BRIEFING NOTES TO THE COMMITTEE FOR ECONOMIC AND MONETARY AFFAIRS OF THE EUROPEAN PARLIAMENT

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The International Financial Architecture and the ECB

Executive Summary

The crisis has reminded us of many well-known weakness of the international financial architecture. A window of opportunity for reform has opened, and should be fully exploited before the pressure dissolves, as has been the case following previous crises.

Unfairly perhaps, the IMF is first on the list of international financial institutions that need to be reformed. Most of the plans under discussions are unlikely to result into action. Redistributing voting rights is a zero-sum game which can only be played on the margin. Reducing the number of European Executive Directors – one third of the total, currently – is a better and more effective alternative. In particular, a single seat for all euro area countries would give them collectively a power equivalent to that of the US. An even more effective and possibly less contentious way to strengthen the Fund's independence and therefore improve its performance, would be to change the role of the Executive Board, making it an *ex post* supervisory body.

Deeply integrated financial markets logically call for world regulation and supervision. This is an idea that is logical but clearly not feasible for many years to come. A significant first step would be to transfer bank regulation and supervision within the euro area to a single body. The ECB has the technical ability and independence to carry out this task.

International macroeconomic policy coordination is desirable in theory but unlikely to occur in practice, if only because its usefulness is not established in normal times. In crisis times, policy coordination is indeed highly desirable. Most likely, the solution is not to set up a permanent body entrusted with effective authority but informal contacts of the kind that central banks have long nurtured under the auspices of the BIS. The G7 was set up precisely to that effect. Its successes are rare and far apart, and the group has become obsolete. The G20 is a step in the right direction but the group is too big to work effectively.

The debate on the international financial architecture last flourished in the aftermath of the Asian crisis of 1997-8. It is now returning to the forefront, again because of the current crisis. The pattern always the same: a crisis reminds us of untreated flaws, the abundance of proposals reveal deep disagreements – most of which represent diverging interests – which deter policymakers from quick action and when the crisis is ended nothing much is done. The G20 meeting next April is meant to avoid a repeat of this pattern, but there is little reason to believe that serious changes will be decided. Anyway, the ECB is ill-placed to take any initiative. At best, it may be given regulatory and supervision authority that it currently lacks.

Current shortcomings

The previous crises (Latin America in the 1980s, 1990s and 2001; Asia in 1997-8) mostly affected developing countries and involved the IMF and the World Bank as primary relief providers. As a result, the limelight was on the international financial organizations. So far, the current crisis has mostly hit the developed countries, which did not need any support. This is why most of the attention has focused on regulatory and supervisory failures. Yet, it is a matter of time before more developing and emerging market countries are hit and call upon the international organizations.

The international financial institutions

As the international lender of first resort,[1] the IMF became very powerful during the 1980s and 1990s when many developing countries, which had followed the Washington Consensus principles of financial liberalization, faced acute external pressure. Quite naturally, its power was resented by borrowing countries subject to conditions that they considered harsh. When the IMF mistepped in Asia, latent resentment surfaced and led to strong criticism. Eventually, the IMF acknowledged some shortcomings. The question is what remains to be done and what can be agreed upon.

Many issues concern the way the IMF staff analyzes the situation. This involves judgment on the quality of the staff work and possible bias in their recommendations. To that effect, the Independent Evaluation Office was created in 2001. It issues several reports a year on various aspects of the Fund's work and on specific interventions. The IEO thus exerts *ex post* peer pressure. Professional economists provide some peer pressure with a shorter lag, an activity that has been facilitated by greater transparency from a previously highly secretive institution.

In recent years, however, attention has focused on the Fund's governance, in particular the voting rights that are perceived to be tilted in favour of the developed countries. Years of negotiation have yielded little more than a symbolic outcome whereby just 2% of voting rights have been redistributed. This is unsurprising for two main reasons. First, it is not clear what criteria should be used. The underlying logic is one of shareholding where power is associated to the amounts deposited, which are related to ability-to-pay, measured by GDP. On this basis, current voting rights are, if anything, tilted in favour of poorer countries as shown Table 1, which includes the 30

[1] This expression, aptly coined by Michael Mussa, refers to the fact that, during crisis times, developing countries are unable to borrow from anyone except the IMF.

countries with the largest voting rights. Alternative criteria (exports, population, size of financial sector) have long been proposed and found their way in a formula that is complicated and therefore controversial and open to endless disagreements. Second, any reallocation of voting rights is a zero-sum game exercise, with winners and losers. Obviously, this makes negotiations highly contentious.

This is why the pressure has shifted towards management issues. The Executive Board, which makes all operational decisions, is composed of 24 Executive Directors and the Managing Director. Eight Executive Directors – one third of the Board – are European, as has been the Managing Director since the creation of the Fund. This has prompted calls for reallocating seats at the Board, another zero-sum game on which no progress has been made so far. The only potential change is a statement that the next Managing Directors will not have to be European.

Table 1. GDPs and voting rights (% of total)

	Voting rights	GDP		Voting rights	GDP		Voting rights	GDP
United States	16.77	27.16	Netherlands	2.34	1.37	Sweden	1.09	0.79
Japan	6.02	9.01	Belgium	2.09	0.81	Argentina	0.97	0.44
Germany	5.88	5.98	India	1.89	1.88	Indonesia	0.95	0.75
France	4.86	4.64	Switzerland	1.57	0.78	Austria	0.86	0.66
United Kingdom	4.86	4.90	Australia	1.47	1.61	South Africa	0.85	0.53
China	3.66	5.46	Mexico	1.43	1.73	Nigeria	0.80	0.24
Italy	3.19	3.82	Spain	1.39	2.53	Norway	0.77	0.69
Saudi Arabia	3.16	0.72	Brazil	1.38	2.20	Denmark	0.75	0.57
Canada	2.89	2.62	Korea	1.33	1.83	Iran	0.69	0.45
Russia	2.69	2.04	Venezuela, RB	1.21	0.38	Malaysia	0.68	0.31

The World Bank has been subject to much less criticism. One reason is that the Bank finances long term projects while the IMF lends during periods of acute distress and under very specific conditions that unavoidably interfere with national sovereignty. Most of the criticism of the Bank has been directed at the ecological impacts of the projects that it finances, at the poverty alleviation record of its activities and at suspected cases of corruption. These are rather specific issues, which mobilize a large number of NGOs but rarely make headlines in the media. The Bank has responded by establishing a dialogue with the NGOs and developing a highly professional communication strategy, largely quieting down outside criticism.

The relative calm that surrounds the World Bank may be surprising, but is easily understandable. The Bank makes loans at rock-bottom rates, because its own borrowing is guaranteed by all member governments, which results in the world's lowest costs. It follows that governments that borrow from the Bank are structurally pleased. In addition, a Bank subsidiary, the International Development Association (IDA) makes zero interest rate loans and even grants to the poorest countries.

Yet, hard questions have to be asked, even if they are unpopular. The Bank was created to provide loans to developing countries that could not borrow from the private sector because they are poor. Fortunately, over the years, a significant number of developing countries have gained access to international financial markets. Still, they continue borrowing from the World Bank, at concessional rates. This means that, in effect, the Bank is competing with private financial institutions, but the competition is unfair since no other institution can raise resources as cheaply as the Bank. The hard question is whether this public activity has indeed helped development. Repeatedly, outside economists have answered this question with scepticism, sometimes negatively. The Bank's own studies predictably reach the opposite conclusion. Since there is no cost of having the Bank – it pays for its own operations by lending at the slightly interest rate than the one at which it borrows – and since it officially helps the developing world, criticism of its *raison d'être* seems outlandish. The same applies to the regional development banks.

Finally, even less attention is devoted the UN system, even though a number of agencies operate under ECOSOC (the Economic and Social Council). Historically, they have often defined themselves as a counterpart to the IMF and the World Bank seen as pro-Western and especially as pro-US.

International regulation and supervision

Financial globalization has reinforced the inter-connectedness of financial markets around the world, especially among the financially-advanced countries. As a consequence, as the crisis spectacularly illustrates, serious failures in one market may lead to contagion to other markets. In practice, this means that the proper functioning of every integrated market matters for all others, a characteristic called an externality. An immediate implication is the need for coordination in the area of regulation and supervision.

This need has been recognized long ago, at least since 1974 when the G10 countries created the Basel Committee on Banking Supervision (BCBS), an independent organization based at BIS headquarters. The Committee has worked as a negotiation forum and produced the Basel Accord I in 1998, now superseded by Basel II. The accords define a set of minimum standards for banks that all countries of the world are encouraged – but not obligated since the BCBS is not a formal organization – to apply. Professional groupings like IOSCO (International Organization of Securities Commission) or IFAC (International Federation of Accountants) have also agreed on common standards. More recently, the G7 supported the creation of the Financial Stability Forum (FSF), which brings together officials from central banks and treasuries from twelve countries with significant financial markets as well as various international institutions. The Forum is mostly used for information exchange and in-depth discussions.

The common feature of these arrangements is that they do not challenge the principle that each country is sovereign in the area of financial market regulation and supervision. As a result, negotiators typically face two opposing objectives: sufficiently international tight regulation and supervision to limit the risks to one's own markets from contagion, on one hand, and light domestic regulation and supervision to enhance the attractiveness and competitiveness of national financial institutions. More importantly, perhaps, the application of agreed-upon standards is left to national authorities that are often keen to not undermine their national champions.

International economic governance

There is no international agreement to coordinate macroeconomic policies.[2] The IMF imposes a number of guidelines on exchange rate and capital movement policies and conduct regular surveillance of all its member countries, but it does not normally attempt to encourage cooperation in the area of fiscal and monetary policies. The absence of any arrangement suggests that the benefits are limited. This is the case in normal times, but the current crisis provides an instance – admittedly exceptional – when it would be desirable that countries adopt compatible policies and not attempt to free ride on each other.

The need for some cooperation was recognized in 1974 when the G7 was started.[3] The G7 served as *de facto* coordinator and had some influence but its effectiveness, always dependent on personal alchemy, gradually waned. Bringing in Russia did not help. On the other hand, G7-Deputies (top civil servants in Finance Ministries) regularly meet and reach agreements. During the period 2000-7, when the main international challenge was the "global imbalances", it became clear that the absence of emerging market countries was undermining the G7 effectiveness.

Coordination among central bankers is less visible but more successful. These meetings take place quarterly at the BIS and bring together central bankers from BIS member countries – the list has expanded over the last decade – as well as from other countries. The meetings are informal and their frequency allows for in-depth discussions that lead to common understanding. The effectiveness of this grouping has been revealed during the crisis.

Major reform objectives

The crisis has confirmed that, as is often the case, policies lag behind reality. Quite simply, an economically and financially integrated world requires common rules and guaranteed enforcement of these rules. Meanwhile, governments are unwilling to give up their prerogatives and public agencies defend their turfs. The crisis has opened a window to make progress, but it is unlikely that much will be achieved.

The creation of the G20 is a response to the increasing anachronism of the G7/8. But the size of the group is too large for effective negotiations to take place. In financial matters, the G20 includes far too many countries with no systematically important financial institutions while countries like Hong Kong, Singapore or Switzerland are absent. Attention is now focused on the London meeting of the G20 in April 2009.

The international financial institutions

There is no plan to streamline the World Bank or the UN agencies, nor is there any willingness to reopen the IMF voting rights issue. Most of the attention goes to the operations of the IMF. The British government has asked that the IMF provide an early crisis warning system but the Fund did devote considerable resources to this

[2] The situation is different for international trade policies, which are coordinated through WTO (World Trade Organization).

[3] It started first as a G5, but was soon extended when Canada and Italy joined in.

goal in the wake of the Asian crisis only to realize that it is a futile effort. The current state of knowledge is simply insufficient to develop an effective tool.

On the other hand, simple reasoning can go a long way if backed by political will. For instance, in the mid 2000s it had become plainly clear that housing prices were excessive in the US and that mortgage lending was developing along dangerous lines. The IMF could have issued strong warnings and pressed the US to deal with the situation in good time. Its management, however, did not feel that it had the weight to engage the Fund's main shareholder. More generally, strengthening independence and accountability of the Fund is highly desirable. This would call for reducing the Executive Board's *ex ante* influence while strengthening its *ex post* oversight.

Another issue is that Fund is likely to be underfunded in the event of a new wave of currency crisis. The easiest way of increasing resources is to issue new SDRs. Such issues have been blocked since 1981, with a proposal pending since 1997.

International regulation and supervision

As it should be, the reform focus is strongly on the regulatory failures that lie at the root of the crisis. Unfortunately, regulation and supervision are subtle undertakings. Public perception is that financial markets and institutions are under-regulated. On the other hand, it is very easy to over-regulate – no public cost, a perception of willpower, the possibility of targeting sacrificial lambs, etc. The problem is not with the quantity of regulation but with its quality and the quality of supervision. Obviously Basel II needs to be overhauled, with two main aims: 1) reduce complexity which is opens the door to opacity and 2) remove the private credit rating agencies from public regulation.

The second challenge is to move beyond national regulation and supervision. It is unlikely that governments will accept to transfer formal powers to a supranational organization but there is an opportunity of strengthening supranational oversight. The areas to be covered are: setting international norms (i.e. re-thinking Basel II), supervising the activities of national supervisors and organizing cooperation for emergency interventions in times of crisis. Norm-setting for banks has been carried out by the BCBS and by IOSCO for stock markets. These are non-official fora, so the question arises whether the time has come for making these arrangements official. The main benefit would be make the adoption of norms compulsory, but there are serious, possibly lethal drawbacks: any compulsory system would require all countries to be part of it; accountability would be difficult; enforcement would call for international treaties. There have been suggestion to raise the profile of the Financial Stability Forum (FSF) but this would require massive investment in staff. The IMF has been seen as a better alternative because it has a large and competent staff but this could create a conflict of interest. Indeed, the Fund would then be responsible for the quality of international regulation, which is more art than science, while it has the duty to provide conditional support in the event when the regulation fails. Additionally, this could require changing its Articles of Agreements, a risky endeavour. A possible arrangement would be to merge the FSF and the BCBS while asking the IMF to supervise national supervisors.

International economic governance

There is much excitement about the creation of the G20. It is indeed a positive step if it replaces the G7/8 that has become obsolete and ineffectual. Yet, its very size is a bad omen and the experience with the G7 is sobering. Informal groupings of powerful nations can occasionally make a difference, and the G7 can boast a few rare such instances.

On the other hand, global economic governance is an idea whose idea has not come. Anyone that doubts this conclusion should only look at the European Union. A (relatively) small of countries with considerable commonality, deeply integrated and supported by supranational institutions (the Commission, the Parliament, the Court of Justice) has made very little progress in macroeconomic policy coordination beyond the partial adoption of a common currency.

The role of the ECB

Most of the issues on the table do not directly concern the ECB. The ECB is only an observer at the IMF, it has no authority in matters of bank regulation and supervision nor does it supervise the asset markets. At best it can express an opinion, which is unlikely to carry much weight and could actually backfire if the ECB is perceived to try to extend its role beyond the powers given by the Treaties. Yet, a reformed international financial architecture would optimally extend the role of the ECB in a number of areas.

IMF representation

Sooner or later – probably later than sooner – the European representation on the IMF Executive Board will have to be reduced. The natural way to do so would be to have a single seat for all euro area members. This would provide the euro area with a weight at least equal to that of the US, including the 15% veto right. In that situation, it would also be natural that the seat be occupied by a representative of the ECB, which is the only relevant euro area institution. The alternative would be to attribute the seat to a representative of the Eurogroup.

Regulation and Supervision

Much the same applies to bank regulation and supervision. Ideally, we would have a world regulator and a world supervisor, but even the EU has been unwilling to move in this direction. The recently created College of Supervisor is clearly a successful effort by national supervisors to thwart any attempt at creating a euro area-wide supervisory body.

Yet the crisis has provided many examples of the need for a euro area-wide supervision.[4] Assuming that this step will be taken, the question is whether we need a single regulator-supervisor like the British FSA and whether supervision should be attributed to the ECB or to an independent agency. The crisis has provided fairly convincing evidence that central banks need to have real-time information that only

[4] Examples: the Société Générale affair, the rescue of Fortis, the Irish decision to guarantee all bank deposits.

the supervisor can have and that they have both the technical capacities and the independence to carry out the task. It follows that, even if that is not theoretically the absolute best solution, in practice the only possible solution is to devolve bank regulation and supervision to the ECB.