The G20, the crisis and the redesign of the international financial architecture

Jorge Carrera
BCRA

November, 2009
The G-20, the crisis and the redesign of the International Financial Architecture

By Jorge Carrera*

All large crises required a reformulation of the International Financial Architecture (IFA). The G-20, abruptly turned into a forum for debate and action vis-à-vis the crisis, focused its efforts in two areas: a) macroeconomic policy coordination to find the way out of the crisis and b) IFA reform in terms of both financial regulations and multilateral lending and supervision of financial institutions. Other critical aspects of IFA reform were not included in the agenda, such as the rules of the international monetary system. To that extent, there is an intense debate about the current situation of “non exchange rate and monetary regime”, which unleashed phenomena such as the global imbalances, lacked clear rules regarding the role of the US dollar in the provision of international liquidity and as reserve value and also lacked a lender of last resort.

The fact that new players, such as the Emerging Countries, have been invited to discuss IFA redesign is highly positive. The challenge is to maintain this framework alive once the crisis has been overcome so that these countries can have a less asymmetric international insertion.

1. Crises as triggers of changes in the IFA

In the last 100 years, the biggest economic crises have been times of breakup and redesign of the International Financial Architecture (IFA). We refer to IFA as the set of institutions, rules (implicit and explicit) and behaviors on which the monetary and financial relations among public and private agents of the different countries are based.

The 1930s crisis entailed the collapse of the gold standard and of international trade and was the economic prologue of World War II. The period 1944-1950 witnessed the consolidation of the Bretton Woods System (BW), based on fixed exchange rate parities among the leading economies, and the foundation of the International Monetary Fund (IMF) and the World Bank (WB). This scheme collapsed in 1971-73 after the abandonment of the gold standard and gave rise to a floating system among the leading currencies. Both the IMF and WB reoriented their focus and became institutions devoted to assist developing countries exclusively. In the latest two IFA redesigns (1944-50 and 1971-73), the United States fuelled all the changes and acted as undisputable leader, accompanied by a reduced number of industrialized economies.

Due to its depth and extension, the current international crisis has some features that make it only comparable to the Great Depression. IFA design at the beginning of the crisis proved to be incapable to alert, prevent and generate solutions for the financial crash we are going through. Therefore, the need to
introduce unthought-of reforms just a short time ago became evident very quickly.

Figure 1 is a schematic illustration of the international economic architecture, where two well-defined areas can be identified. The trading architecture works under a single and plural institution, the World Trade Organization (WTO), which defines and controls highly-formalized trade rules. On the contrary, the financial architecture operates more anarchically since 1973, with institutions such as the IMF and the WB that do not have sufficient power to enforce financial, exchange rate and monetary rules.

Source: Prepared by the author.

The ineffective operation of financial rules and the international monetary-exchange rate regime gave rise to key events which ultimately led to the international financial crisis: global imbalances and financial deregulation. Likewise, though IFA institutions did not have an active role in the origin of the crisis (dotted arrow in Figure 1), they did have clear limitations for crisis prevention and further treatment.

In this paper, we analyze how the leading countries have tackled the challenge of responding coordinately to the crisis and have laid the foundations for an IFA reform towards a lower systemic instability and better capacity of reaction. The discussion will focus on the role played by the G-20, identifying the consensus reached, the medium-term agenda and the pending dilemmas and challenges.

2. What is the G-20?

One of the most original features of the current crisis is the multilateral discussion forum chosen to deal with it: the G-20, where both advanced and emerging economies participate.¹
Unlike previous IFA redesigns, on this occasion the Emerging Countries have the opportunity of participating in the discussion and in decision-making process. The presence of these countries in the G-20 is an acknowledgment of their increasing relative relevance (they represent over 30% of the world GDP and have accounted for approximately 60% of global growth in recent years) and of their growing presence in the international trading, monetary and financial arenas.²

This group was created in 1999 as a consequence of the Asian Crisis. Its main purpose was to promote an environment where the leading advanced and emerging economies could debate at political and technical levels the improvement of the financial system and tackle issues related to long-term growth, such as policies to lessen global warming. Each country has a delegate from the Ministry of Finance and a second representative from the Central Bank. The chair of the group is alternatively held by one member country for a year. Last year, the group was led by Brazil, this year by the United Kingdom and next year by Korea. Technical meetings are regularly organized to offer proposals to governments. For example, the Central Bank of Argentina organized the first meeting of this kind in our country in 2008.

The choice of G-20 as multilateral space to analyze the crisis could seem arbitrary but its raison d'être lies in the representative nature of the players involved. In addition, if speed in action was required, the G-20 had the advantage of being an established forum, with operating dynamics already working.

Therefore, for the first time since its foundation, the Heads of State of the member countries were convened to a meeting in Washington in November 2008. There, a long list of topics and activities was adopted so as to advance with concrete measures in a new meeting of political leaders in London on April 2, 2009. Contrary to what usually occurs in these top-level meetings, the statement agreed in Washington was very ambitious and detailed, and therefore hard to put into practice promptly.

In the period between both meetings, the political and technical levels had an intense discussion and prepared proposals and measures, many of which were revised and adopted at the London Summit. There is a permanent analysis of measures and a debate on the course being followed by the crisis. At the time of publishing this paper, we are in a first stage of implementation of the agreements reached.

The topics dealt with by the G-20 include an important, though not comprehensive, part of the core of the crisis, encompassing issues related to its resolution, such as those referred to IFA redesign for the next decades.

In the following Section, we will analyze the shock policies to lessen the effects of the crisis. Then, the medium and long term reforms of IFA agreed upon by the G-20 will be described. Here, two dimensions must be highlighted: on the one hand, the redesign of multilateral institutions and, on the other, the new rules for financial regulation. Finally, some reflections will be offered on key
aspects not dealt with by the G-20, which might perhaps be part of its future agenda.

3. Short-term actions: the way out of the crisis

Regarding the issue of how to get out of the crisis, the G-20 acted as a coordination forum but also as a significant place where to communicate messages on proposals and agreements reached among the main governments. Raising the G-20 meetings to a maximum level of importance through two Summits of Heads of State created a space for quick action and sent the different economic agents a signal of both firmness in the measures taken and of global cohesion in the decisions adopted.

At the London Summit, there was consensus on the fact that the outlook for 2009 and 2010 had deteriorated remarkably. The world faces a strong contraction in trade levels, a decline in economic growth and an increasing rate of unemployment.

In the technical and political meetings the agreement to prioritize the measures required to restore growth was reached. There was consensus to prevent significant disruptions in the financial system and to apply measures directed to guarantee liquidity and the quick restoration of credit. It was agreed that, whenever possible, central banks should maintain expansionary monetary policies for as long as it is required, using all instruments available that are consistent with price stability.

In this sense, it was admitted that with interest rates close to zero in many countries and a decreasing inflation, the central banks might need to use several monetary policy instruments to stimulate aggregate demand, including the purchase of relatively illiquid assets, or unconventional measures such as quantitative easing and credit easing. There was a vague agreement on the need to promote monetary policy coordination among the advanced economies, avoiding competitive devaluations. However, there was not in this case an in-depth analysis of the potential problems of such coordination exercise.

Taking into account the need to sustain aggregate demand, the Heads of State committed themselves to implement an unprecedented expansionary fiscal policy aimed at reducing or preventing unemployment acceleration. Despite this, the IMF considered that the fiscal effort was insufficient and its recommendation was that every country should make an additional 2% of GDP fiscal impulse.

In this sense, the Asian economies, despite the fact that they were seriously hit by the decreasing international trade, have adopted the most aggressive fiscal policy stimulus (above all China and Japan, which show fiscal expansions over 5%) in comparison to those of the United States, let alone those of Europe. Finally, governments undertook the commitment not to repeat the historical mistakes made during the Great Depression when protectionist measures became the rule.
Since the Emerging Countries have been the main drivers of the world economy in recent years, there is consensus on the fact they should also make a coordinated effort at global level, both in fiscal and monetary terms.

However, it was stated that some of these nations had undergone specific problems when applying counter-cyclical policies. Regarding the monetary policy, the Emerging Market Countries have lower room to maneuver to decrease interest rates since this could trigger an additional capital outflow to the one already suffered. Still, they have some margin to depreciate their currencies, a situation experienced by several economies since the second half of 2008. Although these depreciations have had little inflationary impact in a context of lower commodity prices, their expansionary effect would be limited against a backdrop of widespread recession.

The strong retreat of capital flows towards the Emerging Market Countries has also conditioned the capacity to implement expansionary fiscal policies without generating adverse reactions in the markets. In this sense, the emerging member countries of the G-20 have underlined the strong asymmetries between the monetary and fiscal spaces available to them and those of the advanced economies. Therefore, the need for a mass financing to foster similar policies was an issue debated by the countries. For this reason, the G-20 agenda for IFA reform includes, among its priorities, the increase of the lending capacity of international financial institutions. However, it is difficult to think in financing the Emerging Countries at a level “equivalent” to the capacity of the central countries to finance themselves at very low interest rates in their own currency.3

3.1. Discrepancies about the effectiveness of the measures

If we had to analyze the evolution of the crisis since its eruption in 2007 up to the second meeting of Heads of State in April 2009, we could state that the economic policy has failed to confine the crisis to the financial sector and prevent its spillover to the real economy. So far, most of the activity was performed by the central banks, which lowered interest rates to minimum levels and injected a huge amount of money to banks and credit markets to curb their collapse. However, if the lack of consumer confidence about the future and the uncertainty about bank solvency persist, it will be difficult for credit to resume its normal flow. Currently, some economies are experiencing second round effects going from the real sector (companies, households) to the financial sector, evidenced by the increase of non performing loans and a lower demand for funds directed at new projects.

Given the limits of the monetary policy, several governments (and economists) stated that the first half of 2009 was the most appropriate time to accelerate the fiscal policy. This was the main macroeconomic disagreement between the United States and Europe in the different G-20 meetings. The United States is one of the countries that have done the most to stimulate the economy and has advocated a supplementary and simultaneous fiscal effort by Europe and the remaining economies.
The European Union, led by Germany, has maintained a more moderate position; it has prioritized the bailout of the financial system and has adjusted its fiscal stimulus.

The European argument is based on the fact that several fiscal expansionary packages have been implemented already, and their impact has lags (i.e. their results are not immediate). In Europe, as a legacy of the Welfare State, there is a higher number of economic stabilizers (unemployment benefit, subsidies, tax progressiveness, etc.) representing an additional expense devoted to households. Germany underlined that an increase in expenditures results in a higher public debt (which is already high) for the region and will be a burden for future generations. It also stressed that inflation pressures could reappear quickly as a result of these policies.

Behind this discussion across the Atlantic there is a discrepancy in the way in which the effects and inter-temporal costs of short-term urgent measures are valued. It would seem that the American view is based on the high cost of bearing a long depression today against the likely future costs of controlling a higher inflation level and a high borrowing level. This leads us to think that the US policy bets conclusively to a short recession. The risk is that if, for any reason, the economy does not react in 2010, then the initial effort will have endangered the fiscal and monetary margin for further non-inflationary solutions.

We will see which of these two positions is the most adequate only after several years. At the time of writing this paper, estimates for 2009 show a GDP decline of around 2.8% in the United States, 4.1% in the United Kingdom, 4.2% in the Euro Zone and 6.2% in Japan. Paradoxically, the country where the crisis erupted seems to be the least affected by the crisis, among the advanced economies. Clearly, this contradicts the typical economic interdependence models that assume that, in a domestic shock, the spillovers are lower than the impact suffered by the economy where the crisis erupts. After collecting more data on the issue, we will know if the paradox really exists and, if so, analyze if it was caused by the application of more active policies or by other elements, such as a presumed higher resilience of the US economy.

Since mid 2008, as the G-20 meetings advanced, different stances appeared in the discussions around the financial system bailout, especially the focus on the government actions directed to the banking system, i.e. stimulating toxic asset price by purchasing them and facilitating the “price discovery process” or injecting capital or nationalizing. There is no doubt that Europe and the United States have different views on the degree of state involvement and the available tools.

Also important in the discussions is the implementation of exit strategies. Once deflation risks are left aside, there could be a sharp reversal in the expectations of an inflationary rebound and a devaluation in the most active countries. The monetary policy, above all in the US, would face the dilemma of sustaining the recovery at the expense of a potentially higher inflation rate. A monetary policy that overreacts to a price increase risk could abort the recovery, as it occurred
in 1937. Instead, a loose monetary policy could stimulate new bubbles; according to some authors, this is precisely what happened with Greenspan's policy after the dotcom crisis.

Martin Wolf has summarized the tension between the desire of short-term expansion and long-term contraction stating that the solution would lie in choosing an "abrupt contraction" whose time "has not yet come" (Wolf, 2009). A premature abandonment of exceptional policies could take us back to a deep recession and, if we continue along this exceptional path, increasing inflationary expectations will accumulate and a scenario of stagflation could get hold.

In short, the G-20 role regarding how to face the crisis is to convey a homogenous message to restore confidence in economic policy effectiveness by showing cohesiveness in the objectives. This does not mean that all governments will have the same perception on the actions required in terms of intensity and priorities, but it does mean that there is a willingness to coordinate policies and solve the discrepancies in criteria. Undoubtedly, the two meetings of Heads of State held in November 2008 and April 2009 clearly evidenced the change in the political leadership capacity of the new US Administration and the decision to profit from this initial capital to deepen fiscal and monetary measures.

3.2 The risks of failure and protectionism

If the measures described above were not sufficient to give a vigorous and relatively quick exit to the crisis leading, for example, to a low-growth scenario such as that of Japan during the decade after the 1990s crisis, the revival of protectionism in dimensions like labor, financial, trade and exchange rate, could get hold in the economies.

Labor protectionism is already brutally visible in many countries, virtually equivalent in some cases to xenophobia. As a result, countries prioritize their national citizens in the access to their labor markets and resort to methods going from migration restrictions to subsidies that prioritize local employment in product manufacturing.

In turn, financial protectionism may include stricter regulation on transnational banks and the protection of the institutions with national headquartered as well as exchange rate controls or capital flow regulations. In this case, we are seeing that many institutions and scholars that have traditionally resisted regulations are adopting a more “updated” stance. 4

Trade and investment protectionism is the traditional and more widespread reaction to an external crisis, and is justified on the need for currency and job preservation.

Exchange rate protectionism can be as disruptive as the previous ones. Many countries resisted the appreciation pressure before the crisis and, after its eruption, proceeded to devaluate their currencies. However, they cannot all devaluate at the same time. Devaluations can only have real effects if others
agree to revaluate. This is why one pending challenge is the international monetary system reordering, in an attempt to prevent the relative “exchange rate anarchy” that preceded the crisis.

These protectionist measures may seem understandable in some cases from the individual perspective of a country in distress but if they are taken by all countries simultaneously during a global crisis, then the result is suboptimal.

If we apply one of the teachings of the General Theory on individual behavior in a context of crisis (the thrift paradox), we could state that by trying to save themselves individually, each country worsens the situation of the world economy. Keynes encouraged public spending to compensate the contraction of personal consumption. However, at global level, there is no supranational player that can physically compensate every country’s contraction. In addition, since these economies are open economies, part of the fiscal expansion goes to the partners. Therefore, closing the economy might be partially warranted if the fiscal packages are not coordinated.

4. Architecture I: IFA institutions’ redesign

The crisis revealed that IFA multilateral institutions failed to create regulations to prevent bubbles’, to warn against the onset of the global crisis, to prevent its propagation and to contribute to isolate its effects on the financial system. In addition, there is no full confidence in their capacity to enable recovery.

Regarding the institutional redesign of the existing bodies, the G-20 addressed two important issues. The first one, in which significant progress was made, was to extend the funding from multilateral institutions and ease the access to their credit lines. The second one, where the discussion was harder, was the structures of governance, i.e. the review of the rules governing voice and vote within these institutions.

Regarding the institutions’ funding and its use, the G-20 agreed on relevant changes in the IMF. It decided to double the lending capacity to USD 500 billion through credits of the Fund’s main partners and to issue Special Drawing Rights (SDR) for USD 250 billion. With respect to the instruments, the IMF has announced a first set of measures to review its traditional credit practices and create a new line (Flexible Credit Line, or FCL) that doubles the credit limit and removes the ex-post conditionalities. With this instrument, the IMF seeks to give an answer to Emerging Markets claim for a higher flexibility and fewer conditionalities, which invigorated as from the crisis.

As mentioned in Section 3, this capitalization is critical if we consider the reduction of fiscal space experienced by Emerging Economies so as to conduct anti-cyclical policies similar to those of the advanced economies, in a context where external financing to the former has shrunk considerably.

The G-20 agreed to support a significant increase in the lending capacity of the Multilateral Development Banks (MDB) to USD 100 billion. This includes both the World Bank and regional development banks. On this basis, on April 30,
2009, the Asian Development Bank three-folded its capital, from USD 55 billion to USD 165 billion. Likewise, a decision was made to allocate specific funds to foreign trade, amounting to USD 250 billion.

Lastly, regarding the structures of governance, the review of the number of votes each country is entitled to in order to reflect the higher weight of the Emerging Countries in the world economy, both in production levels and trade and financial flows, will be addressed as early as January 2011. The discussions about IMF and WB governance sought to make the appointment of top authorities more competitive and merit-based. However, the debate and progress in this issue are only preliminary. A higher representation of Emerging and Developing Countries would improve the legitimacy of the IMF in the eyes of its members and would positively impact the effectiveness and efficiency of the institution.

In addition to reforming the existing institutions, the G-20 decided to create a new body, the Financial Stability Board (FSB) (that replaced the Financial Stability Forum (FSF)), which will be made up by former FSF members and representatives from the G-20 Emerging Market Countries, Spain and the European Committee.

The FSB will play a key role in the new IFA since it will be responsible for coordinating the bodies devoted to issue standards and banking prudential regulations, preparing early-warning reports, exchanging information among supervisors and controlling large transnational banks. Regarding the latter, the FSB created the so-called "colleges of regulators" for the 25 leading and systemic transnational institutions. These colleges should include, when appropriate, the supervisors of subsidiaries in Emerging Countries. Anyway, the final decision over its membership will lie in each college’s coordinator. This is the first measure taken to restrict the absolute liberty that transnational banks have enjoyed so far in their world expansion.

The inclusion of Emerging Market Countries in the FSB is one of the most important advances of the G-20 in IFA redesign. In addition, these countries were included as a bloc in the Basel Committee on Banking Supervision (BCBS), in charge of recommending banking regulations.

To conclude this Section, we describe the IFA “map” with the changes introduced by the G-20. As pointed out in the introduction of this paper, the absence of a single space for macroeconomic and financial coordination is evident, unlike what happens with trade at the WTO. Instead, there are several institutions with a varied degree of formality and structure, where the voice of the advanced countries (G7) prevails.

At the top level, we find the political forums (G7 and G-20). As mentioned before, the fact that this crisis is discussed in the G-20, where advanced and emerging economies participate, anticipates the leading role of the latter in the changes to come.
In the case of IFA institutions, there are two distinct categories based on the areas dealt with:

1. In macroeconomic issues, we find institutions that provide financing and manage funds in a similar way to that of a bank: IMF, WB, BIS, Regional Banks (IDB, FLAR, CAF, Asian Development Bank [ADB]).

2. In financial issues, we find institutions that coordinate national regulations or propose international regulations: BCBS (for banking regulations), IOSCO (capital markets), IAIS (insurance companies), IASB (accounting rules), FATF (regulations against money laundering), OECD (regulations against fiscal and banking secrecy), etc. The new coordinator of these institutions will be the recently-founded FSB.

Source: Prepared by the author

5. Architecture 2: How to prepare the new financial rules

Based on the premise that serious failures in the financial system regulation and supervision were the main reasons behind the crisis, G-20 leaders have laid the foundations to establish new “rules of the game" in national and international finance.

The G-20 agreed to build a stricter and globally consistent framework for regulation and supervision in order to reduce the likelihood of a new systemic financial crisis. Unlike the consensus prevailing in recent decades, this agreement aims at a regulation that does not depend so heavily on market discipline. The goal of increasing cooperation among countries is behind the spirit of these changes.

The most relevant points are as follows:
1. Comprehensive approach to regulation: Systemic financial stability must be one of the objectives of the regulators and of the bodies that issue rules & standards. The authorities must have appropriate macroprudential tools (such as measures to curb leverage, capital requirements adjusted through the cycle, forward looking provisions, etc.).

2. Regulation scope: All systemically relevant institutions, markets and instruments must be subject to regulation or surveillance.

3. Supervision of credit rating agencies: These agencies must be subject to a surveillance regime including their registration and compliance with IOSCO standards on the matter. Local authorities must have sufficient power to enforce regulations and prevent conflicts of interest.

4. Private pools of capital: These funds or their managers (including hedge funds) must be subject to registration and information disclosure requirements.

5. Transparent assessment of regulatory regimes: G-20 members commit themselves to make a Financial Sector Assessment Program (FSAP) and publish its conclusions.

6. Pro-cyclicality: The FSF and its member bodies (such as the BCBS) must develop procyclicality-mitigating approaches promoting capital accumulation during booms. Accounting standards should allow for provisions with a “through the cycle” view.

7. Capital: It should serve as an effective buffer to absorb losses through the cycle. Once the conditions allow, the international capital standard must be revised. The BCBS must develop a simple leverage indicator. G-20 leaders must endorse Basel II progressive adoption.

8. Liquidity: Supervisors must establish a global framework to promote sound liquidity buffers to face protracted stress periods in funds availability. In this sense, Argentina proposed that subsidiaries should not provide liquidity to their headquarters in times of financial turmoil so as to limit the effects of this contagion channel.

9. Infrastructure of OTC credit derivatives: ¹⁰Banks must take the steps required to make OTC transactions through their central counterparties (CCP). In turn, CCPs must be subject to surveillance by supervisors and comply with risk management and operating standards, among others.

11. Compensation schemes: They need to be consistent with long-term goals and a prudential risk-taking. Variable components must be linked to performance and risk-adjusted.

12. Fiscal havens: There was consensus on the need to take measures against the non-cooperating jurisdictions and to seek the end of banking secrecy. The reason behind these measures is the potential increase in regulatory arbitrage once regulations become stricter. In fact, these jurisdictions might become an attractive safety valve and deteriorate regulation effectiveness.

6. Pending reform agenda: what the G-20 did not discuss

G-20 decisions and proposals have left aside one of the main factors behind the global financial crisis: the ineffective operation of the international monetary system's rules of the game. So far, the discussion focused on future national and international financial regulations and the reshaping of existing multilateral institutions and the creation of new ones, but there was no debate on the most appropriate global exchange rate-monetary regime. This means that issues such as the cause and eventual correction of global imbalances, the position of the US dollar as reserve value and the absence of a “provider” of global liquidity that could also serve as lender of last resort have not been discussed. As follows, we will analyze these items as an agenda for the pending reform.

6.1 Imbalances

Before the crisis, there was a broad academic and political debate on the importance of imbalances and their risks for global economy.

By imbalances we mean not only the existence of current account deficits or surpluses in a specific country but also current account (and foreign assets) positions in systemically relevant economies. These positions convey both significant distortions regarding world saving allocation and also high risks for the international economy in terms of their sustainability. Specifically, some authors have stated that imbalances reveal an ineffective operation of the international monetary system since saving flows go from several Asian developing economies to advanced countries, such as the United States.

There are several views or lines of reasoning accounting for global imbalances. Bernanke (2005) points to “saving glut” in Asia as the main factor in interest rate reduction in the country that receives those surpluses. In turn, Dooley et al. (2005) see imbalances as an equilibrium phenomenon, under the name of Bretton Woods II. Between China (and the Emerging Asia) and the USA there would be an implicit agreement by which the Yuan-Dollar quasi hard peg allows the former to support its export-led growth and the latter to finance higher consumption levels in exchange for recycling those dollars in US foreign assets. The system generated lower prices in tradable goods and contributed to a low inflation in the United States11.
Reserve accumulation as a strategy sought for by Emerging Countries is another important factor that contributed to explain and deepen imbalances. As from the Asian crisis, characterized by international liquidity access restrictions, these countries realized the higher net benefit of a strong reserve position denominated in dollars (Bastourre, Carrera e Ibarlucia, 2009).

Not only is it difficult to determine a clear causal order in the imbalances but still pending are several dilemmas on the way they will evolve in the new context generated by the crisis.

A fundamental issue is the lack of consensus among scholars and economic policy-makers whether imbalances are harmful or not, or if they are an unavoidable fact given the inter-temporal preferences of the countries. If the idea that imbalances were one of the causes of the crisis gets hold, as it seems it will (FSA, 2009 or Portes, 2009, among many others), then two questions will come up: 1) can imbalances be solved endogenously or should the countries involved reduce their imbalances via ad hoc policy actions?, and 2) should this occur during a crisis or is it a task to be performed during “normal times”?

Beyond the academic discussion, the G-20 is politically likely to conceive by default the idea that imbalances will be corrected automatically and that, if this is not the case, then the ongoing IFA reform (based on higher financial regulation and stronger and more representative multilateral organizations) would be enough to prevent a new crisis.

In short if after the crisis the most relevant countries, in terms of net flows, continue to have the preferences they had until 2007, then we would go back to “Bretton Woods II”. As in the original Bretton Woods, IFA redesign would seek to compensate the inconsistencies with stronger financial regulations, which would play today the role that capital controls had in the 1950s and 1960s.

The link between imbalances and the global exchange rate regime is inherent to this discussion. In this sense, there is no clear answer to the counterfactual exercise of asking if in a world of full currency flexibility against the US dollar in all regions, the imbalances would not have reached the dimension they now have. To the uncertainty on the effectiveness of “market” mechanisms to correct these imbalances we should add the absence of an international institution to encourage this correction as imbalances appear.12

As already pointed out, a context of international consensus to correct imbalances coordinately and progressively appears to be unlikely. Anyway, if this consensus finally emerged, the main issue would be the adjustment method and the definition of the players involved. Should it consist mainly in a progressive dollar devaluation o should it aim at a higher fiscal expenditure to stimulate private spending in countries with surpluses? Would the solution be limited just to a strategic agreement between China and the United States? Wouldn’t it be more appropriate to consider other relevant countries with current account surpluses and therefore find the answer to the problem in a multilateral forum such as G-20?13
6.2 Reform of exchange rate and monetary regime

Since Bretton Woods’ fall in 1973, international financial relations have developed in a "non regime" context, characterized by flotation among the main currencies and the absence of formal agreements or treaties defining the fluctuation rules for exchange rate parities. However, the system was not a pure-flexibility regime since the countries had, instead, some degree of freedom to make their exchange rate and monetary arrangements. Thus, for instance, we identified managed float systems (like Japan’s) or hard-peg regimes within certain monetary areas (as in Europe).

In turn, it was evident that the exchange rate policy was a fundamental pillar in the export-led growth successful strategy for economic development implemented by a group of South and East Asian countries. As a result, a dual global system emerged, made up by a set of undervalued and quasi-fixed currencies against the dollar in Emerging Asia and by floating parities between Europe and the US. This scheme has consolidated as from the Asian crisis, giving rise to the already-mentioned Bretton Woods II.

Nevertheless, the potential interconnections between global exchange rate regime and the current crisis raise a discussion about the need to introduce changes in its organization. Therefore, the question is: which is the most suitable regime to encourage goods and financial assets trade, to prevent the formation of imbalances and to favor exchange rate stability?

Some authors, who consider that market discipline is also applicable to exchange rate markets, would see the path towards a global floating regime among the leading currencies as a natural course of action. The potential volatility would not be traumatic since there are markets to cover that risk.  

On the contrary, other authors, such as McKinnon (2008), think that exchange rate stability could be maintained by:

a. Counter-cyclical policies in countries that show high trade surpluses.

b. Monetary policy alignment in order to reduce interest rate differentials among countries. Some restrictions could even be imposed on the financial institutions' capital flows.

If a “managed float” regime was established to limit the volatility of leading currencies such as the US dollar and the Euro, then we would have the problem that there is no recent experience of large interventions (either joint or individual) since the beginning of this century (The Economist, 2008). Given the size of the exchange rate markets, all efforts should be made to convince dealers through joint statements of the range and desired path for the dollar/euro and dollar/yen parities.

6.3 From dollar standard to shared leadership?
Another relevant issue that will define the future global exchange rate-monetary regime is the role of the US dollar as single monetary standard. The asymmetrical condition of the US currency is evidenced by the memorable statement by John Connally, US Treasury Secretary under Nixon Administration, “the dollar is our currency and your problem” (1971).

In the economic literature, the convention that only one currency can have monetary preeminence is frequently summarized with the phrase "the winner takes it all" and comes from the experience with the dollar in the second half of the 20th century. The explanation lies not only in the United States leadership as political, economic and military power but also in the fact that other governments discouraged the international use of their currencies (Germany due to the inflationary consequences, Japan due to the incompatibilities with its credit system).

However, Eichengreen (2005) or Frankel and Chinn (2005) discuss the likelihood of a shared monetary leadership. In the 1920s, for example, three currencies dominated the international stage (the pound sterling, the dollar and the franc, in that order of relevance). This does not mean that these situations are desirable or free from financial turbulences and volatility. Even more, the inter-war period, when the pound lost ground against the dollar, was also a “non regime” period with high instability and competitive devaluations.

Bretton Woods’ demise in 1973 proves that a high devaluation does not determine by itself the end of a monetary leadership since the dollar continued to be the leading currency. This was due to the fact that, by that time, no other currency seemed to be able to become the main reserve currency, because the dollar could ensure the volume required to make global trade and financial transactions. This means that potential liquidity and the size of the leading country (USA)’s financial system offset the dollar’s higher nominal volatility and inflation against more attractive currencies as reserve value but with lower liquidity, such as the Swiss Franc.

Might we witness a context of dollar decline in the next years? If the answer is yes, would the redesign be progressive and agreed upon, or sharp and conflictive? The real needs of the US economy and the inflation risks faced by the dollar in the medium term could support the hypothesis of a dollar decline. But, its potential competitors (Euro and Yuan) do not provide full certainty about their international role.

The Euro has gained ground in terms of use for financial transactions and as reserve component of Central Banks and sovereign funds, but there seems to be no political will to dramatically increase its share in exchange rate markets. On the other hand, though the Euro Zone has regional space to expand, the European growth rate has been relatively low and there are even doubts about the cost-benefit tradeoff of adopting the Euro in the continental periphery. In addition, the existing members of this monetary zone see that new accessions may dilute their weight in governing bodies. Then, the convergence of the Euro towards an intermediate level of global share, as it occurred with the Yen in the past, could turn out to be a solution.
In the case of China, there are broad capital controls and financial restrictions that limit Yuan's financial role. So far, there have been some attempts to increase its international presence by generating swap lines with several countries, even outside the Asian regional environment (for example, with Argentina and Belarus). However, a sharp dollar decline would not be convenient for China since its reserves are mainly made up by assets denominated in that currency. Therefore, the transition towards a strong Yuan is not necessarily a positive-sum game unless it is made on a gradual basis.

In turn, both Euro and Yuan are currencies of countries relying on export dynamic role and with structural current account surpluses. These characteristics raise doubts about their capacity to inject sufficient international liquidity, in the case they shared monetary leadership with the US dollar.\(^{17}\)

So far, the provision of international liquidity was related to external deficits in the leading country (USA), which has shown a positive and increasing net indebtedness path compared to the rest of the world. From this perspective, the dynamics of imbalances is inherent to its role of monetary leader. So, it remains to be seen if the other potential leaders will be willing to bear deficits so as to provide global liquidity.

As a preliminary conclusion, we consider that the dollar is likely to lose ground but without abandoning its leading role. There are also supplementary interests for G-20 member countries to minimize the likelihood of sharp adjustments in parities or of high-volatility periods. This could be avoided with bilateral agreements between the largest areas and then be endorsed in a wider environment. The post-crisis is likely to require, then, a more homogeneous global managed float than the dual system in force so far.

### 6.4 The global lender of last resort and the Emerging Countries’ reserve composition

The role played by the dollar during the crisis as virtually the only safe asset has meant, for Emerging Countries, strong reversals in capital flows due to the flight to quality, thus reducing the space for counter-cyclical policies that might soften the impact of the crisis. Therefore, capital outflows turn Emerging Markets into the weakest link of the international financial integration.

These episodes, recurrent in every global liquidity shock, limit the role of the domestic lenders of last resort and result in a structurally higher and pro-cyclical financial cost depending on the international conditions.

This behavior, added to the uncertainty about the dollar long-term value, which generates instability in the central bank's international reserves value (mostly denominated in the US currency), would make the case for the creation of an independent and internationally accepted institution that may act as lender of last resort and liquidity provider.
Therefore, one of the lessons drawn from the crisis would be the need to create a global reserves system based on a currency other than that of a specific country (Ocampo 2008). In this sense and for the short term, IFA already has the SDRs, created in 1969 by the IMF\(^{18}\) to supplement the reserve assets of member countries, which could become a widely-used instrument upon the implementation of the new system.

Before the G-20 meeting, the Governor of the People’s Bank of China, Zhou Xiaochuan, suggested the creation of a “sovereign reserve super currency” associated to several leading countries participating in the basket. This currency should have two relevant objectives: provide a stable currency for international reserves and be an instrument of international liquidity.\(^{19}\) The desirable characteristics of such currency would be stability against an anchor, an orderly issuance (defined by ex ante rules), flexibility to respond to sharp changes in demand and, above all, a decoupling from national currencies. This fiat currency should be allotted to countries on a regular basis (i.e. countries would not need a surplus or an increase in their external indebtedness to obtain it).

SDRs could fulfill some of these roles if the reason behind their original creation, not fully complied with, were resumed. As we have seen, the G-20 advanced in this direction with the allocation of SDRs for USD 250 billion. Though this measure is still partial and the approval of previous allocations is still pending, it represents a promising first step. Probably, the composition of the SDR currency basket should be modified to include the Yuan.

7. When the horizon clears up

The G-20 focused its work on two areas: the coordination of macroeconomic policies to overcome the crisis and IFA reform in terms of financial regulations and multilateral lending and supervision institutions. Other critical aspects of IFA reform were not included in the agenda, such as the international monetary system operating rules. In this sense, there is an intense debate about the current "non regime" situation which unleashed phenomena such as global imbalances, lacked clear rules regarding the US dollar role in the provision of international liquidity and as reserve value, and also lacked a lender of last resort.

Neither the economic consensus nor IFA institutions existing until 2008 gave an alert or warned against the risks of a global crisis. In theory and practice, the economy should be able to prove that it can find a quick, efficient and sustainable solution for the current crisis. The lessons of the 1930s seem to be extremely useful not to repeat past mistakes regarding the risks of deflation and automatic adjustment. As a result, we are witnessing how the leading economic powers are launching a comprehensive package of expansionary fiscal and monetary measures.

It is also worth remembering that the latest literature on the 1930s crisis (Eichengreen, 1992; Bernanke, 1995) shows that international dimension, somewhat underestimated by pioneering works such as those of Friedman and Schwartz (1963) and Temin (1976), was highly relevant to explain the depth
and length of the crisis. At that time, the existing IFA, based on the gold standard, full capital movement and an important financial deregulation, played a decisive role in its origin and propagation.

In that international context, countries adopted uncooperative positions leading to large competitive devaluations and tariff wars which, together with the collapse of the economic activity, eventually reduced international trade to one third and destroyed financial exchanges. The Conference of 1933, paradoxically held in London as the G-20 Summit of 2009, revealed the unwillingness of the world powers to find a coordinated response. Economics can now show that, thanks to the implementation of the game theory results, there are cooperative solutions that are superior, in Pareto terms, to competitive equilibriums.

In this sense, after assessing the agreements reached under the G-20, it is legitimate to be distrustful of the depth and extension of the reforms undertaken. However, given the short time elapsed, the experience has been positive since it brought the Emerging Countries into the discussion of short-term measures and IFA redesign.

Once the urgency of the crisis abates, the issues with fewer consensuses today but that need to be faced will be part of the G-20 discussion table. Defining new “rules of the game” for the international monetary and financial system is more complex and conflictive than defining new regulations for the national financial systems or redesigning multilateral organizations, the tasks it has dealt with so far. Vis-à-vis the urgencies imposed by the crisis, the postponement of these issues seems to be a reasonable strategy.

G-20’s pending task is hard, to say the least: establishing a sustainable and cooperative framework. From the advanced countries that created the current architecture and where the crisis originated, we need leadership and consensus building, and from the Emerging Countries we need a performance in line with their new responsibilities. Once the crisis is over, the resulting IFA reform will show the level of commitment of the main players to a more stable and balanced scheme, less prone to generate global imbalances.
Notes

*Head of Economic Research at the Central Bank of Argentina (BCRA). The opinions expressed in this paper correspond to the author and do not necessarily reflect the opinion of BCRA or its authorities. I appreciate the cooperation received from Emiliano Basco, Diego Bastoure, Eduardo Corso, Javier Ibarlucía and Mariano Sardi.

1 The complete list of G-20 country members includes Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom and United States. The European Union should be added to the list.

2 An additional proof of the increasing importance of Emerging Countries is that, by late June 2009, the international economy followed closely the macroeconomic performance of China and India so as to find there an argument to rationalize the idea that the crisis would be “bottoming”.

3 It should be taken into account that after the failure of Lehman Brothers, most of the Emerging World suffered a “flight to quality”, which means that a rollover of the existing debt will be extremely hard to perform. Therefore, additional financing should exceed government spending increase.

4 For example, some governments that implemented financial bailouts have prioritized national capital banks over foreign banks, evidencing the revival of a kind of “financial nationalism”. Against what was expected in the 1990s, the Emerging Countries now seek to prevent foreign banks from draining the domestic liquidity to help solve the problems of their headquarters. This is why ring fencing has increased in these economies with the intention of isolating the domestic decisions of the large financial conglomerates.
5 The FSB was founded in 1999 by the G7 to promote the international financial stability through a better information exchange and higher cooperation in the supervision and surveillance of the banking system. At the behest of the G-20, it was expanded for the first time to include Emerging Countries.

6 This institution has been at the center of controversies, especially because of the suggestion that Basel I and II rules might have been a key factor in the financial expansion cycle before the crisis. Its approach on risk and the potential pro-cyclicality of the rules are among the most conflictive issues.


9 However, the possibility that institutions can practice a regulatory arbitrage has not been explored yet to determine the required homogeneity. Rodrik (2009) argues that regulation activities should be decided at national level, so that each country can choose its own tradeoff between stability and financial innovation.

10 In “Over The Counter” (OTC) transactions, two parties negotiate directly (outside the organized markets environment) financial instruments (equities, bonds, raw material, swaps or credit derivatives).

11 Treasury bonds held by China would also act implicitly as collateral of the foreign direct investment flows it receives from the United States.

12 Under Bretton Woods, one of the tasks of the IMF was to cooperate with the countries that needed to correct current account imbalances through bridge loans to facilitate the exchange rate adjustment.

13 This includes Japan, several Asian economies, Germany and oil-producing countries, among others. From this perspective, the G-20 is the most appropriate space for its members to concentrate most of the global current account flows.

14 In a recent paper (Carrera and Vuletin, 2009) we have illustrated how real exchange rate volatility has been lower during BWII (even controlling for some other determining factors) than in any other period between 1947 and 2007.

15 Regarding the discussion of global imbalances, this would mean that United States would have to be fiscally less counter-cyclical than China if the objective is to reduce the imbalances.

16 The most relevant coordinated exchange rate interventions in the last 20 years were Plaza Agreement (1985), Louvre Agreement (1987), US-Japan joint
interventions in 1995 and 1998, and the G7 action to sustain the Euro in 2000. In the current context of imbalances, with China and the oil-producing countries as large holders of dollar reserves, it is likely that new players should have to participate in this kind of measures.

17 A dilemma faced by any currency of international use originally stated by Triffin (1960). Currently, the advanced economies can inject dollars through currency swaps. However, this scheme is not continuously available to Emerging Countries.

18 It was an attempt to solve Bretton Woods’ problems but it lacked the necessary impulse.

19 Zhou’s proposal finds its inspiration in Keynes’ idea for Bretton Woods, consisting in the creation of a currency, called Bancor, based on a basket of 30 representative commodities.

References


Financial Service Authority (FSA, 2009); “The Turner Review: A Regulatory Response to the Global Banking Crisis”, March.

Ronald McKinnon (2008); “A New BrettonWoods?”, mimeo, Standford University.


Temim, P. (1976); *Did Monetary Forces Cause the Great Depression?*, New York: W. W. Norton.

The Economist (2008); “Divine Intervention”, March 27.
