Reforming the International Financial Architecture, 2011 Edition[1]

Barry Eichengreen

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If U.S. President Clinton's treasury secretary Robert Rubin is responsible for coining the phrase "international financial architecture" in a speech at the Brookings Institution in 1998, I deserve some of the blame for popularizing it.[2] I used it in the title of my 1999 book, *Toward a New International Financial Architecture,* published by the Peterson Institute.[3] I say blame because the term architecture conveys a rather misleading sense of the nature of the process. Mirriam-Webster's on-line dictionary defines architecture as "a unifying or coherent form or structure" (as in "this novel displays an admirable architecture").[4] In other words, the term implies a unity and coherence that financial markets, institutions and policies do not possess. Alternatively, Mirriam-Webster defines "architecture" as "a formation or construction resulting from or as if from a conscious act." But many of our international arrangements have, in fact, evolved as unintended consequences of past actions rather than as the result of anyone's conscious act, "as if" or otherwise. The post-Bretton Woods exchange rate system, starting in the 1970s and extending through the present day, was more the product of the inability of policy makers to agree on the form that the exchange rate system should take than the result of any conscious decision.

Consider current efforts to strengthen the international financial architecture. Do they reflect conscious action and are they likely to deliver the unity and coherence connoted by the label? Conscious action there certainly is, but it is decentralized and imperfectly coordinated. The process of attempting to strengthen bank capital standards and bank regulation generally takes place mainly through the deliberations of the Basel Committee on Banking Supervision. Reform of regulations and practices involving not just banks but financial markets and institutions is the domain of the Financial Stability Board.[5] But the division of labor between the Basel Committee and the FSB is not clear, just as the line between bank and nonbank financial institutions is shadowy.[6]

[1] Keynote address delivered to the annual research conference of the Bank of Korea, Seoul, May 26th.
[2] See Rubin (1998). Google's Ngram Viewer allows us to search for mentions of this phrase across publications. It first appears in 1998 and then rises, tracing out the logistic curve familiar to scholars of technological diffusion, peaking in 2002 before declining.
[3] Eichengreen (1999). This was my best seller to date, courtesy of the promotional efforts of the Institute of International Economics. Janet Yellen, then chair of President Clinton's Council of Economic Advisors, tells me the story of arriving, together with Rubin, in the Oval Office and finding the president carrying a copy of the book together with his yellow highlighter. They turned to one another and whispered "What's he reading? We'd better get a copy of that…"
[4] http://www.merriam-webster.com/dictionary/architecture
[5] Whose members include not just national central banks and regulators but also international financial institutions and the major international financial standard-setting bodies. An example of its work is its recently released a report on enhancing the stability and efficiency of over-the-counter derivatives markets. The entire catalog of reports is at http://www.financialstabilityboard.org/
[6] Can you say "shadow banking system?"

Moreover, the guidelines set down by the Basel Committee and FSB must be given content and implemented through legislative and regulatory decisions at the national level, where nothing guarantees uniform implementation and enforcement. Decisions on regulating capital flows and exchange rates are similarly taken at the national level. The IMF is anxious to develop standards for acceptable practice in these areas, since national policies can have cross-border and systemic implications. But it remains to be seen whether its members will permit it to do so and whether there will be consequences for countries failing to comply.

Structural adjustment assistance and emergency liquidity provision (what is called in Korea the global financial safety net) are also the domain of the IMF, which has been working to expand and update its facilities so that they can provide an alternative to reserve accumulation. But there are also regional financial safety nets like the Chiang Mai Initiative Multilateralization (CMIM) and the European Financial Stability Facility (EFSM, eventually to become the European Stability Mechanism), and bilateral swaps and credits like the four $30 billion swap lines extended by the Federal Reserve to Mexico, Brazil, Singapore and South Korea following the failure of Lehman Brothers. We have barely begun to ask the question of how these global, regional and bilateral arrangements fit together. To the extent that there is a coordination center for these efforts, it is the Group of Twenty, which endorses the efforts of the Basel Committee and FSB, works together with the IMF on the Mutual Assessment (or MAP) Process intended to establish the compatibility of national economic strategies, and helps to set marching orders for these institutions. But the statements of the G20 are often pitched at – to put it politely – at a very high level.

My overall assessment is that there is a proliferation of conscious action but less than the desired degree of unity and coherence.

Having opened this can of worms, I will now proceed to close it. Rather than attempting to provide a synthetic view of efforts to strengthen the international monetary and financial system, I will touch on three aspects of the process that I view as problematic. These are the revised Basel Capital Adequacy Standards (Basel III); the continuing absence of a cross-border bank resolution mechanism; and the limits of the IMF's response to the interlinked problems of global imbalances, currency misalignments, volatile capital flows, and ongoing reserve accumulation. I leave the sweeping synthesis to the closing roundtable.[7]

Let me start with the Basel III accords endorsed by G20 leaders in Seoul last November. Basel III is supposed to correct the flaws in Basel II (and also in Basel I, Basel II not yet having been implemented at the time of the crisis in the United States and much of Asia). It requires banks to hold more capital. It requires them to hold better capital. It recommends a capital surcharge for systemically significant financial institutions. It acknowledges the importance of liquidity as well as capital adequacy.

Unfortunately, it also has gaping holes. First, there is the question of whether the new higher capital ratios are high enough. Seven per cent may be higher than four per cent, but it is still not very high by historical standards. If one looks back over 100 years of financial history,

[7] Where I will have a second shot.

one finds bank capital ratios of 20 per cent and more.[8] A recent Bank of England paper concludes, in this spirit, that the new Basel III requirements are much too low.[9] An official Swiss commission has similarly concluded that Swiss banks, large Swiss banks in particular (not to be repetitive), should be held to much higher capital standards than agreed by the worthies at Basel.

Second, there is the countercyclical capital buffer. Given the strongly procyclical behavior of bank lending and the tendency to underestimate risks in boom times, the case for countercyclical capital standards is compelling. But the idea is still under debate. Rather than setting down a global standard, the Basel Committee delegated this evidently delicate decision to national authorities (decreeing only that it should be "implemented according to national circumstances"). Korea has shown how it is possible to take significant steps in this direction by imposing a tax on the banks' noncore foreign currency liabilities. But one might ask: why only noncore *foreign currency* liabilities? The bank tax proposed by the Obama Administration but not passed into law essentially proposed to tax all non-deposit liabilities.

Third, there is the capital surcharge on "systemically important" financial institutions. Again, the argument in favor is compelling, both as a way of prefunding rescues of systemically important institutions and as a deterrent to growing too large, connected and systemically important to fail. But both how high this surcharge should be and how to measure systemic importance remain unspecified. Given bank lobbying, there is reason to doubt that the surcharge will be sufficiently high and that the definition of systemic importance will be sufficiently encompassing. The IMF's proposal to adopt a "financial stability contribution" at the global level has already come to naught.[10]

Finally, there is the role of the rating agencies, of which Asian observers have long been critical. (Americans and Europeans may be late to this game, but we are with you now…) Notwithstanding the desire to reduce the importance of ratings in the Basel process (given their backward-looking nature), they remain central to assessing the riskiness of complex securities held by banks. Basel III offers little in the way of an alternative. In the United States, the Dodd-Frank Act curtails the role of credit ratings in the regulatory process but does not suggest what to put in their place. Simple statistical models (known as "backtesting" and "probability-of-default models") are one option, but they hardly engender confidence given the credit-rating agencies' own use of similar kinds of analysis. Basel III remains, fundamentally, a risk-weighting approach to financial regulation that lacks a basis for calculating risks. While adding a simple leverage ratio a la Switzerland would help, this is unpopular among the banks, which seem to be succeeding in resisting it or at least in placing it at very high levels (like 33 to 1, the leverage of Bear Stearns prior to the crisis).[11]

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[8] The most comprehensive study of this of which I am aware is Grossman (2007). In the most recent crisis, U.S. bank losses exceeded 7 per cent of capital (Hansen, Kashyap and Stein 2010), which hardly suggests that 7 per cent is enough.

[9] See Miles et al. (2011). Basel III also does less than originally promised (in December 2009) to require banks to hold higher quality capital, instead permitting them to count deferred taxes, mortgage-servicing rights and their investments in the common shares of nonconsolidated financial institutions.

[10] See IMF (2010a).

[11] And even that is being phased in over five or more years.

The second aspect of the current reform process that I see as problematic is the continuing absence of a global regime for resolving troubled banks. There is no shortage of studies of this problem: there is a BIS paper, an IMF paper, a European paper, and a number of private papers, notably one by Morris Goldstein and Nicholas Veron.[12] The failure of Lehman Brothers showed how disruptive it can be to have to wind up an internationally active financial institution in the presence of different resolution and bankruptcy regimes in different countries.[13] The absence of an adequate resolution regime hastens the failure of troubled financial institutions as national authorities scramble to protect the national interest. It interferes with the continuity of critical functions and depressed the recovery rate of creditors. The associated uncertainty can be a motor for contagion, as we learned in the autumn of 2008.[14]

A series of reports and studies have identified what needs to be done to address these dangers. At a minimum, national resolution regimes should be harmonized, and the authorities in different countries need to agree on who takes the lead on the various aspects of the resolution process. They need to develop understandings about how the fiscal costs of resolution will be shared. Regulators should pool information and documentation. They should do contingency planning and play war games before the fact.[15] The IMF, predictably, has proposed the promulgation of international standards for national legal frameworks.

The question is whether this will be enough. I am skeptical. Efforts at harmonization notwithstanding, national legal arrangements will continue to differ, because national legal traditions differ. Cooperation on financial matters may be relatively advanced in Europe, but this did not prevent very serious problems from arising in the cases of Fortis (the Belgian/Dutch financial conglomerate) and Dexia (the French and Belgian bank).[16]

An explicit global solvency framework for financial firms would be a desirable alternative, but it does not seem to be in the cards. The other option is to ring-fence financial business so that the perimeters of the supervision and resolution regimes coincide. All transactions would be separately structured within each national jurisdiction in terms of capital, liquidity, assets and operations. At a minimum, regulators will require foreign bank subsidiaries to have significant amounts of their own capital. Yet whether even this is politically feasible is an open question.[17]

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[12] See BIS (2010), IMF (2010b), Ayadi, Lierman and Balling (2010) and Goldstein and Lierman (2011).

[13] Anglo-American conflicts in winding up Lehman Brothers may be well known, but the fact of the matter is that Lehman operated in 50 countries.

[14] If you need more evidence of this, I have only one word for you: Iceland.

[15] Having financial institutions write living wills can be helpful for this process. The Dodd-Frank Act of 2010 will require this of U.S. banks.

[16] Europe has admittedly made some progress in this area, as described in Ayadi, Lierman and Balling (2010). It has adopted a Credit Institutions Reorganization and Winding-Up Directive that dictates treating European banks as single entities in winding up regimes (not that this helped in the case of Fortis – see below). It has a Settlement Finality Directive designed to protect the wholesale payments system. And it has a Financial Collateral Directive to ensure that collateralized transactions are netted or closed out without legal interference. But it still does not have strongly harmonized national resolution regimes. Whether activation of the European Banking Authority on January 1st, 2011 will make a difference is yet to be seen.

[17] Even if it is, large cross-border banks that enjoy economies of scale and scope as a result of operating in multiple national markets will lobby against it.

But these complications do not relieve policy makers of having to choose. Ring-fencing and a global resolution regime are the only options for making the world a safer financial place. The international community has to choose.

Let me turn finally to global imbalances. In thinking about the IMF's approach to this problem, it is tempting to quote Tallyrand on the Bourbons – "they have learned nothing and forgotten nothing." In 2006, prior to the global financial crisis, the IMF launched a multilateral consultation on the global-imbalances problem.[18] The initiative was designed to make the participants aware that imbalances could unwind in ways that caused serious economic and financial disruptions, to achieve a consensus on diagnosis and remedy, and to encourage coordinated adjustment in which surplus countries expanded demand while deficit countries took steps to consolidate, while the real exchange rates of the former were permitted to appreciate relative to those of the latter. The result was an appearance of consensus but little action, at which point the process was overtaken by events.

Now with the world economy's two-speed recovery from the crisis, global imbalances are back, along with worries about a disorderly correction. But the IMF has little more in its tool kit than five years ago. To my eyes, the recently-created Mutual Assistance (or MAP) Process looks a lot like the Multilateral Consultations Initiative; the name has changed and the number of countries involved is larger, but the content is little different. The IMF can use its bully pulpit together with multilateral surveillance vehicles like the *WEO* to call for policies to promote faster rebalancing, but it has no way of compelling their adoption. This is especially so in the case of large countries that don't borrow from the Fund and are therefore immune to its pressure.

In particular, the Fund remains reluctant to propose stronger sanctions against countries with chronically misaligned exchange rates and that run persistent current account surpluses. This is not for wont of ideas. From the Peterson Institute alone, we have proposals that the IMF should be obliged to send a mission to any country with a surplus greater than 4 percent of GDP, where that mission would be charged with examining whether its exchange rate was undervalued. Or that the World Trade Organization should be given the power to penalize a country for maintaining an undervalued exchange rate by using its dispute settlement system to authorize trade restrictions against an offending country (with the evidence to convict being supplied by the IMF). Or that a reserve-currency country should have the right of counter-intervention against a country maintaining an undervalued currency, subject to a right of appeal to the IMF.

My own proposal, harking back to Keynes' clearing-union plan, is for a progressive tax on the reserves of current-account surplus countries that would increase with the size and persistence of those surpluses. (The revenues might be turned over to the World Bank, UNDP or another development agency or used to mitigate the effects of global climate change.) I actually wrote the paper in question, "Out-of-the-Box Thoughts on the International Financial Architecture" – there's that phrase again – on commission for the Fund.[19] A variant of this idea then appeared in a January 2011 paper prepared by IMF staff for the institution's executive board. The idea there is that future SDR allocations could be contingent on a country's adherence to norms regarding reserve accumulation – chronic surplus countries could be denied

[18] It involved the U.S., the Euro Area, China, Japan and Saudi Arabia as participants.
[19] Eichengreen (2009).

their allocation, in other words.[20] But a staff report to the board, phrased in noncommittal terms, is still very far from policy.

We are also progressing too slowly in reforming the international reserve system. Reform means creating more attractive alternatives to reserve accumulation for countries seeking insurance against financial shocks. The IMF has established a Flexible Credit Line for countries with strong policies and a Precautionary Credit Line for countries with (I quote) "moderate vulnerabilities," but so far there have been few takers, potential borrowers being worried about stigma effects. (Only Mexico, Colombia and Poland have FCLs. If you want to know what a country with "moderate vulnerabilities" looks like, Macedonia became the first recipient of a PCL in January.) Allowing the IMF to unilaterally prequalify countries in groups could solve this problem, but the official community remains reluctant to go down this road.

The CMIM, for its part, has yet to be utilized. If it had in fact already evolved into a credible reserve pooling arrangement, then we would expect to see the participants slow their reserve accumulation. It is hard to detect much sign of this.

Reforming the reserve system also means contemplating what follows the current dollar-centric regime. The IMF, talking its book, has suggested an enhanced role for Special Drawing Rights, which could be allocated in larger amounts and more regularly. I am skeptical that the SDR can supplant the dollar and other national currencies as the principal form of international reserves, since central banks regard as useful only reserve assets that can be used for market intervention, since there are few private markets in SDRs. I am ready to be convinced that creating these markets is possible, but nothing I have seen so far inclines me to repent. IMF staff has recently described what would be involved in encouraging private use of the SDR. The Fund could sell SDR-denominated bonds.[21] Other IFIs and sovereigns could do likewise. National pension funds and sovereign wealth funds could be encouraged to become active on the demand side. Banks would be encouraged to provide hedging instruments to cash managers as a way of stimulating demand by large corporations. Governments or the Fund itself would have to provide liquidity support to the market in SDR-denominated instruments through an SDR repo facility. Private financial institutions would act as market makers and develop a settlement and clearing system.[22] This is a formidable agenda. More realistic in my view would be to concentrate on what is needed to smooth the operation of an international reserve system made up of multiple national units, not just the dollar but also the euro and eventually the yuan.

As for capital flows, the IMF's position has clearly evolved since 1997-8, which will be happy news in this part of the world.[23] Its recent paper on capital controls (IMF 2011b) acknowledges their value as a second-best form of prudential regulation and recognizes the limitations of a one-size-fits-all approach to capital-account regulation. The paper observes that the Fund "could issue principles for the guidance of members" on the appropriate design of these policies, but concrete guidance is lacking.

[20] IMF (2011a), p.10.
[21] It sold a limited number of SDR-denominated notes in 2009.
[22] Again, I am gratified to read this, since this is what I described in Eichengreen (2009) as being entailed in commercializing the SDR.
[23] See Ostry et al. (2010).

The paper then observes that one country's decision to restrict capital inflows (or outflows) may have implications for other countries and, in some cases, for the stability of the international system. But whether the Fund will have the wherewithal to induce countries to alter such policies when they have negative effects on other countries or the system as a whole is uncertain. The end result of this process may simply be yet another code of conduct honored mainly in the breech. That there is an analogy between the spillover effects of capital controls and the spillover effects of misaligned exchange rates suggests that the Fund's efforts to get countries to internalize the external effects of controls will be subject to all the same challenges.

Let me conclude. Crises can be catalysts for change. The Great Depression was the catalyst for constructing the post-World War II Bretton Woods regime. The Asian crisis was a catalyst for IMF reform, for creating the Financial Stability Board, for establishing the Chiang Mai Initiative and – perhaps less positively – for the advent of the terrible twos: Basel II and Bretton Woods II. The Global Credit Crisis and Great Recession led to the emergence of the G20, to IMF reform, and to Basel III. More effort is being devoted today to strengthening the international financial architecture than in a long time, maybe since the original Bretton Woods deliberations, reflecting the fact that the recent global crisis is the most serious such event since the 1930s. But what all this effort will produce is unclear. Views of the process of reforming the international financial architecture are a classic "glass-half-full, glass half empty" question, as we are about to hear again in the course of the next two days.

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