countercyclical component on a probabilistic assessment of the systemic risk, without going into speculations about the boom is a “bubble” or not.

I am calling this approach “prudential taxation” because it borrows elements from both prudential regulation and tax policy. It is prudential because it aims at reducing the risk of financial disruption *ex ante*, in the same way as the prudential regulation of banks. But it pertains to tax policy rather than regulation to the extent that it would cover all financial instruments of a given type (such as debt) even when those instruments are not issued by banks or regulated financial institutions. The perimeter of the tax, in other words, would be much wider than the perimeter of financial regulation and supervision.

Finally, why an international agreement? The first, standard, reason is to mitigate the risk of international tax competition that would lead to an inefficiently low level of the tax. The second reason, which is less standard but I think not less relevant, would be to mitigate the risk of regulatory capture by domestic special interests.



# ***Solutions to Restore International Financial Stability***

*by Dino Kos*

The classical gold standard operated for twenty years, ending in 1914. The gold exchange standard operated haphazardly in the two decades between the two wars. Bretton Woods was born in 1944 but was not launched until the early 1950s and was finished by the early 1970s. The current floating rate regime, which has coincided with a great incidence of financial crises, has now been operating for nearly four decades. Despite the incidence of financial crises in recent decades, and especially in the past year, there were no strong arguments made during the course of the conference for a fundamental revision of the exchange rate regime. Indeed most of the comments have focused on improvements to “micro” functioning of the current regime (regulatory, credit rating process, risk management processes, compensation, the growth of shadow banks, etc) rather than a fundamental reappraisal and replacement of the overall system.

In general I share this view. In my view a macro approach would in many ways be preferable, but will not happen because national governments will not cede sovereignty that would be required. The approach will be to address and fix the micro deficiencies that have been identified.

I will focus the regulatory sphere, which will need a substantial re-think and improvement in the months and years ahead. Let me briefly mention four quick points:

## *Dollar Based Banks*

First, we need to come to terms with the “new banking geography”. Historically we have thought of banks as being defined by where their headquarters is. Banks from Tokyo are Japanese and banks from Frankfurt are German and so forth.

When the funding crisis hit, such assumptions were challenged. Generally we think of the home country as taking to lead to support a bank with a funding problem. In this crisis, that went out the window. The ECB and Swiss National Bank could not provide all the dollar liquidity that European banks required. Only the Fed could and over the course of months hundreds of billions of swaps were mobilized.

Why? In short, the reason is that a bank’s geographic home no longer tells you much the denomination of its risks. UBS and Credit Suisse, for example, are Swiss-based, but they are really global dollar-based banks. Most of their risk is denominated in currencies other than Swiss francs, predominantly dollars. One could argue that Deutsche Bank is similarly a dollar-based bank with increasingly larger risks being taken outside Germany. HSBC doesn’t even pretend. It even publishes its accounts in USD.

Regulators will have to come to grips with the myriad of issues this reality introduces. Central banks have already had to deal with liquidity issues, but looking forward it is so clear that supervising these large global banks will have to be more of a joint venture between the major regulators. Protocols will have to be developed not only about liquidity provision, but also regulatory requirements and enforcement. The interconnectedness of the global financial system necessarily implies the current mode of supervision will need to be significantly revamped.

## *Regulatory Decisions*

At a time of crisis, there is pressure on finance ministers, central bankers, and regulators to take quick action to stem the crisis, punish wrongdoers, and rebuild the regulatory system to assure

“this does not happen again”. Decision made in the months and years ahead will be consequential and need to be carefully considered. A rush to make decisions prematurely increases the risks of serious unintended consequences.

In this context let me note one recent example that has received inadequate attention. The subject is AIG. According to its second quarter 10Q, American International Group had sold credit insurance amounting to \$446 billion through credit default swaps (CDS).

Of that amount, \$307 billion was written “to facilitate regulatory capital relief for financial institutions primarily in Europe”, according to the wording in the 10Q (page 42). What exactly was this business? In short, according to the rules that European regulators used in the implementation of the Basel rules, banks reduced their capital charges if they “insured” certain assets (bonds, loans, etc) with highly rated insurers. Being AAA-rated, AIG dominated this business.

However the incentive regulators provided to individual banks to reduce their own risk profile had a massive unintended consequence: it provided the incentive to concentrate vast amounts of risk into a single institution (AIG). A failure of AIG would have left a huge number of banks without protection and created a possible domino effect. It certainly explains, at least in part, why the decision was made to provide government support to AIG.

This is just one example. Regulators will need to be smarter. Risk can be shifted but cannot be eliminated. Will capital rules cause risk to be shifted to places where it should not?

I raise this because of nervousness both about the next-generation capital regime, but also about the current regime. Basel II is several hundred pages long and is just now being implemented. I have yet to meet someone who understand all of it. People understand sections, but I’m talking about the whole.

Work on Basel II started in 1998 and did not finish until the 2005

or 2006. The crisis, the conversion of investment banks into commercial banks, the mergers, the losses, the capital injections, etc, have changed the banking landscape. And more changes are in the pipeline. Unfortunately Basel II is already outdated. In the meantime: What unintended consequences reside there?

### *Pro-cyclicality*

Much has been written and discussed about the “pro-cyclicality” of capital requirements. The conventional wisdom is that capital requirements force banks to tighten credit in a downturn and expand credit in an upturn.

Let me offer a slightly different view. The problem is not that capital requirements are pro-cyclical. The reality is that banking is pro-cyclical. Indeed human psychology is pro-cyclical. Capital requirements are essentially neutral on this point. Such rules do not make banks tighten credit in a downturn more than that bank would have done so anyway.

U.S. investment banks, for example, were not subject to the Basel rules until recently. Their behavior in previous cycles therefore could not be explained by the machinations of the Basel rules. Indeed, risks were typically housed in the holding company or unregulated subsidiary specifically to avoid capital rules. And yet their behavior in down cycles was aggressively pro-cyclical. During the down cycles of 1994 and 1998, they typically reduced risks significantly – much more than commercial banks.

The critics of really want the Basel capital rules to be counter-cyclical by, for example, introducing a structure where loan loss reserves are required to be added during the good times. This would lower earnings in the boom, would increase provisions, implicitly limit leverage, and reducing the probability of having a bubble develop.

The model that has been put forth for consideration is the system used in Spain where banks are required to increase reserves during the up cycle even though they cannot identify a deterioration – or may even see improvement – in the loan book. In that

way, the bank will, in theory, have a bigger buffer going into the downturn, will not have to add as much to loan loss reserves, and therefore have the capability to maintain credit.

This is certain worth looking at. However we should have reasonable expectations. Even in Spain the results, I would argue, have been mixed. The performance of Spanish banks stocks in the current cycle is comparable to other major banks. Spanish savings banks are paralyzed by construction loans. More pointedly, if this worked as well as the proponents argued, wouldn't we also see less likelihood of asset bubbles? And yet Spain had among the biggest debt-financed construction booms in Europe.

In short, it is unlikely that a "counter-cyclical" provisioning system will provide the "silver bullet". A more expansive approach will be needed.

### ***Leverage***

Having said that we should be cynical of how well countercyclical provisioning measures may work, you may be surprised by my argument that we should pay far more attention to broad measures of leverage in the system.

Asset bubbles get a great deal of attention. The BIS and others have written extensively about bubbles. Instead of focusing on asset bubbles per se, I would suggest the focus instead be on excess leverage. Why? Asset bubbles are difficult to identify. And it's not clear policymakers have the tools to deal with asset bubbles. Finally it's a political and nightmare. Central bankers going out and saying equity prices are too high and should fall are not looked on kindly by governments or citizens.

Instead the focus should be on identifying growing leverage and controlling the aggregate amounts of leverage. Why focus on leverage? I don't think we should necessarily be worried about every bubble. Most are small and systemically unimportant. Policymakers should only be concerned about rapidly growing debt and leverage levels that affect collateral values and place

credit intermediaries at risk.

That means bringing in all institutions that intermediate credit under the regulatory umbrella, of setting adequate capital ratios, and being willing to adjust margin requirements when risk is rising and debt is expanding in a given sector.

One of the biggest failures, in my view, in the most recent cycle is that loans were made to poor quality borrowers without due diligence as to whether the loans could get paid back. Supervisors are there to assure that banks operate in a safe and sound manner. What could be more unsafe and unsound than knowingly making loans to people without the capacity to repay?

Worse, the loans had very high loan-to-value ratios. In other words, margin requirements were being reduced at a time when risks were rising. Regulators will need to monitor leverage among a broad range of participants and instruments.

At a more micro level, futures exchanges set minimum margins for various futures contracts. Those margins are adjusted over time. Applying such an approach at a macro level would involve significant issues such as defining what levels of leverage are dangerous; how would such rules be applied and by whom; and of course, how would those “unintended consequences” be avoided?

In the end such an approach involves much great government involvement in our financial markets. The level of intrusiveness is much higher than the situation historically. However given the equity stakes held by governments, the involvement in management, compensation, and lending decisions (e.g., pressure to modify mortgages in the U.S.) this level of intrusion is relatively modest.





# ***A New Bretton Woods?***

*by Ronald McKinnon*

The Bretton Woods Agreement of 1945 was a response to the Great Depression and World War II that had left international monetary arrangements in a shambles. It was essentially bilateral, negotiated between the British Treasury (Keynes) and the U.S. Treasury (White) in 1943-44—with Canada sometimes acting as an umpire. Once the two financially prominent countries agreed on new rules for stabilizing exchange rates and moving toward current account convertibility while limiting volatile capital flows, other countries ratified the agreement in stages. In practice, many countries—both industrial and developing—often took several more years to put the IMF rules into effect.

After 1947, the GATT, now WTO, negotiations on foreign trade—tariffs and commercial policies—were successful as long as they were also mainly bilateral: the Western European bloc negotiated mainly with the United States. However, at the end of each negotiating round, MFN treatment was extended to most other countries outside the Soviet bloc. Developing countries did have a marginal say. Article 18 of the old GATT exempted them from the requirement to reciprocally reduce their own tariffs. This was disastrous for them, and fortunately is being phased out under the WTO. But the latest Doha round of the WTO, with a large group of negotiators, could not be concluded at all. Too many emerging markets, India, China, and Brazil among them, were recalcitrant in the face of American and European agricultural protectionism.

In the current great global financial crisis, stabilizing monetary and exchange relationships among nations is, as in 1945, devoutly

to be wished. But even if it were possible to limit the number of negotiators to the most financially prominent countries, success would not be guaranteed—although such a gambit is well worth trying. Who are the financially relevant countries? In Asia, China and Japan, and in Europe, the euro zone with which the U.K. might want to be affiliated. In North America, just the United States— with Canada possibly again acting as umpire.

Once these four groups agree on a set of rules for restoring exchange rate stability, aligning interest rates, reducing trade imbalances, and—most importantly— mitigating counterparty risks in financing foreign and domestic trade, other economies in the world system would benefit enormously. But outside the Big Four, other countries could follow, but not be bound by, the new rules on which the larger countries agree.

These suggested new rules, to be discussed below, are incremental to the existing IMF articles. Thus all countries would continue to respect their existing IMF obligations, particularly that of current account convertibility under Article 8.

### *New Incremental Rules for the Game*

Because of the paramount importance of mitigating the global economic downturn, let us focus first on four basic principles (rules) of a new, if as yet informal, international monetary order. They extend, but are not inconsistent with, the IMF's existing Articles of Agreement.

1. *Stabilize exchange rates.* In the Great Depression, beggar-thy-neighbor currency depreciations— often the inadvertent result of volatile international capital flows—generated a “never again” presumption in the minds of the Bretton Woods negotiators. In the immediate postwar, international capital flows and exchange rate fluctuations were to be strictly limited even as nations were encouraged to return to current account convertibility to restore multilateral trade. But after the Nixon shock in 1971, the IMF's Article 4 was amended to eliminate the requirement of exchange stability—which remains optional.

2. *Reduce large trade (savings) imbalances.* In a global economic downturn where deflation is now threatening, countercyclical fiscal expansions should be concentrated in economies with trade surpluses arising out of relatively high national saving rates. The now defunct “scarce currency” clause of the original Bretton Woods Agreement would have permitted member countries to impose trade restrictions on exports from chronic surplus economies. But now fiscal expansion is far preferable. Concomitantly, in countries with chronic trade deficits, i.e., mainly the United States, fiscal expansion, if any, should be muted.
3. *Suppress “carry trades”.* Either align national monetary policies so as to eliminate chronic cross-country interest rate differentials, or impose capital and other prudential controls on financial institutions, to prevent agents from leveraging themselves by borrowing at short term in low interest countries to lend long to, or buy illiquid assets in, countries with higher interest rates. Foreign direct investment (FDI) could be exempt. (Capital controls not affecting current-account transacting are still legal under the existing IMF articles.)
4. *Reduce or eliminate counterparty risk in financial transacting.* In international trade, use national export-import banks, or other government banks and agencies, to provide unsubsidized letters of credit to importers—foreign or domestic—whose normal bank or trade credit has dried up.

To provide analytical and empirical support for each of our four new rules would require a major position paper for each one, and to analyze further the symbiotic relationships among them would demand even more space and time. Here I focus mainly on Rules 1 and 2 in a truncated, but still critically important, two-country model of China and the United States.

***China and the United States:  
Partners for Managing the Global Economic Crisis?*<sup>1</sup>**

Clearly, what had been mainly a financial crisis with a seizing-up of interbank and commercial bill markets, is now spreading with full force to the “real” economy. Consumption and investment spending in the industrial center of the world economy is falling, with even sharper downturns—coupled with currency crashes—in economies on the periphery producing primary products. Although less severely impacted by the global downturn than the American or European economies are, China’s high-growth economy is slowing more than most analysts expected.

Beyond making every effort to unblock credit markets as per rule 4 above, what is the best way to mount a global countercyclical policy?

Though China and the United States are an unlikely duo to mitigate the current economic crisis, they have good reasons to cooperate. Both have strong vested interests in ameliorating a global downturn while preserving the foreign exchange value of the dollar. Trade between them is huge, but extraordinarily unbalanced. China is the largest creditor of the United States, nervously holding nearly \$2 trillion in official foreign exchange reserves. The large U.S. trade deficit in manufactures with China (and East Asia more generally) has contracted the U.S. manufacturing base and inflamed American politics by throwing red meat to the protectionists. A cooperative economic program that addresses the near-term global macro crisis on the one hand, and the festering China-U.S. trade imbalance on the other, is feasible and highly desirable.

The collapse of the U.S. housing bubble in 2007-08 is the proximate reason for the worldwide spread of the credit crisis. Aggregate demand in the global economy is declining because of the retrenchment in U.S. household spending, which is necessary to reduce the U.S. trade deficit. Because the Federal Reserve overreacted by cutting interest rates too much, the flight

<sup>1</sup> An earlier version of this article appeared in the *Shanghai Securities News* (24 September 2008)

of hot money from the dollar up to four months ago worsened the seizing up of credit markets in the United States.

When counterparty risks are acute, the huge U.S. interbank markets are further impaired because of a shortage of prime collateral in the form of U.S. Treasury bonds. When foreign central banks, such as the People's Bank of China (PBC), intervened to buy dollars to prevent their currencies from ratcheting upward, they invested the proceeds disproportionately in U.S. Treasuries and so incidentally worsened their shortage in private U.S. financial markets.

But China also has domestic financial problems including a banking squeeze. Because of ultra-low U.S. interest rates and American "China bashing" to appreciate the renminbi, the deluge of hot money inflows into China had forced the PBC to buy dollars in the foreign exchange market to prevent the renminbi from ratcheting up sharply. True, the surprise strengthening of the dollar over the past four months has provided a respite from continual renminbi appreciation. But just the expectation that the renminbi is likely to be higher in the future impedes private capital outflows from China to finance its huge trade surplus—and so further tightens credit conditions in the United States and Europe.

From the inordinate buildup of China's official foreign exchange reserves, Chinese domestic money growth had been excessive and had led to too much inflation—some of which leaked out into the rest of the world. In trying to sterilize the domestic monetary consequences of the rapid buildup of official exchange reserves, the PBC has had to impose high reserve requirements on its commercial banks—but these impede the commercial banks' lending to the private sector.

To deal with the global crisis, therefore, how should the U.S. and Chinese governments proceed?

First, the U.S. should stop China bashing in several dimensions. In particular, the PBC should be encouraged to stabilize the yuan/dollar exchange rate at "today's" level—to lessen hot money

inflows and the potential inflationary overheating of China's economy, and to protect the renminbi value of its huge dollar exchange reserves. Since July 2008, the dollar has strengthened against all currencies save the renminbi and the yen, and the PBC has stopped appreciating the RMB against the dollar. So now is a good time to convince the Americans of the mutual advantages of returning to a credibly fixed yuan/dollar rate.

There is a precedent for this. In April 1995, U.S. Treasury Secretary Robert Rubin ended 25 years of bashing Japan to appreciate the yen—and announced a new “strong dollar” policy that stopped the ongoing appreciation of the yen and saved the Japanese economy from further ruin. But this policy was incomplete: the yen continued to fluctuate, thus leaving too much foreign exchange risk within Japanese banks, insurance companies, and so forth, with large and increasing dollar holdings from Japan's trade surplus. This foreign exchange risk locked, and still locks, the Japanese economy into a near-zero interest-rate liquidity trap.

Second, after the PBC regains monetary control as China's exchange rate and price level stabilize, the Chinese government should then agree to take strong measures to get rid of the economy's net saving surplus that is reflected in its large current account and trade surpluses. This would require some combination of cuts in tax rates, increases in government expenditures, and reduced reserve requirements on commercial banks. To further increase household spending, much higher dividends from enterprises should be encouraged—or mandated. Then, as China's trade surplus in manufactures diminishes, pressure on the American manufacturing sector would be relaxed with a corresponding reduction in America's trade deficit. Worldwide, the increase in spending in China would offset the forced reduction in U.S. spending from the housing crash.

Again there is an important historical precedent. In the great crisis of 1997-98, most East Asian countries depreciated their currencies—with Indonesia, Korea, Malaysia, Philippines, and Thailand, whose currencies were attacked—suffering steep economic slumps. Fortunately, China alone kept its dollar

exchange rate stable, but it did face a potential deflationary slowdown. However, in March 1998 Premier Zhu Rongji announced his famous trillion dollar fiscal expansion to be spread out over the next four years or so. The huge size of this fiscal expansion was unprecedented. Because the yuan/dollar rate was fixed, the increase in government spending (mainly for infrastructure investments) stimulated domestic aggregate demand more effectively. China maintained its high growth rate and its East Asian neighbors recovered faster because they could more easily export to China.

Now China is a much bigger actor on the world stage. So with the slump in spending in the U.S. and elsewhere, China should step in with a big new fiscal expansion, which it is well placed to do because of its huge trade surplus that should be reduced anyway. China's public finances are now very strong with a surge in tax revenues, and the old bad loan problem with its banks has been largely corrected as enterprises—both state-owned and private—are now very profitable.

After the first draft of this paper, on November 10, China's government did announce new fiscal spending of \$580 billion (Chinese Yuan 4 trillion) to be spent over the next two years. This is a lot of money and a welcome step in the right direction. But how much is truly incremental spending, and how much is a bundling of past expenditure programs, is still unclear. What is clear, however, is that, in "real" terms, this fiscal stimulus is still much smaller than Zhu Rongji's \$1 trillion expansion announced in early 1998 and carried out over the following four years. Then China's economy was much smaller, and the Asian crisis—although very serious for China—was much smaller than the fall in global aggregate demand in the current crisis.

In contrast to China's, the U.S. public finances are in a mess. The pre-crisis fiscal deficit is still with us. In addition, the U.S. government has taken on huge new contingent liabilities from bailouts of innumerable financial institutions that will hamstring the federal budget for years to come. Thus any new U.S. fiscal stimuli, or big new spending programs not covered by tax increases, should be out of the question. Even if implemented,

they would wind up increasing the American trade deficit.

In summary and following rules 1 and 2, a further “negotiated” fiscal expansion in China—with a formal end to China bashing so as to secure the yuan/dollar rate as the quid pro quo—would seem to be the most promising start for mitigating the global slump. With this precedent (or in concert), the other major trade-surplus countries—Germany and Japan—could follow with their own fiscal expansions while stabilizing the euro and the yen against what would then be a yuan/dollar bloc. But this is an ambitious story for another time.





# *Financial Disaster Recovery*

## *A Private-Sector Agenda for Risk Management by Ira Millstein and George Vojta*

Trust in financial institutions and their advisors has been lost. There will be additional regulation, but regulation alone cannot restore trust. It is necessary for the private sector to act to restore its important role in the financial system. Unlike previous crises, such as the dot.com burst, Asian Crisis, Great Depression, or the Tulip Collapse, the current extraordinary turbulence results from financial institutions wounded, in some cases mortally, by egregious failures in corporate governance and risk management. These weaknesses— inappropriate risk-taking and malfeasance— must be acknowledged with honesty and without reservation, and the requisite remedial action must be defined and rigorously implemented.

The remedy must originate with the boards and managers in adults had direct or indirect shareholdings. In 1985, the figure was 28 percent; in 2002, it was about 40 percent, or 84 million individuals. Indeed, the beauty—but also the peril —of the evolutionary path of public corporations in the United States since the last century is that they increasingly represent the investment of an ever-wider segment of the population.

Direct ownership is only part of the story. Conceptually, the whole system has now moved away from us—individuals as beneficiaries. Individuals who used to save for retirement or to send their children to college by directly holding stocks in the GEs and GMs of the world—the “forced capitalists,” as dubbed by Delaware Chancery Judge Leo Strine, Jr.—now make their investments through financial intermediaries such as pension funds and mutual funds. In 1980, institutional

investors held more than 37 percent of the equity markets. Today, they hold about 60 percent of all U.S. stocks, according to The Conference Board. As a result, corporate governance and capital markets' vitality has become a matter of charge of our financial institutions. The current state of affairs involving massive government intervention has been chronicled fully by the media. However, we firmly assert that a financial system dominated and controlled by the state is not a solution; it brings its own deficiencies. The market, over the long term, if appropriately regulated, has been found to be the most efficient system for wealth creation; savings must continue to be allocated to their best use. Gross undermining of the market system can be resisted by acknowledging the fault lines in need of repair and voluntarily repairing them ourselves to the extent possible.

Let us consider, for a moment, the world of financial institutions and their impact on the population at large. In the last century, direct or indirect individual shareholdings in public corporations have increased dramatically. In 1952, about 6 percent of U.S. general interest, and corporate crises are even more likely to have detrimental effects on society as a whole.

### ***Enter the New Investors***

Another striking new feature of today's capital markets is the constant proliferation of different types of shareowners within the "institutional" category with increasingly heterogeneous objectives and tactics. For example, Sovereign Wealth Funds, half of which came into being since 2000, managed assets somewhere in the range of \$1.9 to \$2.9 trillion as of June 2008, according to Risk-Metrics Group. Private-equity funds engineered deals with an enterprise value of \$1.4 trillion in the boom years of 2006 and 2007. Hedge-fund assets have increased about 3,000 percent since 1990, and accounted for approximately 30 percent of total U.S. equity trading volume in 2006.

This proliferation of new owners puts the model of shareholder activism, which was envisioned in the 1980s and 1990s, under severe strain. Institutional investors were once presumed to share a common goal when exerting pressure on boards to monitor

management and effectively guide firm strategy. That assumed homogeneity now seems long gone, and heterogeneity is ever on the rise. This diversity of shareowners has brought a whole host of agendas, strategies, and values to the table. Some of these owners have limited investment horizons and are only interested in realizing a short-term profit, and others may have hedged or shorted their positions and consequently have a financial interest in the failure of the enterprise.

With this new array of owners came a blizzard of new financial instruments, which are complex, and often incomprehensible, even to the most financially literate; deregulated markets stimulated such innovation. The emergence of new financial instruments and new owners was mutually reinforcing. Hedge funds were one of the main buyers and users of complex financial instruments, which were also used to finance the private-equity boom between 2005 and 2007. The new financial instruments, such as credit default swaps, other derivatives, and CDOs, differ from conventional public stock and debt, as the latter are not subject to similar regulatory requirements. Observers, such as The New York Times columnist Floyd Norris, have noted that this problem of “unregulation” was due less to the fact that regulation was scaled back “than to Wall Street’s finding ways around it by establishing new products that could work between the cracks.”

In recent years, large traditional financial institutions followed the risk-taking example of hedge funds and private equity in pursuit of their double-digit returns. They hired mathematicians and scientists who dominated the innovation function, and developed esoteric market strategies and financial instruments.

We assert that the current crisis is due in no small part to this surge in risk-taking behavior by financial institutions, coupled with lapses in good corporate governance.

Significant cultural change occurred in the most established institutions and with it came a diminished overall commitment to good management practices and service to constituents and society. One reason, perhaps, was the fear of losing the best and

brightest to the new hedge and private-equity groups. There was a new attitude of profit seeking for the institutions' own benefit, rather than fiduciary duties to you and me. This phenomenon was reinforced by the primacy of "doing deals" as opposed to serving clients/constituents. Revenue from trading and principal risk activities became dominant.

Other factors also contributed to and reinforced the deterioration of sound management and governance practices in financial institutions. The first was the contravention of the check-and-balance role of independent gatekeepers—lawyers, accountants, and rating agencies, as John Coffee, Columbia Law professor, has noted. Among the most egregious examples was the case of Arthur Andersen and Enron, and more recently, the flawed rating methodologies for the new complex securities instruments.

### *The Regulatory Gaps*

Deficiencies in regulatory oversight also contributed to this dysfunctional condition in financial institutions. The Gramm-Leach-Bliley Act, enacted in 1999, allowed commercial and investment banks to merge, thereby enabling intermediaries to compete in all segments of the financial market. However, it was envisioned that all diversified institutions would become financial holding companies under Federal Reserve supervision. Regrettably, large investment banks chose to avoid supervision by the Federal Reserve through use of specialized charters, off balance-sheet activities, holding companies, and other means, while insurance companies formed thrift holding companies under the Office of Thrift Supervision (OTS). The Securities and Exchange Commission remained the primary investment bank regulator, but failed to create credible competencies or carry out supervisory activities at this level to any meaningful degree, and oversight by the OTS was deficient. This enormous gap in regulatory oversight allowed excesses in risk-taking to occur in these two sectors. The extravagant incentive and compensation policies in financial institutions rewarded short-term profit at any cost and completed this disastrous picture.

Greed prevailed throughout the entire financial "industry," and

without proper oversight, was allowed to flourish. The full panoply of abuses included “illegal parking” and tax avoidance; tainted equity research; illegal backdating of options; fraudulent conveyance of securities and conduct of auctions; abusive sales practices; excessive short-selling and leverage; gamed rating of leveraged and subprime securities; leaks of inside information; deficient settlement processes for derivatives; little or no regulation of hedge funds, rating agencies, private-equity firms, and over-the-counter derivatives; opaque, deceptive consumer marketing; and just plain criminal fraud.

We are now experiencing the full thrust of public resentment of the excesses fueling this misconduct: a lack of trust in the capital market and institutions, and anger over the assertions of general corruption of the financial sector as a whole.

### *The Governance Remedy*

The implementation of strong corporate governance practices is essential to the long-term success of our corporations. And with the long-term success of corporations, the overall health of our economy and the welfare of society as a whole follows. Strong corporate governance practices are here understood as an effective system of checks and balances inside each corporation (management accountability to boards and board accountability to shareholders and stakeholders), clarification of the rights and responsibilities of all constituents of the corporate enterprise, and a clear understanding that the role of the corporation in society is to benefit shareholders and stakeholders.

We now have a unique opportunity to use self-help to revamp governance structures. The first priority is for boards to change their focus from profit for the benefit of themselves and management to a renewed commitment to managing society’s savings (ours) for the benefit of their shareholders and stakeholders (us). Boards must re-establish and enforce the standard that risks are to be undertaken for the benefit of their constituents, not for the personal gain of management. Second, directors need to be far more competent and engaged, have the courage and expertise to validate and oversee the strategy and risk profile of

the enterprise as beneficial to all stakeholders. Third, shareholders must exercise their responsibility to elect directors who are qualified to discharge these responsibilities. Governments which become shareholders have the same obligation.

That leaves the question of whether boards of this nature can effectively oversee complex institutions to assure that the risks undertaken are appropriate and contribute to the long-running integrity of the enterprise.

We believe the answer is “yes.”

Our perspective is derived from long experience with more than 80 boards, from experience in the financial sector, and from being early advocates and supporters of the governance movement, long before governance was incorporated into mainstream thinking and mandated by legislation.

### ***Prescription for Improvement***

Effective oversight of risk by strong and competent independent boards must be re-acknowledged as a basic element of good corporate governance. This begins with splitting the offices of chairman of the board and chief executive officer. Splitting these roles solves the inherent conflict of self-oversight and permits the CEO to focus on running the enterprise, while allowing the non-executive chairman to manage the board and recruit board members with requisite technical expertise and time commitment to provide adequate oversight. A case could also be made for more internal directors on the board to facilitate availability of proper information for board oversight decisions.

Available technologies, such as XBRL, allow the reporting of risk in as much, or as little, detail as wanted or needed. These technologies can produce for the board sufficient and digestible reports, which are different from, and more effective than, the largely unintelligible mass of information based on detailed financials and footnotes.

In addition, individual institutions should conduct an annual comprehensive review of their risk profile, and eliminate activities that do not stand up to rigorous capital, liquidity,

ethical and suitability standards. The results of this review should be validated by external auditors, rating agencies, and regulators, and these validations should be disclosed. The SEC should promote such a process by requiring significantly more disclosure about risk exposure, board actions in monitoring and managing such risks, and assuring that the disclosure standards are updated as required.

We are heading for reform of regulatory agencies that most likely will establish umbrella supervision, probably by the Federal Reserve, over the entire financial system, that should, and will, focus on corporate governance, risk management, capital standards, and liquidity. Supervising organizations must insist, strongly and consistently, that firms establish, maintain, and execute worldclass governance and enterprise risk-management programs. Equally important, supervising institutions should levy sanctions on those who fail to meet this standard. All carrot and no stick does not provide sufficient incentive.

A multitude of risk models have been proven to be flawed and require a comprehensive review in individual firms. Client suitability policies and ethical conduct standards must also be reassessed and reissued; the board should mandate termination of all employees guilty of conduct that violates suitability and ethical policies. Gatekeeper relationships must also be placed on an arm's length basis.

Compensation systems need to be redesigned to moderate rewards, penalize poor performance and unethical conduct, encourage effective service to stakeholders and society, and deemphasize short-term profit in favor of long-term corporate value. Conducting more intensive training of staff and board members emphasizing their fiduciary obligations to stakeholders and society is necessary, and certified board members should be evaluated annually. As part of this course of action, an active stakeholder accountability process should be established for shareholders, creditors, clients, staff, competitors, suppliers, society, and the environment.

## *The Time is Now*

The implementation of formal and substantive governance improvements around risk management with the recruitment of the right type of directors will go a long way in restoring trust in financial markets. And this is the ideal occasion to do so. Not only are financial institutions desperately in need of rebuilding trust, but the recent wave of government intervention in the sector is likely to lead to stringent corporate governance requirements if such improvements are not made voluntarily. The government now has skin in the game.

The Millstein Center for Corporate Governance and Performance at the Yale School of Management, an active partner of the OECD and the International Corporate Governance Network, is currently launching a major project titled “Reconstructing Trust: A Private Sector Agenda” to research, describe, and advocate for the necessary reforms discussed above. It is but one of the flowers that should grow as we find new ways of restoring trust.

All of us, authors included, who have labored in the financial sector must accept degrees of responsibility and accountability for what has happened. But now is the time to begin serious work to deal with the problems and restore the system to health.

Ira M. Millstein is the senior associate dean for corporate governance at the Yale School of Management, and senior partner, Weil, Gotshal & Manges LLP; George Vojta is the chairman of the advisory board of the Yale School of Management Millstein Center for Corporate Governance and Performance; chairman and CEO of Westchester Group LLC, and former vice-chairman, Bankers Trust Corp.

## ***Eight Factors Necessary to Restore Faith and Accountability***

What are the elements of a sound enterprise risk system? The gravity of the current situation calls for emphasis to be placed on the following eight factors:

- A risk officer at the senior-management level and risk-management groups independent of business lines with real authority for approvals of all risks.
- A risk-adjusted capital discipline that addresses firm-wide core business and transaction-level capital requirements.
- A new-product approval process (especially for complex instruments and risk models), independent of business lines, at the senior-management level. A robust process may have made many of these initiatives unprofitable.
- Fully transparent and comprehensive internal and external reporting, which implies no “conduits,” other off balance-sheet vehicles or risks, and no illicit “parking activity.”
- Extensive training and certification of competence in risk management for board members, and self-assessments of board performance by peers.
- Timely, comprehensive risk reports for credit, market, operating, liquidity, and other risks deemed appropriate for the individual firms utilizing XBRL, or comparable IT technologies. These reports should be regularly reviewed by senior management and the board.
- Full disclosure of risk-management processes in filings, annual reports, and analyst presentations.
- Regular reviews by the board audit committee, internal control officers and external auditors, rating agencies, and regulators of the risk-management system for adequacy, compliance with policy, and appropriate disclosure.



## ***After the Turbulence – Where to Next for Emerging Markets?***

*by Jens Nystedt*

*The views expressed in this Note are those of the author and do not necessarily represent those of Moore Capital Management LP.*

While it is too early to draw lessons from the current bout of turbulence and global recession, we can at least spend some time to think about what the world is going to look like when the situation starts to stabilize and gradually recover. Mohamed El-Erian noted during the IMF/World Bank meetings in Washington DC that it may sometimes be more useful to think about where we are all going to end up (the destination) than to figure out all the possible future paths. This is particularly important for policy makers in both the G7 and emerging markets as they have a key role to play in determining the ultimate destination for EM.

To better discuss what the destination could look like for emerging markets we have to agree on the starting point. So where do we start? Most of causes of the current turmoil and global recession are by now well-known and reasonably well analyzed. At the end of the day, however, once we have some perspective on the ongoing crisis we may reach somewhat different conclusions. However, in broad brush terms it seems that there is by now wide agreement that the pricking of the US housing bubble also rapidly deflated a much larger global asset bubble, which has caught most policymakers and countries globally by surprise. While each country individually generally felt able to withstand

a modest down turn (remember the decoupling debate), no one foresaw a synchronous global downturn, which will by the end of it be the worst we have seen since the 1930s (or 1973/75 if we are lucky). The pricking of the global asset bubble also gives us a chance to revisit our original assumptions of the rise of the BRICs (or emerging markets) and what were the main causes for their spectacular performance over the last few years.

### ***A failure of surveillance and too much complacency?***

Only a year ago the dominant theme in emerging markets from both policy makers and market participants was that of decoupling. Given the remarkable re-coupling in economic fundamentals and now the onset of a global recession, what were observers missing?

Revisiting the rise of emerging markets, what were the real drivers? In retrospect, I think it should be recognized that most, but certainly not all, of the rapid improvement in emerging market economic fundamentals were driven by a combination of a low global interest rate environment, strong G7 growth, weaker US dollar, and ensuing ever higher commodity prices. There have been periods like that in the past, but probably never to the same extent. To their credit, many emerging markets this time around took advantage of the supportive cyclical environment and saved some of the windfall, but unfortunately not nearly enough given the shock they are currently experiencing. Moreover, a criticism that can be levered against many, even the star performers in EM with only a handful of exceptions, is once the pressures on them early in the decade abated there was much less impetus for continued structural reform and trade liberalization.

Balance sheet imbalances matter and the EM corporate sector did again. Michael Dooley often told me that one of the key lessons of the lost decade of the 1980s was that at the end of the day all corporate debt is sovereign in emerging markets. While the current turmoil has again born out this insight, it seems that Professor Dooley was not only right about this in emerging markets, but in the G7 as well. With the pricking of the global asset bubble it became clear to most policy makers

that even though they had reduced significantly their sovereign balance sheet mismatches, their corporate sector, many times unbeknownst to them, had engaged in similar unsustainable behavior as they did during the last major round of capital inflows into emerging markets 1996-1998, i.e. they overindulged on cheap external financing. Corporates from Brazil, Mexico, and Korea, etc., found the easy lending environment irresistible and went on an external borrowing spree under only a slightly different assumption than Asian corporates did back during the Asia crisis. This time around, instead of taking a pegged currency for granted EM corporates assumed that their own currencies were set to largely appreciate for the foreseeable future. Hence, even exporters, who should have had a natural hedge, over hedged themselves through exotic fx derivatives and found themselves quite vulnerable once the dollar turn took place. While we are now aware of some of the balance sheet mismatches and the fall in EMFX reserves has started to reflect this, it is likely that more is to come. Moreover, the loss in market access for most corporates combined with a desire by international banks to cut back their EM exposures, would suggest that further capital outflow pressures are still to come.

There are still plenty of other balance sheet mismatches to worry about. In addition, to the corporate sector's appetite for fx borrowing, households, wherever possible, also tried to take advantage of the low interest rate environment and borrow in fx for consumption and housing. In the case of central Europe, this balance sheet vulnerability was well, and often, flagged by the IFIs. Nevertheless, most policy makers did not see the build up of fx denominated mortgages as a macro problem, even though the inflow reached several percentage points of GDP annually in countries such as Hungary. Their inflow, not only increased Hungary's balance sheet mismatch, but also increased appreciation pressure on the forint, which in turn made fx borrowing more attractive. In retrospect, it would fair to say that there was a sense of complacency from both policymakers and the market regarding these buildups in balance sheet mismatches in both Central Europe and the Baltics.

Where did surveillance fail, why did we not see the current

turmoil spreading and eventually engulf emerging markets? Partly I think it was a lack of imagination about how severe the current deleveraging shock could be. The fact that commodity price held up even though G7 growth slowed sharply certainly provided an important shock absorber and for the first 12 months of the current asset bubble collapse EM looked fairly robust. Hence, maybe there was a false sense of security permeating emerging markets that took its first real hit after the collapse in commodity prices in July and August. This was followed by increasingly bad economic data in September, and then by a sharper EMFX and fixed income sell-off as the deleveraging ‘tsunami’ took hold. A credit crunch that started to impact trade financing as well as G7 policy initiatives that clearly were aimed to protect its own economies and financial systems, potentially at the expense of emerging markets, also played a role. Hence, it is understandable, given the unprecedented nature of the crisis that surveillance missed to flag how the crisis would spread and through which channel it would impact emerging markets. Where surveillance could have done a better job, however, would have been to focus more clearly on the country’s balance sheet and in the build up phase of several imbalances raise yellow flags and trigger some form of policy action. The fact that several of the imbalances were allowed to build is all the more surprising given that some of the problems that are leading to pressures on several EM currencies today, even on those with ample foreign exchange reserves, are of a similar nature as those we had seen during the Asia crisis.

### *What is going to be different in the future?*

The cyclical environment is going to be much less supportive for emerging markets for a number of years. Let’s go through why:

- **First, below trend global economic growth for longer.** We should take as given that G7 growth will be sub-trend for years to come as the US consumer rebuilds his balance sheet through savings and the federal government tries to extricate itself from its unprecedented intervention in the country’s financial system. Core inflation pressure should be well contained even in the context of more aggressive monetary policy action going forward. The turmoil has also

revealed flaws in the degree of integration and cooperation among the EMU members and if anything has sped up the willingness of Central Europe, Denmark, and Sweden to join the Euro-zone. Such attempts at joining, all else equal, should imply fairly restrictive fiscal policies as the future members of the Euro-zone try to meet the Maastricht criteria. China, on the other hand, now realizes how exposed it was to external demand and has embraced a large stimulus program that presumably will see further policy initiatives to spark domestic demand if the ones so far prove insufficient. Overall, global growth is likely to be subdued and below trend for years to come. Moreover, to the extent emerging markets were planning to finance their investment plans through international capital flows (for example India's 5-year ambitious infrastructure plan) they would have to be revised significantly downwards.

- **Second, deleveraging pressures will eventually stop, but not clear we will see any significant re-leveraging for a while despite a fairly supportive interest environment.** Similar to the end-1990s double digit investment returns in a post-crisis world will be ample. Hence, the need to leverage for a decimated global investor community will be much less. However, it is not clear that the emerging markets would do well on a relative basis compared to similar investment opportunities in G7. The search for yield and the risk tolerance that boosted flows into emerging markets was to some extent a late cycle phenomena, which only came years after the turning point in EM fortunes back in 2001/2002. Hence, distressed opportunities in G7 are likely to see renewed investor interest first, and only eventually, EM.
- **Commodity prices should turn the corner first and at least not be a drag on EM globally over the medium term.** The third pillar of the EM bullish story over the last few years was commodity prices and as argued it was the removal of that pillar that finally triggered a wholesale questioning of the de-coupling thesis. Looking ahead, however, it can be argued that in a world of even below trend global growth

the outlook for commodities and especially energy is still supportive, i.e. investment into new supply is likely to be curtailed sharply. Hence, while asset prices overshoot, it looks more likely that commodity prices will be able a more supportive pillar going forward than has generally been suggested. This should benefit those emerging markets that are still important commodity exporters. Unfortunately, it only worsens the pressure on those emerging markets that are exposed significantly to the only gradual recovery in the G7 and that are also net energy importers.

### *What about the destination?*

There are at least three destinations for emerging economies worth to consider; the ideal, the bad one, and finally the likely one. Let's take the change in the cyclical environment as given and assume that we are in for a multi-year period of sub-trend global growth. Such a backdrop will increase the long-term challenges facing emerging markets and will allow those emerging economies that did go through "true" structural change to outperform.

- **The ideal destination.** This is fairly easy to agree upon. The ideal destination is hopefully one where as few as possible of the emerging market economies have gone through maxi devaluations, lost their fx reserves, defaulted, or had to introduce capital controls. Sovereign defaults are probably the least likely given the improvement in sovereign balance sheets, but will depend on how much of any individual country's corporate sector that the sovereign is forced to guarantee. Also the issue of the sovereign's willingness to pay, against a less supportive commodity price backdrop, is likely to re-emerge even though many of these sovereigns have the ability to pay. Given the extent to which a lot of the cyclical improvement was saved in 'rainy day' funds such as SWFs, these are now being deployed/depleted to avoid any large and ad-hoc rounds of fiscal tightening or rapid deceleration in growth. The ideal destination presumably also involves a renewed focus on structural reforms and improved surveillance. Pre-cautionary savings to avoid

similar shocks in the future will also be a welcome part of the ideal destination. Moreover, there will be a desire to pursue tighter links with the G7 either through outright joining their currency areas or through the permanent setting up of swaps lines with the Fed or intra regionally within Asia. What the recent deleveraging crisis presumably teaches emerging economies is that there is no such thing as too much reserves. The ideal destination also involves some form of reform of the IMF where it can play the role in truly filling the multi-lateral surveillance gap including an attempt at fully-fledged balance sheet analysis at a country level. Moreover, we have already seen the emergence of the G-20 as a credible forum for global debate and policy cooperation. Hopefully this will continue. If we reach the ideal destination it is still not business as usual in EM, but there is still business and investments that will be made. Policy makers will have learned from this second Asia-style crisis and tweak the functioning of global capital markets rather than a wholesale reform of them. Leverage and capital flows are unlikely to return quickly to EM even in this ideal scenario and EM has to adapt itself to a less benign growth scenario regardless.

- **The bad destination.** Presumably it is also quite straight forward for us all to agree on what could be a truly bad destination. Clearly such a destination has echoes of the 30s. Beggar-thy-neighbor capital controls could become the Smoot-Hawley tariff barriers of the 21<sup>st</sup> century. The IMF has no jurisdiction regarding capital account controls, which was a reform initiative that fell victim to the Asia crisis, and it is unlikely that some form of multilateral action could stop countries from unilaterally imposing capital controls if they risk running out of reserves, deposit flight, or see the wholesale withdrawal of interbank (and trade) lines. Given the size of outstanding interbank lines to EM of nearly USD2.5trn, the potential vulnerability to their withdrawal is significant and the foreign liabilities of EM as whole was at the end of Q2 in the vicinity of USD12.5trn with leverage running at a multi-year high going into Q3. In the bad destination, there would nearly be no distinction

between those EM countries that did their homework and saved and those that didn't, as the degree of deleveraging and policy contagion of capital controls would take the innocent bystanders with them. The IMF would be too small to help except for a handful of smaller EMs and the G7, subject to its own severe challenges, in this scenario would probably be mostly focused on itself. Unfortunately, if we arrive at the bad destination then the whole EM investment thesis is likely to be questioned again and we may see a scenario not unlike that of the lost decade in Latin America during the 80s.

- **The likely destination.** There are of course many potential destinations between the two extremes outlined above and the next few months will be critical in determining which destination we will end up closer to. The early realization that IMF resources are not sufficient (see Japan's announcement of being willing to augment these resources presumably for the SLF) is encouraging and hopefully will lead to rapid action to augment them. It is the G7's responsibility, and in its own self-interest, to extend the 'protection umbrella' provided by the Fed swap lines and IMF SLF to as many countries as possible. To some extent such swap lines are likely to also help countries that are only border-line sustainable for too long, but such support is far better than to risk not helping out an EM country that 'deserves' it. We may have time to resolve the border-line cases later, but for now there is a real need to coordinate on the good equilibrium outcome through active policy action as in the case of inaction the probability that we reach the bad destination would increase on a daily basis. Coordinated fiscal loosening, as we are starting to see, also reduces the tail risk of the bad destination, but emerging markets should err on the side of caution. Private sector financing is unlikely to be easily forthcoming in any likely scenario and while many EM economies believe that they are in a position now to pursue independent monetary and fiscal policies it is better that they wait to be sure than to be proven wrong by market action. G7 will have to do most of the heavy lifting on the stimulus front and seems to be already ready

to respond. If all the recent policy proposals are enacted and emerging economies err on the side of caution and avoid policy mistakes such as defending overvalued exchange rates we can be optimistic that the bad destination is avoided. Unfortunately, however, the ideal destination may already be unachievable given the size of the shock and the policy actions already undertaken.

## ***Conclusion***

The current turmoil involves the first real test of the emerging market investment thesis since 2001/2002. The shock to the system is much larger than anybody had anticipated and fortunately many emerging markets were extra-ordinarily prepared. Nevertheless, policy initiatives over the next few months will be critical in determining whether or not we are able to avoid a truly bad destination for emerging markets. Balance sheet mismatches were allowed to be built up for too long and now are unraveling at unprecedented speed, thereby challenging some of the best sovereign balance sheets. Less robust sovereign balance sheets are already succumbing to the stress and while the very advantageous cyclical environment supported a massive inflow into emerging markets almost regardless of fundamentals, the best we can hope for is that when the flows run out there is at least some discrimination between the macro-economic outlook for various emerging markets. While this is far from the ideal, it is a likely outcome and the IMF combined with the G7 have a vital role to play that emerging markets in the periphery are not forgotten.

Against the above backdrop the investment thesis into EM has to be re-thought. While there have been clear examples of structural improvements and improved policy making in emerging markets, the extent of those improvements were somewhat exaggerated by cyclical factors. Moreover, investments in to emerging markets that were sold on the basis of the uncorrelated nature of the asset class have to be revisited. It is an open question whether the asset class can be sold on the basis of any structural story over the next few years. Rather, it may be more about distressed opportunities and about country outliers that are truly out or underperforming

a fairly tepid global recovery. Moreover, there is a need for true balance sheet analysis to get away from the traditional analysis of just looking at the stock of FX reserves without fully taking into account the potential drains and capital flight. The IMF is well-placed to do this in the future, but there is no reason why individual countries couldn't publish their own estimates and analysis. As we have learned during previous crises, transparency is the first line of defence against contagion and there is still a lot to be done in this regards by both EM and the G7.

Given what is likely a consensus view on both the ideal and the bad destinations, there is reason to be constructive on the likely outcome of at least avoiding the worst. The target needs, however, to be firmly fixed on the ideal as any slippage risks a bad outcome with echoes of the depression coming back to the fore. Emerging economies would be well served by remaining cautious regarding any cyclical relief and still prepare for a worst-case-scenario. For the private sector, especially for the international investors, the current episode will leave them with little firepower in participating in any recovery rally and they can't necessarily be counted upon to provide any classic "catalytical" support. Rather the focus will shift back to the dedicated, mostly long-only, EM veterans who can pick up distressed assets on an unlevered basis and help the eventual recovery in the emerging economies.





## ***South Centre Calls for Revamping the Global Financial Architecture***

The financial crisis that originated in the United States a year ago has become a global financial crisis unprecedented since the Great Depression. Since mid-September financial markets have collapsed and the world is entering into possibly the worst recession of the post-Second World War period. The credit freeze has severely hit developing countries through increasing risk premia and a severe cut in financing, even of short-term commercial lending. Capital outflows from developing countries have generated a collapse of stock markets and exchange rates and a loss of reserves. Commodity prices have plunged and export orders are being cut worldwide. Even developing countries that were seen as relatively invulnerable to a recession in the industrial world are now feeling the strain.

The financial crisis has shown how dysfunctional the current international financial architecture is to manage the global economy of today, with its myriad of interconnections through which financial turmoil spreads across the world and with its revealed and significant regulatory deficit. In the 1980s, the debt crisis in Latin America, Africa and other parts of the developing world, and in the late 1990s the succession of the Asian, Russian and Latin American crises, had already revealed that something was deeply wrong with that architecture. The industrial world did not understand the need for serious rethinking of the governance of global finance. The fact that this time developed countries are at the center of the storm may now lead them into action. The call by some of them to engage in a reform of the current governance and convene a Bretton Woods II Conference is, therefore, most welcome.

The South Centre wants to join its voice in the call for revamping global finance, based on six lines of action:

1. *The process and institutional design that it develops must be inclusive.* We welcome the initiative of industrial countries but underscore that any discussion process must be inclusive, giving adequate voice to both industrial and developing countries, and to both large and small countries. The governance system that it designs must be based on *representative institutions*, not on any one ad-hoc grouping of countries, be it the G7, a G13 or a G20. We call in particular for a deeper involvement of the United Nations in any reform process, as it is the most representative global institution. Indeed, the follow-up to the Conference on Financing for Development to be held in Doha, Qatar, in late November and early December is the best occasion to launch a participatory process leading to a reform of the global financial architecture, with the backing and close collaboration of the United Nations and the Bretton Woods institutions. This process should include a discussion of the voice and representation of developing countries in international economic decision making and norm setting, as mandated by the Monterrey Consensus. So far the only reforms in this area were undertaken by the International Monetary Fund (IMF) and were extremely modest.

2. *The regulatory deficit of global finance must be corrected.* The magnitude of the current crisis is clearly associated with inadequate regulation and supervision of financial activities. Since the Asian crisis, it became an established criterion that financial liberalization must be accompanied by stronger prudential regulation and supervision. This principle has been applied in many parts of the developing world but was entirely disregarded in the United States, where further liberalization was accompanied by deregulation and weak supervision of financial intermediation.

The discussion on regulation must start by agreeing on basic regulatory principles. The first principle is that regulations must be comprehensive, to avoid the massive loopholes through non-banking intermediation that led to the current turmoil. This will

also include regulating the types of transactions that led to the current crises, particularly securitization and derivatives, and force all the markets to be open and transparent and thus limit over-the-counter operations. They should also have a strong counter-cyclical focus, thus avoiding excessive indebtedness (leverage) and force the accumulation of increasing capital and provisions (reserves) during booms. This should also imply that, when pricing assets according to their market value (mark-to-market pricing) to maintain transparency, the system must have mechanisms to avoid asset price bubbles from feeding into the credit expansion, and asset price busts from feeding into the credit squeeze (for instance, variable loan-to-value ratios through the business cycle). Reliance on the internal models of financial institutions, the major focus of Basel II, should be discarded. It has already shown how perilous it can be, and how the use of similar risk models by financial institutions can lead to greater instability. To these new principles we must add well established ones: restricting monopoly power, encouraging diversification and avoiding unsafe financial products. Suffice is it to say that even these well established principles were not followed in recent years.

Any system that is designed in this area should be based on a well functioning network of national and regional authorities (which is still missing in the EU) and include truly international supervision of financial institutions with a global reach. The IMF should *not* be at the center of the regulatory system. The BIS and the Basle Committee are better placed, but this would require a fundamental reform to broaden their membership and avoid two major problems that the Basle Committee has faced in recent years: the lack of representation of developing countries, and the excessive influence over regulation by large multinational banks. Alternatively, building on these institutions, a new Global Financial Regulatory Authority could be created.

3. *The IMF should be revamped.* Four essential reforms of the IMF should be part of the reform agenda. The first is the creation of a meaningful and truly global reserve currency, which could be based on the IMF Special Drawing Rights (SDRs). This would overcome both the inequities but also the instability that is

inherent in a global reserve system based on a national currency. Experience has indicated that this system is plagued by cycles of confidence in the US dollar and by periodic shocks due to policies of the reserve currency country that are adopted without any consideration of their international impact. A system based on competing currencies would also be inadequate, as it does not eliminate the inequities of the system (the unfair distribution of seigniorage powers and the need to transfer resources from the developing to industrial countries through the accumulation of foreign exchange reserves) and may be even more unstable, due to the volatility of the exchange rate among competing reserve currencies.

The second issue is the need to place the IMF at the center of global macroeconomic policy coordination, not the G7 or in fact any Group. This is the only way to give developing countries a voice on the issue. The multilateral surveillance exercise on global imbalances launched by the Fund in 2006 was an interesting step in that direction, but it has lacked binding commitment by the parties and an accountability mechanism.

The third issue is the need for the IMF to lend during balance of payments crises rapidly and without overburdening conditionalities, particularly when the sources of the crises are a rapid reversal of capital flows and a sharp deterioration in the terms of trade. This means putting in place a preventive credit line for capital account crises (such as the defunct contingency credit line) and making active use of the compensatory financing facility (which has not been used in recent years due to overburdening conditionalities) and of the Poverty Reduction and Growth Facility to manage the adverse terms of trade shocks faced by low-income countries. This implies that the IMF would act more like a central bank, providing liquidity in an agile way, the way central banks have actually been providing funds in industrial countries on a massive scale in recent months. In the case of the IMF, the financing for such liquidity could be counter-cyclical issues of SDRs.

The current IMF agreement does not commit countries to capital account convertibility and thus leaves them with full

autonomy to adopt capital account regulations, either to restrict excessive capital inflows during booms or to control capital flight during crises. The evidence of strong linkages through which both financial euphoria and panic are transmitted worldwide indicates that it would be wise to make more active use of capital account regulations. So, as a fourth issue, the reform effort should encourage the IMF not only to tolerate but actually to encourage and advise countries on what regulations to impose under given circumstances. Indeed, the regulatory structure that must be developed to manage financial stability in the global era should include provisions that apply to cross-border capital movements, such as: generalized reserve requirements on cross-border flows, minimum stay periods, and prohibitions to lend in foreign currencies to economic agents that do not have revenues in those currencies.

4. *A coordinated global macroeconomic policy package must be urgently adopted.* The global recession now under way calls for a strong policy response. This means a clear expansionary monetary and credit policies in all industrial countries (which is still missing in Europe) as well as expansionary fiscal policies. Developing countries should also be part of the solution, and should adopt equally expansionary policies. Those countries that have accumulated large amounts of foreign exchange reserves do have more room to maneuver to adopt these policies than they had during previous crises. For those who do not, this implies that it is essential to avoid the IMF conditionalities of the past, which forced developing countries to adopt contractionary macroeconomic policies.

This also means that a large increase in Official Development Assistance (ODA) to low income countries can play an important role to both combat poverty and contribute to the generation of aggregate demand at the global level. Additional ODA is particularly important to avoid contractionary policies in the poor countries in the face of a deterioration of their terms of trade due to the collapse of commodity prices.

Past crises have also shown that multilateral development banks can play an essential role when private financing dries up.

One particularly problematic issue during crises in developing countries is the curtailment of commercial credit available to exporters, which severely limits an essential mechanism through which countries can recover from crises. So, the launching by multilateral development banks of a large scale program of commercial lending should be at the center of the crisis response efforts. No conditionalities should be attached to these credit lines.

5. *An international debt court must be created.* The lack of a regular institutional framework to manage debt overhangs at the international level—i.e., a court similar to those created to manage bankruptcies in national economies, the decisions of which are legally binding—is one of the major deficiencies of the current international financial architecture. The system has relied in the past on ad-hoc mechanisms, such as the Baker and Brady Plans of the 1980s and the Heavily Indebted Poor Countries (HIPC) and the Multilateral Debt Relief (MDRI) Initiatives since the mid-1990s, or on traumatic individual debt renegotiations. The problem of all these mechanisms has been that they generally come too late, after high indebtedness has had devastating effects on countries. Conditionalities have also been a significant source of problems for several poor countries in the case of the HIPC and MDRI and must be immediately lifted to allow those countries to benefit from these Initiatives. The only regular institutional mechanism is the Paris Club, which deals exclusively with official financing but must overcome its traditional reliance on sequential debt rescheduling, which again means that excessive debt hangs on countries for excessively long periods. The discussion of the new international financial architecture should solve this problem by creating an international debt court, which would serve both as mediator and eventual arbitrator of both public and private sector international loans.

6. *The system must rely more broadly on regional institutions, and developing countries should actively cooperate to create them.* In all of the areas of reform, the IMF should make more active use of regional institutions, such as the Chiang Mai Initiative or the Latin American Reserve Fund, and support their creation

in other parts of the developing world. Indeed, the IMF of the future should be seen as the apex of a network of regional reserve funds –that is, a system closer in design to the European Central Bank or the Federal Reserve System than to the unique global institution it currently is. This is also the system in place in the case of multilateral development banks. A similar institutional design could be adopted for prudential policies or for the international debt court. A denser network of institutions seems better adapted to a heterogeneous international community, and it is likely to provide better services and give stronger voice to smaller countries.

The developing countries are in an excellent position to contribute to this task, given their large foreign exchange reserves. Using those reserves more actively for swap arrangements among central banks, pooling them in reserve funds, or using them to support the development of regional bond markets are all mechanisms to multiply the room to maneuver that they provide. These reserves and existing sovereign wealth funds could also be used to multiply the creation of multilateral development banks owned by developing countries, and by investing in the capital and bonds issued by such institutions. A network of multilateral development banks is already in place, though unevenly developed in different regions of the developing world. The multiplication and growth of these institutions is fertile ground for South-South cooperation.

## **ISSUED BY BOARD MEMBERS OF THE SOUTH CENTRE**

**Benjamin William MKAPA**, President of Tanzania (1995-2005), Chairman of the Board

**Chief Emeka ANYAOKU**, Nigeria

**Norman GIRVAN**, Jamaica

**Abdul MINTY**, South Africa

**Deepak NAYYAR**, India

**José Antonio OCAMPO**, Colombia

**Zhaoxing LI**, China

**Leticia Ramos SHAHANI**, Philippines

**Yousef AL ZALZALAH**, Kuwait

**Bagher ASADI**, Iran

South Centre is an intergovernmental policy think tank of developing countries.

For more information, visit [www.SouthCentre.org](http://www.SouthCentre.org)





# ***Will the Crisis Trigger a Revival of The IMF?***

*by Jean Pisani-Ferry*

As recently as a few weeks ago, a widely held view was that the IMF had lost its relevance in a world of increasingly free capital mobility where the financing needs of more and more developing countries were covered by capital markets. At the same time its legitimacy was at stake as a large part of the developing world openly questioned the sincerity of its advice and the structure of its governance. Even the governor of the Bank of England, Mervyn King, echoed the queries, commenting that “the Fund’s remit is unclear. Its lending activities have waned, and its role in the international monetary system is obscure” (King, 2006).

Suddenly, however, calls for a “new Bretton Woods” have again put the Fund at the centre of the discussions on the reform of global financial and monetary arrangements. This note discusses the main challenges it faces and some options for reform<sup>1</sup>. Its main conclusion is that while the financial crisis and the revival of international cooperation put an end to existential questioning about the future of the Fund, it is unlikely to recapture the central role it once had and must rather adapt to a fragmented and changing landscape.

## ***1. A changing landscape***

What a difference a year makes! Among officials gathered

<sup>1</sup> This note is based on remarks prepared for a panel organised by the Per Jacobsson Foundation in Washington, DC, on 12 October 2008. The transcript of the panel discussion with Andrew Crockett, Stanley Fischer, Trevor Manuel and Raghuram Rajan can be found on <http://www.imf.org/external/np/tr/2008/tr081012.htm>. I thank Martin Kessler for assistance in the preparation of this note and Ignazio Angeloni and Stéphane Rottier for comments on an earlier draft.

in Washington for the Annual Meetings of the Fund and the Bank there was noticeable anxiety about the state of the world economy, but also palpable relief about an institution that had just completed a major downsizing and whose relevance had been openly questioned. Several reasons can be given for this change of heart:

- The need for assistance is rising again. The sudden rise of sovereign bond spreads and reversals of capital flows are hurting emerging countries that had previously enjoyed unrestricted access to cheap private capital. Furthermore, while there were until recently many potential substitutes for the IMF, such as regional powers and regional development banks, in the current environment of high risk aversion the Fund is the only institution able to elicit market confidence in the quality of policy in countries suffering from sudden stops. The IMF is thus likely to regain its central role in the provision of conditional assistance to countries in crisis.
- The IMF has the best expertise on financial and banking crises. No other institution in the world has first-hand experience of the variety and the common characteristics of the problems encountered in financial crises. No other institution has accumulated similar expertise on the resolution of such crises<sup>2</sup>.
- The current financial crisis has triggered an unprecedented call for coordination at global level, as illustrated by the remarkable degree and speed of convergence of the G7 countries (and soon afterwards of the International Monetary and Financial Committee) on the response to the crisis. Governments had started to be pulled apart by national politics, but markets have forced them to hang together and converge on a common template in spite of political and institutional differences. Having been much despised in recent years, international policy coordination is experiencing a revival.
- Last but not least, the IMF has (re)gained intellectual

<sup>2</sup> This is best illustrated by the comprehensive data assembled by Laeven and Valencia (2008).

credibility. The Global Financial Stability Report (GFSR) of April 2007 accurately described the first stages of the crisis that unfolded four months later. The GFSR of April 2008 estimated the losses at a level (about a trillion dollars, which proved to be a conservative estimate) which suggested that the ad-hoc solutions contemplated by governments would not do the job. The April 2008 World Economic Outlook (WEO) was markedly more pessimistic than forecasts by national governments and was widely criticised for that. In retrospect it was right – even not pessimistic enough.

## ***2. Lingering questions***

It would, however, be misleading to consider that questions and doubts about the role of the Fund were only the result of an exceptional period and that, as the ‘Great Moderation’ is now over, it will naturally regain the attributes of its past glory. In the medium term, four factors that are likely to persist raise questions about the Fund’s future mission.

- There will be a continuing need for an institution in charge of conditional financial assistance. But even though there will be many more countries under Fund programmes in 2009 than in 2007 – including, for the first time in a decade, an advanced country – some of the factors behind the observed drop in the number of financial crises in the 2000-2007 period (Figure 1) are likely to be persistent.

To start with, the quality of domestic policy institutions in the emerging and developing world has been strengthening continuously, as indicated for example by the status of central banks, and the quality of policies has been improving too. As an illustration, in 2007 only 5% of the countries in the world had inflation above 15% as against 18% of countries in 1997 and 28% in 1987. For sure, this is no guarantee against policy mistakes, but this certainly diminishes their probability.

Second, many countries in the world are better self-insured than they were. Over the last ten years, the median reserve ratio has grown from 10% of GDP to

20% of GDP – essentially because reserve ratios have been rising in the developing and emerging world. Even though these improvements have often given rise to complacency – as illustrated by vulnerability to inflationary shocks and the fact that a number of countries have recently been taking risks with current account deficits of unprecedented magnitude, in the medium

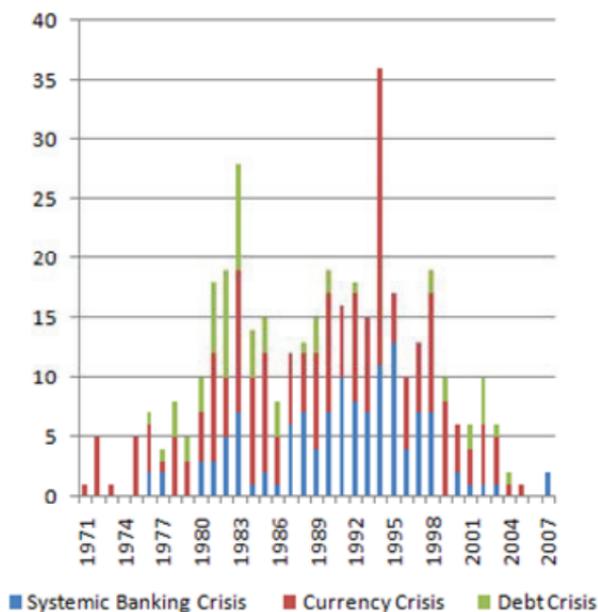


FIGURE 1: ANNUAL NUMBER OF FINANCIAL CRISES, 1970–2007  
SOURCE: LAEVEN AND VALENCIA (2008)

term it is far from certain that there will be a return to the frequency of crises observed in the 1980s and the 1990s. The need for conditional financial assistance will remain, but it is probably still on a declining trend.

This does not mean that the role of the Fund in this respect is unimportant, nor that the revamp of its facilities is unnecessary. But conditional financial assistance function is too specific, and in the medium term the countries in need of it are likely to be too few, for this role alone to justify putting the IMF at the centre of the world international financial and monetary architecture.

- Surveillance is handicapped by the rise of giants and by doubts about the adequacy and legitimacy of Fund advice.

Bilateral surveillance retains a role for small and medium-sized countries but the litmus test is whether the Fund is able to speak truth to large players such as the US, the EU or China – and be influential. On this criterion, the IMF has not performed well in recent times. Even though its analysis was accurate, nobody can remember what exactly the Fund told the US government about credit risks and policy responses, and this is going to diminish its ability to exercise surveillance in the years to come<sup>3</sup>. This did not escape the Chinese authority, as indicated by Deputy Governor Yi Gang's statement at the International Monetary and Financial Committee<sup>4</sup>.

The same can be said of exchange-rate surveillance. In 2007, at US insistence, the IMF revised its principles for exchange-rate surveillance, which dated back to 1977. The purpose of the revision was to give it the possibility to slate countries whose exchange policies contributed to 'external instability'. But the only significant result of the revision of the decision on exchange rates has been to weaken the authority of the Fund itself: after having been too shy to resist US pressure, it has been too shy to criticise China.

Finally, multilateral consultations, though an innovative initiative, have not delivered much more than the rehearsal of previously stated positions. To assemble China, the euro area, Japan, Saudi Arabia and the US at the same table was an achievement, but the exercise lacked

<sup>3</sup> Its task was complicated by the fact that the US was among the few countries to refuse to accept a Financial Sector Assessment Programme (FSAP) by the Fund

<sup>4</sup> "The lack of effective surveillance of the reserve currency issuing countries and their weak financial policy discipline has resulted in [...] difficulties for other countries in preserving macroeconomic stability and boosting growth while posing serious risks for global economic and financial stability [...] The Fund must draw lessons from the crisis and take corrective measures to enhance its surveillance over the developed countries – especially the reserve currency issuing countries [...]" (Yi Gang, 2008).

ownership, and in the end the result was disappointing.

Summing up, what will remain of surveillance in the last decade is most probably that, against the background of a credit boom of rare magnitude, massive capital flows from poor to rich countries, the build-up of colossal reserves, and enduring controversies over exchange rates, the Fund has not been able effectively to exercise its mission to ‘oversee the international monetary system in order to ensure its effective operation’.

- The oversight of capital markets regulation is a major task for the years ahead. It will certainly be given priority on the agenda for global financial reform. However, in the main advanced countries this role has been taken over by the Financial Stability Forum (FSF) after its creation in 1999.

This is a surprising development because the FSF is nothing but an ectoplasm. It has no legal status, no structure, no power and no staff, yet it has become the core institution where the agenda for financial regulators in the advanced countries is set and its recommendations have been followed through. In recent times it has been able to define, promote and monitor a coordinated response to a series of regulatory challenges raised by the financial crisis<sup>5</sup>.

This is a major challenge for the Fund, and not only on account of the potential turf battle. The FSF is in many respects the exact opposite of the Fund. Its effectiveness results from the political mandate given by the G7 but also from its informality and versatility. National authorities – governments, central banks and regulators – are willing to cooperate within it because their participation in it does not involve any formal transfer of power. So an informal club can succeed where an institution with nominally formidable powers has not – at least as long as the number and diversity of participating countries remains limited.

- Politics are increasingly difficult. Ever since the Asian crisis,

<sup>5</sup> Angeloni (2008) provides a discussion of the record of the FSF in comparison to the lack of significant achievements at European level.

the Fund has been struggling to regain political legitimacy. Put simply, its job was easy when, backed by the only superpower and a powerful group of like-minded countries, it was giving advice to medium or small-sized countries whose economic policies were of debatable quality. Those days are gone. Beyond the accusation that its advice may be questionable and the suspicion that it does not apply the same yardstick to all countries, the deeper problem is that the Fund is now torn between the G7 and the developing countries. To regain the legitimacy lost in the developing world it needs to distance itself from the G7, but it cannot afford to lose the support of the advanced countries which still form the majority of its shareholders.

The upshot is therefore that the need for closer market oversight and strengthened international cooperation does not automatically translate into a broader mandate for the Fund.

### ***3. A pragmatic agenda***

Against this background, how can the Fund reinvent itself and what should it now do?

- It must first adapt to a changing institutional landscape. The view is sometimes expressed that the ‘new Bretton Woods’ agenda implies that the IMF should again become the leading global economic and financial institution. However the centrality of the IMF is gone. Michel Camdessus’ dream of transforming the International Monetary and Financial Committee (IMFC) into the governing structure for the world economy is beyond reach<sup>6</sup>. There is certainly a role for a reformed IMFC in the governance of the Fund, but it is unlikely to substitute any of the existing or would-be ‘G’s’. Robert Zoellick spoke in a recent speech of a new ‘Facebook for multilateral economic diplomacy’, and this telling image indicates how much the world has changed since the days of Bretton Woods. The existing G’s and

<sup>6</sup> The roots of this view can be found in Art. 12, Section 1 of the IMF’s Articles of Agreement, which states that the Fund shall have a Council if so decided by an 85% majority of its members.

other ad-hoc groupings are likely to remain and new ones are about to be created such as the G14 or the ‘Steering Group’ advocated by Zoellick himself. Instead of dreaming of a return to the good old days, the objective for the IMF should be, as it were, to make friends on Facebook, ie to provide expertise and support to the G’s. It is the institution that can bring analytical and policy consistency to what otherwise risks being a loose system of governance. This was alluded to by Dominique Strauss-Kahn (2008) in his speech at the Bruegel/Peterson conference on Friday 10 October, and there are rumours of Italian ideas to enlarge the G7 and use the IMF as a supporting institution.

- It must support the G’s, and rely on them, to foster multilateral surveillance. The lessons from recent years is that the Fund has been unable to exercise its surveillance mission effectively. The question is what reforms would make it better able to exercise it in the future. There are two different issues here.

One is who should be in charge of the policing of exchange rates, if and when needed. This is probably an issue of the past, and a rather narrow one to start with, but one that has mobilised much time and diplomatic effort in recent years. The reason why the Fund has been unable to come up with a clear statement goes beyond the obvious political fact that as an institution, it cannot afford to side with the US and antagonise China. If the Fund is formally to determine whether an exchange rate is manipulated – ie to exercise quasi-judicial powers and thereby open the way to the filing of complaints at the World Trade Organisation – it needs quasi-judicial procedures. The model here should be the WTO, whose decisions on trade conflicts are taken by independent panels. Without such powers, the role of the Fund should instead be to provide analyses and recommendations to the relevant G in order for it to hold evidence-based discussions.

The other issue is how best to provide overall diagnoses and assessments of the situation and policies of the major players – including on exchange-rate related matters but more fundamentally on the broader set of policy choices. This is certainly an issue of major relevance for the short

term. With the need for urgent action the degree of coordination and convergence has increased dramatically within Europe and among G7 countries. It is unlikely to stop there. A few months ago we were all worrying about the commodity price boom and the implications of fast-growing food and energy demand in emerging countries. Markets are now pricing a global recession, the response to which is bound to require global policy action and involve emerging as well as advanced countries. The IMF can play a key role in supporting coordination within the Gs through analysis and proposals. To borrow Mervyn King's image, it should here play the role of the cricket umpire and tell the truth to the players in order to give a sound basis to the discussion among them.

- It needs to improve its procedures for country surveillance. It is often argued that there is no need for Fund surveillance of national policies anymore. This is disputable. Even advanced countries can benefit from external advice and IMF reports can trigger policy discussions within them. It could conceivably even go further. For example, an important issue for the years to come is how governments can credibly anchor their fiscal policies in the medium term. They will need considerable flexibility in the short term to respond to the recession but this will entail the risk of markets questioning their sustainability. Domestic rules and institutions are often weak. One could imagine that countries would draw benefit from voluntarily submitting themselves to IMF oversight in order to lend credibility to their commitment until they get back to a normal position.

The main issue is rather the Fund's ability to speak up, ie to emphasise the key conclusions of its analysis and bring them to the attention of national policymakers. This relates to governance. As observed in the Independent Evaluation Office report (IEO, 2008), the Board has both supervisory and executive roles, and there tends to be confusion between the two roles. Specifically, why should the Board decide on analysis? This is not best practice and, furthermore, the IEO report points out that on average only 4 out of 24 Executive Directors attend Board meetings where Article IV

reports are discussed. Rather, there should be a distinction between expertise and recommendations, which would imply having staff analysis released under the responsibility of management, as for the WEO and the GFSR.

- Macro-financial surveillance is new territory. With the Financial Sector Assessment Programmes (FSAPs) and the GFSR, the Fund has gained leadership in a field whose importance is underlined by all observers (see for example Brown, 2008). It does can draw on a wealth of experience with the GFSR and the WEO to transform itself into the key institution in charge of linking macroeconomic analysis and financial surveillance. It does face a potential competitor in this field, the Bank for International Settlements (BIS), but the BIS is a central banks' club and the role to be played here goes beyond the remit of central banks. However it faces three problems.

The first is the magnitude of the intellectual and policy challenge. The consistency between financial stability and macroeconomic assessments remains limited. It has been observed, not least by the IEO, that there was much too little use of the results of FSAPs in the Article IV consultations. Also, the consistency between the GFSR and the WEO is an issue. These are methodologically difficult but solvable problems, which primarily require investing resources to address them.

The second problem is that the Fund has a comparative advantage in linking macroeconomic and financial developments but not in the analysis of market developments: it is certainly an institution with a perspective on financial markets but one that primarily speaks to governments. Unlike the central banks it does not have an established channel of communication with the markets. It can hire people with market expertise but does not do business with market participants.

The third problem is implementation, which in most cases implies action by national regulators and/or international regulatory bodies. The Fund has limited regulatory powers and it is unlikely to accrue many. It should rather act

through the existing regulators and their groupings. As far as advanced countries are concerned, this means the FSF and the Fund should therefore find ways to develop cooperation with it – potentially through serving as the FSF’s secretariat.

Provided these problems are addressed, the Fund could gain a significant role as the key institution that links analysis of macroeconomic and financial developments and draws implications for macrofinancial supervision, relying on others such as the FSF for implementation.

In conclusion, the IMF faces the difficult task of redefining its role in a world economy that is undergoing profound political and economic change. It has done so several times in the past – when the fixed exchange rate system broke down, when the Latin American debt crisis erupted, or when communist countries started their transition, to mention only three prominent examples. For this even more challenging transformation, it can rely on strong assets – its wide membership, its governance, the quality of its expertise, its intellectual credibility, the continued need for financial assistance. But it needs to display a combination of modesty and boldness that, in the past, has not always been a defining characteristic of the institution.

## *References*

- Angeloni, Ignazio (2008), ‘Testing Times for Global Financial Governance’, Bruegel Essay and Lecture Series n°3, October, <http://www.bruegel.org/Public/PublicationPage.php?ID=1170>
- Brown, Gordon (2008), ‘An International Programme for Strengthening the Global Financing System’, mimeo, October.

Independent Evaluation Office of the IMF (2008), 'Governance of the IMF: An Evaluation', [http://www.ieso-imf.org/eval/complete/eval\\_05212008.html](http://www.ieso-imf.org/eval/complete/eval_05212008.html).

King, Mervyn (2006), 'Reform of the International Monetary Fund', Speech at the Indian Council for Research on International Economic Relations, New Delhi, February, <http://www.bankofengland.co.uk/publications/speeches/2006/speech267.pdf>.

Laeven, Luc, and Fabian Valencia (2008), 'Systemic Banking Crises: A New Database', IMF Working Paper n° 08/224, September, <http://www.imf.org/external/pubs/ft/wp/2008/wp08224.pdf>.

Strauss-Kahn, Dominique (2008), speech at the Bruegel/Perterson Institute conference, <http://www.imf.org/external/np/speeches/2008/101008.htm>.

Subramanian, Arvind (2008), 'A master plan for China to bail out America', Financial Times, 7 October, <http://www.iie.com/publications/opeds/oped.cfm?ResearchID=1016>.

Yi Gang (2008), Statement at the XVIIIth meeting of the IMFC on behalf of People's Republic of China, October.

Zoellick, Robert (2008), 'Modernizing Multilateralism and Markets', Speech at the Peterson Institute, 6 October, <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21927552~pagePK:34370~piPK:42770~theSitePK:4607,00.html>





# ***Ten Fundamental Issues in Reforming Financial Regulation and Supervision in a World of Financial Innovation and Globalization***

*by Nouriel Roubini*

U.S. Treasury Secretary Hank Paulson recently presented his proposals for a reform of the system of supervision and regulation of financial markets following the most severe – and still ongoing – financial crisis in the U.S. since the Great Depression. And soon the Draghi Commission within the Financial Stability Forum will report its conclusions and proposals for reform of the financial system to the G7 Finance Ministers.

To understand whether the U.S. Treasury proposals make sense one should first analyze what are the problems that an increasingly complex and globalized financial system faces and what are the shortcomings of the current system of financial regulation and supervision, in the U.S. and around the world. Only a detailed consideration of such problems and shortcomings can lead to the recognition of the appropriate reforms of the system. So, let us consider in more detail such problems and shortcomings of the financial system and of its regime of regulation and supervision. They can be summarized in ten points or issues.

First, the system of compensation of bankers and operators in the financial system is flawed as it is a source of moral hazard in the form of gambling for redemption. The typical agency problems between financial firms' shareholders and the firms' managers/bankers/traders are exacerbated by the way the latter are compensated: since a large fraction of such compensation is in the form of bonuses tied to short-term profits and since

such bonuses are one-sided (positive in good times and, at most zero, when returns are poor) managers/bankers/traders have a huge incentive to take larger risks than warranted by the goal of shareholders' value maximization. The potential solutions to this gambling for redemption bias are varied: restricted stock that has to be maintained for a number of years; or a pool of cumulated bonuses that is not cashed out yearly but that can grow or shrink depending on the medium-term returns to particular investments.

But even leaving aside the problem of how to change such compensation in a highly competitive labor market for talent in the financial sector, it is not obvious that the suggested solutions would fully work: for example in the case of Bear Stearns about 30% of the firm was owned by its employees and such employees had restricted stock. However this system of compensation did not prevent Bear Stearns from making reckless investment that eventually made it insolvent. Possibly this was the case because the individual compensation was not tied to the individual investment/lending decision. Still, the appropriate system of compensation of bankers/traders should be evaluated as this is now an important factor that distorts lending and investment decisions in financial markets.

Second, the current models of securitization ( the "originate and distribute" model) has serious flaws as it reduces the incentive for the originator of the claims to monitor the creditworthiness of the borrower. In the securitization food chain for U.S. mortgages every intermediary in the chain was making a fee and eventually transferring the credit risk to those least able to understand it and bear it. The mortgage broker, the home appraiser, the bank originating the mortgages and repackaging them into MBSs, the investment bank repackaging the MBSs into CDOs, CDOs of CDOs and even CDO-cubed, the credit rating agencies giving their AAA blessing to such toxic instruments: each of these intermediaries was earning income from charging fees for their step of the mortgage intermediation process and transferring the credit risk down the line to other investors.

One possible solution to the lack of incentives to undertake

a proper monitoring of the borrowers would be to force the originating bank and the investment bank intermediaries to hold some of the credit risk, for example in the form of their holding some part of the equity tranche in the CDOs or holding some of the MBS that they originate. But it is not obvious that such solutions would fully resolve the moral hazard problems faced by financial intermediaries. In fact, while the securitization process implied a partial transfer of the credit risk from the mortgage originators and the managers of the CDOs to final investors the reality is that – even with widespread securitization – banks and other financial institutions maintained a significant exposure to mortgages, MBS and CDOs. Indeed in the US about 47% of all the assets of major banks are real estate related; and the figure for smaller banks is closer to 67%. I.e. the model of “originate and distribute” securitization did not fully transfer the credit risk of mortgages to capital market investors: rather, banks, other financial institutions and broker dealers (for example Bear Stearns) did keep in a variety of forms a significant fraction of that credit risk on their balance sheet. Indeed, if that credit risk had been fully transferred such banks and other financial intermediaries would have not suffered the hundreds of billions of dollars of losses that they have recognized so far and the many more that they will have to recognize in the near future.

Thus, excessive risk taking and gambling for redemption did occur in spite of the fact that financial institutions were still holding part of the credit risk. So proposing that such institutions hold some of that risk – rather than try to transfer all of it – does not seem to be a solution that will fully resolve the problems deriving from the wrong set of financial incentives faced by bankers and from the poor risk management within financial institutions. If the fundamental problem is one of the moral hazard deriving from the way that bankers are compensated forcing financial institutions to hold more of the credit risk will not resolve the problem that led in the first place to the poor monitoring of the creditworthiness of the borrowers and to the poor underwriting standards.

Third, the regulation and supervision of banks and the lighter – on in some cases such as that of hedge funds non-existent –

regulation and supervision of non-bank financial institutions has led to significant regulatory arbitrage: i.e. the transfer of a large fraction of financial intermediation to non-bank financial institutions such as broker dealers, hedge funds, money market funds, SIVs, conduits, etc.

The problems with this financial innovation are twofold: first, some of the institutions in this shadow banking system (or shadow financial system) are systemically important. Two, most of these institutions are at risk of bank-like runs on their liabilities as they borrow in short-term and liquid ways, they are highly leveraged and they invest and lend in longer-term and more illiquid ways.

In the case of banks the risk of runs is significantly prevented by the existence of deposit insurance and by the lender of last resort support that the central bank can provide to depository institutions. Publicly provided deposit insurance is generally not warranted for non-bank financial institutions as the protection of small investors/depositors -who don't have the expertise to monitor the lending/investment decisions of banks -is not generally an issue for such non banks. But as the recent Bear Stearns episode as well as the run on and collapse of other members of the shadow financial system suggest bank-like runs on non-banks can occur and are likely to occur more often if such institutions do not properly manage their liquidity and credit risks.

While provision of lender of last resort support to non-bank financial institutions that are not systemically important is not warranted such support may be justified for the very few institutions that are systemically important. And indeed the recent Fed actions - \$30 billion rescue of Bear Stearns, and two new facilities that allow non-bank primary dealers to access the Fed's discount window and to swap their illiquid MBS products for safe Treasuries - imply that the lender of last resort support of the Fed has been now extended to systemically important non-bank institutions. This is the most radical change in monetary policy and in the role of the Fed since the Great Depression as the Fed is not suppose to lend to non-banks. Thus, if these systemically

important institution now benefits from the safety net of the Fed the same regulation and supervision that is applied to banks should also be applied to these systemically important financial firms, not just in periods of turmoil (as recently recommended by Hank Paulson) but on a more permanent basis. Otherwise the moral hazard distortions of such financial safety net would be serious and severe.

But if these institutions should be regulated like banks because they are systemically important and receive the Fed's lender of last resort support one cannot have a system where the regulation and supervision of a subset of non-bank financial institutions is different depending on whether the institution is systemically important or not. Otherwise regulatory arbitrage would lead financial intermediation to move from banks and systemically important broker dealers to more lightly regulated smaller broker dealers and other non-bank financial institutions.

Thus, while the safety net of the Fed and other central banks should remain restricted to banks/depository institutions and to – subject to some constructive ambiguity – systemically important non-banks, the regulatory and supervisory framework should be similar for banks and non-bank financial institutions: regulatory capital, type of supervision, liquidity ratios, compliance and disclosure standards, etc; they should all be similar for banks and other financial institutions. Otherwise regulatory arbitrage will shift financial intermediation and risks to other more lightly regulated institutions.

For example, the loophole that allowed SIVs and conduits to operate with little supervision and no formal capital requirements under the pretense that these were off-balance sheet units – when the sponsoring bank was providing large credit enhancements and guaranteed liquidity lines that made these units de facto on-balance sheet activities of the firm – was deeply flawed. Unless these and a whole host of other special purpose vehicles are regulated and supervised as if they were on-balance sheet units this type of regulatory arbitrage will lead again to the financial mess that the SIVs created.

Moreover, a comprehensive supervisory and regulatory regime that covers both banks and non-banks would also allow a better monitoring and assessment of systemic financial risks that, at the moment, are not properly supervised. Providing both regulators/supervisors as well as investors with the reporting and disclosure of information that allows an assessment of systemic financial risks will be essential to have a sounder financial system.

Poor liquidity risk management and the risk of bank-like runs on non-bank financial institutions has been shown to be a severe problem in the shadow financial system: the entire SIV/conduit regime has recently collapsed given the roll-off of their ABCP liabilities; hedge funds and private equity funds collapsed because of risky investments and redemptions or roll-off of short term credits; money market funds whose NAV fell below par had to be rescued to avoid a run on them; Bear Stearns collapsed because of poor credit/investment choices but also because of a sudden run on its liquidity. While banks have are fundamentally maturity-mismatched given their reliance on short-term deposits there is no reason for non-bank financial institutions to run large liquidity/rollover risk especially as they do not have deposit insurance and no access – apart from the systemically important ones -to the central banks' lender of last resort support.

Thus, an essential element of the common regulation of all non-bank financial institutions should be a greater emphasis given to the management of liquidity risk. Such firms should be asked to significantly lengthen the maturity and duration of their liabilities in order to reduce their liquidity risk. A firm that makes money only because it borrows very short, has little capital, leverages a lot and lends long and in illiquid ways is reckless in its risk management. Such firms should certainly fully disclose to their supervisors and investors the liquidity and other risks that it is undertaking. But it should also be required to reduce its liquidity risk with a variety of tools that ensure a greater liquidity buffer. Fourth, most regulatory and supervisory regimes have moved in the direction of emphasizing self-regulation and market discipline rather than rigid regulations. One of the arguments in favor of this market discipline approach is that financial innovation is always one or more steps ahead of regulation; thus, one need to

design a regime that does not rely on rigid rules that would be easily avoidable via financial innovation.

This market discipline approach is behind the reliance on “principles” rather than “rigid” rules, the reliance on internal models of risk assessment and management in determining how much capital a firm needs, the reliance on rating agencies assessments of creditworthiness, and a key element of the philosophy behind the Basel II agreement. But this model based on market discipline has been proven vastly flawed given that the way bankers are compensated; also, the risk-transfer incentives provided by the “originate and distribute” model implies that internal risk managers are effectively ignored in good times when “the music plays and you gotta dance”; similarly the conflicts of interests of rating agencies led to mis-ratings of new and exotic financial instruments.

Thus, while reliance on principles is useful to deal with financial innovation and regulatory arbitrage a more robust set of clear rules and regulations that go with the grain of principle-based regulation and supervision is also necessary. Strict reliance on market discipline has been proven flawed in a world where bankers are improperly compensated, where agency problems lead to poor monitoring of lending, where a flawed transfer of credit risk to those least able to understand it and manage it occurred, and where regulatory arbitrage was widespread and rampant.

Fifth, even before being fully implemented the Basel II agreement has shown its serious flaws: capital adequacy ratios that pro-cyclical and thus inducing credit booms in good times and credit busts in bad times; low emphasis on the importance of liquidity risk management; excessively low capital requirements given the serious financial risks faced by banks; excessive reliance on internal risk management models; excessive role given to the rating agencies and their ratings. These are serious shortcomings of the new capital regime for large internationally active banks and depository institutions.

To reform Basel II given the current severe financial crisis is

not an easy and simple task; but the urgency of this reform is undeniable. Particular importance should be given to: measures that would reduce the pro-cyclicality of capital standards, a factor that is a source of boom and busts in credit; and measures that increase – rather than decrease the overall amount of capital held by financial institutions. Indeed, recent history suggests that most financial institutions were vastly undercapitalized given the kind of market, liquidity, credit and operational risks that they were facing in an increasingly globalized financial system.

Sixth, by now the conflicts of interest and informational problems that led the rating agencies to rate – or better mis-rate – many MBS and CDO and other ABS products as highly rated are well known and recognized. Having a large fraction of their revenues and profits coming from the rating of complex structured finance products and the consulting and modeling services provided to the issuers of such complex and exotic instruments it is clear that rating agencies are ripe with conflicts of interests. Add to this the flaws of a system where competition in this credit rating market is limited given the regulatory barriers to entry and the semi-official role that rating agencies have, in general and in Basel II in particular; the potential biases of a system where rating agencies are paid by issuers rather than the investors; and the informational problems of raters that know little about the underlying risks of new complex and exotic instruments.

What are the potential solutions to these conflicts of interest and other problems in the rating business? Open up competition in the rating agencies market; drop the semi-official role that rating agencies have in Basel II and in the investment decisions of asset managers; forbid activities (such as consulting or modeling) that cause conflicts of interest; change the model of ratings paid by issuers rather than by investors; the free riding problem of having investors pay for ratings can be solved by pooling the investors' resources in a pool that can be used to collectively purchase the ratings. Certainly rating agencies have lost a lot of their reputation in this ABS ratings fiasco; and only serious and credible reforms – not just cosmetic changes – will be required to restore their credibility in the rating business.

Seventh, there are fundamental accounting issues on how to value securities, especially in periods of market volatility and illiquidity when the fundamental long term value of the asset differs from its market price. The current “fair value” approach to valuation stresses the use of mark-to-market valuation where, as much as possible, market prices should be used to value assets, whether they are illiquid or not.

There are two possible situations where mark-to-market accounting may distort valuations: first, when there are bubbles and market values may be above fundamental values; second, when bubbles burst and, because of market illiquidity, asset prices are potentially below fundamental values. The latter case has become a concern in the latest episode of market turmoil as mark-to-market accounting may force excessive writedowns and margin calls that may lead to further fire sales of illiquid assets; these, in turn, could cause a cascading fall in asset prices well below their long term fundamental value. However, mark-to-market accounting may also create serious distortions during bubbles when its use may lead to excessive leverage as high valuation allow investors to borrow more and leverage more and feed even further the asset bubble. In either case, mark-to-market accounting leads to pro-cyclical capital bank capital requirement given the way that the Basel II capital accord is designed.

The shortcomings of mark-to-market valuation are known but the main issue is whether one can find an alternative that is not subject to gaming by financial institutions. Some have suggested the use of historical cost to value assets (where assets are booked at the price at which they were bought); others have proposed the use of a discounted cash flow (DCF) model where long run fundamentals – cash flows – would have a greater role. However, historical cost does not seem to be an appropriate way to value assets. The use of a DCF model may seem more appealing but it is not without flaws either. How to properly estimate future cash flows? Which discount rate to apply to such cash flows? How to avoid a situation where those using this model to value asset subjectively game the model to achieve the valuations that they want as the value of the asset in a DCF model strongly depend on assumptions about future cash flows and the appropriate

discount factor? Possibly mark-to-market may be a better approach when securities are held in a trading portfolio while DCF may be a more appropriate approach when such securities are held as a long term investment, i.e. until maturity. But the risk of a DCF approach is that different firms will value very differently identical assets and that firms will use any approach different from mark-to-market to manipulate their financial results.

The other difficult problem that one has to consider is that any suspension of mark-to-market accounting in periods of volatility would reduce – rather than enhance – investors' confidence in financial institutions. Part of the recent turmoil and increase in risk aversion can be seen as an investors' backlash against an opaque and non-transparent financial system where investors cannot properly know what is the size of the losses experienced by financial institutions and who is holding the toxic waste. Mark-to-market accounting at least imposes some discipline and transparency; moving away from it may further reduce the confidence of investors as it would lead to even less transparency.

Some suggest that the problem is not mark-to-market accounting but the pro-cyclical capital requirements of Basel II; that is correct. But even without such pro-cyclical distortions there is a risk that financial institutions – not just banks – would retrench leverage and credit too much and too fast during periods of turmoil when they become more risk averse. Thus, the issue remains open of whether there are forms of regulatory forbearance – that are not destructive of confidence – that can be used in periods of turmoil in order to avoid a cascading and destructive fall in asset prices. But certainly solutions should be symmetric, i.e. applied both during periods of rising asset prices and bubbles (when market prices are above fundamentals) and when such bubbles go bust (and asset prices may fall below fundamentals). But so far there is no clear and sensible alternative to mark-to-market accounting. Eighth, the recent financial markets crisis and turmoil has been partly caused by the fact that the – over the last few years – financial markets have become less transparent and more opaque in many different dimensions. The development of news

exotic and illiquid financial instruments that are hard to value and price; the development of increasingly complex derivative instruments; the fact that many of these instruments trade over the counter rather than in an exchange; the fact that there is little information and disclosure about such instruments and who is holding them; the fact that many new financial institutions are opaque and with little or no regulation (hedge funds, private equity, SIV and other off-balance sheet special purpose vehicles) have all contributed to a lack of financial market transparency and increased opacity of such markets.

But private financial markets cannot function properly unless there is enough information, reporting and disclosure both to market participants and to relevant regulators and supervisors. How much reporting and disclosure -and to whom -is appropriate is a difficult question. But it is clear that for the last few years financial market have become excessively opaque in ways that are destructive of investors' confidence. When investors cannot price appropriately complex new securities, when investors cannot properly assess the overall losses faced by financial institutions and when they cannot know who is holding toxic waste securities risk (that can be priced) turns into generalized uncertainty (that cannot be priced) and the outcome is an excessive increase in risk aversion, lack of trust and confidence in counterparties and a massive seizure of liquidity in financial markets. Greater transparency and information – including the use of fair value accounting (that, in spite of its shortcomings, is still the best way to value assets) – as well as prompt recognition by financial institutions of their exposures and losses are essential to restore the investors' confidence in financial markets.

Some specific ideas on how to make new complex and exotic financial instruments more liquid and easier to price would be to make such instrument more standardized and have them traded in clearing house-based exchanges rather than over the counter. The benefits of standardization are clear as such standardization would allow to compare securities with similar characteristics and would thus improve their liquidity. Moreover, instruments that are exchange-traded through a clearing house would have much lower counterparty risk, would be subject to appropriate

margin requirements and would be appropriately marked-to-market on a daily basis.

Ninth, what are the appropriate institutions of financial regulation and supervision and the system of such regulation and supervision in a world of financial innovation and globalization? There are many alternative models that have different pros and cons.

An increasingly popular model is the one of a unique and centralized financial regulator and supervisor, as in the case of the UK's FSA where all financial policies – for banks, securities firms, other financial institutions, insurance companies, etc. – are under one umbrella. Another model is the US one where you have more than half a dozen or more of financial regulators and supervisors at the federal level and another layer of them at the state level. While some have argued that the US system because it foster beneficial competition about the best practices among different regulators the shortcoming of the US system, an incoherent set of overlapping regulators and a race to the bottom – rather than to the top – in terms of excessively deregulatory competition, have now become clear. One overall financial regulator may be too little but sixty plus of them is obviously way too many. A streamlining of such institutions and concentration of most regulatory and supervisory activities among a smaller number of institutions is certainly necessary.

Further, whether supervisory and regulatory power over banks – and possibly other systemically important financial institutions – should be kept within the central bank (as in the US) or whether it should be given to another regulator (as in the case of the UK FSA) is a difficult and controversial issue. Some worry that taking such powers away from the central bank – while maintaining its role as the lender of last resort -would reduce the ability of the central bank to oversee financial vulnerabilities in specific institutions and in the overall financial system (systemic risk). But as long as there is a proper exchange of information between the regulator and supervisor of banks and of other financial institutions and the central bank these informational issues can be properly managed. The UK debacle over Northern Rock was

caused not by the existence of a single financial authority (the FSA) but rather – in part – by the lack of coordination and proper information exchange between the FSA, the Bank of England and the UK Treasury. Thus, the UK model of a single financial regulator/supervisor is – in principle – superior to a model where such powers are fragmented among many and different institutions. But proper coordination and information exchange is essential to make this system work.

Tenth, and finally, reforms of financial regulation and supervision cannot be done only at the national level as regulatory arbitrage may lead financial intermediation to move to jurisdictions with a lighter – and less appropriate -regulatory approach. Indeed, the recent US debate on reforming capital markets was driven – before the current market turmoil – by the concerns that a tighter regulatory approach in the U.S. (say the Sarbanes-Oxley legislation) was leading to a competitive slippage of New York relative to London in the provision of financial services.

In a world of financial globalization, mobile capital and lack of capital controls capital and financial intermediation may move to more lightly regulated shores. While the idea of a global financial regulator – or a global financial “sheriff” – is for the time being a bit far-fetched a much stronger degree of coordination of financial regulation and supervision policies is necessary to avoid a race to the bottom in financial regulation and supervision and to prevent excessive regulatory arbitrage. Such international coordination of financial policies is currently occurring on a very limited scale and will have to be seriously enhanced over time. Certainly within the Eurozone a system where bank supervision and regulation occurs only at the national level while only the ECB would be able to provide lender of last resort support in the case of a systemic banking crisis or when a major systemically important cross-border institution gets into trouble is an untested model. Over time financial supervision and regulation within the Eurozone will have to move from the national level to a Eurozone-wide level.

Finally, how do the U.S. Secretary Paulson proposals for the reform of the financial system compare with the principles and

ideas for optimal financial regulation and supervision discussed above? An appropriate answer requires a detailed discussion that will be provided in the near future in this forum. But in brief summary, such proposals while representing a step forward – have many shortcomings and they overemphasize the role of self-regulation, market discipline and reliance on principles rather than rules that have miserably failed to deliver an appropriate regulation and supervision of the financial system. Given that we are still in the midst of the worst U.S. financial crisis since the Great Depression, a crisis that has shaken the foundations of modern financial capitalism, the current US Treasury proposals have significant shortcomings that don't address the core and structural financial risks and vulnerabilities that the current crisis has revealed.





# ***Global Financial Crisis and Restructuring the International Monetary System***

*by LI Ruogu, Chairman & President  
Export-Import Bank of China*

A stable and effective international monetary system is an important assurance for sustainable and healthy development of the world economy. The current financial tsunami urges that the world today need to reinvent a stable and rational international monetary system. Here today, I am pleased to take this opportunity to share with you some of my observations on this issue.

First of all, let me review briefly the development and evolution of the international monetary system after the World War II as well as its impacts on the world economy. In the beginning of the 20th Century, with the gradual withdrawal of the gold standard gradual from its historical position, the early financial and trade system collapsed after the 1929-1933 Great Depression and the subsequent World War II, bringing the world economy into a halt. In July 1944, in order to revive and reconstruct the global economic system, more than 700 delegates from 44 countries gathered at Bretton Woods in New Hampshire, the United States of America, setting up a US dollar-centered “double-link” currency system, under which the US dollar was linked to gold while other currencies were pegged to the dollar and became convertible to gold at an official rate of USD 35 per ounce.

The Bretton Woods System provided a universal standard for currency exchange and played a positive role in the postwar international trade and economic growth. The fact that the US

dollar became a major international reserve currency helped address the deficiency of the international settlement capacity and the shortage of international reserves arising from insufficient gold supply in the market at that time. The pegging of all other currencies to the US dollar contained exchange rate fluctuation and maintained currency value at a relatively stable level, which contributed to the commodities and capital flows around the world. The annual growth rate of global exports from 1948 to 1971 registered at 8.4%, compared with the one from 1913 to 1938 at a mere 0.7%.

Over this period, the United States provided substantive amount of US dollars through its financial aid, credit and importation of goods and labor services. As a result, it strengthened the global purchasing power and enabled recovery and reconstruction of the postwar world economy. In the meantime, the US dollar obtained its central position in the international monetary system. It also brought substantive benefits to the United States. Such as, one, it generated high seigniorage revenue for the US government. Second, it led to higher flexibility in the US economic policy and its greater tolerance of international payment deficits without immediate adjustment. Third, it facilitated the outflow of American commodities and capitals and supported external expansion in such fields as politics, economy, military and technical standards, which can hardly be calculated fully in monetary terms.

Nevertheless, the Bretton Woods System has its intrinsic limitations. The most fatal one lies in the instability resulting from the use of a national currency, namely the US dollar, as the major reserve currency. The paradox is that the development of the world economy and international trade demands for an increasing money supply for settlement and reserve, which can be sourced from long-term trade deficits of the US. The premise of the US dollar acting as major international currencies requires the United States to be a country of long-term trade surplus or balanced international payments to ensure a stable and strong dollar. These two requirements are contradictory with accordance to the theory of Triffin Dilemma.

For this reason, after series of crises of US dollar in the 1960s and 1970s, the Bretton Woods System completely collapsed. In 1971, the US Government de-linked its dollar from gold, and so began a new era of “floating exchange rate”. Although the US dollar no longer undertakes the role of gold exchange since then, it’s central position in the international monetary system still remains, and new unfairness and inequality begin to emerge into global economic activities, which are demonstrated in the following three aspects.

First, the US dollar issuing right is a matter of US sovereignty that no other country is entitled to interfere with. Dollar issuance, decided only by the needs of the US economy, exerts a strong influence on economies that hold US dollar-denominated reserve assets and the world economy at large. Despite varying economic cycles, other countries are forced to adjust their economic policies in line with those of the US. Massive supply of Euro dollars and Asian dollars arising from the US expansionary economic policy has resulted in more complexities and turmoil to the global financial market as well as rapid rise of financial speculation, which had undermined the market’s ability to serve the real economy. As a result, financial crises frequently broke out, and small and medium-sized economies suffered consequently.

Second, in order to protect themselves from crisis, countries with no other choice of international currencies have to hold US dollars in huge stocks to purchase US treasury and corporate bonds, which made all the money flow back into the US. In other words, the US is free to borrow from the world as much as it wants with disproportional repayment obligations. In addition, the US can alleviate its external debt burden, promote exports and improve its balance of international payments by devaluing the US dollar. Moreover, huge inflow of US dollars can push down interest rates and consequently reduce the financing cost of fiscal deficits to the effect of luring the US into adopting an expansionary monetary policy.

Third, given the lack of a convincing definition, the so-called “floating exchange rate” is only taken as a concept opposite to the “fixed exchange rate.” In fact, there should be a benchmark

for “floating”. However, due to the difficulty in identifying such a benchmark, the US dollar-centered exchange rate system constitutes one of the root causes for the frequent outbreak of financial crises.

Now, I would like to highlight the major problems plaguing the current international monetary system in the context of the ongoing global financial crisis. The current crisis started from the US and has soon swept across the world. Its force of destruction and rapid contamination has gone beyond most people’s expectation. As for the causes of this crisis, there have been many arguments within the academic circle and among governments, from which I summarize as follows.

First, it is a result of the US real estate bubbles. The US government has always given priority to home ownership. The two mortgage financiers, Fannie Mae and Freddie Mac, were founded for this purpose. In recent years, the easy monetary policy, rising property prices and accelerated asset securitization in the US have driven lending institutions to leverage on financial derivatives and extend mortgage loans to a population of lower credit rating and low solvency in the pursuit of high returns, which sowed the seeds for financial crisis.

Second, it is a result of the imbalance between the fast-growing financial innovation and the regulatory concept featuring an over-trust in market discipline. Factors such as the massive production of financial derivatives, the over estimated leverages ratio, and the lack of fair and objective standards in the rating system all contributed to the financial crisis this time.

Third, the US monetary policy should shoulder primary responsibility for the crisis. Since January 2001, the US has been pursuing an easy monetary policy coupled with tax cuts, subsidies and other incentives, which provided the market with a massive supply of low-cost money that directly led to the booming of the US real estate market. However, the interest rate hikes afterwards turned the bubble into burst.

Fourth and most importantly, debt-based consumption is above all the root causes of this crisis. Over the years, consumer spending

has been a major drive of the US economic growth and excessive consumer debt has brought about an economic boom based on a fragile financial foundation, especially when taking into account the very low domestic savings rate which dropped from 10.08% in 1984 to 4.6% in 1995 and further down to 1.8%, -0.4%, -1% and -1.7% between 2004 and 2007, respectively. These figures point to a huge debt bubble behind the economic prosperity in the US. In 2007, the outstanding liability of the US Government, residents and enterprises accounted for as high as 229.74% of its GDP, among which the share of residential debt obligations amounted to 100.30%. Therefore, when the asset bubble evaporated, the huge debt came to the surface and a crisis of insolvency broke out in the end.

Looking back at history, the US economic model has long been based on consumption and indebtedness, which has prevailed ever since the 1970s. Such economic model cannot sustain in any country, and yet it can find an explanation in the light of the current international monetary system. The largest difference between today's dollar standard system and the gold standard in the past lies in the fact that the US can freely print greenbacks as much as it likes to make external payments and satisfy domestic consumption needs without shouldering any obligation. Meanwhile, for developing countries, in their efforts to stimulate economy through exports, they gained massive dollar reserves based on US sovereignty credit, and then have to return these dollars back by investing in US financial assets. In this way, a global cycle of trade (goods)-finance (capital) is formed.

Frankly speaking, the ongoing crisis has revealed some serious flaws in the current international monetary system.

First, the unlimited issue of the US dollar as a reserve currency reflects in effect a "credit-based" standard, which enables the US to dump its dollars into the world economy freely, while repayment cannot be guaranteed due to the "floating exchange rate."

Second, the current international monetary system, which is based on the interest of few developed countries, lacks equal

participation and decision-making. The US, relying on its currency privilege, imposes seigniorage on all other countries, and spreads its risks worldwide through financial innovation. As a result, the whole world has to pay the bill for the US financial crisis without any other choice.

Last but not least, the current adjustment mechanism has its limitations. As the world central bank, IMF is short of both capital and authority. Its irrational voting system and institutional arrangement gives the US veto power. And the European Union as a whole has an even bigger say in votes than all the other members including the US, which in fact represents another veto. Consequently, it is impossible for IMF to pass any resolution against the interest of the US or Europe, which in turn deprives its the ability to monitor and discipline their economies.

Ladies and gentlemen,

The ongoing financial crisis is inflicting heavy losses on the world economy. With revealed irrationality and flaws in the current international monetary system, it also offers a good opportunity for system restructuring. As it is impossible to work out and adopt a feasible substitute within a short period of time, we still have a long way to go in the reform of the international monetary system.

In my opinion, the remonstrating process can be divided into two stages. For the first stage, the main target is both to control the US macro-economic policies and restrain its dollar issuance so as to prevent the US from returning to the previous track of employing monetary policy for economic recovery, an action that is likely to invite another round of economic bubbles. This demands both consensus and compromise among major countries. The US should seek for its economic recovery through restructuring, while other countries, especially the developing countries, should take gradual steps to reform their export-driven growth model. I'd like to suggest that this stage be completed within a not too long period.

For the second stage, the target should be to reconstruct international monetary system with a new order in international

finance that is more reasonable and fair. One of the core issues on the reform is the selection of standard currency for international reserves.

Currently, the financial circle has mainly proposed the following solutions to this issue: the return to the former gold standard; the restoration of the US dollar standard; the establishment of a commodity-reserve standard; or the reform of the special drawing rights, SDR, reserve basis.

The return to the former gold standard can help avoid excessive issue of currency and prevent the plundering on inflation tax and seigniorage by some individual countries. This system is also good in that it does not make use of the appreciation and depreciation of nominal exchange rate for protectionism. However, there is a fatal defect in gold standard, that is, the contradiction between the definite gold reserve and the indefinite economic growth will lead to sluggish growth and deflation of the world economy in the long run. Therefore, it is unlikely to pick up the gold standard that has been abandoned for half a century.

In terms of the US dollar standard, as there is no solution to the innate limitation of using one single currency as the reserve currency, practices have already proven that this system is not stable, which is testified by the current financial crisis. Similarly, it is also impractical to use a primary product as the currency basis. However, it might be feasible to reform the existing SDR into a payment currency in a real sense and further to substitute the dollar-dominant currency by “a basket of currencies” commonly accepted by all countries. To be more specific, a new Bretton Woods System focusing on “a basket of currencies” should be established. And of course, we need to discuss on the selection of that basket of currencies by taking into account of such factors as a country’s GDP, trade volume, reserves, population and share in the world market.

In reconstructing the international monetary and financial system, IMF should further strengthen its function and role as a pivotal multilateral institution, and should reform its own governance by improving surveillance and supervision over the

economic policies of major reserve-currency countries. This is another important aspect of the international monetary system reform.

First, the current distribution of quota and voting power in IMF is not reasonable enough.

On the one hand, the “basic votes” are giving way to those on the money basis. Since the establishment of the IMF, the total number of votes has grown by 37 times, while the share of the basic votes has dropped from 11.3% in 1944 to 2.1% in 2002, which indicates that the basic votes have almost lost their original function and effect.

On the other hand, the fund quota, the basis for the vote distribution, no longer reflects the change in the current international economic pattern. Instead, it fully demonstrates the dominance of developed countries in the IMF decision-making while neglecting the growing economic strength in the fund quota of developing countries including Brazil and China. Therefore, the quota needs to be re-allocated, and basic votes need to be expanded for developing countries, so as to avoid the veto of one country or one group (such as the EU).

Second, IMF should set down practical limits over member countries via supervision and regulation. For example, although Article IV of the IMF Article of Association covers most developed countries, IMF has no practical binding influence on the policy-making of these members. The global economic development demands for a more reasonable and fair environment. Therefore, no matter whether it is in the reform of the distribution of the votes and quota or in the effectiveness of its resolutions, the IMF has to take feasible, practical and workable measures that balance the interests and concerns of all parties.

The global economic development calls for a new order in international economy and finance. With China’s fast-growing economic strength, increasingly opened trade and finance and the improved financial environment, RMB is embracing

increasingly matured conditions for its regionalization and internationalization, and will definitely grow into an important currency in the international monetary system. At the same time, China will play a more active role in the reform of international financial system and make due contribution to the stable growth of the world economy.



# ***Restoring International Financial and Monetary Stability***

*by Jeffrey Shafer<sup>1</sup>*

Over the last eighteen months we have seen a financial unraveling, starting in the United States but now affecting most of the world's markets. This has no parallel since the early 1980s, if then. The focus of officials right now must be on stabilizing markets and economies by countering the acute liquidity crisis.

- Consumers and businesses are unable or unwilling to spend, so governments must spend.
- The private sector is unable or unwilling to provide capital or to lend so government must invest and lend.
- Some governments are constrained in their capacity to spend and to lend, so they need support from others.

These essential needs are recognized. Governments are acting, and they are acting with a high degree of cooperation. The main question is whether they are acting forcefully enough and rapidly enough. In this respect, the current inter-regnum in the United States is a problem. The details do matter – whom to support? How? And on what scale? But I will leave these questions to others on this program and turn to the issue of what to do after the crisis has been addressed to avoid another one on this scale.

Before sketching some thoughts on this, I do want to confess deep pessimism that future crisis can be completely avoided.

<sup>1</sup> The views expressed in this paper are those of the author and do not necessarily reflect those of Citi

Fundamental human nature lies behind the recurrence of excess followed by panic as long as there have been markets. Three problems recur:

1. People flock to where money is being made and take good businesses or good trades too far.
2. Underweighting of low probability losses of enormous magnitude seems to be a recurring problem. The root cause of this may be human nature, distorted incentives or both. Neither is perfectible.
3. It becomes increasingly difficult over time for financial authorities, who are also human, to restrain activities at which people seem to be making money and which are attracting more and more financial and human capital. In my professional life I have watched the excesses of Latin American lending, dotcom startups and sub prime lending. I was in the Federal Reserve System when it failed to respond effectively, despite considerable concerns, to curb Latin American lending in the early 1980s.

Such pessimism should not be an excuse for inaction. Officials must try to head off problems. Even if they only lessen the frequency or somewhat reduce the severity of financial crises following excess, better market oversight will have a huge return. And looking at what has failed, there are clearly ways to do better. But it is also important not to become complacent about financial stability and fail to maintain a strong and flexible emergency response capability. Just two years ago, many were questioning whether there was a continuing need for an IMF to deal with financial problems once they are upon us. Now we know we need a bigger and stronger IMF, and this old institution has demonstrated new flexibility in responding to problems that have developed in new ways. We will always need a strong and flexible emergency response capability.

### ***Building more effective financial supervision and regulation***

Last March, the U.S. Treasury released a Blueprint for a

Modernized Financial Regulatory Structure, which has been almost forgotten in the midst of battle after battle with immediate systemic threats. The Blueprint provides a complete and coherent conceptual framework for thinking about government supervision and regulation of the financial system. This framework divides government responsibilities for the financial system into three spheres:

- Business conduct
- Safety and soundness
- Market stability

Whether or not one concludes that each of these responsibilities should be undertaken by a separate official body with authority that spans all (national or global?) markets, focusing on how to be effective in meeting each of them is the right way to think about the problem. I will offer some thoughts on each of them, but I will concentrate on the third, about which there has been much superficial commentary, but nothing yet that has grappled with the fundamental problem of market stability – policies to further it involve intervening in, as well as monitoring the system, not just individual institutions. I have some thoughts on this that could point in the right direction.

### ***Business conduct***

One important lesson from the sub-prime mortgage crisis is that market practices require more regulation and oversight than they have received in the United States in recent decades. Two assumptions were used to justify very light-tough consumer protection – (1) that reputational risks were a sufficiently strong inhibitor of predatory behavior and (2) that consumers are capable of making informed, optimal decisions about complex financial matters even when confronted by sales people with an incentive to guide them to bad decisions. Both failed to hold up. Mortgage structures became so complicated that even a financially sophisticated person had trouble making a good decision, and borrowers in the sub-prime mortgage market were not financially sophisticated. We are learning that it was

not uncommon for people to be sold mortgages that were more expensive than others that they could have qualified for. And mortgage originators encouraged borrowers to misrepresent their qualifications or even did it for them. We in America have learned an expensive lesson: that people will be taken advantage of if the government fails to protect them. Consumer protection, investor protection and prevention of abusive trading practices must all be effectively implemented in the financial regulatory systems of the future.

### *Safety and Soundness*

Safety and soundness regulation has focused in the past on banks. This is because the market failure that is most often identified as requiring safety and soundness regulation is moral hazard. Banks have access to the lender of last resort, in many countries some or all deposits are guaranteed by the government, and, since some banks are too big or too critical to be allowed to fail, there is an implicit support that creates incentives for excessive risk taking. All of these government roles give rise to moral hazard. One critical issue that will have to be faced when the system is being put back together is how much more moral hazard will have been created as a result of actions taken in the midst of crisis, where will it distort behavior and what new supervision and regulations is therefore called for. Clearly institutions that were not seen before as within the protection of governments now are.

The Treasury seems to see moral hazard as the sole rationale for safety and soundness regulation. It is a critical reason to undertake it. But one can also make a case for safety and soundness regulation to deal with other market failures if taxpayers are going to receive the bill for failure. The discussion of the incentive distortions created by compensation systems is an example of this legitimate concern. There may be others and it would be a mistake to take a narrow view.

But supervision and regulation to ensure that risk management by individual institutions is appropriate and reflects the public's potential exposure is not an adequate response to the threat

of systemic risks. A system of individual institutions that have better risk management systems and higher capital ratios may be more stable. But the core systemic risks that led to the current crisis developed within institutions subject to state-of-the-art supervision. In retrospect, we can see many ways to improve this, but it would be naïve to think it could not happen again if other things are unchanged. The imbalances in markets created risk exposures for a broad spectrum of institutions that met individual safety and soundness standards.

### *Market Stability*

The present crisis is not mainly the result of institutions choosing to take on excessive risk. Rather they took on risks that were not seen – in sub-prime mortgages repackaged in CDOs, in SIVs, in auction rate securities, in leveraged loans, in CDS exposure and other areas. One fundamental problem was that funds flowed into hot areas – housing and LBOs. These flows accelerated into speculative finance conditions. A second fundamental problem was the assumed liquidity of positions, often highly leveraged, in what turned out to be crowded trades. Liquidity disappeared when institutions needed it. These systemic positions built up over a period of years in which monetary policy had been accommodative, actual and implied market volatility had reached record lows, and credit spreads narrowed to the point that even conservative investors were reaching for yield while believing they were not taking on significant risk.

There was a debate whether monetary policy should tighten in response to the house price appreciation. This was a debate about the appropriate monetary policy response to asset prices, which went back at least to the Japan bubble economy of the late 1980s. The view at the Fed, and I shared it at the time, was that its job was to set monetary policy so as to achieve an implicit inflation target over time. A central bank should not slow an entire economy and put people out of work when there is clearly a capacity for growth without accelerating inflation. It is hard to make the case for a more forceful conventional monetary policy response, even in retrospect. But this is not the only choice.

Monetary policy in normal times is conducted with one instrument – the supply of central bank demand liabilities or high-powered money. (In current distressed market conditions central banks are also directing the supply of high-powered money in an effort to compensate for market breakdown, but this reflects a need and opportunity created by very unusual market conditions. The lender-of last resort function can be thought of as simply the conduct of monetary policy in disrupted markets.) The one monetary instrument in normal times can be used to control either the quantity supplied—central bank demand liabilities—or its price – the interbank interest rate. With one instrument, the authorities can only pursue one objective. Sad historical experience has taught us that the core objective should be price stability, with limited scope for short-term tradeoffs against output. One could not direct monetary policy toward asset prices without giving up inflation control so long as one has only one instrument.

The key question in setting up a Market Stability Authority is whether there are additional instruments that are available on the shelf or can be developed to pursue the objective of curbing speculative finance or a buildup of liquidity risk in markets. Without policy instruments, all of the data collection and analysis that can be done will count for little.

There are, in fact, instruments in place now and others can be developed to enable the Market Stability Authority to affect markets. Two instruments were once thought of at least partly as cyclical financial market regulators but have fallen into disuse in the U.S. and most other countries as cyclical instruments: margin requirements on equity positions and reserve requirements on banks. (The PBOC has moved reserve requirements forcefully over the recent cycle and may well have given China a stronger banking system heading into more stressful times as a result.) A third existing instrument that has not been used cyclically is the Basel capital ratio. Not only has it not been used cyclically, but its design has made it strongly procyclical. Other instruments could be designed. One possibility is a maximum leverage requirement on fixed income positions (in effect, margin requirements) that are administrated anti-cyclically by a Market Stability Authority,

reversing the current procyclical behavior of risk managers under pressure from safety and soundness authorities.

The Market Stability Authority, whether lodged in the central bank or an independent institution, should be endowed with instruments to affect markets. Many of the candidates have a safety and soundness function as well, but the function can be divided. For example, there could be a base capital ratio (ideally one that was less procyclical in its administration than the current one) and a supplemental capital ratio that could be adjusted cyclically by the Market Stability Authority. The same approach could be followed on reserve requirements and margin requirements although there are less clear reasons for dual implementation of these.

It will be extremely important that the Market Stability Authority have powers to create instruments extending across the full range of the financial markets. If instruments constrain one part of the market and leave others parts unconstrained, financial intermediation will shift to the unconstrained markets and excessive risks will become concentrated there. This is what happened when the Eurodollar market grew up outside the reach of U.S. bank reserve requirements in the 1960s and 70s although this ended benignly when the Fed eliminated reserve requirements on competing domestic deposits in the early 1980s. It happened with sadder consequences when SIVs developed outside the Basel capital regime. And one could cite many other examples.

Should the market stability function be global or national? Although the effects of market stability problems can be felt globally, they have their source within currency areas, normally a country. Because of this and because of the lack of accountability and legitimacy of a true supra-national authority, the best road forward is to build Market Stability Authorities on a national level, with the Euro area a potential exception. Cooperation among authorities will be critical, as it is now among central banks. They may, at times, wish to act in concert. But they should act on their own authority.

I have merely sketched the outlines of the tools of a Monetary Stability Authority. There is a need for this function to be differentiated from traditional monetary policy, although there is a case for incorporating it within the central bank. In the wake of the current crisis it is critical to develop more fully the information requirements, analytical tools and instruments for the conduct of a Monetary Stability Authority to reduce the risk of a recurrence. There is a critical function to be carried out that has been missing in recent decades.



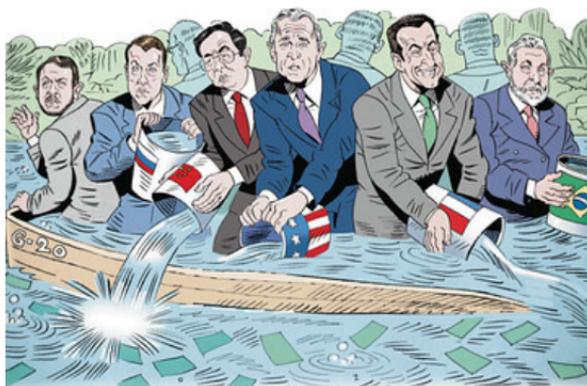


## ***Stable Money Is the Key to Recovery***

*How the G-20 can rebuild the ‘capitalism of the future.’*

*by Judy Shelton*

Tomorrow’s “Summit on Financial Markets and the World Economy” in Washington will have a stellar cast. Leaders of the Group of 20 industrialized and emerging nations will be there, including Chinese President Hu Jintao, Brazilian President Luiz Inacio Lula da Silva, King Abdullah of Saudi Arabia and Russian President Dmitry Medvedev. French President Nicolas Sarkozy, who initiated the whole affair, in order, as he put it, “to build together the capitalism of the future,” will be in attendance, along with the host, our own President George W. Bush, and the chiefs of the World Bank, the International Monetary Fund and the United Nations.



*MARTIN KOZLOWSKI*

One thing is guaranteed: Most attendees will take the view that Wall Street greed and inadequate regulatory oversight by U.S.

authorities caused the global financial crisis -- never mind that their own regulatory agencies missed the boat and that their own governments eagerly bought up Fannie Mae and Freddie Mac securities for the higher yield over Treasuries.

But whatever they agree to pursue, whether new transnational regulatory authority or globally mandated limits on executive remuneration, would only stultify prospects for economic recovery -- and completely miss the point.

At the bottom of the world financial crisis is international monetary disorder. Ever since the post-World War II Bretton Woods system -- anchored by a gold-convertible dollar -- ended in August 1971, the cause of free trade has been compromised by sovereign monetary-policy indulgence.

Today, a soupy mix of currencies sloshes investment capital around the world, channeling it into stagnant pools while productive endeavor is left high and dry. Entrepreneurs in countries with overvalued currencies are unable to attract the foreign investment that should logically flow in their direction, while scam artists in countries with undervalued currencies lure global financial resources into brackish puddles.

To speak of “overvalued” or “undervalued” currencies is to raise the question: Why can't we just have money that works -- a meaningful unit of account to provide accurate price signals to producers and consumers across the globe?

Consider this: The total outstanding notional amount of financial derivatives, according to the Bank for International Settlements, is \$684 trillion (as of June 2008) -- over 12 times the world's nominal gross domestic product. Derivatives make it possible to place bets on future monetary policy or exchange-rate movements. More than 66% of those financial derivatives are interest-rate contracts: swaps, options or forward-rate agreements. Another 9% are foreign-exchange contracts.

In other words, some three-quarters of the massive derivatives market, which has wreaked the most havoc across global financial

markets, derives its investment allure from the capricious monetary policies of central banks and the chaotic movements of currencies.

In the absence of a rational monetary system, investment responds to the perverse incentives of paper profits. Meanwhile, price signals in the global marketplace are hopelessly distorted. For his part, British Prime Minister Gordon Brown says his essential goal is “to root out the irresponsible and often undisclosed lending at the heart of our problems.” But if anyone has demonstrated irresponsibility, it is not those who chased misleading price signals in pursuit of false profits -- but rather global authorities who have failed to provide an appropriate international monetary system to serve the needs of honest entrepreneurs in an open world economy.

When President Richard Nixon closed the gold window some 37 years ago, it marked the end of a golden age of robust trade and unprecedented global economic growth. The Bretton Woods system derived its strength from a commitment by the U.S. to redeem dollars for gold on demand.

True, the right of convertibility at a pre-established rate was granted only to foreign central banks, not to individual dollar holders; therein lies the distinction between the Bretton Woods gold exchange system and a classical gold standard. Under Bretton Woods, participating nations agreed to maintain their own currencies at a fixed exchange rate relative to the dollar.

Since the value of the dollar was fixed to gold at \$35 per ounce of gold -- guaranteed by the redemption privilege -- it was as if all currencies were anchored to gold. It also meant all currencies were convertible into each other at fixed rates.

Paul Volcker, former Fed chairman, was at Camp David with Nixon on that fateful day, Aug. 15, when the system was ended. Mr. Volcker, serving as Treasury undersecretary for monetary affairs at the time, had misgivings; and he has since noted that the inflationary pressures which caused us to go off the gold standard in the first place have only worsened. Moreover, he

suggests, floating rates undermine the fundamental tenets of comparative advantage.

“What can an exchange rate really mean,” he wrote in “Changing Fortunes” (1992), “in terms of everything a textbook teaches about rational economic decision making, when it changes by 30% or more in the space of 12 months only to reverse itself? What kind of signals does that send about where a businessman should intelligently invest his capital for long-term profitability? In the grand scheme of economic life first described by Adam Smith, in which nations like individuals should concentrate on the things they do best, how can anyone decide which country produces what most efficiently when the prices change so fast? The answer, to me, must be that such large swings are a symptom of a system in disarray.”

If we are to “build together the capitalism of the future,” as Mr. Sarkozy puts it, the world needs sound money. Does that mean going back to a gold standard, or gold-based international monetary system? Perhaps so; it’s hard to imagine a more universally accepted standard of value.

Gold has occupied a primary place in the world’s monetary history and continues to be widely held as a reserve asset. The central banks of the G-20 nations hold two-thirds of official world gold reserves; include the gold reserves of the International Monetary Fund, the European Central Bank and the Bank for International Settlements, and the figure goes to nearly 80%, representing about 15% of all the gold ever mined.

Ironically, it was French President Charles de Gaulle who best made the case in the 1960s. Worried that the U.S. would be tempted to abuse its role as key currency issuer by exporting domestic inflation, he called for the return to a classical international gold standard. “Gold,” he observed, “has no nationality.”

Mr. Sarkozy might build on that legacy if he can look beyond the immediacy of the crisis and work toward a future global economy based on monetary integrity. This would indeed help

to restore the values of democratic capitalism. And Mr. Volcker, an influential adviser to President-elect Barack Obama, could turn out to be a powerful ally in the pursuit of a new stable monetary order.

### *Loose Money and the Roots of the Crisis*

*This is the way the world ends  
This is the way the world ends  
This is the way the world ends  
Not with a bang but a whimper.*

— T.S. Eliot “The Hollow Men” (1925)

The world is not ending. Despite the wrenching turmoil in global financial markets and morbid allusions to the death throes of capitalism, it ain't over. Not until people quit believing in themselves, not until people quit believing in a better future.



CORBIS

But the whimpering is real, and justified, because it hurts to have your world come crashing down. And global financial markets are definitely crashing, even when the impact is momentarily

softened through massive injections of artificial money—“artificial” because the fiat money does not represent a store of genuine value but rather an airy government claim to future wealth yet to be created.

In the aftermath of this financial catastrophe, as we sort out causes and assign blame, with experts offering various solutions – More regulation! Less complex financial instruments! – let’s not lose sight of the most fundamental component of finance. No credit-default swap, no exotic derivative, can be structured without stipulating the monetary unit of account in which its value is calculated. Money is the medium of exchange – the measure, the standard, the store of value – which defines the very substance of the economic contract between buyer and seller. It is the basic element, the atom of financial matter. It is the money that is broken.

These days, we don’t often refer to the validity of the money itself but rather to “monetary policy” and how the Federal Reserve has managed to calibrate the money supply to economic activity over the last two decades. There are plenty of critiques; the most pointed ones blame former Fed chief Alan Greenspan for keeping interest rates too low, too long.

During his 19 years at the monetary helm – from 1987 to 2006 – Mr. Greenspan served under four different U.S. presidents. At least one of them, George H.W. Bush, blamed Mr. Greenspan for keeping interest rates too high. The stock market crash that occurred in October 1987, two months after Mr. Greenspan’s confirmation under Ronald Reagan, sent the Dow Jones Industrial Average down 508 points (23%). It required huge injections of liquidity, which subsequently needed to be mopped up with tighter monetary policy. “I reappointed him,” the elder President Bush said. “And he disappointed me.”

President Clinton likewise reappointed Mr. Greenspan – and soon learned the terms of the trade-off for reduced short-term interest rates: Bring down the fiscal budget deficit. Spurred on by a Republican Congress, it actually happened; the federal budget was balanced in 1998. All too briefly, the Fed’s biggest

concern was how to carry out future monetary policy if we ran out of government debt securities for open-market operations. The fiscal deficit subsequently ballooned after 2001, due to spending in excess of revenue growth, while interest rates and unemployment – and inflation, counterintuitively – remained low. One thing for sure: We will have more than enough government debt securities.

There's a reason for this short diversion into Mr. Greenspan's long watch. While he is readily demonized today – Italy's finance minister recently characterized him as the man who, after Osama bin Laden, "hurt America the most" – Mr. Greenspan is also the man who was awarded the Presidential Medal of Freedom and whose honorary titles include Knight Commander of the British Empire and Commander of the French Legion d'honneur.

So how does such an accomplished central banker turn out to be a monetary doofus?

Scapegoats are wonderfully convenient receptacles for our collective disappointment, but that's all. When credit markets seize up, when financial instruments disintegrate, when the dollar fails – it's not because Alan Greenspan was not sufficiently omniscient. He wasn't, true. But no one ever was. No one ever could be.

If capitalism depends on designating a person of godlike abilities to manage demand and supply for all forms of money and credit – currency, demand deposits, money-market funds, repurchase agreements, equities, mortgages, corporate debt – we are as doomed as those wretched citizens who relied on central planning for their economic salvation.

Think of it: Nothing is more vital to capitalism than capital, the financial seed corn dedicated to next year's crop. Yet we, believers in free markets, allow the price of capital, i.e., the interest rate on loanable funds, to be fixed by a central committee in accordance with government objectives. We might as well resurrect Gosplan, the old Soviet State Planning Committee, and ask them to draw up the next five-year plan.

“There are numbers of us, myself included, who strongly believe that we did very well in the 1870 to 1914 period with an international gold standard.” It would be easy to dismiss this statement as a quaint relic from Mr. Greenspan’s earlier days as an Ayn Rand acolyte; his article on “Gold and Economic Freedom” appears in her 1966 compendium “Capitalism: The Unknown Ideal.” But Mr. Greenspan said it, rather emphatically, last October on the Fox Business Network. He was responding to the interviewer’s question: “Why do we need a central bank?”

Whatever well-intentioned reasons existed in 1913 for creating the Federal Reserve – to provide an elastic currency to soften the blow of economic contractions caused by “irrational exuberance” (and that will never be conquered, so long as humans have aspirations) – one would be hard-pressed to say that the financial fallout from this latest money meltdown will have less damaging consequences for the average person than would have been incurred under a gold standard.

Moreover, the mission of the central bank has been greatly compromised. Can anyone have faith that Fed policy decisions going into the future will deliver more reliable money? Don’t we already know in our bones that the cost of this latest financial nightmare will be born by all of us who store the value of our labor and measure our purchasing power in the form of dollars? As John Maynard Keynes, the famous British economist, observed in his “Tract on Monetary Reform,” published in 1923:

“It is common to speak as though, when a Government pays its way by inflation, the people of the country avoid taxation. We have seen that this is not so. What is raised by printing notes is just as much taken from the public as is a beer-duty or an income-tax. What a Government spends the public pay for. There is no such thing as an uncovered deficit.”

The entire world has been affected by the breakdown of the U.S. financial system, thanks to the globalization of investment capital. But the free flow of capital – along with free trade – is a good thing, the best path to global prosperity. The problem is that the role of the dollar as the world’s primary reserve

currency has been called into serious question, both by allies and adversaries. Writing in the People's Daily, Chinese economist Shi Jianxun laments: "The world urgently needs to create a diversified currency and financial system and fair and just financial order that is not dependent on the United States."

Let's do exactly that. It is time to take on the task of establishing a new foundation for international economic relations and financial relations – one dedicated to open markets and based on monetary integrity. Every country is responsible for anchoring its own currency to the universal reserve asset, and every citizen has the right to convert the national currency into the universal reserve asset.

That's how a gold standard works. A bimetallic system, linked to silver and gold, works the same way. In either case the money is fixed to a common anchor – and thus automatically functions as a common currency to serve the needs of legitimate producers and consumers throughout the world.

How would such an approach cure financial market ills? Nothing can rescue humans from occasionally making bad choices or succumbing to herding instincts. But on the same principle as democracy and free elections, embedded in the aggregate judgment of individuals over time is a wisdom that outperforms the most ostensibly savvy administrator. Sound money would go a long way toward eliminating the distortions that pervert financial decisions and credit allocations. Price signals do matter; if they don't, then free markets don't matter, and capitalism doesn't work. In which case, let government dictate demand and regulate supply.

No, we need to fix the money. Literally.

One of the candidates for president of the United States might issue the call for international monetary reform. Bad timing? The memo that resulted in the 1944 Bretton Woods international monetary agreement was written three weeks after Japan attacked Pearl Harbor. The next global conference need not take place in Bretton Woods, N.H., but rather Paris

or Shanghai. Countries should participate on a voluntary basis, no coercion, in full recognition that the goal is to hammer out a new financial order where the validity of the monetary unit of account is not determined by hollow men roaming the marble halls of government central banks.

This is where the new world of sound money begins. This is where the unknown ideal of capitalism takes form.

**Ms. Shelton, an economist, is author of “Money Meltdown: Restoring Order to the Global Currency System” (Free Press, 1994).**





# ***Restoring International Financial Stability: Five Guidelines For Regulatory Reform***

*by Alexander K. Swoboda*

There is no shortage of specific proposals to reform and stabilize the international financial and monetary system. The most recent, on the official front, is the statement released by the leaders of the G-20 on November 15. Their call for action on regulatory and supervisory issues is essentially a condensed version of the no less than 67 recommendations listed in the Financial Stability Forum's October update of its April Report on Enhancing Market and Institutional Resilience. There are of course many more proposals, official and private, from Morris Goldstein's favorite<sup>10</sup> measures to the numerous suggestions contained in the set of 17 papers collected in the VoxEU electronic book edited by Richard Baldwin and Barry Eichengreen.

There are some dangers in this abundance of proposed, often specific, measures and work plans. First, one tends to lose a sense of priority, a sense of what is crucially important and what is not. Second, one tends to lose sight of what the proposed measures, both individually and collectively, are supposed to achieve, of how they fit in the general reform of the "global financial architecture." Third, it would be good to have some criteria by which to judge whether any proposed measure is likely to be appropriate and effective.

So, rather than add my own n favorite measures, I will outline the principles that, in my view, should guide reform in the light of the current turmoil and of first principles of policy design. I will concentrate on medium-term issues of financial market regulation and supervision rather than on the short term or on

the broader international monetary architecture aspects of the crisis.

### ***1. Key features of recent financial turmoil***

Though there are many similarities between the current and previous postwar financial crisis episodes, there are also important differences. These need to be taken into account in the design of regulatory reform.

In the first place, the crisis is general in scope whereas previous episodes tended to be confined to specific segments of the financial industry, for instance major banks in the Swedish case or Savings and Loans banks in the U.S. case. The current crisis engulfs firms comprising almost the entire financial industry, from non-bank mortgage lenders, conduits and SIVS, money market funds, hedge funds, and monoline insurers to investment and commercial banks. And it concerns a whole range of asset classes and markets; it is not confined to mortgages and mortgage-backed securities but extends to asset backed securities in general, car and credit card based loans, credit default swaps, money market funds, and commercial paper.

Second, this crisis is global in geographic reach rather than national or regional. Yes, the trigger was the subprime mortgage debacle in the United States but it could have been something else, commercial real estate or credit default swaps to mention but two. It is obvious today that America is not the sole source or focus of the crisis as some observers, including the German Finance Minister, would have had us believe only a few weeks ago. Markets are too intertwined, major banks are too global, and toxic assets too widely held for the problem not to extend to Europe and, eventually, to emerging market economies as markets freeze, credit dries up and the price of capital shoots up. And, if anything, European banking institutions are more highly levered than those in the United States, which implies that even relatively small common shocks can have strong negative effects on that side of the Atlantic also.

Third, the combination of globalization, leverage, a much

abused originate and distribute model, and untested financial innovations in the form of highly complex financial instruments has led to an extraordinary opacity of the extent and distribution of risk across firms, instruments markets and countries.<sup>1</sup> This opacity and complexity has contributed to illiquidity, the breakdown of the price discovery process in several financial markets, and thus to the current difficulties in pricing complex (and some not so complex) securities. In addition, complexity and opacity amplify uncertainty when, as is almost always the case, liquidity problems are taken to signal the existence of potential insolvency. The problem today is thus that we know some institutions are actually or potentially insolvent but we don't know which, in what country and for how much. In such circumstances even prime banks cannot raise money from other prime banks in the interbank market for any but very short maturities. The perception of counterparty risk even in simple transactions and among prime names has escalated to levels unknown in the postwar period. Trust is disappearing.

To add to the uncertainty, it has also become extremely difficult to assess the systemic consequences of the failure of any single financial institution. Would Lehman have been allowed to fail if the authorities had known the impact of its bankruptcy on money market funds? Moreover, uncertainty surrounding the impact of the financial crisis on the real economy and of the feedback loop from the real economy to the financial markets, makes it difficult to gauge the duration and geographic distribution of the coming

<sup>1</sup> The notion that innovative instruments, securitization, derivative and insurance markets make it possible to unbundle various types of risk and to distribute them to those most willing and able to bear them to the benefit to all is not wrong—provided leverage remains limited, the original loan contracts are correctly structured and monitored, that counterparties are clearly defined, and so on. When these conditions are not met, the incentives are for excessive risk taking and leveraging when times are good. When times turn bad, the extraordinary complexity and opacity of a number of markets is revealed.

recession with any precision.<sup>2</sup>

In short, the world's financial markets —as a result of low and flat interest rates, excessive credit expansion, financial innovation, new complex and untested financial instruments, inappropriate regulation and supervision, excessive leverage, and so on —have become extraordinarily complex, uncertain, fragile and volatile. As a consequence, the current turmoil is not only a liquidity and a solvency crisis, it is much more: a severe and rapidly spreading confidence crisis that reflects a meltdown of trust in our financial system and institutions, private and public.

## *II. Remedies and guidelines*

The obvious priority is to restore trust. The immediate task, however, is to avoid a meltdown of the financial and economic system. This requires unclogging the credit markets (re-liquefying them) and recapitalizing, merging, or closing insolvent financial firms. With the collapse of trust, liquidity and solvency issues have become so intimately intertwined that it is imperative to pursue both tasks simultaneously. The various emergency measures that have been adopted so far and that will be adopted over the next days, weeks and months should avoid a complete collapse of the financial system and should allow it to start functioning again, even if in still hesitant fashion. At the same time, fiscal measures to cushion the impact of the recession are in order. However, these short-term measures will not, by themselves, restore trust. For that to occur, the financial system will have to be profoundly reshaped. Part of this reshaping, such as the disappearance, merger, or downward resizing of a number of financial firms, will occur naturally and be market determined. Another part will concern institutional reform and be a matter for public policy.

In a medium-term perspective, observance of the five basic

<sup>2</sup> One thing, however, is almost certain: there will be no decoupling either geographically or between financial markets and the real economy, between Wall Street and Main Street if you wish. The two streets are intimately intertwined since financial and stock markets determine the cost of capital for firms and the latter's growth and profits are reflected in the stock market.

guidelines below would go some way to insure appropriate and effective regulatory reform.

### ***1. Prudential regulation should become anti-cyclical***

Economic history shows that financial markets are subject to cycles where euphoria alternates with despair, where busts follow booms and vice-versa. The recent past has shown that regulatory and supervisory policy has tended to amplify rather than dampen such cycles. Not only Basel II but any fixed capital-asset ratios are examples of pro-cyclical measures. They suffer from a defect typical of most prudential regulation: they are designed to help individual institutions cope with idiosyncratic shocks but worsen matters for the industry and system as a whole when macroeconomic shocks hit the entire industry. The reason is of course that in boom times asset revaluations lead to an increase in available equity and therefore an incentive to an increased demand for assets and, if the whole industry acts in similar fashion, a further increase in asset prices. In the bust phase, as falling asset prices (or rising defaults) lead to a fall in equity, financial institutions try to restore their capital-asset ratio by selling assets (or, partly, by raising capital), leading to further falls in asset prices and to further reductions in balance sheets. Combine this with the tendency (documented notably by Hyun Song Shin) for target leverage ratios to rise in boom times and fall in downturns, with the falling (rising) Basel II risk weightings in cyclical upturns (downturns), with declining risk aversion in the wake of the “Great Moderation” and the Greenspan put, and with the feedback loop between financial markets and the real economy, and you have the recipe for a perfect financial storm.

The solution is simple in principle: let buffers be buffers. That is, provide incentives for capital/asset ratios to rise in the upward phase of a financial cycle and allow them to fall in the downward phase. How to encourage financial firms to increase their capital cushion in good times so as to dispose of a larger buffer in bad times is not obvious. The Spanish policy of allowing and encouraging dynamic provisioning over the cycle does, however, constitute one promising example.

More broadly, macro-prudential supervision and regulation needs to be reinforced to avoid that regulation that makes micro-economic sense amount to macroeconomic folly. It is quite likely, in this context, that Basel II will be fundamentally reshaped, that adjustable liquidity ratios will be (re-)instated, and that central banks will be given increased responsibilities in the maintenance of systemic stability. Whatever is the outcome, however, any reform measure should pass the anti-cyclicality test.

## ***2. To each goal its instrument***

Whatever institution is given responsibility for financial stability must also be given the tools that are necessary to discharge this responsibility. In many countries that institution is or will be the Central Bank. The Central Bank, however, cannot be expected successfully to pursue multiple objectives with a single instrument, the setting of nominal policy interest rates, lest it be felled by Central Bank Schizophrenia, a disease that is destructive both of economic and of financial stability and, hence, of confidence. This does not mean that the monetary authorities have to renounce any role in moderating output variability or in helping stabilize financial markets while keeping interest rate policy focused on a medium-term price stability objective. Nor does it mean, in our context, that they cannot lean against credit booms by raising interest rates slightly more rapidly than they otherwise would. It does mean, however, that there is only that much they can do with that single instrument without sacrificing the medium-run objective of price stability. The current turmoil has indeed led to a search for additional instruments: the extension of the maturity of central bank lending, the broadening of the universe of acceptable collateral, the availability of central bank credit to non-bank financial intermediaries are all examples. Interest-rate policy and this type of liquidity policy, however, are not entirely independent instruments. It is therefore important that the panoply of policy instruments be expanded further so as to come close to the “one instrument for each target” precept (the other solution being to reduce the number of targets). In the context of financial stability, variable capital-asset ratios, liquidity ratios and margin requirements are among the policy instrument innovations to be

considered. Assignment of instruments to targets in accordance to their comparative advantage (the Mundellian assignment principle) is also important lest inefficiency and dynamic instability be introduced. To take an obvious example, it would be inefficient to use margin requirements to stabilize the price level and the policy interest rate to control leverage.

### ***3. Incentive compatibility and moral hazard***

Incentive compatibility is fundamental to the success of any policy reform. That is, the incentives provided by any piece of legislation, by administrative decrees, by financial regulation and supervision, or more broadly by any policy action must be compatible with, and foster, the social goals pursued by these actions. Take, for instance, the desire to limit executive compensation to levels necessary for economic efficiency. Rather than putting uniform blanket caps on remuneration, it would seem preferable to enact legislation that locks in bonuses, to increase transparency and shareholder voice, and to ban bad governance practices that allow executives, and especially CEOs, to sit on, or attend remuneration committees. To avoid that the originate and distribute model of securitization lead to excessive risk taking, it would be useful to require the originator to retain a significant share of the securitized assets on balance sheet and a significant equity share in the structured products that it sells. And so on.

Most regulation, however, will tend to create some perverse incentives. Deposit insurance, to take a well known example of moral hazard generation, tends to lead to overly risky behavior on the part of the insured institution and lax monitoring on the part of the depositor. There are two “neat” corner solutions to the moral hazard issue: the extreme of a totally unregulated “caveat emptor” system (with no deposit insurance, no bail-outs, no LLR...) or a tightly regulated system in exchange for the provision of stability by the state. Neither extreme solution is acceptable or practicable today. A compromise must be reached but the devil is in the details. Awareness and attention to the incentive compatibility and moral hazard issues inherent in any regulation is the best one can require or hope for.

#### ***4. Limit spillovers and unintended consequences***

Policy measures frequently have unintended consequences and/or spillover effects, sometimes as a consequence of incentive incompatible schemes (see above). In the context of current financial turmoil such spillovers will often be general and international as well as local and confined to particular markets. The Irish deposit guarantee episode, for example, entailed both national and international spillover effects, whether unintended or not.

There is no pat solution to the problem, whether at the national or at the global level. But its existence gives rise to two caveats. First, try not to rush into emergency measures before having thought through their possible consequences. This is particularly important when considering medium-term more permanent reform. Second, it is essential in the longer run as well as in crises times that negative international spillovers be minimized. To that effect, some international coordination of macroeconomic policies is needed as is better harmonization of regulatory and supervisory practices to insure a minimum of coherence of various national measures.

#### ***5. Preserve openness***

With a bit of luck and provided the preceding principles are heeded, the world economy may weather the financial storm and limit the damage caused to the real economy by the coming recession. But trust will be restored only if reforms are pursued with determination and persistence over the coming years. Adhering to the four criteria for reform listed above should help. At the risk of belaboring the obvious, preserving openness constitutes a fifth and crucial guideline for reform. If there is one lesson that must be remembered from the Great Depression if the world is not to slip into a far more severe recession: keep economies and the trading system open, do not let protectionism and beggar-thy-neighbor policies take hold, lest the only option left be take cover and pray.





# ***International Financial Institutions Reform Proposals***

*by George Vojta*

## ***OVERVIEW***

The traditional missions and mandates of the Multilateral Development Banks (World Bank/Regional Development Banks), i.e. infrastructure and development finance, and the International Monetary Fund, i.e. balance of payments and exchange rate stability, need redefinition.

## ***SHORTCOMINGS AND LIMITATIONS***

### ***Multilateral Development Banks***

- Project lending to middle-income countries is no longer necessary. Private capital markets provide a more effective and efficient source of funding to these countries.
- Confidential, privileged consultations and transactions are counterproductive. Transparency in all business affairs is crucial to accessing private capital markets and efficiently allocating resources. Member countries, however, retain a veto over the content and release of country reports and assessments.
- MDB resources are inadequate to support and resolve major finance-related crises. The MDBs' roles in crisis management are largely limited to peripheral issues with marginal systemic stability impact, e.g. emergency funding for energy or food shortages. Such issues would be better managed through other bodies.

- The operational environments within the MDBs are chaotic, incoherent, and not well controlled. The absence of focus, transparency, continuity, external audit, and measurement of results relative to project activity has led to the burgeoning of dysfunctional initiatives. The proliferation of poorly managed and uncoordinated project initiatives often leads to waste and even harm, e.g. hospital funding in India.
- Member interest in financing from the MDBs is declining.
- Operating results have declined to a near loss.

### ***International Monetary Fund***

- The major systemic financial priorities are now nurturing and strengthening the global financial architecture, enhancing systemic crisis management, and extending emergency finance to select countries. Ensuring exchange rate stability and restoring current account deficits as countries liberalize their economies is now anachronistic.
- Traditional conditional financing is almost nil. Except for extreme situations, e.g. Ukraine, Iceland, Hungary, Pakistan, conditional financing has been replaced by private-sector capital. The IMF's recent launch of the Short-Term Liquidity Facility may be helpful at the margins.
- The IMF's role in supporting and resolving major finance-related crises has become secondary to G20 Central Banks and Finance Ministries. The mechanisms and tools available to the IMF to deal with systemic crises are out-dated, inadequate, and inappropriate.
- Confidential, privileged consultations and transactions are counterproductive. As with MDB assessments, IMF consultations are subject to country member restrictions and vetoes.
- The surveillance functions of the IMF are inadequate. Aside from the confidential nature of country assessments, IMF country reports also suffer from lack of relevance to larger systemic issues.
- The operational environment of the IMF is chaotic,

incoherent, and not well controlled. The absence of focus, transparency, continuity, external audit, and measurement of results relative to project activity has led to the burgeoning of dysfunctional initiatives.

- Operating results have declined to a near loss.

## ***REFORM OPTIONS***

### ***Multilateral Development Banks***

- The MDBs should be positioned as facilitators of development through the promotion of responsible private investment. This promotion should focus on consulting/risk mitigation initiatives targeting the lower-middle to poorest countries.
- The MDBs should support initiatives to create and support country conditions that attract responsible foreign/domestic private investment. In particular, the MDBs should promote macro policies to achieve positive credit ratings; adherence and implementation of best practice standards; the elimination of corruption; and functional and robust financial systems.
- Loans and investments through the MDBs should be restricted to the lower-middle and poorest countries.
- Confidential, privileged consultations and transactions should be eliminated.
- The operational environment should be rationalized and streamlined to ensure focus, transparency, accountability, and effectiveness.
- Initiatives to promote responsible private investment and investible country conditions should be harmonized with the private sector. This harmonization should include not only consulting/risk mitigation, but technical assistance, as well.

### ***International Monetary Fund***

- The IMF should promote a standards-based global architecture. This architecture should include international best practice standards, policies, and procedures in support of responsible private-sector investment, on the one hand, and country conditions that attract responsible private-sector investment, on the other.
- Loans and investments through the IMF should be restricted to the lower-middle and poorest countries.
- Confidential, privileged consultations and transactions should be eliminated.
- The operational environment should be rationalized and streamlined to ensure focus, transparency, accountability, and effectiveness.
- Technical assistance and capacity building initiatives should be harmonized with the private sector.

### ***Joint MDB and IMF***

- The IFIs should maintain focus on select priorities, eliminate all activity not directly related to the new mandates and missions, reduce staff and project volume, and tighten overly-decentralized project decision-making.
- The IFIs should support G20 Central Bank and Finance Ministers within the Bank for International Settlements/Financial Stability Forum framework as a global crisis management group. This group should also have a private-sector component.
- The IFIs should use their reserves to sustain profitability and avoid loss in the medium term and rebalance and reduce their expense bases to achieve long-term sustainability.
- The IFIs should support private-sector efforts to provide public-goods that contribute to responsible private investment. Such efforts would include the collection, dissemination, and utilization of information that enhances risk management, responsible investment, crisis prevention, and good corporate governance.

## **SUMMARY**

### ***The MDBs' New Missions and Mandates***

Support sustainable development in lower-middle to poorest countries through infrastructure finance (roads, ports, electricity, water, education, health care); direct debt/equity finance to support rural productivity, microfinance, and small- and medium-sized enterprises; provide policy guidance and technical assistance to create favorable country conditions for responsible private investment; and, with the IMF and private sector, ensure a functional and stable financial system.

### ***The IMF's New Mission and Mandate***

Lead the effort to achieve a viable global financial architecture based on international best practice standards; assist Central Banks, Ministries of Finance, and the Bank for International Settlements/Financial Stability Forum network to achieve consistent cross-border regulatory and supervisory coordination and crisis prevention and management; and, with the World Bank and the private sector, promote a responsible private-sector driven, market economy model for sustainable development.



# ***APPENDIX***



# ***CFA Institute Memorandum to the Treasury Select Committee: Accounting and the Banking Crisis***

## **1. INTRODUCTION**

The CFA Institute Centre<sup>1</sup> represents the views of its members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct*.

The Centre is involved in policy formulation, advocacy and thought leadership on financial reporting matters. To fulfil its mandate the centre actively engages with accounting standard setters and with its membership. There are several strands to the centre's work on financial reporting. These include ensuring investor considerations are factored into accounting standard setting process, communicating to members and pooling their views on key financial reporting issues and public awareness on financial reporting transparency.

---

<sup>1</sup> The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA, and offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 98,000 members. The membership comprises of investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. In addition we have a network of 136 member societies organised across 57 countries and territories.

## 2. EXECUTIVE SUMMARY

- 2.1. The causes of the current financial crisis are poor lending practices, inappropriate risk management, model failure, asymmetrical compensation schemes and poor governance, not fair value or mark-to-market reporting. In fact, fair value reporting has helped to reflect the true severity of these problems.
- 2.2. **At the crux of the debate on fair value reporting by banking institutions is whether it provides a more reliable proxy of economic worth compared to alternative reporting methods during inactive markets.** We believe that where available, market prices provide the best proxy of underlying economic worth. Including a discount for both liquidity and non performance risk in observable market prices enables the reflection the economic reality and conveys information to investors about the effects of these risk factors.
- 2.3. Considering the bespoke structured products that significantly contributed to the credit crisis, there are lessons to be learnt about the high likelihood of model error due to over-optimistic assumptions when relying largely on internal models. See 7.2.5
- 2.4. A summary of our key messages follows:
  - A. Fair value provides the best representation of economic reality. It provides an early warning system and is the only accounting regime that can facilitate the timely correction from previous bad decisions.
  - B. Investors are opposed to the suspension of fair value and believe fair value contributes to transparency in financial institutions.
  - C. The pro-cyclical effects of fair value accounting arise because of the failure to delink information required for overall transparency from that applied in the determination of capital adequacy. Please see paragraph 7.8 for elaboration.
  - D. Rather than reducing the application of fair value, the focus should be on improving and expanding its current application across all financial instruments.

## 3. RECOMMENDATIONS

We recommend the following for the Committee's consideration:

- 3.1. Attention should be focused on the causes of the financial crisis as highlighted in paragraph 1.1 and 6.1, not financial reporting.
- 3.2. Support the expansion and development of fair value across all financial instruments. See sections 6
- 3.3. That any systemic circuit-breaker should be introduced through the regulatory capital reserve. See section 7.8.

- 3.4. That political leadership should be directed at safeguarding the integrity and independence of the international financial reporting standard setting framework, and supporting the ongoing convergence and improvement of financial reporting quality under the auspices of the International Accounting Standards Board (IASB). See sections 8 and 9.

#### 4. PREAMBLE

- 4.1. CFA Institute's support for fair value accounting is backed by a poll conducted of our 12,000 person EU membership, which shows that **79% were opposed to suspension of fair value and 85% believe that suspending fair value would decrease investor confidence in the banking system.** We acknowledge that there are some limitations and implementation difficulties associated with the fair value measurement approach (see paragraph 6.5). Nevertheless, fair value has a well established history of application under International Financial Reporting Standards (IFRS). Fair value is the best available alternative of measuring financial instruments and on balance, it significantly contributes to the overall transparency of financial institutions. **Hence, fair value standards are critical to the integrity of the financial markets and should be maintained.**
- 4.2. Financial reporting information is used by investors for capital allocation and concurrently by regulators for the assessment of safety and soundness of financial institutions. Nevertheless, there is a need to disentangle these two objectives as there is a tension between the need to provide relevant information for investors versus information that is geared at stability and soundness. Pro-cyclical effects of fair value accounting often arise due to the failure to delink information required for overall transparency from that applied in the determination of capital adequacy (see paragraph 7.8). **Any systemic circuit-breaker should be introduced through the regulatory capital regime.**
- 4.3. The anticipation that concealing mark to market losses will re-instil investor confidence and is an antidote to pro-cyclicality seems to be based on the misconception that observed net income volatility is the sole stimulus to investor perception of the risk of financial institutions. We argue that a more effective way of restoring confidence and ensuring investors do not misinterpret firm performance is to enhance the financial statement presentation so as to enable investors to distinguish between core operating earnings from gains or losses of holding assets. This should be coupled with meaningful disclosures that can convey the inherent uncertainty and margin of error on the valuation of complex financial instruments. **The emphasis should be on helping investors to interpret the reported values. Rather than suspension, we recommend the improvement of fair value reporting and associated disclosures.**
- 4.4. As stated the fair value measurement basis is not without limitations and there are clearly challenges on how to consistently apply fair value for illiquid financial instruments. However, consideration of the application rules needs a deliberative

process that necessarily draws upon the expertise and mandate of an independent standard setter, namely the IASB. Any rushed or partisan influence of minority interests that forces the IASB to adjust accounting standards will be detrimental to the overall quality of financial reporting. It can derail the ongoing convergence and improvement of global financial reporting. **There is a pressing need for our political leaders to support the work of the IASB and to separately address the causes of the credit crisis.**

- 4.5. EU has provided global leadership in the path to the realisation of converged, high quality accounting standards. Given the considerable progress that has been made and resources invested in the convergence process, it will be hubristic, wasteful and contrary to the welfare of investors, auditors and financial statement preparers if European authorities take any measures to undermine the IASB

## 5. PURPOSE AND INTENDED AUDIENCE OF FINANCIAL ACCOUNTS

- 5.1. We consider financial accounting information to be the *‘lifeblood of capital markets* and a key part of the mosaic of information applied by investment analysts and portfolio managers when they are assessing the performance prospects and risks of reporting entities. Financial accounting information is an important conduit for corporate managers to convey and communicate the past, current and prospective economic reality of their reporting firms.
- 5.2. We concur with the objective of financial reporting articulated by the IASB conceptual framework<sup>2</sup> identifying the primacy of investors as users of financial statements. The framework states

*“The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions”* and that *“Financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing and uncertainty of the entity’s future cash inflows and outflows.”*

- 5.3. An updated pronouncement, contained in the exposure draft ‘Preliminary views on improved financial reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision Useful Financial Reporting Information’, states

*“The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions”.*

- 5.4. The framework further delineates the primary qualitative characteristics of useful financial information namely relevance (i.e. decision useful), reliable (faithful

---

<sup>2</sup> International Accounting Standards Board Framework for the Preparation and Presentation of Financial Statements; London 1989

representation of economic reality), comparability, understandability and timeliness.

- 5.5. CFA Institute Comprehensive Business Reporting Model<sup>3</sup> (CBRM) similarly asserts that to be useful in making investment and other financial decisions, reported information must be timely, accurate, understandable and comprehensive.

## 6. BENEFITS OF FAIR VALUE FOR FINANCIAL INSTITUTIONS

- 6.1. **Fair value is not one of the causes of the credit crisis.** The causes of the crisis have been well chronicled by different bodies such as the Financial Stability Forum. The focus on fair value detracts from the real factors that created and exacerbated the credit crisis. Several factors within financial institutions including excessive leverage, reckless lending practices, weak risk management practices, risk distribution mechanisms that encouraged morally hazardous behaviour and the systemic uncertainty on the location of transferred risk, all contributed to the crisis.
- 6.2. We consider fair value accounting to be an integral part of high quality financial reporting. Fair value as a measurement approach has a long history of implementation under both International Financial Reporting Standards (IFRS) and the preceding UK Financial Reporting Standards (FRS). It is **neither a novel nor a recently enacted approach**. The application of fair value across different asset and liability categories has history dating back to almost 25 years. In addition to financial instruments under IASB standards, fair value can, for example, also be used in the measurement of property, plant and equipment, investment properties and biological assets. The adoption and implementation of fair value has always been the by-product of a deliberative process by the IASB. Besides the long established use of fair value under IFRS, the merits of fair value have been under consideration and debated by investors, preparers, auditors, regulators, and academics for decades.
- 6.3. In our advocacy to the accounting standard setters, **CFA Institute has consistently supported the use fair value as the appropriate measurement basis for all financial instruments**. This view is further supported by the results of recent surveys of investment professionals. In particular, of the 2,006 respondents to a March 2008 survey of CFA Institute members on the topic, 79 percent believe that fair value improves financial institution transparency and understanding of risk profile and 74 percent believe that it improves market integrity. Two follow up surveys were conducted during the months of September and October 2008 and the results confirmed earlier findings. Our survey of membership in the EU showed that 79% were opposed to suspension of fair value and 85% believe that suspending fair value would decrease investor confidence in the banking system, see Appendix (section 12) for detailed results. These findings reaffirm our position that **continuing the use of fair value in accounting for financial instruments is vital to the integrity and transparency of markets**.

---

<sup>3</sup> CFA Institute Centre for Financial Market Integrity 'A Comprehensive Business Reporting Model'- Financial Reporting for Investors- July 2007

6.4. Full fair value accounting of all financial instruments is superior to the alternative of amortised historical cost. This is so for various reasons including the:

- provision of timely, relevant and decision useful information. It is the only accounting regime that can provide an early warning system and facilitate correction.
- fair value ensures the consistent application of accounting for financial instruments and therefore yields more comparable information.
- the timely information content of fair value and associated disclosures can contribute to a firm's risk management processes.

We elaborate further on these benefits in the appendix under section 10

6.5. The two often cited limitations of fair value are a) measurement error and b) artificial income volatility. In response we note that

A. Measurement error is not peculiar to the fair value approach. Accounting as a practice has always allowed a significant level of estimation when managers are exercising judgement. For example, the provisioning for bad loans and the determination of amounts by which to depreciate properties, are all a matter of judgement and inherent in these judgements is a susceptibility to measurement error. On the other hand the fair value approach is designed to minimise measurement error as it necessitates reference to market prices where available, and thus allows the reflection of consensus views on the worth of financial assets. This minimises the measurement error that could arise from a single firm's management team.

B. Artificial income volatility: Artificial income volatility in part arises due to the hybrid, mixed measurement attribute approach where both fair value and amortised historical cost are applied and the mismatches in approach for corresponding assets and liabilities leads to income volatility. In this instance fair value is not the cause of artificial volatility and in fact the adoption of full fair value will be a remedy.

C. Unrealised holding gains and losses can also result in income volatility. Two questions that arise are a) whether income volatility associated with unrealised holding gains and losses has information content for investors, and b) whether it reflects economic volatility. For a financial institution, the decision to hold, sell or buy financial instruments is in part driven by their market value. Hence unrealised holding gains and losses have information content for investors on the effective asset and liability management. At the same time it allows accounting volatility to match economic volatility. Enhanced disclosure of the nature of income and a presentation that differentiates between realised and unrealised gains or losses, can help investors to comprehend the information content.

6.6. **We believe that the fair value accounting treatment encapsulates the essential attributes of relevance and faithful representation of economic reality.** Reducing the quality of financial reporting disclosure by suspending or restricting the application of fair value accounting for financial institutions can have multiple

undesirable consequences. These will include reducing the information quality and imposing capital allocation inefficiencies.

- **Reducing financial information quality:** Suspending or curtailing the application of fair value for a financial institutions breaks the link between market changes in financial instruments and their valuation in financial reports. **One of the problems highlighted by the ongoing crisis is the delayed reflection of underlying fundamental data (e.g. declining home prices) in the valuation of financial instruments that were not reported at fair value, such as mortgage loans.**
- **Capital allocation inefficiency:** Reducing the disclosure quality will escalate the difficulties that investors and financial institution counterparties have in differentiating between high risk and low risk firms. This in turn will lead to adverse selection and capital misallocation and likely translate to a higher uncertainty premium and a corresponding increase in the cost of capital. The lost decade in Japan, where financial institutions concealed losses, is an appropriate reference point of the counter-productiveness of deferral of recognition of real economic losses. **Reducing transparency can only limit the self-correcting capacity of capital markets.**

## 7. FAIR VALUE AND THE CREDIT CRISIS

7.1. In the context of the credit crisis, two main aspects that are frequently debated is whether it is a) appropriate to apply fair value treatment for financial instruments during inactive or distressed markets and b) whether fair value has pro-cyclical effects.

### 7.2. *Fair value and illiquid instruments*

7.2.1. It is true that markets do go through phases of exuberance and depression and in these situations market prices may have noisy and anomalous characteristics. Nevertheless, market prices remain the best measure for economic worth as they are unbiased and reflect the consensus of capital market participants on the economic worth at any point in time. As stated earlier, we believe that fair value is the most relevant (i.e. decision useful) and reliable (faithful representation of the economic reality) of financial instruments.

7.2.2. The question often debated is whether market prices are appropriate proxies of economic worth for illiquid financial instruments. At the heart of the debate is whether observable market prices during an inactive market:

- A. Are superior to the application of entity specific models? A consensus view of economic worth has the merit of being unbiased. Besides the accounting standard allows for adjustments of market inputs. We develop this notion further in 7.2.3.

- B. Are superior to historical cost as a proxy of economic worth? As argued fair value provides an updated assessment of economic fundamentals and conveys information on other risk factors such as liquidity and non performance risk. In this respect it is much more relevant than historical cost for financial instruments. Historical cost for financial instruments can totally hide risk such as is the case with derivative instruments that do not require investment at inception. They could reflect outdated, overstated values for example for mortgage instruments that were originated during the phase of market exuberance. Hence historical cost both underestimates values (i.e. derivatives) and overestimates values (i.e. assets incepted during asset bubbles).
- 7.2.3. The contention often made by financial institutions is that they are holding assets to maturity, therefore that they do not have to monetise such assets at the reporting date. On this basis they anticipate that the future cash flow realisation is likely to be higher than that reflected by the observable market price. This thinking is premised on the anticipation that risk factors such as illiquidity discount will not be a factor at the point of realisation. However, such an optimistic anticipation of change of market conditions at realisation is not necessarily founded on any verifiable evidence. On the other hand, market prices when available reflect the consensus prediction of risk factors that currently exist and are likely to arise in the foreseeable future.
- 7.2.4. The merit of fair value is that it allows an updated assessment of all risk factors including liquidity and non performance risk. Should the instrument specific liquidity conditions improve, then the financial institutions shall be able to report gains. The reflection of the impact of changing market conditions on risk factors has information content for investors. As we have stated in paragraph 6.5 tracking the impact of these risk factors on financial instrument values has information content on asset and liability management practices.
- 7.2.5. The credit crisis in part stemmed from the volume of structured, bespoke products where a significant number of capital market participants unwisely placed excessive reliance on the rating of Credit Rating Agencies (CRAs), when pricing the risk associated with these products at their origination. CFA Institute has been involved in the review of the role of CRAs and our findings show that one has to be cautious about unduly relying on internal models for valuation purposes. This is because they have a bias towards being too optimistic in their assumptions. **There are lessons to be learned on the risks that could arise due to internal model error.**
- 7.2.6. The concerns raised on the question of illiquid financial instruments by various financial institution preparers and other stakeholders, makes it evident that there have been legitimate difficulties in ensuring the consistent application of the existing accounting literature on this matter. There is difficulty in identifying situations of where a disorderly transaction has occurred and therefore market inputs can be ignored according to current accounting standards.

- 7.2.7. In this regard we welcome the deliberations undertaken by the International Accounting Standards Board's (IASB) valuation expert advisory panel. We concur with the findings in their report issued on October 31st 2008.
- 7.2.8. This report upholds the application of fair value in the valuation of financial instruments while illuminating on how to handle difficulties that can arise when measuring financial instruments during inactive markets. The report also dispels the misconception that there are scenarios in which accounting standards compel reporting entities to provide misleading values because of prevailing distressed markets.
- 7.2.9. The objective of the international accounting standards on financial instruments (IAS 39 and IFRS 7 under IASB) was to reflect the economic reality of reporting entities in all instances. In particular, it is helpful that the paper clarifies that current accounting literature **does not prohibit the use of management's internal assumptions when observable market inputs are unavailable**. However, the assumptions used must include appropriate risk adjustments that market participants would make for non-performance and liquidity risks. Factoring in illiquidity discounts and non-performance enables a depiction of economic reality of financial instruments.
- 7.2.10. Regardless of whether financial institutions either apply market based inputs or their internal models, we believe that disclosures of how managers determine values and the inherent uncertainty around these values is what is most helpful for investors. **Comprehensive disclosures can help avoid misinterpretation of numbers and therefore ensure that investors are informed about the financial condition of a reporting financial institution.**
- 7.2.11. Clearly there is need for continued education from the accounting standard setters to help ensure consistency in application in the accounting principles of illiquid financial instruments. We support the initiative undertaken by the two significant accounting standard setters IASB and the US Financial Accounting Standards Board (FASB) to clarify the application of literature.

### ***Fair value and Pro-cyclicality***

- 7.3. The main point we would like to state is that the pro-cyclical effects of fair value are overstated. (Please see attached articles<sup>4</sup>)
- 7.4. A useful backdrop to the debate around the pro-cyclical effects of fair value treatment is to consider the extent to which the recognition of fair value gains and losses through the profit and loss account occurs within European financial institutions. The recognition of fair value gains and losses through profit and loss is required for financial instruments held in the trading book. IMF report published in October 2008 (attached as supplementary material) provides illustrative aggregate data of European financial institution as of the end of December 2006. The

---

<sup>4</sup> 1) Nicolas Veron, May 2008- 'Fair value accounting is the wrong scapegoat for the crisis' and 2) IMF Chapter 3 'Fair Value Accounting and Pro-cyclicality'- October 2008

published data shows that the **fair value adjustments that require recognition through the profit and loss account are not applied across the entire financial institution balance sheet**. Financial institution losses also arise from amortised cost impairments and from realised losses of available for sale and held to maturity items. Fair value write-downs that are not made through the profit and loss (e.g. those relating to available for sale) do not impact on regulatory capital and besides the regulators have the option of writing back losses that they believe do not pertain to the solvency of the reporting institution.

Trading Book- European Financial Institutions as of December 2006	
Assets	Percentage
Debt Securities	14.98
Equity Securities	6.32
Derivatives	14.71
<b>Percentage of book assets</b>	<b>36.01</b>
Liabilities	
Debt and Equity Securities	12.77
Derivatives	15.34
<b>Percentage of book liabilities</b>	<b>28.11</b>

IMF report Fair value accounting and pro-cyclicality

- 7.5. Understated in the debate on the pro-cyclical effects of fair value are the equivalent impacts of the alternative amortised cost approach. Impairment of assets, though less frequent would still be necessary under an amortised cost regime. This is because the amortised cost treatment requires the recognition of gains and losses using the lower of cost or market value principle. **Hence it is important to consider that write-downs will not arise exclusively due to fair value accounting.**
- 7.6. Fair value accounting facilitates self correction. However, not often mentioned in the debate is the economic pro-cyclical effects of delayed or less frequent write-downs under a amortised historical cost approach. The delayed recognition of losses reduces the incentives of managers to engage in economic risk management and restructuring during economic climate downturns. Relative to fair value accounting, an amortised cost approach can result in morally hazardous risk origination during a buoyant and booming economic period because financial institutions are aware that they may have relatively more flexibility to defer their losses if a downturn occurs. The combination of morally hazardous risk origination during booming economic environments and relative inertia during market downturns has pro-cyclical economic consequences. We refer to the lost decade in Japan as a suitable reference point.
- 7.7. It is also important to realise that because fair value accounting requires the updated valuation of financial assets and financial liabilities, the write downs of assets are offset by gains of liabilities. The relatively symmetrical treatment of assets and liabilities under fair value effectively dampens any pro-cyclical effects

of fair value accounting in contrast to the write downs incurred through the amortised cost approach confined to assets.

### *7.8. Managing Pro-cyclicality*

**7.8.1.** As pointed out in the IMF report, pro-cyclicality of fair value could possibly arise due to a) the linkage between financial reporting and regulatory capital and b) investor over-reaction to artificial net income volatility. **Hence given the overall benefit of transparency derived from fair value accounting, we would propose measures should be taken that mitigate any pro-cyclical effects rather than suspending fair value accounting.**

**7.8.2.** The October 2008 IMF report suggests that a way of mitigating fair value volatility from affecting the solvency of financial institutions is to delink financial reporting information from capital adequacy determination. Regulators should have flexibility to determine the parameters that provide the most appropriate yardstick of the solvency of financial institutions and thereafter to determine the required capital buffers. We would support measures that focus on regulatory capital changes if the objective is to provide a systemic circuit breaker during the credit crisis

### *7.9. Managing possible over-reaction to net income volatility*

**7.9.1.** The push to suspend mark to market accounting is in part triggered by concerns about the consequences of observable net income volatility on investors' perception of risk. Net income is unquestionably an input used by investors when assessing firm performance, but it is a single input. Simply managing the net income number underestimates the sophistication and reflects a misunderstanding of the decision heuristic of investors. This is because financial reporting is part of the mosaic of information that helps to inform investors to assess the risks and prospects of reporting entities. There remain alternative indicators showing that financial institutions are under strain.

**7.9.2.** The current crisis reflects a loss of confidence by investors and between counterparties on the true financial condition of financial institutions. In the absence of information on updated economic values of financial instruments, investors will likely impute market value of these instruments. **Hence, suspending fair value accounting will only encourage investors to engage in a guessing game on the true financial condition of and fuel the sense of uncertainty about financial institutions.** The choice is whether to rely on fully informed investors to make corresponding capital allocation decisions.

**7.9.3.** To enable investors to identify the nature and sources of earnings volatility, we encourage the provision of a better and more disaggregated financial statement presentation format that is more comprehensible for investors. Under such a format investors should be able to differentiate between core operating earnings from the gains and losses of held assets (as also

recommended in paragraph 6.5) In addition we recommend enhanced disclosures that help investors understand the uncertainty associated with reported valuations. The focus should be on refining the current accounting framework so as to minimise the risk of investors and other users misunderstanding reported net income numbers.

## **8. ROLE AND ACCOUNTABILITY OF IASB**

- 8.1. The *raison d'être* of the IASB is to create a single, high quality set of financial reporting standards. The genesis and evolution of standard setting by the IASB and its predecessor, the IASC from 1973 to the present is indicative of the demand for a single set of accounting standards. We strongly support the creation of a single set of high quality, global accounting standards as this will enable the comparability of investee firms across the globe and facilitate cross border asset allocation.
- 8.2. It is worthwhile for the member states of the EU, including the UK, to reflect on the history of the IASB. In particular on the impact of the decision by the EU, made in 2000, in wake of the Financial Services Action Plan, followed on by the 2002 legislative endorsement that saw the adoption of IFRS by listed EU companies with effect from 2005. These set of decisions marked a watershed moment in the overall convergence process. It provided impetus to the whole process and presents an example where the EU provided global leadership in the path to the realisation of a desirable, global product for investors, auditors and multinational financial statement preparers. During the last 12 months, there has been serious deliberation undertaken by the US Securities and Exchange Commission (SEC) to adopt IFRS, the lifting of reconciliation requirements for foreign filers on US exchanges and the ongoing convergence between IFRS and US GAAP under the memorandum of understanding between the IASB and FASB. The observed willingness to adopt IFRS by the world's largest capital market is arguably in part a by-product of the earlier EU decision to adopt IFRS.
- 8.3. The independence and accountability of the IASB is a necessary prerequisite to enable the ongoing convergence of accounting standards between US GAAP and IFRS. We believe that independence and accountability of the IASB to its key stakeholders will result in efficiency, rigour, and inclusiveness in both the due process and substance of the board's deliberations.
- 8.4. Our proposals to ensure the independence and accountability of the IASB were addressed in our consultative response to the review of the IASCF constitution. A summary of the key proposals is contained in the appendix, paragraphs 11 (IASCF Constitution recommendations).
- 8.5. At this juncture, regional intervention could derail the convergence of international financial reporting as it will set a precedent for similar responses by other current and prospective adopters of IFRS. For this reason, we would be concerned about any political override to current accounting rules.

- 8.6. Given the considerable progress that has been made and resources invested in the convergence process, it would be hubristic, wasteful and contrary to the welfare of investors, auditors and financial statement preparers if European authorities take any measures to undermine the IASB. The European political authorities should instead safeguard the ongoing process of financial reporting convergence.
- 8.7. We strongly encourage the UK and other European legislative and regulatory authorities to facilitate and enable the functioning of an independent, accountable, efficient and effective IASB that can thoughtfully address all financial reporting matters including the concerns related to accounting for financial instruments under IAS 39.
- 8.8. The authorities should not overlook the benefits of UK and other European markets aligning their financial reporting with that of other leading capital markets such as the US and Japan. The credit crisis has shown that global oversight capabilities are desirable to match the reality of the global economy that includes an interconnected global financial architecture. The establishment for a single, high quality set of standards is consistent with the objective of attaining global oversight.

## 9. STANDARD SETTING PROCESS

- 9.1. We understand that these are exceptional times and governments are expected to resolve the economic and banking crisis. While this situation may warrant the expeditious implementation of several identified measures, there is the risk that circumventing the due process of the current accounting standard setting process, based on the concerns of a single industry, could be detrimental to the broader welfare of other stakeholders and especially investors. Recognition should be made that financial reporting rules made with financial institutions in mind during the crisis will also affect the preparers and investors of non financial institutions.
- 9.2. The last few weeks have raised several and significant concerns with regard to consideration of financial reporting rules. On 13<sup>th</sup> October 2008, the IASB enacted new reclassification rules under what seemed to be at the behest of EC political pressure and thereafter there have been proposals for further amendments to IAS 39. We are very concerned by the events of the last few weeks because
- 9.2.1. There is no coherence in the objective of the amendments. The only common goal seems to be to change accounting rules to allow financial institutions to present favourable results in the next few quarters. The changes in some instances claim to be aimed at lowering the competitive disadvantages of European Financial Institutions relative to US peers. **From an investor perspective, global convergence is desirable as it captures two important dimensions a) harmonisation that enables comparability and b) an improved set of standards.** However the proposed amendments related to financial instruments, seem to only apply the principle of harmonisation to US

GAAP on an opportunistic and selective basis and in ways that lower the quality of financial reporting for investors (e.g. allowing flexible reclassification that reduces comparability). There is a real risk of cross jurisdictional, mutually reinforcing deterioration in the quality of standards.

- 9.2.2. The changes have a short term orientation and mainly cater to financial institutions. They mainly aim to improve quarterly numbers of the financial institutions. As stated earlier this will likely compromise the comparability of financial institution performance.
  - 9.2.3. There is no explicit reference or articulation of intent to ensure the quality and comparability of standards in the amendments that are being considered.
  - 9.2.4. The due process is not inclusive and investors are under-represented in the considerations. For example the EC stakeholder consultation on the 21<sup>st</sup> October was to a selected number of participants. **Such a process cannot ensure an unbiased and representative contribution from all financial reporting constituencies.**
  - 9.2.5. The changes to accounting rules do not seem to be congruent with the other interventions by the governments in this crisis. For example with the taxpayer investment in financial institutions, it is important to consider which accounting regime will provide transparency, enable ongoing performance monitoring and likely ensure the realisation of gains on the massive fiscal investment made.
  - 9.2.6. Finally there is an inherent contradiction between measures that threaten to fragment current international financial reporting and the espoused intention of establishing global oversight capacity.
- 9.3. The trigger for the intended amendments to accounting standards are the concerns related to fair value accounting. As illustrated in paragraphs 7.3 to 7.9, this is a false premise for change as the pro-cyclical effects are overstated. We reiterate that fair value is not a novel approach to accounting. Although limited to particular assets and liabilities, fair value accounting is a well established component of the financial reporting landscape. As asserted, it does provide investors with timely and decision useful information and is the only accounting regime that has early warning system characteristics.
- 9.4. The overall accounting standard setting process should not be compromised due to general concerns related to a specific accounting standard (i.e. IAS 39). Accounting information has multiple dimensions including defining the measurement approaches and disclosures of different assets and liabilities. Beyond financial instrument and financial institution related accounting, there exists a vast body of accounting literature that depends on the current standard setting architecture. These include literature relating to operating assets, intangible assets, pension accounting to mention a few examples. Hence, an ad-hoc or politicised process targeted at a single standard can have disruptive effects and impose negative externalities to the entire accounting framework.

- 9.5. As is evident from the current debate, the application of fair value is an area with multiple dimensions and encompassing an array of complex issues. These issues can only be meaningfully resolved based on deliberative consideration. An unduly rushed up amendment to current accounting standards, catering only for the concerns of the financial institution fraternity can be detrimental to the overall quality of financial reporting. This is particularly true for IAS 39, which is one of the most complex standards issued by the IASB.
- 9.6. The history of standard setting can provide examples showing that the absence of rigorous deliberation at inception of accounting standards will only necessitate significant interpretative guidance and their revision at future dates. On this basis we strongly support the existence of an independent and accountable standard setting board (i.e. IASB).

## **10. APPENDIX I (ELABORATION OF BENEFITS OF FAIR VALUE)**

### **10.1. INFORMATION CONTENT AND REPRESENTATION OF ECONOMIC REALITY**

- 10.1.1. Fair value by definition, considers the most current and complete assessments about the value of economic items. Fair value accounting is preferable to historical cost accounting because it provides an early warning system about an entity's financial condition by emitting signals about the risk exposures of the assets held. Fair value accounting also provides information on the opportunity cost of continuing to hold financial instruments.
- 10.1.2. Unlike fair value accounting, under an amortised cost approach, gains and losses can be deferred. An amortised cost treatment leads to less frequent recognition of the gains and losses of financial instruments held.
- 10.1.3. Due to the untimely recognition of impairment gains and losses, the amortised cost approach can mask economic reality and is not as transparent as the fair value approach. Due to these features, amortised cost accounting can dis-incentivise managers from acting in the best interests of its shareholders. For example, an institution holding a loan recorded at cost that was issued during a phase of market exuberance may be slow to recognize impairment of the loan caused by deteriorating economic conditions. In that case, the cost approach is a lagging indicator of a firm's true economic position.
- 10.1.4. In contrast to amortised cost impairment related adjustments, mark to market adjustments convey more meaningful economic information and have higher predictive values. For example, the effective interest rate under fair value accounting is indicative of the likely cost of refinancing at the time of reporting. The same can be said of other risk factors (e.g. prepayment and default rates) applied to valuation of reported assets and liabilities.

## **10.2. FAIR VALUE ENABLES THE CONSISTENT ACCOUNTING TREATMENT OF SIMILAR ECONOMIC ITEMS**

10.2.1. Fair value accounting for financial instruments eliminates accounting that is determined by managerial intent. For example, two instruments with exactly the same economic characteristics should not be accounted for differently simply based on whether management intends to hold one to maturity and the other for sale. The application of multiple accounting treatments for similar financial instruments can make it very difficult for users to translate the economic meaning of reported numbers in the balance sheet and income statement. This view is backed by survey evidence. 72% of respondents to the 2007 CFA Institute Financial Reporting and Measurement Survey indicated that companies should not have recognition and measurement options for similar instruments. **Comparability is at the heart of investor financial analysis.**

10.2.2. We also believe that accounting that is based on managerial intent can introduce management bias. Firms can for example manage earnings through the selective realisation of unrealised gains and losses.

## **11. APPENDIX 2 (IASCF RECOMMENDATIONS)**

The Trustees of the International Accounting Standards Committee (IASC) Foundation initiated their second five year review of the organization's constitutional arrangements. A summary of our positions on key proposals are

11.1. *Monitoring Group:* We support the Trustee's proposal to create a Monitoring Group with accountability to public authorities. This group will strengthen the overall process for standard setting by conducting liaison activities with governmental and other organizations. Furthermore, it will provide an effective means for overseeing the functioning of the IASB and its Trustees to ensure their objectives are met. However we feel that the proposed membership of the Monitoring Group could be strengthened by including investors. Investor representation would provide direct experience with standard setting issues and enhance public confidence in the quality of standards.

11.2. *Investor Representation on the Trustees:* Investor representation on the Trustees should be expanded to include more investors. Currently, the Trustees are dominated by preparers, auditors, and regulators. Increased investor representation greatly enhances the confidence of users in the oversight of the standard setting process.

11.3. *Functions of the Monitoring Group:* The proposed functions of the monitoring group are reasonable and appropriate. This includes approval of the appointments of Trustees; overseeing the functioning of the Trustees; and serving as the interface between the IASB and public authorities and other organizations.

11.4. *Self Interest Threat and Governance:* The development of the plans for the institution of the Monitoring Group are at an early stage. The plans call for the

revision and reform of the Foundation’s governance and procedures to ensure the IASB’s long-term sustainability and independence. We encourage the Trustees to expose the Memorandum of Understanding, which will define the terms of reference of the relationship between the Monitoring Group and the Trustees to the public for comment. Furthermore, we stress that the Monitoring Group be designed to act solely in the public interest.

11.5. *Role of Trustees’ Appointments Advisory Group:* We do not feel that there is a role for the Trustees’ Appointments Advisory Group since these selections and appointments will be the responsibility of the Monitoring Group.

11.6. *IASB Funding:* We believe that the Monitoring Group must seek and obtain an entirely independent and sustainable source of funding for the IASB. This will ensure independence of the IASB and its standard-setting function from the influence of special interests.

11.7. *Expanding Membership:* We believe the proposal to expand the IASB to 16 members is unnecessary to ensure that it efficiently and effectively meets its objectives. Of much greater importance to us is that the IASB comprise full time members with no remaining responsibilities or obligations to any other bodies or organizations and that it have adequate investor representation. Furthermore, we believe that increased investor representation on the IASB is critical to firmly establishing public confidence in the standard setting process. To that end, we strongly urge the Trustees to require that if new positions are created, such positions are filled with investor representatives

11.8. *Geographical Dispersion:* The proposed regional representation is appropriate to ensure the representation of global views in the standard setting process, however, we believe the targets for geographical diversity should be re-assessed no less than every 5 years to ensure the targets adequately and fairly represent a broad base of international interests.

## 12. APPENDIX 3 (CFA Institute Member Polls)

### 12.1 CFA Institute overnight poll of EU based members on the suspension of Fair Value Accounting. Results as of 2nd October 2008.

Do you support a suspension of fair value standards under the International Financial Reporting Standards (IFRS)?

Yes	127	21%
No	470	79%

Total=597

Do you think such a suspension would increase or decrease confidence in the European banking system?

Increase	86	15%
Decrease	473	85%

Total=559

These percentages exclude anyone who selected “not sure” for the particular question asked.

We have just over 11,600 members in the European Union—meaning each of these questions has a margin of error of +/-4% at the 95% confidence level.

## 12.2 CFA Institute Member Poll Results on bank bailouts as of Oct. 14, 2008

(5,148 respondents; poll was distributed on Oct. 9, 2008)

Q1. Last week, the U.K. government announced plans to strengthen the capital base of domestic banks by direct investing in the equity of those banks. Is this approach a model that governments worldwide should follow?

	Number of responses	Response percentage
Yes	3174	75%
No	1082	25%

Q2. If governments were to guarantee all short-term debts of solvent financial institutions, would this restore the confidence institutions need to begin trading with each other again?

	Number of responses	Response percentage
Yes	3142	83%
No	660	17%

Q3. To what extent would the following government measures, other than direct investment in banks and guaranteeing of bank debts, help to unfreeze the credit markets? (1 = not at all; 5 = completely agree)

	1	2	3	4	5
Central banks taking steps to eliminate insolvent institutions and to foster recapitalization of institutions deemed solvent. (N=5091)	5%	11%	22%	46%	16%
Full disclosure of bank assets, asset valuations, and valuation assumptions to the market. (N=5094)	5%	15%	23%	33%	25%
Government doing nothing: the markets will sort this out without additional government intervention. (N=5076)	51%	25%	11%	7%	6%

Q4. The markets remain volatile even after the measures taken by governments in recent weeks. To what extent have the following contributed to the continuing volatility? (1 = not at all; 5 = completely agree)

	1	2	3	4	5
Concern about the likelihood of a global recession (N=5109)	1%	6%	16%	49%	29%
Concern that financial institutions continue to hold assets at values that do not accurately reflect current market value.(N= 5111)	1%	8%	16%	44%	31%
Lack of coordinated actions by regulators across regions. (N=5113)	7%	22%	30%	28%	12%
Mark-to-market accounting (N=5097)	15%	24%	25%	24%	12%
Slow pace of implementation of the original US\$700 billion bailout package in the United States. (N=5107)	12%	28%	29%	23%	9%
The end of the ban on short selling in the United States (N=5105)	28%	30%	21%	15%	5%
The unwillingness of commercial banks to lend to each other.(N=5109)	1%	3%	8%	36%	52%



# ***Proposals on the Financial Crisis***<sup>1</sup>

## ***Club Praxis***

### ***1. Europe as the engine of the international financial reform***

A strong consensus has recently emerged on the weaknesses of the current financial regulatory framework. Existing regulatory bodies have failed to prevent or manage the crisis that has struck the world financial system. There are several reasons:

- The jurisdiction and the scope of intervention are national whereas the crisis has been global.
- Regulators only follow company specific risk, do not track inter-company risk and therefore cannot monitor overall systematic risk.
- Prudential regulation has mostly covered banks but has ignored numerous institutions, such a credit intermediaries which have been at the core of the financial crisis.

In order to build indicators for evaluating systematic risk caused by financial operations, we think there is a need:

- to broaden the scope of regulation to all financial institutions (credit and insurance companies, hedge funds,..) which are larger than a minimum size.
- for the regulatory authorities, to track the exposures of each

<sup>1</sup> Please contact Yann Coatanlem, [yann.coatanlem@citi.com](mailto:yann.coatanlem@citi.com), and Minh Trinh, [minh.trinh@nb.com](mailto:minh.trinh@nb.com) for further information on the work of Club Praxis. The views expressed herein are our owns and do not necessarily reflect the views of our respective institutions.

company with all its counterparties beyond a minimum size. Tracking these exposures will help in building a systematic risk indicator that will trigger the involvement of the regulator.

Because counterparties of large financial institutions are often found across the national borders, there is a need to create an international financial regulator who will be able to centralize counterparty risk data and whose decisions will be implemented by the national regulators and central banks.

Realistically, with some expected resistance from the United States, we recommend reforming the financial system first in Europe with the participation of at least the countries of the Euro zone and of Great Britain, starting with the creation of the international regulator who will operate under the supervision of the central banks and the national governments. The setup of a cohesive European regulatory framework will encourage more work towards a more global one.

## ***2. Creation of an international systematic risk reserve fund***

In order to prevent liquidity risk caused by distressed financial firms and their destabilizing effects on financial markets, we suggest the creation of an international systematic risk reserve fund (ISRRF) which would be managed by the central banks and the IMF. This fund would insure against systematic risk and complete the self-insurance feature of financial firms that have to meet regulatory capital requirements.

Today, governments already play the role of insurers but without any contributions from firms that receive their assistance, causing important risk of moral hazard.

Participation to this fund would be mandatory for all companies that are potentially source of systematic risk (banks, brokers, insurers, large hedge funds, financial subsidiaries of industrial companies, exchanges...). Today, many non-financial institutions are extremely active in financial markets and can weaken the

overall financial system. They would have to contribute to the fund to the same extent as the traditional financial firms would.

The fund would calculate the premiums charged to the banks and other institutions according to their contribution to systematic risk. The fund would be invested in SDRs (“Special drawing rights”) during period of non-crisis in order to minimize investment risk and would become the liquidity provider of last resort in crisis time.

Participation to this fund would be equivalent to the subscription of an insurance policy with an indemnity system that would depend on the losses caused by a liquidity crisis (“financial catastrophe insurance”).

The IMF could monitor the risk and calculate the premiums on the behalf of the fund. We believe these new tasks should be consistent with the global systematic risk surveillance mandate of the IMF.

Each central bank would be in charge of collecting the premiums, investing and preserving the fund at the national (ex: Federal Reserve) or regional level (ex: ECB).

The SDRs would earn the interest rate computed according to the rates paid by each basket currency (US Dollar, Yen, Euro, British Pound).

During a crisis, central banks would convert the DTS in any currency of their choice using the exchange rate of the IMF and relying on the individual central banks, according to the liquidity needs, and even create SDRs with the approval of the other central banks. Excess liquidity would be absorbed (sterilized) by issuing government bonds, which are in high demand during these times.

### ***3. Return to simplicity and standardization***

The complexity and the lack of transparency of some financial contracts and instruments have been a source of confusion for

borrowers, investors and regulatory authorities. This has been amplified by the fact that many securities have been traded over the counter (OTC).

Promotion of standardization, meaning classification and codification of financial instruments, would reduce asymmetric information which is common in some markets, would improve market transparency, would facilitate regulation and would encourage the creation of norms for managing their risk. This standardization could be done under the supervision of a Financial Products Surveillance Board and helped by a different tax and regulatory treatment of standard and non-standard products: one could mandate higher regulatory capital for new instruments or limit the aggregation of their risks with the other products in the calculation of capital requirements.

#### ***4. Nomination of a Risk Officer***

We believe that there is a need for a “Risk Officer” within the international regulator. This Chief-Risk-Officer of the financial system would have the authority to ask for all information on trading and investment portfolios as well as on counterparties of all financial transactions, on and off-balance sheets.

In particular, it is necessary to gain some detailed information of each position in all portfolios, in order to limit ambiguous and misleading information – for instance, if a bank reports a CDO as a riskless bond and the regulator has no way to verify the information, his work will be severely curtailed. The risk staff of the regulator will have to define the risk measures to be provided by the companies and should be able to recalculate these measures by themselves. A particularly useful measure of risk is “stress-testing”, which looks at how different market scenarios can impact the positions. One should not forget that for almost incomprehensible reasons, many US banks have neglected to consider the scenario of a fall in the US real estate market: an independent party could have usefully reminded them that real estate prices can also go down. This contrarian view has been missing because of a lack of international or economic perspective.

Furthermore, the regulator should be able to aggregate all the risk of the institutions to build a view of systematic risk. A detailed knowledge of all the positions is necessary, since systematic risk is not reduced to the sum of all the risks. Modern technology should allow this type of organization.

Fundamentally, the setup of this new function should make the risk control dynamic, whereas there previously were only static rules which were easily diverted. It will create a new risk culture in which everyone understands his own risk, but also his contribution to systematic risk and can anticipate that the regulator will act towards enforcing stability and the common interest. To build a partnership with the regulated institutions, the Risk Officer should second representatives among the institutions.

### ***5. Communication on risks***

An important lesson of the crisis is that investors should think along two dimensions: expected gains and estimated risk.

For all new financial products to be commercialized, issuers should disclose publicly a series of risk characteristics. These characteristics should be sufficiently clear and standardized so that investors or buyers of these products can easily aggregate them to evaluate the risk of their portfolios.

They should be defined by the international regulator and could be risk factors such as interest rates, option volatility, credit spreads, correlation etc.

These characteristics should be as complete as possible so that the most important risks are accounted for. For instance, in the case of a CDO, one cannot just only provide with the interest rate risk but one should also mention degradation of credit markets, even if the probability of such event is low in the short-run.

### ***6. Adapting regulation to business cycles***

A pillar of prudential regulation of banks – as it is described in the

Basel II agreements is the notion of regulatory capital, calculated from a risk estimate by the bank (Value at Risk). Several studies have highlighted the pro-cyclical feature of such a rule: during a speculative bubble, there is less capital requirement, and therefore increase of default risk in the downturn phase of the business cycle.

Moreover, as it is based on the net position of the bank, this approach does not always uncover or penalize leverage, an important factor that increases risk.

The former method of calculating capital requirements (Basel I), using regulatory ratios applied to the size of positions, penalized the leverage effect but did not reward better risk management.

It is not realistic to completely forego the framework of Basel II, which has taken so many years to be implemented by large financial institutions to meet the requests of current regulators.

We approve an intermediary solution to reinforce bank capital during expansion period by calculating capital reserve requirement as a weighted-average of reserves calculated using methods of Basel II and Basel I (regulatory ratios). This method would reduce incentives to use leverage at the peak of the cycle by requiring more reserves and would decrease the pro-cyclical nature of Basel II.

### ***7. Prevention of speculative bubbles***

The current financial crisis has begun with a real estate bubble fed by an excessive creation of credit distributed to subprime households. Financial innovation – securitization and risk redistribution – combined with yield-seeking investors in a low yield environment has provided the necessary funding for the purchase of overvalued assets.

We recommend the control of asset inflation not by monetary policy (because it has only a blunt instrument, the short-term interest rate and should be focused on monetary inflation), but by a risk capitalization policy that will be tuned according to the risk of overvaluation. Banks that finance the purchase

of overvalued assets would be penalized. Overvaluation will be estimated using bubble risk indicators by asset class. The indicators would combine a comparison of fundamental and market values, historical analysis of risk premiums and the overall amount of credit allocated to the asset classes.

### ***8. An impartial role for rating agencies***

We recommend that official references to ratings in the current legislations (restricting certain investors to investment grade products as defined by such ratings) be removed and/or to enlarge the circle of certified rating organization to increase competition. Indeed, credit ratings have been misleading for many investors, especially in the case of leveraged structured products such as CDOs for which their use is questionable. Rating agencies will continue to exist and regulators may not have the means to closely monitor them or solve in a satisfactory manner the conflicts of interest inherent in their current business model - an alternative would be to institute a tax on the buyer, but this would create a bias as low rated products are less likely to be bought). This proposal will still allow investors to use credit ratings if they wish to do so alongside other indicators, putting them on the same footage as opinions of financial analysts.

### ***9. Reinforcement of the independence of “whistle blowers”***

Risk managers have not always been in a strong position to enforce their views in financial institutions, especially when their views have conflicted with front office or sales units. Governance rules should be revisited to enhance their positions in the firms management and ensure that the CRO, the CFO, the Head of Compliance, and all whistle blowers in general, have a reporting line to the board.

### ***10. Maintaining accounting discipline***

We should emphasize that there is no reason not to use mark-to-market accounting for liquid assets. At the same time, it is dangerous to use this principle blindly.

Mark-to-Market should remain an important accounting principle, but we should address aggressively key issues which have made a lot people question Mark-to-Market itself. Two areas in particular require to be fixed: 1) pricing of subprime CDOs (ABX indices have proven to be very illiquid), 2) private equity deals: FASB 157 imposes an evaluation based on a market exit price, but there is not necessarily a lot of information available in the market, and private equity deals are essentially hold to maturity. One can imagine that banks would have been greatly affected by the Internet crash of 2000, had FASB 157 been enacted.

It is essential for the new international regulator, without foregoing the mark-to-market philosophy, to be flexible when its strict application leads to dead ends. It is critical to require companies to produce accounting annexes and disclosures which should be as exhaustive as possible and to publish recommendations during exceptional circumstances such as the present crisis, about the content of these disclosures to complete the financial and accounting information. We should therefore be able to overcome temporary difficulties in applying an accounting principle, without renegeing on it.

## CLUB PRAXIS

### DIRECTOR

**Yann Coatanlem**, Managing Director, Citigroup

### MEMBERS

**Jérôme Clausen**, Agence Française pour les Investissements Internationaux

**Rama Cont**, Professor, Columbia University and Research Director CNRS

**Raphaël Douady**, Directeur de la Recherche, CNRS, RiskData

**Zina El Gheribi-Schmitz**, Vice-President, Galileo Global Advisors

**Xavier Gabaix**, Professor, New York University

**Benoît Gausseron**, Dexia

**Matthieu Grollemund**, Attorney at Law, Paul Hastings

**Augustin Landier**, Professor, New York University, Old Lane LP

**Thomas Lefebvre**, Morgan Stanley Principal Investments

**Guillaume Martinez**, Deloitte

**Julien Ravalais Casanova**, Director, Invest in France Agency, London

**François Removille**, Agence Française pour les Investissements Internationaux

**Minh Trinh**, Neuberger Investment Management



# Conference Agenda

Monday, November 24, 2008

**7:30 Welcome Breakfast and Registration**

Venue: Petit Salon and Grand Salon

**9:00-9:10 Introductory Remarks:**

- **Marc Uzan**, Executive Director, Reinventing Bretton Woods Committee
- **Edmond Alphandery**, Chairman of the Board, CNP Assurances, France

**9:10-10:55 SESSION I - The Breakdown of the International Financial System? Solutions and Proposals to restore international financial and monetary stability**

Chaired by: **Wolfgang Münchau**, Chairman, Euro Intelligence

- **Eisuke Sakakibara**, Professor of Economics, Waseda University, Japan
- **David Hale**, Chairman, Global Hale Advisers
- **Kemal Dervis**, Administrator, United Nations Development Program
- **Mark Sobel**, Deputy Assistant Secretary for International Affairs, US Department of Treasury

**10:55-11:15** Coffee Break

**11:15-12:45 SESSION I *Continued***

Chaired by Edmond Alphandery, Chairman CNP Assurances

Contributions from:

- **Richard Clarida**, Strategic Advisor, Pimco, and Professor of Economics Columbia University
- **David Claydon**, Managing Director, Morgan Stanley
- **Jeffrey Shafer**, Managing Director, Citigroup

**12:45-14:30 Lunch**

Speaker: **Clay Lowery**, Assistant Secretary, International Affairs, US Department of Treasury

**14:30-16:30 SESSION II - Solutions to Restore International Financial Stability**

Chaired by: **Jacob Frenkel**, Vice Chairman AIG, and Chairman Group of 30

**14:30-16:30** SESSION II - Solutions to Restore International Financial Stability

Chaired by: **Jacob Frenkel**, Vice Chairman AIG, and Chairman Group of 30

**14:30-15:30** Contributions from:

- **Michael Dooley** Partner, Cabezon Capital,
- **Peter Garber**, Strategist Deutsche Bank
- **Barry Eichengreen**, Professor of Economics, University of California at Berkeley

**15:35-16:20**

- **Nouriel Roubini**, Professor of Economics, Stern School of Business, and Chairman RGE Monitor
- **Tim Adams**, Managing Director the Lindsey Group
- **Alexandre Swoboda**, Professor of International Economics Emeritus, The Graduate Institute of International and Development Studies, Switzerland

**16:20-16:40** Coffee Break

**16:40-18:00** SESSION III - Solutions to Restore International Financial Stability

Chaired by: **George Vojta**, Chairman, Financial Standards Foundation

- **Dino Kos**, Managing Director, Portales Partners
- **Malcolm Knight**, Vice Chairman, Deutsche Bank
- **Andy Haldane**, Executive Director designate, Bank of England
- **Mark Siegel**, Member of the Board, FASB
- **Mark H. Adelson**, Chief Credit Officer for Standard & Poor's

**19:30**

Welcome Drinks and Dinner

**Venue: Aquavit Restaurant, 65 East 55th Street, New York, NY 10022,**  
*(Phone: 212-957-9045)*

Tuesday November 25, 2008

7:30 **Welcome Breakfast** (Petit Salon)

8:30-10:00 **SESSION IV - Building an International Monetary and Financial System for the 21<sup>st</sup> Century: Merits and Demerits for the Current System and Agenda for Reform**

Chaired and Introductory Remarks by **Robert Mundell**, Nobel Prize of Economics, Professor of Economics at Columbia University

- **Michael Bordo** and **Harold James** Professor of Economics, Rutgers University and Professor of History, Princeton University
- **Ronald Mac Kinnon**, Professor of Economics, Stanford University
- **Judy Shelton**, Economist, Author
- **Richard Cooper**, Professor of Economics, Harvard University
- **Yung Chul Park**, Professor of Economics, Seoul National University

10:00-10:20 Coffee break

10.20-11:30 **SESSION IV - Continued**

- **Olivier Jeanne**, Professor of Economics, Johns Hopkins University
- **Jean Pisani-Ferry**, Director, Bruegel
- **Reza Moghadam**, Director, Policy Review Department, IMF

11:30-13:00 **SESSION V - What is at Stake for the Emerging Markets?**

Chaired by: **Larry Brainard**, Chief Economist, Trusted Sources

- **Joyce Chang**, Global Head of Emerging Markets and Credit Research, JP Morgan Chase
- **Jose Antonio Ocampo**, Professor of Economics, Columbia School of Public Affairs
- **Jens Nystedt**, Moore Capital Management
- **Dominic Wilson**, Co Head, Global Economic Research Goldman Sachs
- **Lewis Alexander**, Global Chief Economist, Citigroup

13:00-14:15 **Lunch**

14:15-16:00 **SESSION VI - The stake of Emerging Economies in the International Financial System**

Chaired by: **Robert Mundell**, Nobel Prize of Economics, Professor of Economics at Columbia University

- **Mario Blejer**, Adviser Banco Hipotecario, Argentina
- **Roberto Unger**, Minister of Strategic Affairs, Brazil
- **Charles Soludo**, Governor Central Bank of Nigeria
- **Martin Castellano**, Chief of Staff of the Governor, Central Bank of Argentina
- **Yan Q fa**, Vice General Manager, Export Import Bank, China

16:05-16:10 **Concluding Remarks**



## *List of Authors*

**Mark ALLEN** Former Director, IMF

**Sven ARNDT** C. M. Stone Professor of Money, Credit, and Trade, The Robert Day School of Economics and Finance, Claremont McKenna College

**Christoph AVENARIUS** Director, Alternative Investments, Credit Suisse

**Mate BABIC** Professor of Economics, University of Zagreb

**Amar BHATTACHARYA** Secretary General, G24

**Michael BORDO** Professor of Economics Rutgers University

**Lawrence BRAINARD** Chief Economist, Trusted Resources

**Martin CASTELLANO** Chief of Staff, Central Bank of Argentina

**Richard COOPER** Professor of Economics, Harvard University

**Kemal DERVIS** Administrator, UN Development Program, Former Minister of State, Turkey

**Barry EICHENGREEN** Professor of Economics, University of California at Berkeley

**Erich HARBRECHT** Head International Financial System Division, Bundesbank

**Tryggvi Thór HERBERTSSON** Former Special Economic Adviser, Prime Minister's Office, Iceland

**Harold JAMES** Professor of History, Princeton University

**Olivier JEANNE** Professor of Economics, SAIS, The John Hopkins University

**Dino KOS** Managing Director, Portales Partners

**Ronald McKINNON** Professor of Economics, Stanford University

**Ira M. MILLSTEIN** Senior Associate Dean for Corporate Governance at the Yale School of Management, and Senior Partner, Weil, Gotshal & Manges LLP

**Jens NYSTEDT** Moore Capital Management

**Jose Antonio OCAMPO** Professor of Economics, School of Public Affairs, Columbia University

**Jean PISANI-FERRY** Director General, Bruegel

**Nouriel ROUBINI** Professor of Economics, New York Stern Business School; Chairman, RGE Monitor

**LI RUOGU** , Chairman & President Export-Import Bank of China

**Jeffrey R. SHAFER** Vice Chairman, Global Banking, Head of Economic and Political Strategies, Citigroup

**Judy SHELTON** Economist and Author

**Alexander K. SWOBODA** Professor of International Economics Emeritus, The Graduate Institute of International and Development Studies

**Marc UZAN** Executive Director, Reinventing Bretton Woods Committee

**George VOJTA** Chairman, Financial Standards Foundation





## **List of Participants**

Tim ADAMS	Managing Director, The Lindsey Group
Carl ADAMS	Advisor to the Management Committee Standard and Poor's
Mark H. ADELSON	Chief Credit Officer for Standard & Poor's
Lewis ALEXANDER	Global Chief Economist, Citigroup
Jean-Luc ALEXANDRE	Managing Director, BNP Paribas
Mark ALLEN	Former Director, IMF
Edmond ALPHANDERY	Chairman of the Board, CNP Assurances, Former Minister of Economy
Sven ARNDT	C. M. Stone Professor of Money, Credit, and Trade, The Robert Day School of Economics and Finance, Claremont McKenna College
Christoph AVENARIUS	Director, Alternative Investments, Credit Suisse
Susumu AWANOHARA	Director, Medley Global Advisers
Amar BHATTACHARYA	Secretary General, G24
Mario BLEJER	Adviser, Banco Hipocaterio, Argentina
Michael BORDO	Professor of Economics Rutgers University
Lawrence BRAINARD	Chief Economist, Trusted Resources
Luigi BUTTIGLIONE	Partner, Head of Global Strategy, Brevan Howard
John H. CARLSON	Portfolio Manager, Fidelity Investments
Martin CASTELLANO	Chief of Staff, Central Bank of Argentina
Joyce CHANG	Global Head of Emerging Markets and Credit Research, JP Morgan

Julie CHON	International Economic Advisor, US Senate Banking Committee
Richard CLARIDA	Strategic Advisor, Pimco, and Professor of Economics, Columbia University
David CLAYDON	Managing Director, Morgan Stanley
Patrick COMBES	Chairman, VIEL Group
Richard COOPER	Professor of Economics, Harvard University
Arnab DAS	Head of Global Market Research, Dresdner Kleinwort
Bob DANNHAUSER	Senior Policy Analyst, CFA Institute
John DEARIE	Senior Vice President, Financial Services Forum
Kemal DERVIŞ	Administrator, UN Development Program, Former Minister of State, Turkey
Christian DESEGLISE	Partner BTG, Adjunct-Professor Columbia University's School of International and Public Affairs
Michael DOOLEY	Partner, Cabezon Capital
Sophia DROSSOS	CFA, Morgan Stanley, Research
Pierre DUPONT	Two Sigma Investments
Barry EICHENGREEN	Professor of Economics, University of California at Berkeley
Klas EKLUND	Adviser, SEB
Gazi ERCCEL	President, Ercel Global Advisors
Eric FINE	Chief Investment Officer, G-175 Capital LLC
Kristin FORBES	Professor of Economics, Sloan School of Management, MIT
Ernestina FORNAROLI	Senior Manager of the Governor's office, Central Bank of Argentina
Jacob A. FRENKEL	Vice-Chairman, American International Group, Inc.
Peter GARBER	Strategist, Deutsche Bank
Alessandro GIRAUDO	Chief Economist, Group VIEL

Rishi GOYAL	Economist, Strategy, Policy and Review Department, IMF
Heidar GUDJONSSON	Managing Partner, Novator
Andy HALDANE	Executive Director Designate, Financial Stability Division, Bank of England
David HALE	Chairman, Hale Global Advisers
Jim HALEY	Director General, Ministry of Finance, Canada
Erich HARBRECHT	Head International Financial System Division, Bundesbank
John G. HEIMANN	Senior Advisor – Former Comptroller of the Currency, Warburg Pincus
Trygvi þór HERBERTSSON	Former Special Economic Adviser, Prime Minister's Office, Iceland
Ernani HICKMANN	Director, Tulio Vargas Foundation
Robert HILLS	Advisor, UK Executive Director's Office, IMF
Michael JALIMAN	Senior Advisor, Vantage Partners
Harold JAMES	Professor of History, Princeton University
Olivier JEANNE	Professor of Economics, SAIS, The John Hopkins University
Nicholas JOICEY	Director, International Finance Division, UK Treasury
Louise KANTROW	Permanent Representative to the United Nations International Chamber of Commerce
David KAPLAN	Managing Director, Highland Financial Holdings
Malcolm KNIGHT	Vice Chairman, Deutsche Bank
Christian KOPF	Portfolio Manager Spinnaker Capital Limited

Dino KOS	Managing Director, Portales Partners
Manu KUMAR	D & E Shaw
Marc-Antoine LACROIX	Deputy Financial Counsellor, French Embassy
Clay LOWERY	Assistant Secretary for International Affairs, US Department of Treasury
Roberto MANGABEIRA UNGER	Minister of Strategic Affairs, Brazil
Marco MARTELLA	US Representative of Banca d'Italia
Isabelle MATEOS Y LAGO	Senior Economist, IMF
Ronald McKINNON	Professor of Economics, Stanford University
Andrea MENEZ	Portfolio Manager, BTG Partners
Maziar MINOVI	Managing Director, Investment Management Division, Goldman Sachs
Reza MOGHADAM	Director, Policy Review Department, IMF
Manuel MONTES	Chief, Policy Analysis and Development, Financing for Development Office, UNDESA
Wolfgang MÜNCHAU	Chairman, EuroIntelligence
Robert MUNDELL	Nobel Prize of Economics, Professor of Economics, Columbia University
Alberto MUSALEM	Managing Director, Tudor Investments
Franz NAUSCHNIGG	Director, international Affairs, Central Bank of Austria
Edward NELL	Professor of Economics, New School of Social Research

Jens NYSTEDT	Moore Capital Management
Jose Antonio OCAMPO	Professor of Economics, School of Public Affairs, Columbia University
Matt ORSAGH	Senior Policy Analyst, CFA Institute
Norberto PAGANI	Senior Manager of International Relations, Central bank of Argentina
Yung Chul PARK	Professor of Economics, Seoul National University
Jean PISANI-FERRY	Director General, Bruegel
Yan QIFA	Vice General Manager, Economic Research Dept., Export-Import Bank of China
Rogelio RAMIREZ DE LA O	Director General Ecanal SA
Martin REDRADO	Governor, Central Bank of Argentina
Nouriel ROUBINI	Professor of Economics, New York Stern Business School Chairman, RGE Monitor
Alan RUSKIN	Global Chief Economist, Royal Bank of Scotland, Global Markets
Eisuke SAKAKIBARA	Professor of Economics, Waseda University
Carsten SAMUSCH	RBC Capital Markets
Kurt SCHACHT	Director, Centre for Financial Market Integrity
Benu SCHNEIDER	Economist, Department of Economic and Social Affairs, United Nations
Michaela SCHRADER	External Affairs, IMF
Brad SETSER	Senior Fellow, US Council on Foreign Relations

Jeffrey R. SHAFER	Vice Chairman, Global Banking, Head of Economic and Political Strategies, Citigroup
Judy SHELTON	Economist and Author
David M. SIEGEL	Co-Chairman and Founder of Two Sigma Investments
Marc SIEGEL	Member of the Board, Financial Accounting Standards Board
Denise SIMON	Managing Director, HSBC Halbis
Domenico SINISCALCO	Managing Director, Morgan Stanley
Mark SOBEL	Deputy Assistant Secretary for International Affairs, US Treasury
Chukwuma SOLUDO	Governor, Central Bank of Nigeria
Shari SPIEGEL	Principal, New Holland Capital
Timothy STEWART	Managing Director, Fortress
Jörg STOSBERG	Permanent Mission of Germany to the UN
Alexander K. SWOBODA	Professor of International Economics Emeritus, The Graduate Institute of International and Development Studies
Heliodoro TEMPRANO	Deputy Head of Unit, Directorate General for Economic and Financial Affairs, European Commission
Chris THOMPSON	Alternate Executive Director, Tudor Investment
Minh TRINH	Senior Vice President, Neuberger Investment Management
Angel UBIDE	Managing Director, Tudor Investment

Leanne USSHER	Assistant Professor Queens College, City University of New York
Marc UZAN	Executive Director, Reinventing Bretton Woods Committee
Paulo VIEIRA DA CUNHA	Principal, Tandem Global Partners
George VOJTA	Chairman, Financial Standards Foundation
Paul WACHTEL	Professor, NYU Law School
Marsha WALKER	President, GG Group, USA
Pierre François WEBER	Head of Macro-finance Division, Financial Stability Directorate, Banque de France
Martin WEISS	Specialist in International Trade and Finance, Congressional Research Service, Library of Congress
John WILLIAMSON	Senior Fellow, Institute for international Economics
Dominic WILSON	Co-Head of Global Economic Research, Goldman, Sachs & Co
Miranda XAFA	Alternate Executive Director, Executive Board, IMF
Songzuo XIANG	Editor in Chief, Global Business and Finance Magazine
Li XIAOWEI	Economic Research Dept., Export-Import Bank of China
Ricardo ZUBERBUHLER	Chief of Public Relations, Central Bank of Argentina



***Sponsored by:***

Morgan Stanley



***Co-Hosted by:***









***Building an International  
Monetary and Financial  
System for the 21<sup>st</sup> Century:  
Agenda for Reform***

**Conference Proceedings**

**W**hat we are witnessing today is not just a crisis in the system, it is a crisis of the system. The global financial framework is broken, and the level of trust in capital markets is at all time lows. As a new step in the globalization process, there should be a focus on enhancing world trade and financial flows, in a way consistent with sustainable economic growth. On November 24-25, 2008, the Reinventing Bretton Woods Committee held a conference in New York City aimed at addressing solutions and proposals to restore international financial and monetary stability.

eBook published by



***REINVENTING BRETTON  
WOODS COMMITTEE***