



The crisis and the challenges for international governance: A European perspective

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It is meaningful that one of the very first decisions taken after the crisis erupted in full force in September 2008 was to reform international governance by creating the G20. This long overdue decision was in part accidental, but it was nevertheless indicative of the consensus within the international community that designing and implementing an appropriate response required creating a more legitimate and more effective body than the G7. The upcoming G20 meeting in London is expected to result in further reforms, this time of the international financial institutions.

The relationship between the financial crisis and international governance is not entirely straightforward. The crisis is certainly by now a global one but it has been at root a crisis of the US banking system that immediately contaminated the European banking system. It is only when the crisis took a turn for the worse in September 2009 that the rest of the world started being really affected by capital flow reversals and the collapse of world trade.

A few numbers may illustrate the point. According to the IMF, US banks have suffered 57% of the losses on US-originated securitised debt and European banks 39%, leaving only 14% for the rest of the world. More generally, North America and Europe jointly represent 70% of the global supply of financial assets and they probably account for an even larger share of financial regulation, which again would suggest that managing the financial crisis and even more preventing future ones could have essentially remained a transatlantic affair.

The need for a global economic venue where the leaders of the major industrialised, emerging and developing countries meet and discuss directions for international governance is in fact much more pronounced in other domains like food security (with Europe and North America jointly accounting for less than one-third of world cereal demand), energy and climate (with the same regions accounting for 40% only of CO2 emissions), and trade (where, again, Europe and North America account for somewhat more than 40% of world total only).

It was nevertheless the financial crisis that triggered a change in global governance. The question is now whether the G20 will be able to deliver on the expectations it has created. To discuss the consequences of the crisis for global governance the first section of this note addresses the regulatory agenda. Macroeconomic dimensions are taken up in section 2. Conclusions are offered in section 3.

1. The regulatory agenda

It is widely recognised that the crisis in large part originates in the deficiency of financial regulation – knowing that “deficiency” can mean absence or insufficiency, but also inadequacy. Was this failure of governance primarily a national failure, or a failure of international cooperation to which stronger global governance can remedy?

Deficiencies were no doubt in many respects entirely national. To give only a few examples, the belief that regulators cannot know better than markets had little to do with external developments and the competition between public agencies that resulted in an excessively lax supervision of US banks was a purely internal deficiency. By the same token, the very uneven exposure to toxic assets of banks within Europe illustrates that it was in the power of national authorities to exercise strict oversight of their banking systems – as done with success in Spain. Failures of national authorities cannot be blindly ascribed to international deficiencies.

Weaknesses in international governance have however also contributed to regulatory and supervisory deficiencies. Three important channels have been:

- *Competition among regulators resulting in “regulatory shopping” by transnational players and as a consequence in a loosening of national regulations or a weakening of their effectiveness.* For example, the off-balance sheet conduits of some German banks were established in Dublin, which explains in part why they were neglected by supervisors. The same applies to the operation of weakly regulated and supervised Icelandic banks in the UK and elsewhere.

- *Disagreements among regulators resulting in weak global frameworks, excessive reliance on self-regulation or the subcontracting of important part of regulation to private organisations.* A key example here is the rulebook for international banking supervision issued by the Basel Committee for Banking Supervision. The painfully negotiated framework has been largely invalidated by the crisis because of its excessive reliance on ratings and the banks’ internal risk assessment models.

- *Resistance by national authorities to the transfer of significant responsibilities to supranational bodies, resulting in incoherent and/or vulnerable frameworks.* The key problem here has been the supervision of transnational financial institutions. Some global banks have grown too large to be supervised by any national authority and even more to be bailed out by any national treasury.

Despite its extensive legislative apparatus, the EU itself has not been immune from these problems. Especially the third one is acute as the number of pan-European banks has grown in recent years, but supervision remains essentially national and coordination among national agencies is of limited effectiveness. However there is no willingness to contemplate radical reforms. The recent Larosière report commissioned by the European Commission and endorsed by the European Council does not envisage centralising the supervision of pan-European banks and advocates instead closer cooperation between national authorities.

Crisis management since summer 2007 has confirmed that the tension between the globalisation of finance and the weakness of international governance is a major problem in the current crisis. Cooperation between central banks in the provision of liquidity to distressed banks has been remarkably smooth but international cooperation in the resolution of banking rises has been less exemplary. Many problems have emerged, for example as regards the coordination of deposit guarantee schemes, but the most difficult one is no doubt the rescue

of banks with significant cross-border operations. This raises major difficulties for small countries with large, internationalised banking systems, such as Austria or Ireland.

The issue is especially acute within Europe where it has only been given partial, ad-hoc solutions (for example when the Belgian-Dutch group Fortis was jointly bailed out by the two governments). The crux of the matter is that the taxpayer remains ultimately national and that for this reason governments reject the notion of a burden-sharing scheme that would commit them to contributing to the budgetary rescue of a non-national bank.

The upshot is that even in the EU, the tension between economic internationalisation and political accountability has not been resolved in a satisfactory way. As pointed out by the recent report of Lord Turner, chairman of the British Financial Services Authority, “The current arrangements [...] are not a sound basis for the future regulation and supervision of European cross-border retail banks. Sounder arrangements require either increased national powers, implying a less open single market, or a greater degree of European integration”.

From this perspective the G20 agenda provides only a partial response. The European insistence on extending oversight to all financial institutions in all countries and on cracking down regulatory and tax heavens can be seen as a stepping stone towards a comprehensive regulatory architecture. The Europeans have learned from experience that it is only in exceptional circumstances that entrenched special interests of this sort can be overcome and they have every reason to push their agenda ahead. This should not hide, however, that tax and regulatory heavens are not the core of the issue. Rather, the fate of global financial regulation depends on the attitude of the main players – the US, the EU and its member states, Switzerland, Japan, and China.

So far, these players have not departed from their traditional stance. The G20 November declaration insisted that “regulation is first and foremost the responsibility of national regulators” and on regulatory reform it emphasised the role of the Financial Stability Forum, a club of regulators, rather than that of the International Monetary Fund, a structured institution equipped with decision-making powers. The Obama administration is certainly more sympathetic to global institutions than the previous one but Congress is unlikely to delegate significant regulatory powers to supranational bodies. It is therefore likely that cooperation will be intensified further and that regulation will be tightened but that the distribution of powers between national and international institutions should remain broadly intact.

What is uncertain is the attitude of private institutions. As Mervyn King, the governor of the Bank of England, said, banks have experienced that they are “global in life but national in death” and the perception that this is a reality is bound to influence their internationalisation strategy. At the time of writing it is unclear whether the trends towards the creation of global financial players will continue or be significantly tamed by the experience of the crisis.

2. The macroeconomic agenda

The macroeconomic roots of the crisis are less unanimously recognised than its regulatory roots, but a growing number of contributions has emphasised the role of global macroeconomic conditions in creating an environment auspicious to financial instability.

From the immediate aftermath of the Asian crisis up to the outbreak of the global crisis, the world economy has been characterised by an unusual but seemingly stable pattern of savings flows. Throughout a decade the poor countries, chiefly China, have been financing the rich ones, chiefly the US, whose savings deficit represented some 2% of world GDP. Instead of resulting in capital flows from capital-rich to capital-poor countries as expected, financial globalisation was letting capital flow in the opposite direction. In 2005 Fed governor (now president) Ben Bernanke famously spoke of a “global savings glut”.

Several, possibly complementary explanations have been offered to account for this surprising pattern. Emerging countries, especially China, have been accused of keeping their exchange rate artificially low in order to stimulate exports and run an external surplus. Following the traumatic experience of the 1997-1998 crisis, the accumulation of foreign exchange reserves by the same countries has been seen as a form of self-insurance that would avoid them recourse to the IMF if confronted with macroeconomic and financial shocks. Finally, it has been argued that households and companies in those countries had little trust in the value of domestic financial assets and that they had preference for US-made assets of reportedly better quality and safety.

Whatever the weight given to these explanations, the massive flow of foreign savings into the US was bound to impact interest rates, savings behaviour, and the market for financial assets. Indeed it contributed to keeping long-term interest rates low, thereby fuelling the real-estate boom, to lowering domestic savings, thereby feeding the consumption boom, and to increasing the demand for US-made safe assets, thereby contributing to leverage and the manufacturing of assets of dubious quality. It is these conditions that, combined with a lax regulatory environment, provided the perfect incubator for boom-and-bust.

This type of analysis leads to emphasise the lack of global macroeconomic surveillance and the role it could have played, had the world economy been equipped with effective global institutions. In particular, exchange rate surveillance should have prompted policy corrections in the presence of massive and lasting external surpluses and deficits; trust in the multilateral regime should have made self-insurance unnecessary; and, although less straightforward, alternative assets could have been offered to surplus countries. The world pattern would have been different and arguably less auspicious to complacency towards the risk of instability.

This suggests that the reform of the international financial institutions should have a role in creating conditions for future financial stability. This dimension of the global agenda was largely overlooked by the G20 meeting in November but its main tenets have since then emerged. Global financial institutions, especially the IMF, need:

- To warn against economic and financial developments that involve risks of instability and send signals to governments and supervisory institutions so that they can tighten oversight accordingly;
- To provide effective insurance against private capital flow reversals and for that they must be equipped with sufficient firepower. This implies increasing their resources to a level commensurate with potential needs in a context where crises are characterised by massive outflows;

· To exercise even-handed surveillance over the policies of the major countries and blocks and issue warnings when these policies contribute to global instability. This implies making the institutions legitimate through a more adequate representation and weight of the participating countries.

What this sketchy analysis suggests is that issues of governance and of effectiveness are very closely linked. Keynes used to say that the job of the IMF is “ruthless truth-telling” but the Fund today lacks effectiveness in dealing with global problems because it does not have the legitimacy that would allow it to tell the truth to China and the independence that would allow it to tell the truth to the US.

Ultimately, the reform of global financial institutions should be seen as a stepping stone towards a balanced international monetary system of the sort recently advocated by people’s Bank of China’s governor Zhou. It is crystal clear that a prerequisite for such a system is a bold institutional reform.

The recent reform of quota and voice at the IMF has evidently not been commensurate to these needs. It has not even been sufficient to create or recreate the needed ownership in the institution among emerging and developing countries. The G-20 has mandated that ministers prepare proposals to reform international financial institutions, including giving greater voice and representation to emerging and developing economies, and G20 ministers have agreed that it should be done by early 2011. This indispensable reform needs to go far beyond the incremental changes agreed upon in 2008. It implies in practical terms a reduction in the number of European votes and seats, possibly leading to a consolidation, and the renunciation to the U.S. veto power. Without such a reform the IMF will continue to be perceived as an instrument of yesterday’s powers and it will be unable to play the macroeconomic role it needs to play.

If there is a venue where such reforms need to be discussed, it is the G20 summit. The matter is not a technical, but a political one. The question put to the heads of state and government is whether they agree on a major redistribution of powers within the institution and at the same time on a strengthening of its role and effectiveness.

3. Conclusions

Back in November, global governance reform was the world leaders’ chosen response to the outbreak of the crisis. They now have to deliver and they are at risk of disappointing. This would be a very unwelcomed development, because it would signal a collective inability to act and could trigger retreat towards national, possibly nationalistic solutions. History teaches us that failed international conferences in times of deep crises are to be avoided.

The G20’s agenda so far has put emphasis on regulatory reform. There is no doubt room for sensible initiatives, some of which are remotely related to crisis prevention and some of which could have more effectiveness. But there are limitations to what the G20 can do in this field. First, most of the issues to be solved are of the responsibility of the narrow group of countries with sophisticated financial systems. It is appropriate to involve emerging and developing countries in the discussion but their participation is unlikely to change the outcome

significantly. Second, regulatory cooperation can be improved but there is little room for radical reform. Problems within the EU are an indication that the supervision of financial institutions remains a fundamentally national responsibility. Third, reforms are technical in nature and this adds to the risk of disappointing.

The reform of international financial institutions, first and foremost the International Monetary Fund, is a more promising avenue. If significant enough it could help contain developments conducive to instability. It could embody the transition to a US-dominated world economy to a more balanced, multilateral regime. And it is the condition for rebuilding trust in the system among emerging and developing countries and thereby for avoiding the kind of quasi-secessionist behaviour observed in recent years.

This is at core a very political issue where only heads of states and governments can take initiative. The G20 meeting in London offers a rare opportunity for launching a bold reform process. It belongs to the United States and to Europe to take the initiative, because their power and representation in the international financial institutions prevents the rest of the world from ownership in them.

References

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