The future of the international financial architecture

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Road map

- The new old issues
- Reforming global economic governance
- Reforming the IMF
- Two more modest proposals…

What have the IFA debates achieved?

‘According to the survey, progress in the reform of IFA since 1998 seems modest… greater in the areas of strengthening the financial sector and transparency, whereas it is significantly less in crisis prevention and especially in crisis resolution.’

‘…crises are not [seen as] less likely as a result of the modest and uneven progress observed in IFA…’

‘The relatively poor assessment of crisis resolution initiatives, except CACs, may be related to the fact that the latter seem the only tool with any reasonable prospect of success…’

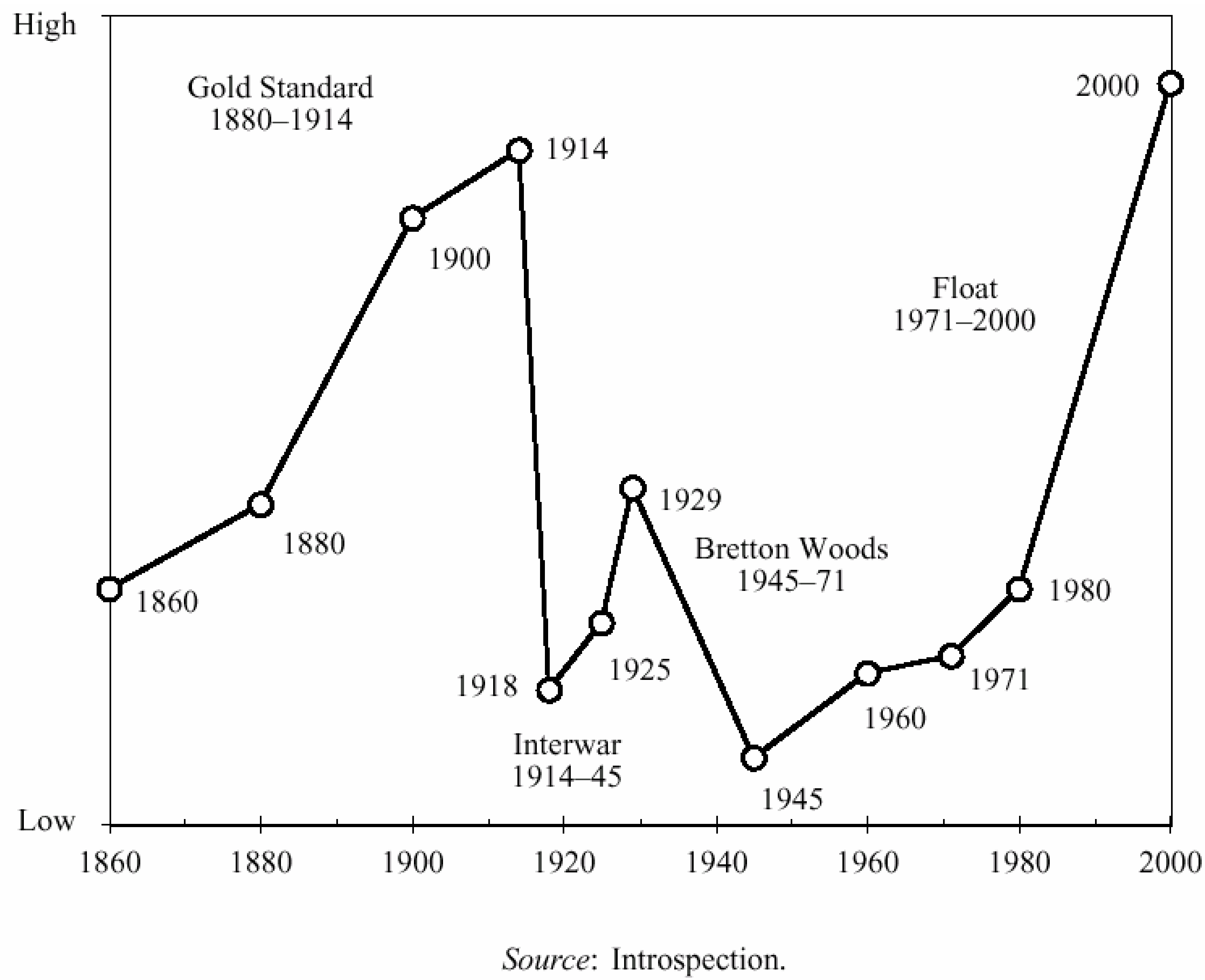
‘*…academics give the most negative assessment of progress…*’

A Review of Progress in the Reform of the International Financial Architecture since the Asian Crisis, Banco de España, June 2004

New issues

- The key issue: international financial integration – ‘financial globalisation’…
- …and with it, greater macroeconomic and financial interdependence
- But how new is that?
  - 1870-1913 was also an era of high integration – worked fairly well without lots of international institutions
  - nothing new in contagion – *e.g.* serial defaults 1931-33
  - how much greater interdependence?
    - distance still matters
    - regionalism limits globalisation

Financial integration – so what's new?



Source: Obstfeld and Taylor (2001)

Out of sight, out of portfolio…

Table 4 Economic interactions and distances
(flows relative to their magnitude at 1000km)

	Trade	Equity flows	FDI	Technology
1000km	1.00	1.00	1.00	1.00
2000km	0.42	0.55	0.75	0.65
4000km	0.18	0.31	0.56	0.28
8000km	0.07	0.17	0.42	0.05

Source: *Making Sense of Globalisation*, CEPR Policy Paper no. 8, July 2002

Is the problem just 'trilemma aversion'?

- Can't have monetary autonomy, fixed exchange rates and capital mobility
- In 1870-1913, countries conceded monetary autonomy to UK
- Now we 'want it all' – but occasionally we don't like consequences of capital mobility or of floating exchange rates
- And we think that international cooperation should *do* something about that – *e.g.*
  - limit exchange rate volatility and misalignments
  - prevent crises
  - sort them out if they happen nevertheless

How to proceed?

- Reform ‘governance’ – a new Bretton Woods?
- Reform IMF
- ‘Modest proposals’
  - a new crisis prevention measure
  - new institutions for crisis resolution

Difficult even to agree principles for reforming governance

- Institutions should be effective, legitimate, accountable, representative *(6th Geneva Report,* 2004) – sure, but…
- Accountability requires transparency, clear objectives
- Accountable to whom? national governments, 'the global community', NGOs?
- What criteria for representativeness? population, GDP, financial strength, … *Cf.* search for EU QMV formula!
- Conflicts among desiderata
  - effectiveness may require some degree of secrecy (central banks, confidentiality of Article IV reports)
  - representativeness can hamper effectiveness (*e.g.*, EU enlargement and size of decision-making bodies) and may be seen as undermining legitimacy (*e.g.*, US view of UN General Assembly)

Could it happen?

- Proposals for new institutions or ‘informal structures’
- Assign new tasks to existing institutions
- Let them find the new tasks themselves – IMF has been successfully opportunist since breakdown of BW exchange rate regime
  - 1970s petrodollar recycling
  - 1980s debt crisis
  - 1990s transition in the East and financial crises
  - 2000s financial sector focus
- Could *substitute for institutional innovation* –
  - regionalism
  - more large currency unions plus some capital controls to shield smaller countries outside

Focus on reforming IMF – why?

- Everyone's favorite target – from American unilateralists to antiglobalization movement
- Current roles do reach too far – but *Executive Board resists narrowing* of mandate
- Yet *little role now in reducing global imbalances* through changes in key currency exchange rate policies
- Bad *policies –* some criticisms justified…
- Creditor country taxpayer *subsidies* to borrowers
- Source of *moral hazard*
- Legitimizes domestic bailouts and consequent *regressive income transfers*
- Dictates policies over an excessively wide range of countries and issues – *too powerful and intrusive*

Radical alternatives

- *Abolition* - but then what does deal with market failures in international financial system?
  - not G7 - inappropriate and incapable
  - no other existing international organization - why recreate the Fund elsewhere?
  - regional ‘Funds’? not sensible to fragment global economic leadership in a world of increasing globalization
- The *markets* - without a safety net, would appropriate incentives develop? history says no

The *wrong* (or unrealistic) roles for the Fund

- Expanded *ILLR*
- *Big bailout packages* when payments standstills and possibly debt workouts are required
- International *bankruptcy court*
- Surveillance (and conditionality) in non-financial ‘structural/social’ areas
- Ratings agency
- Poverty reduction
- Substitute for market finance
- *Surrogate for US Treasury* - or G7

And the *right* roles

- *surveillance*, policy analysis, policy advice – only in areas of the Fund’s *core competence*: exchange-rate and associated macro policies, capital account, financial sector
- *monitoring compliance* with international standards and data provision
- *balance-of-payments standby* lending
- *crisis management* and *crisis lending* (not just for prequalified countries) and *ILFR* (see below) – but when that doesn’t suffice…
- assessing justification for *payments standstill*
- promoting *orderly workouts*

Two proposals – one for crisis prevention, one for crisis resolution

- The Fund as 'lender of *first* resort'*
- Back to the future: the 'New York Club' (recall the Council of Foreign Bondholders and the Foreign Bondholders Protective Council)

*See Cohen and Portes (2004a, 2004b)

Confidence crises

- Decomposition of debt dynamics: primary deficits, non-fiscal fundamentals (growth), *confidence* (interest rates)
- *Confidence crisis*: perception of high risk raises spread, that raises debt service burden, that provokes crisis
- May be a rational equilibrium if fundamentals underlying debt service depend partly on creditworthiness
- A pure confidence crisis is a *coordination problem*

‘Not the CCL’ – but a measure against confidence crises

- Preventing confidence crises: **IMF as lender of *first* resort** – country commits not to borrow from markets at ‘excessive’ spreads (*e.g.,* 300 bp), but rather to go to IMF
- Correspondingly, IMF commits *ex* ante to lend at that spread – *e.g.,* for 6 months, once renewable – while country follows IMF program to deal with problems that have caused spreads to rise beyond acceptable level

‘New York Club’

- A permanent, ‘light’ bondholders’ committee
- Would negotiate with debtor on behalf of all bondholders
- With a small secretariat, would develop procedures, precedents and ‘case law’ – *cf*. Paris Club, London Club
- With official sector support and coopting major market participants, it would have enough legitimacy to attract bondholders away from ‘guns for hire’
- And once it were to accept a debtor’s offer, few creditors could or would hold out for better terms – especially since NY Club approval would be gateway to renewed market access
- Historically, that was how CFB and FBPC ‘solved the aggregation problem’

So what's the future for the IFA?

- No '*grands projets*'
- Yes, some reforms for the Fund
- A new facility – the **ILFR**
- A new (old) institution – the **NY Club**

Pay off the architects, bring in the builders – at least until we see the '4th generation crises'