Asia and the Global Financial Crisis

Conference sponsored by the Federal Reserve Bank of San Francisco, Santa Barbara, Oct 18-20. 2009

Reforming the Global Financial Architecture

Lunchtime remarks by Andrew Crockett

Introduction

"Architecture" may seem a rather pretentious word to describe the ad hoc set of arrangements that make up the current international financial system. Even a reformed financial system will surely lack the clarity of structure and design that are the hallmarks of good architecture. But a financial system should nevertheless conform to certain broad principles, which can be readily understood and widely accepted. It is these principles that I want to talk about today.

To my knowledge, there is no generally-agreed definition of what is meant by the term "global financial architecture". I will take it to encompass three things: *first* the basic economic model by which international financial relations are conducted; *second*, the network of institutional arrangements that are put in place to manage these relations; and *third*, how decision-making power in the system is distributed among individual countries. I hope that what I mean by each of these aspects will become clearer as I go along. My central theme is that all three aspects of the international financial architecture have been profoundly affected by the way in which the world economy has evolved over the past few decades, and by certain trends that have come to a head in the current crisis.

The first major trend of the post war era has been the growing ascendancy of the free market philosophy. This has led to a focus on open and global financial markets as the principal driving mechanism for the international allocation of resources. Not only is this a somewhat different model of international financial relations from that envisaged at Bretton Woods, it has called for new institutional mechanisms to manage it. Now, however, the current financial crisis has placed in question the validity of some aspects of this new model.

The second major trend has been the growing weight in the world economy of newly emergent economies. This has rendered outdated the distribution of power in the global institutions created after the Second World War. The fact that the crisis had its origins in the major financial centres has intensified the calls by emerging markets for more say in how international financial relations are managed.

These trends, and the questions now being raised about the financial architecture, have major implications for Asian economies. Asian countries have been both the beneficiaries and occasionally the victims of financial globalization. They have been the countries that have seen their shares of world output and trade grow the fastest. Asia therefore has a key

interest in a more robust framework of international finance, and in a more equitable sharing of decision-making authority. But it has hitherto played a relatively minor role in the design and management of the international monetary system.

In my remarks today, I will begin by considering the changing economic model of international financial relations; and how institutional structures have been adapted to reflect the changes that have taken place. I will then say something about how the experience of the past two years has altered perceptions of the working of the system, and how reforms are taking account of the lessons learned. Lastly I will discuss how the relative roles of different countries need to change to reflect new realities of the global balance of economic power.

The changing model of international financial relations

The basic model of international economic relations has evolved enormously from the system set up in the aftermath of the Second World War. In the words of Padoa Schioppa and Saccomanni, the international monetary system has gone from being "government-led" to "market-led". (Padoa-Schippa and Saccomanni, 1994)

The Bretton Woods system, established in 1944, assigned a key role to governmental decision-making. And it did so in a framework of largely separate and independent national financial systems. Consider four central features of an international financial system: the exchange rate regime; the balance of payments adjustment process; international liquidity creation, and payments arrangements. Under Bretton Woods, all has a substantial measure of government management. *Exchange rates* were fixed and could be changed only by intergovernmental agreement in specified circumstances of "fundamental disequilibrium". Otherwise governments were expected to defend them by exchange market intervention. *Balance of payments adjustment* was pursued through the deliberate use of domestic demand management to secure a stable current account. *International liquidity* depended on the fixed dollar price of gold, and the mechanism for liquidity creation was hotly debated in international fora. And *capital account payments* were in most countries subject to restriction through exchange controls.

Over time, however, this government-led system was undermined by forces of economic liberalization, particularly in capital markets. Capital controls proved difficult to enforce, and were eventually rejected on philosophic grounds also. The fixed exchange rate system among the major countries broke down in 1971, and was replaced by a floating regime, in which market forces played the major role. International liquidity became essentially demand-determined, as aggregate reserve balances were increasingly based on national decisions. And the adjustment process was largely market-driven, with major governments eschewing current account targets and allowing exchange rate movements, rather than domestic demand policies, to perform the function of equilibrating demand and supply for foreign exchange. In sum, where previously governmental decisions had dominated the management of the international monetary system, by the latter decades of the 20th century market forces largely guided cross border flows of real and financial resources.

To be sure, not all countries moved to the same extent or at the same pace. Many emerging markets still today manage their exchange rates and maintain some capital controls. But by the beginning of the current century, it was possible to say that the basic architecture of the international financial system was based on market forces, which in turn operated through open and global capital markets. Nation states generally accepted a responsibility to pursue prudent domestic monetary and fiscal policies, but this was assumed to be consistent with allowing market forces to determine exchange rates and international financial flows.

Institutional implications of the new model

A major consequence of the liberalizing trend was an enormous expansion in cross border capital flows. The separation that had existed between national capital markets in the earlier post war years was almost completely eroded, and a single global capital market developed. Concomitantly with this process, financial market players were growing in size and geographical spread. They were developing new financial instruments that facilitated the management of risk and taking of positions in a wide range of markets. As markets became more "complete" it became harder for government policies to escape their discipline. If anything, however, this was regarded as a further benefit of a market driven international financial system.

The growth of global financial markets signaled significant changes in the basic model within which international economic relations were managed. The relative importance of *governmental* decisions about exchange rates, liquidity creation and so on, declined relative to *regulatory* decisions about how financial institutions and markets were supervised.

Within national economies, increased importance was attached to central banks, whose monetary policies directly affected financial market conditions, and to those agencies responsible for the regulation and supervision of institutions and markets. To begin with, however, and, with the benefit of hindsight, surprisingly, the preservation of financial stability was not a major focus of regulators' attention. Many financial systems had been heavily regulated for decades, with controls on permitted fields of activity, market entry, prices of services, and interest rate levels. These controls resulted in financial repression, but effectively insulated financial systems from instability. Basically, the cushion of rents was so large that failures were highly unlikely.

With the flowering of liberalization, however, the model of an administratively regulated financial system came into question both nationally and internationally. The basic assumption of the liberal economic model was that market forces are largely beneficent, and so the thrust of regulation should be to facilitate their operation. In such a model, the dangers of financial instability might be greater, but it was thought that these dangers could be controlled by a combination of the enlightened self interest of market players, the self-equilibrating properties of markets, and risk-based, "light touch" supervision by the regulatory authorities.

The international dimension of a lightly regulated market based financial system was the need to ensure a level playing field for global financial institutions, through comparable regulation in individual national markets. But which body, in the "architecture" of the system, should be charged with promoting the necessary global cooperation?

The IMF was not well-suited to this task for several reasons. One was the fact that the expertise of the Fund had been built up in the macro-economic area, and the Fund staff had relatively less experience in financial matters. Another was the fact that the Fund was an intergovernmental agency, largely dominated by finance ministries, whereas much of the authority in the financial arena was wielded by other agencies such as central banks and financial regulators.

As a result, and little remarked by observers at the time, important areas of responsibility for the management of the international financial system passed into the hands of bodies other than the IMF. A number of these were found in Basel, where central bankers had been meeting since the 1930s. With the increased prominence of monetary policy as the principal tool of macroeconomic policy, and the growing independence of central banks, the monthly (later bi-monthly) meetings of central bank Governors in Basel became a significant element in the structure by which international economic relations were managed.

Other significant developments in the institutional architecture were the creation in 1975 of what later became the Basel Committee on Banking supervision, the growth in the authority of the International Organisation of Securities Commissions (the securities regulators, IOSCO) and the establishment of a network of central bank committees to monitor market trends and developments. Lastly, in 1999, the Financial Stability Forum was established to bring together in a single body the key institutions concerned with issues of national and international financial stability.

Three aspects of this new institutional architecture are worth noting. First, it developed largely ad hoc, and outside the framework of formal treaty obligations. This gave it flexibility in operation but robbed it of legitimacy. Second, it was largely unplanned, in the sense that each committee was established to meet a particular need with little attempt at coordination or overall design. And third, it developed within a philosophical framework that regarded market forces as largely stabilizing.

The impact of the crisis

What does the current crisis tell us about the desirability and effectiveness of a market-based, global financial system, and the architecture that has developed to manage it? There are many lessons, but perhaps the most obvious one is that unfettered market forces have not prevented a synchronized global meltdown in financial markets, with devastating consequences for real economic activity and employment. We have learned

that market failures are more widespread and problematic than we previously believed. A lightly regulated financial system does not necessarily tend to a stable equilibrium.

Reforms to the previous regulatory philosophy are therefore called for. The questions now faced are what these reforms should be and how they can be brought about. Will they be a modification at the margin of the basic open market approach? Or will they involve much more far-reaching restraints on market forces, and perhaps a move back from globalization? As these issues are being resolved, there is also the question of what institutional structure will be most effective in managing a reformed financial system.

One view is that globalization has been proved wanting in the present crisis, and that what is required is much greater dose of governmental involvement in key economic areas. This could include more managed exchange rates, stricter controls over movements of capital, and tighter licensing of financial products. It could also involve more governmental control of the shape of national financial systems, perhaps through breaking up financial conglomerates and/or limiting the activities of foreign firms. Those who favour this approach recognize that it involves a retreat from globally integrated financial markets but feel that the costs of this are less than advertised, and worth paying to obtain the benefits of greater stability in national financial systems.

There are undoubtedly superficial attractions to more direct government involvement in key financial markets and prices, and more local control over national financial markets. It could help avoid some of the consequences of unfettered market over-reactions. It could prevent governmental policy objectives from being frustrated by market developments. Emerging markets in Asia, for example, feel vindicated in their policy of managing exchange rates, accumulating large foreign exchange reserves and maintaining capital controls. Those that have limited foreign involvement in their financial sectors believe this has helped protect them from a drying up of lending.

More restrictions over financial institutions could also limit some of the costly cross-border contagion we have seen. Regulators such as the FSA in London are seeking to guard against imported instability by introducing measures to require global institutions to manage their local balance sheets according to national prudential standards. There are calls for financial innovation to be managed so as to avoid the use of "weapons of mass financial destruction".

Seductive as some of these arguments are, I believe that, if pushed too far, they carry significant potential costs for the world economy. Accepting them unquestioningly could begin a trend that might lead to the fragmentation of capital markets, and a retreat from globalization. It should not be forgotten that globally integrated capital markets have brought great benefits. The aim of the reforms that are now urgently needed should therefore be to preserve these benefits while addressing the specific defects that have resulted in such damaging instability. The new financial architecture should therefore be based on a greater recognition that market failures can occur, that market forces therefore need to be better controlled, and that new institutional mechanisms are needed to manage these processes. How can this be achieved?

Concerning macroeconomic variables, it is clear that market forces can cause capital flows and asset prices to overshoot. But this does not mean that governmental decisions would be better. As a general matter, the reverse is almost certainly true. But we probably need a conceptual framework that enables us to decide when it is legitimate to override market signals in the interest of systemic stability. Take the case of asset bubbles. For a long time, it was assumed that asset bubbles were impossible to identify in advance, and that the best policy was to mop up the consequences after they had burst. Now, there is greater interest in seeing whether credit financed bubbles can be addressed as they are emerging, and how monetary or regulatory policies can be used to control them. Research is beginning to have some success in identifying early warning signals of unsustainable financial imbalances.

In attempting to make counteracting financial imbalances operational, however, international cooperation will be key. It will be very important to have a coordinated view of what is possible and desirable in this area. Divergent approaches could well lead to inconsistent monetary policies and to undesirable exchange rate movements. The aim should be the correction of potential *sources* of instability rather than trying to suppress their consequences.

Moving from macroeconomic concerns to financial regulation, it should be possible to devise market-friendly tools to preserve stability, rather than administrative-type restrictions on what financial institutions are allowed to do and where they are allowed to operate. The crisis has demonstrated that banks need to hold larger capital buffers to internalize the costs of potential public support, and that the range of institutions subject to supervision should be widened. It has also shown the need to address procyclicality in the financial system and to take a much wider view of the macroprudential aspects of systemic stability. There is thus a strong basis for an internationally coordinated set of guidelines for managing financial systems. Devising and implementing these guidelines presents a demanding, but achievable, research and policy agenda for the international community.

There would be significant drawbacks if individual countries pursued separate approaches to strengthening their financial systems. The benefits of a global capital market depend on reasonably consistent national regulations to provide a level playing field for competition. Without this, there are risks of regulatory arbitrage. Experience seems to suggest that in the presence of regulatory arbitrage national regulators will seek to erect barriers to cross-border activities, in order to preserve their capacity to control risks in their domestic financial system. This may be understandable, but undermines the benefits that flow from a global capital market.

In my view, an efficient international financial architecture should involve a truly global framework of supervision and regulation, together with international agreement on the management of crises and the resolution of failing institutions. Only in this way would regulators be able to assure public opinion in their respective countries that they were

protected against the risks of financial instability, while preserving the benefits of an open international financial system.

Three principles are of key importance. First, regulation should be based on a common framework of rules across national jurisdictions. This is the easiest (though still not easy) element to achieve. Banking and other financial regulators should agree on minimum prudential standards for the institutions under their control, and for a common coverage of regulated institutions and markets. This requires building on the current Basel capital standards, with modifications to strengthen guidelines that have been shown to be inadequate.

Second, and harder, there need to be understandings about supervisory implementation, ie, about how regulations established by common agreement are interpreted and enforced. This is difficult because national supervisors have a statutory responsibility for the institutions incorporated within their jurisdiction, and do not always feel able to rely on the prudential supervision of foreign supervisors over foreign-based institutions. The key here is to find mechanisms, perhaps through colleges of supervisors, which provide reassurance to national supervisors that they can rely on the judgments of foreign peers.

The third element is a mechanism that permits the orderly winding down of a failing institution. This is undoubtedly the hardest, as it goes to the heart of national legal systems and touches on the fiscal responsibilities of national governments. For moral hazard reasons, no institution should be perceived as too big to fail, so mechanisms are needed that will allow failure without imposing unacceptable costs on either national taxpayers or partner countries

There are four key prerequisites of an acceptable failure regime: (i) imposing losses on stakeholders that are predictable and consistent with avoidance of moral hazard; (ii) avoiding unnecessary damage to "innocent bystanders", especially when that would provoke a loss of confidence in otherwise sound financial institutions; (iii) minimizing taxpayer costs; and (iv) sharing equitably across affected countries any residual fiscal burden.

This is a demanding set of requirements. I fully understand that they are easier to set out than to implement. But unless we are able to build a more cooperative international structure of supervision and crisis management, we are at risk of squandering the gains of many decades of growing financial globalization. No region would be at more risk of losing from this than Asia. For this reason, Asian countries need to have clear ideas about how the architecture of finance should be reformed, and to be prepared to use their enhanced role in the global decision making process to this end.

The distribution of decision making power

I come, lastly, to how power and influence should be exerted by participant countries in the international financial system. This has been a dominating theme in discussions about the reform of the IMF.

The reason for the debate is obvious. Since the early 1970s, there have been rapid changes in the relative economic weight of different countries, which have rendered obsolete the preexisting power structure in international finance. This is particularly apparent in the quota shares of the IMF and World Bank. Changing economic weights have affected many regions, but they are most clearly evident for Asia. Asian countries have developed rapidly over the past three decades or so. Excluding Japan, their share of world output has risen from 7.8 percent in 1975 to 14.6 percent today. Even this understates the growth in the importance of these nations in international financial relations. Asia's share of world exports has risen from 8 percent to 23 percent over the same period, and its share of global foreign exchange reserves from 21 percent to 49 percent.

It is clear that Asia merits greater representation in the key international decision making bodies. But to be effective in increasing Asia's voice, Asian countries need to be clear on their objectives. A first question is to identify the bodies that are likely to be most influential in shaping the global financial architecture. A second is to develop a strategy for achieving more "clout" in these bodies. A third is to work out what it is Asian countries want, in a substantive sense, in the model of international financial relations. And a fourth is to utilize their growing voice collectively to achieve these goals. Let me end my remarks by commenting briefly on each of these.

Concerning the bodies that will wield the most influence in the financial system of the future, it would be a mistake, in my view, to focus only on the IMF and World Bank. These are certainly important institutions, and the IMF will probably play a major role as the forum for discussing macroeconomic imbalances. But also of importance will be the G20 and the various sub-groups formed under its aegis. In this connection, the Financial Stability Board (FSB) assumes particular prominence. It seems likely that the FSB will be the forum that develops the regulatory structure of a reformed financial system, and makes recommendations about international harmonization of regulatory standards. Also of key importance will be the various committees established under the umbrella of the BIS, which will also participate in the FSB. These include, in particular, the Basel Committee on Banking Supervision, the Committee on the Global Financial System, and the Committee on Payment and Settlement Systems.

The good news is that the Asian members of the G20 are now also members of all these bodies. But this still leaves open the second question, that of how to develop a voice in the Committees commensurate with the growing importance of Asian economies. This is not a question of voting power, since there is no voting structure in the committees. Rather, influence depends on the perceived value of the intellectual contribution to the discussion. So it will be important for Asian countries to be represented by respected technical experts, with the latitude to participate in discussions without being bound too

restrictively to a “party line”. Formal statements prepared by capitals are unlikely to be well received.

Third, and most importantly, Asian countries need to decide exactly what shape of international financial system best suits their needs for the medium and long-term future. In my view, Asia will be an increasingly active participant in cross-border financial relations and would benefit from an architecture that facilitates global integration of capital markets and banking systems. If this is true, Asia would benefit from a supervisory structure in which more decisions were harmonized at the global level. This of course runs counter to instincts to preserve domestic freedom of action in regulatory matters. It will be necessary for Asian countries to decide where their long term balance of interest lies, and pursue that holistically, rather than react to particular issues on an individual basis.

Lastly, Asian countries need to decide how to concert their voice to best effect in groupings where there will inevitably be disparate interests. Given that the G20 and FSB are ad hoc groupings and do not have the legitimacy of universality and a treaty basis, I believe it would be useful for Asian members of these bodies to “reach out” to non-member countries in the region, both to keep these countries informed of developments and to solicit their input to key decisions. This would enhance the legitimacy of the Asian voice.

Conclusion

Allow me to sum up. The “architecture” of the future global financial system seems likely to continue to be based on a market driven model, but one in which market regulation will play a more substantial role than hitherto. The institutional structure for managing such a system will probably be fragmented, with various international regulatory bodies playing a role alongside the established international financial institutions. And Asian countries have the opportunity to have a larger voice in the management of the system.

If I am right in this, the architecture of the new arrangement will not be tidy. But it will be based on a number of key principles, which it is important to keep in mind as specific arrangements are developed. These include: a recognition that open markets are the basic organizing framework for international financial relations; a willingness to intervene to counter market failures where there is a collective judgment that such failures have occurred; a network of institutions to give effect to the principles just outlined; and a distribution of authority within these institutions that allows all participant countries to feel their views are adequately taken into account.

It will be a challenge to put these principles into effect. But the prize is worth it, in terms of a stable and cooperative international financial system that exploits the undoubted advantages that global capital markets can offer.

References

1. Padoa-Schioppa, T and F. Saccomanni: "Managing a Market-led Global Financial System" in P.B. Kenen (ed) *"Managing the World Economy: Fifty Years after Bretton Woods"*, Washington, DC, Institute for International Economics, 1994, pp 235-68.