



The Global Crisis and the International Financial System: Reform to Recover

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Abstract

There is intense debate on the origins of the current crisis. The causes of the world's current financial and economic meltdown can be traced to two different factors: regulatory failures and macroeconomic imbalances.

It seems that global imbalances are here to stay, at least for a while. Curbing them definitively is hard to achieve when economies are managed with no explicit attention to global consistency.

There is a great need for coordination and cooperation. The International Financial System (IFS) has shown flaws in dealing with the imbalances. Changes are necessary. The sustainability of the recovery process may profit from a reformed system, which takes into account the current global economic scenario.

The purpose of this paper is to focus on the IFS, its role in the current crisis and in preventing and addressing future ones. History has taught us at least one lesson – crises are cyclical, but their frequency and effects can be managed and mitigated.

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Introduction

The current international crisis may be finally bottoming out. After the worst has passed, policymakers must now focus on the recovery process. While the full effects of the turmoil may take years to overcome, some lessons can be learnt from this period.

There is intense debate on the origins of the crisis. The causes of the world's current financial and economic meltdown can be traced to two different factors: regulatory failures and macroeconomic imbalances. It became clear that the present International Financial System (IFS) was not prepared to deal with these problems. When the crisis erupted, the focus was primarily on regulatory failures. As events unfolded, some degree of consensus emerged, and not only were both factors considered determinants of the crisis, but it was their interaction that intensified its effects.

The IFS's shortcomings are at the heart of the present crisis. When talking about causes, consequences and solutions to the turmoil, it is impossible not to think about adapting the IFS to the new configuration of the world economy. In fact, ever since the creation of the Bretton Woods Institutions, when countries faced crises, policymakers found themselves discussing the adequacy of those institutions, possible reforms and improvements to their toolkits.

The purpose of this paper is, therefore, not to extend the already-prolonged debate on the causes and consequences of the crises, but rather to focus on the IFS, its role in the current crisis and in preventing and addressing future ones. History has taught at least one lesson – crises are cyclical, but their frequency, size and effects can be managed and mitigated.

1. The Crisis, the International Financial System and the IMF

Over the past two years, the global economy has faced the most severe crisis since the Great Depression. The financial turmoil that started in the US housing market in the summer of 2007 gradually spread to the rest of the American and world economy, reaching its worst point in the fall of 2008.

The transmission channel of this crisis was, at first, through financial sector linkages such as cross-border investments on credit derivatives. During much of 2008, economic growth seemed to be holding up, particularly in emerging market countries, giving rise to the debate on decoupling. However, later that year, the financial turmoil started to spill over to the real economy causing a dramatic decline in global demand, economic activity, and international trade across the globe.

The current crisis can be compared to many other crises, but, at the same time, it is unique in many ways. On one hand, it is similar to the financial crises that have plagued emerging market economies over the past fifteen years, as a lack of confidence in their debt payment capacity provoked investors to suddenly stop lending. The fear became self-fulfilling and debt could not be rolled over. Analogously to emerging market crises, the deficiencies in the banking system spread to the rest of the economy, causing an economic contraction (Johnson, 2009).

On the other hand, this crisis is unique. For the first time in decades, no country was spared; it was generated in the advanced economies; it was the first one since the profound integration of international trade and financial markets, with the emergence of new and complex instruments; and, finally, its problems could not be traced to an explicit commitment to a fixed or quasi-fixed nominal anchor that led currencies to collapse.

The main trigger of the current crisis was the default in the US subprime mortgage market, whose risk was spread through complex and non-transparent derivatives. Most economists consider that distorted incentives, inadequate risk management and lax supervision encouraged the financial sector to take increasingly large, poorly understood risk exposures, financed through high-leveraged positions and a growing reliance on wholesale short-term funding. However, it is unlikely that all this would have developed to the same extent had the macroeconomic environment not been characterized by low interest rates, rising asset prices and large imbalances in consumption and investment in the United States, mainly supported by an excess of savings in Asia and in oil producing countries (Visco, 2009).

The combination of the above-mentioned problems found a catalyst in the IFS. Although we have dealt with serious crises in the recent past, none of them had the potentially devastating effects of this one. Previous crisis resolution efforts, therefore, were not as comprehensive as they have been now. In addition, crisis prevention efforts in the past were geared towards reforms in emerging market economies (EMEs) and their public sectors.

Lessons should be drawn from the past. It is clear that the IFS is not stagnant, as it evolves continuously especially in response to crises. The Paris peace conference, the Great Depression, and the Second World War were a series of historical events and ideological evolutions to influence the design and work of the postwar IFS (Boughton, 2004). They made the creation of multilateral financial institutions possible and largely determined the form they would take. Subsequent events led these institutions to alter their practices in various ways to stay relevant in a changing world. However, the international financial System did not keep up with the speed of global economic and financial changes.

One of these changes was the globalization of financial markets, which had a significant role in the shaping of the international financial System. Capital flows were of limited scope when the Bretton Woods Institutions were founded. Their importance increased in the 1970s, driven by the accumulation of "petrodollars" by oil exporting countries and their recycling to oil-importing sovereign borrowers through large international banks (Boughton, 2000). Since then, cross-border flows had become an essential and complex source of finance for both industrialized and emerging market economies around the world.

In the 1980s, the debt crisis had an even deeper impact on the international financial System. The IMF became a crisis manager and coordinated with the private sector lending efforts to the affected countries. With the ongoing globalization process, IMF resources clearly became insufficient to deal with the magnitude of the new challenges. The Fund, therefore, acted as a catalyst for the restructuring of debt by the private sector, whose involvement became indispensable.

The same countries that had benefited from inflows after the debt crisis were suffering from the effects of sudden losses of confidence and withdrawals of capital, thus resulting in the EME's crises of the 1990s and early 2000s. During this period, the IMF remained at the forefront of efforts to coordinate temporary official financing and members' reform policies, with its focus on the emerging economies and the public sector.

In the last few years, a period of continuous growth, dubbed "The Great Moderation", seemed to have replaced the historic alternation between good and bad times (Lara Resende, 2009). The IMF's role was questioned as the private sector seemed to be sufficient to cater for countries' liquidity needs. However, "The Great Moderation" concealed the slow consolidation of problems at the core of the IFS, as imbalances in the developed world started to be a source of concern. Despite the growing unease and red flags raised during this period, no concrete action was taken. After the end of 2007, things changed abruptly.

The reform agenda, as envisaged by the G-20, is vital for the recovery process. The roadmap for a sustainable recovery could encompass a broad set of features such as building a system with disciplining procedures, rethinking the role of the IMF, and strengthening the supervision and regulation of financial markets and institutions.

While it is possible to affirm that maybe the worst from this crisis has passed, it is also plausible to say that the tasks ahead are daunting. This is an appropriate time to discuss and to pursue permanent changes to the IFS. It is important to revive some old ideas and bring to life new ones in order to enhance the stability of the system, combat the effects of the current crisis, and pave the way for a sustainable recovery.

2. Emerging Market Economies, Developed Economies and their role on the rise of Global Imbalances

Until very recently, the main objective of policymakers in EMEs was the consolidation of external confidence. Therefore, macroeconomic policy could not be anti-cyclical; it had to be pro-cyclical, in order to rebuild confidence. Following the crises of the 1990s and the beginning of 2000s, many EMEs took important steps to strengthen their economies. They adopted more prudential regulation and financial oversight, improved their current account and fiscal positions, successfully managed their liabilities, and developed more robust monetary frameworks. The accumulation of substantial international reserves was also a very important condition that mitigated risk aversion towards EMEs. The consolidation of these reforms created an atmosphere conducive to the development of domestic capital markets, enabling public and private sector to finance themselves domestically, relying less on foreign capital.

Reduction of vulnerabilities to external financing helped EMEs to be better prepared to face the current crisis. They learned painful lessons about the risks of approaching the limits of their external restriction. To avoid being surprised by a sudden drop of investor confidence, when going too far in their dependence on foreign capital, EMEs adopted a cautious attitude. They understood that in order to benefit from the world's financial and commercial expansion, it was necessary to complete a significant number of reforms and also adopt a supportive role to be towed by the dynamism of the first world-economies. Domestic growth had to be always conditional to the growth of the external demand (Lara Resende, 2009).

Thus, this time around, emerging markets had the capacity, absent in previous crises, to implement counter-cyclical measures, which not only limited the direct negative effect of the crisis on these countries, but also reduced the indirect effects from other economies (Truman 2009b). However, not all countries were similarly equipped to deal with the crisis. Some of them, highly dependent on foreign capital, particularly in transition economies, were unable to cushion the effects of the rapid slowdown and had to resort to IMF assistance.

Some industrial countries, for their part, acted as though there were no limits to their sustained growth. Since the bursting of the “dot-com” bubble, they had experienced historically low levels of interest rate and inflation. Consumption was increasingly high, sustained by the surplus and reserve accumulation process of emerging economies, much of it invested in U.S. Treasury bonds. Within an environment of abundant liquidity and low return back home, money from developed economies was channeled to the more stable emerging economies and to derivatives built domestically to increase return.

The excess of liquidity helped to build a real estate bubble, with securitization instruments spreading risk across borders. The flow of money to EMEs put pressure on their currencies. While many EMEs’ currencies appreciated, others avoided appreciation by remaining pegged to the dollar. World savings were concentrated on a few large emerging economies, most notably China, and global consumption was heavily dependent on the US. The world growth was propelled by US expenditures, which were financed by financial innovations.

In an effort to avoid future crises, easier said than done, there should be a way to curb imbalances that stem from a disequilibrium between global savings and investments which would, in turn, reduce volatility in exchange rates and asset prices.

3. Curbing Global Imbalances: The Ongoing Debate

It seems that global imbalances are here to stay, at least for a while. Several issues require special attention, particularly with the onset of the recovery process. The lack of policy coordination, the search for new stores of value, and the need to avoid excessive reserve accumulation are among the topics that merit prompt responses.

First, curbing definitively the imbalances is a hard task when economies are managed with no explicit attention to global consistency. The lack of a common nominal anchor or the absence of clear “Rules of the Game”, according to Haley (2009), makes the process of adjustment more complicated and asymmetric.

Several nominal anchors have been used successfully in the past, such as monetary targeting, fixed exchange rate and nominal income targeting. After the collapse of the Bretton Woods System, most developing countries maintained some kind of exchange rate peg. However, with the evolution of the global economy and the adoption of inflation targeting regimes in some countries, many EMEs progressively floated their exchange rates.

Examples of Nominal Anchors

Nominal Anchor	Targeted Variable	Historical Examples
Monetary Targeting	M1	US early 1980s
Nominal Income Targeting	Nominal GDP	Less Developing Countries
Fixed Exchange Rate	Dollar, Euro	ERM

Jeffrey A. Frankel, 2005 apud Haley, 2009

As the global economy changed rapidly in the last decades, international adjustment no longer can be accommodated by coordination of policies of major industrialized economies. The current system does not take into account the growing share of global growth and GDP held by EMEs thus making the adjustment process contentious over who should take the burden. Cooperation will be needed.

Haley presents two basic approaches to address the problem of the differing nominal anchors now in use. Systemically important countries could agree on a nominal anchor, perhaps inflation targeting with flexible exchange rates, or find another anchor that could accommodate multiple exchange rate arrangements. This accomplishment would not be simple. Alternatively, the surveillance function at the Fund could be strengthened to better align incentives and to promote sound policies. In any scenario, the Fund, as the main institution of global governance, will have to adapt itself to the new global economic configuration.

Second, countries' extreme reliance on a single international store of value may put the system further at risk. In order to reduce further volatility in asset prices and exchange rates, policymakers are discussing the ability of some assets to serve as reliable stores of value. Many policy approaches were envisaged. Maybe the most discussed is People's Bank of China Governor Zhou's supra sovereign reserve currency, possibly the SDR. Its issuance would neither be linked nor determined by a single country, which would serve as a source of liquidity. However, for the SDR to assume the role of an important international currency, SDR markets would need to become deep and liquid: a significant amount of SDRs would need to be issued and largely traded. Alternatively, one possibility would be, for countries with surplus savings, to develop their own stores of value by expanding the range of financial assets in their own currency available to domestic and international investors.

In addition, the discussion from the 1970s on the IMF's Substitution Account has resurfaced. Such an account would accept deposits on foreign exchange, primarily US dollars, from Fund members in exchange for an equivalent amount of claims denominated in Special Drawing Rights (SDRs). Broadly, this account could facilitate the evolution of a more smoothly functioning International Financial System by allowing central banks to diversify out of dollars without precipitating a run on the dollar, which could undermine confidence in US financial markets (Eichengreen, 2009). Fund estimates show that the dollar's share of allocated reserves has declined very slowly from roughly 70% in 2001 to 64% in 2007 (Collins, 2009).

Third, in order to address excessive reserve accumulation, additional ideas have surged. Several authors have suggested the adoption of rules, based on measurable indicators that would trigger actions when policies put global stability at risk. Schadler (2009) suggests a rule that would limit sudden changes in reserve accumulation. These limits could be based on the countries' GDP and there could be waivers for currency boards. Alternatively, Einhorn (2009) proposes that the WTO could impose taxes on the countries' exports that exceed certain levels of reserve accumulation. Eichengreen (2009) recommends the establishment of a process that would give surplus countries an incentive to adjust. For example, any country running a current account surplus over 3 percent, for three years straight, would be required to transfer a percentage of the excess to the IMF at the end of every year. However, these proposals are politically complicated as they interfere in the domestic management of international reserves.

All these initiatives tackle, to some extent, the causes of international imbalances and the roots of the financial crisis. Nonetheless, they all have their drawbacks, which can be originated in economics, finance, politics or even in a combination of the three. Achieving a better global adjustment will necessarily start with a better-balanced recovery, with less reliance on the American consumer and on Asian savings. Major advanced economies will need to implement more effective monetary and fiscal policies, while systemically important emerging market countries, in addition to following appropriate fiscal and monetary policies, must implement more flexible exchange rate policies.

The debate has yet to mature, and here lies the importance of institutions such as the IMF and the G-20. The next section addresses the IMF importance and its new role.

4. A New Role for the Fund

The Fund has had to re-examine its role several times in the past. In the first quarter of a century after its establishment, the IMF, in addition to promoting balanced growth, was responsible for safeguarding a rules-based system, with fixed but adjustable rates. With the collapse of the Bretton Woods system, the focus of the Fund's surveillance functions shifted to domestic policies, while the growth objective remained unaltered.

Before this crisis, the widespread view was that systemically important countries had either self insured against future crises, through reserve accumulation, or had full access to international financial markets. However, the crisis has aptly demonstrated that, despite the comfortable situation of some systemically important countries, the Fund still had an important role to play in providing both precautionary resources and official lending to offset sudden stops of capital inflows faced by emerging markets, despite the fact that many had pursued sound policies.

The IMF has proved to be proactive when dealing with short-term needs. After discussions in the G-20, the IMF adapted, in a short period of time, its credit line toolkit through the creation of the Flexible Credit Line (FCL) and the modifications on the Stand-By Arrangement (SBA) and the Exogenous Shock Facility (ESF).

IMF surveillance of exchange rates was not an important issue in the two decades following the abandonment of fixed exchange rates. A natural adjustment occurred as all the systemically important were on the same nominal anchor monetary targeting with floating exchange rates. When a misalignment of exchange rates did happen, the coordination was left to the major industrialized economies, through negotiated accords. After the appreciation of the dollar in the first half of the 80's, the finance ministers of the G-5 countries met in September 1985 and decided to adjust their monetary and fiscal policies with the objective of depreciating the dollar, resulting in the Plaza Accord. In early 1987, concluding that the dollar had depreciated sufficiently, the finance ministers of the G-5 negotiated the Louvre Accord, designed to maintain the currencies within a narrow band.

However, since then countries with fixed or quasi-fixed rates have gained importance. The Articles of Agreement forbid the manipulation of currencies to gain unfair advantage or that inhibits balance of payments adjustment – Article IV, section 1 (iii). Nonetheless, the Fund has been overly timid in the enforcement of this obligation.

There was a call to improve IMF surveillance, which culminated in the 2007 Decision on Bilateral Surveillance over Members' Policies. This Decision revises the principles of country-level surveillance to make sure that they remain relevant and to increase the effectiveness of the Fund's surveillance as the main tool in its crisis prevention efforts. Although the implementation of the Decision has been considered positive with an enhancement of the quality of Article IV reports (Lavigne and Vasishtha, 2009), a first evaluation shows that there is room for improvement in several areas. There could be a strengthening of the link between domestic macroeconomic policies and external stability, especially in the advanced world. Also, more attention could be given to cross-border spillovers. Moreover, the Fund's framework for evaluating exchange rate policies is not being effectively implemented and needs strengthening. For the IMF to play its role in global adjustment, members should be more open to a candid dialogue with Fund management and staff on exchange rate policies.

The strengthening of Fund surveillance may be one of the most difficult and important issues coming out of the global financial crisis. In order to reduce the incidence and vehemence of future crises, the role of the Fund will be fundamental for consensus building and for the coordination of macroeconomic policies, macro and microprudential rules and on implementing the procedural agreements.

5. Coordination and Cooperation: The Future Options for the International Financial System

As presented earlier in this paper, the crisis was fuelled by global imbalances and found its trigger and contagion through loopholes in regulation and supervision of financial markets. The IFS was unable to prevent the crisis and counter its effects. A lot of work is already underway to address the issues of regulation and supervision, but little has been done to address the IFS' shortfalls.

The IFS has gone through many phases and focused on different issues, as policymakers have sought to learn from past turmoil episodes. The lesson seems clear. Today's world economy differs considerably from the one the international financial System was designed for. A

desirable IFS needs to be equipped to curb macroeconomic imbalances, mitigate regulatory failures and also to embody the new world economic representativeness.

As a first step, a successful round of reform needs to reduce global imbalances. Cooperation and an even-handed sharing of the burden of adjustment are fundamental. A solution might be a gradual increase in the saving rates in the developed nations, accompanied by the same gradual increase in the consumption in Asian countries. Deficit countries would need to increase their exports or decrease their imports. A realignment of exchange rates may be needed.

Secondly, promoting international cooperation and coordination is fundamental. This crisis has shown that the G-7 policy coordination is not sufficient to adjust the world economy. The role of the G-20 needs to be reinforced and sustained, as EMEs and developed countries need to work together. The importance of central bank coordination was demonstrated during the crisis. At the end of 2007 the Federal Reserve, for example, established swap lines with other banks, which were expanded in size and participation over the following year. Monetary policy actions, although to a lesser degree, were also coordinated.

Thirdly, relying on cooperative behavior is not enough. In the absence of clear “rules of the game”, the IMF surveillance becomes even more crucial. However, the current IMF surveillance framework is adequate only to identify problems, lacking enforcement power. Currently, only members under the Fund programs implement the IMF’s recommendations. It is clear that the IMF needs new mechanisms to improve its crises prevention framework. Some actions to improve surveillance have already been identified and some are already being implemented such as: the development of a joint IMF-FSB early warning exercise; recognition that crises can start anywhere, including in advanced countries; and integration of the Fund’s financial sector work in the World Economic Outlook and Article IVs. But more than addressing these shortcomings, the key to improving the Fund’s surveillance will be its ability to influence the action of governments (Callaghan, 2009).

And last but not least, the realignment of quotas and voice in international institutions is indispensable. Global economy has changed greatly in the last sixty years, and the Bretton Woods Institutions are no longer legitimate mirrors of the current distribution of financial and economic influence. After the ratification of the 2008 Quota Reform, the IMF should move boldly towards a more substantial increase in quotas, resulting in a significant realignment of the voting power and in less asymmetries between developed and developing countries. The BWIs will only succeed and be more legitimate if their members feel adequately represented.

Conclusion

Today's relevant issues have a global character, and it is clear that dealing with the challenges of a globalized world, whose limits are becoming narrower by the day, is no easy task. Studying the unfolding of previous crises is necessary – but not sufficient – to avoid the same traps that may hamper the well-functioning of the global economy.

As things cool down, it is very important not to lose momentum. This crisis is an opportunity for deeper changes. The official community should clearly take the corrective actions to put out the fire, but at the same time should plant the seeds for a more balanced future.

Crises are cyclical, but reducing their occurrence and their potential damage is feasible. Therefore, rapid advance towards the construction of a new System, a new institutional framework, should not be taken for granted. There is a long road ahead. Thinking outside the box is needed.

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