Revitalizing Global Economic and Financial Cooperation:
Observations on the Global Financial Architecture

Submission by Charles H. Dallara,
Managing Director, Institute of International Finance
for the
Panel Discussion "Toward A New Global Financial Architecture"
INET Spring Conference, April 9, 2010

Since the outbreak of the Asian financial crisis more than a decade ago, world leaders have been searching for ways to make the global financial system more resilient, less crisis-prone, and better able to play its essential role in supporting broadly-shared growth. Their deliberations have touched a wide range of critical issues—not least, governance in the international financial institutions; the adequacy of financing for development; the best appropriate mix of financing and adjustment for solving balance of payments problems; and global currency arrangements.

Today I do not plan to comment in detail on these important issues. By now I think most of us are convinced of the need for the IMF and other global institutions to adapt their voting shares and governance structures to reflect the growing importance of emerging market countries in the global economy. What remains is for decision makers to get serious, and get on with the job. There has been a quantum jump in IMF resources, and discussions are underway on capital increases for the multilateral development banks. Recent economic literature includes many provocative suggestions regarding currency issues, the SDR, and the possibility of a new Bretton Woods conference. But I suspect that the degree to which the US dollar may be supplanted in the future by the SDR or by some other national currency, such as the euro or RMB, will ultimately depend on policy performance and market preferences.

I say "suspect" because it is important to acknowledge that we are operating in a world of great uncertainty. We owe a considerable debt of gratitude to George Soros for his willingness to question conventional wisdom and try to find new paradigms for dealing with economic issues. Somewhere in the interplay of public policies, academic debates, and the contrast between experience and the predictions of economic theory, we have been reminded how little we really know. The multi-disciplinary approaches and new ideas he keeps bringing to the table are examples of the type of fresh thinking we need if we are to find our way forward.

In this presentation, I would like to focus on two powerful phenomena that have shaped the global financial architecture—globalization and nationalism—and the ways in which they are playing out in some of today's crucial policy debates. Throughout human history there has been a strong tendency toward integration of societies and markets, driven by changes in technology and the spread of knowledge. And despite some interruptions, globalization has been a defining characteristic of the modern era—most notably since the end of the Second World War, with the creation of new multilateral institutions and mechanisms for international cooperation helping to generate unprecedented improvements in human welfare.

The recent global financial crisis led to severe economic and social disruption. Whether it will also cause significant back-tracking in the process of globalization and international cooperation remains to be seen. Economic recovery has begun, stimulated in part by cooperative efforts in the G-20. But we have also been left grappling with heightened tensions between globalization and nationalism, as policy makers respond more and more to political imperatives at home. The end-result could be a temporary bump in the road, or a more lasting change of direction, in which it will be difficult to find an appropriate balance between national political agendas and the actions needed to promote sustained and inclusive global growth. I will try to apply this perspective to three sets of issues: the ongoing reform of financial regulation; policy coordination to contain global imbalances; and the scope for institutionalizing consultations between the official and private sectors.

More effective financial regulation

By now there is a broad consensus on the shortcomings that led to the recent global financial crisis—in particular, inadequate market practices and structures in the financial industry, weaknesses in supervision and regulation, and macroeconomic policy decisions that led to excessively loose monetary conditions and widening global imbalances. Action has gotten underway on a variety of fronts to correct these problems. But I think there are still some missing pieces—and these relate in particular to gaps in the global financial architecture.

The crisis reminded us that while businesses typically organize themselves globally, financial supervision and regulation are mostly carried out by national governments. So there is an inherent issue of coordination. Unfortunately, we have also seen that when crises strike, there is a tendency for national authorities to become inward-looking. The result can be a competition to guard one's own citizens against he worst possible consequences of a disorderly situation, rather than cooperation to achieve better outcomes for all. Previous global upheavals led to agreement on ways to improve coordination, like the formation of the Bretton Woods institutions or the European Coal and Steel Community. Will we able to do anything comparable this time?

The G-20 got off to a good start by pushing for the creation of the Financial Stability Board, and by asking the FSB to develop an internationally-coordinated road map for regulatory reform, drawing on the work of the Basel Committee and other expert groups. The FSB and the Basel Committee have mobilized world-class talent for this job, and they been working diligently, on a demanding timetable, to flesh out proposals for regulatory reform in the areas called for by the G-20. If they are allowed to do their work and are not sidetracked at the political level, there is a good chance that the end-result will be something of great value.

But it is not self-evident at the moment that this will happen. In particular, I am concerned that progress toward agreement on regulatory standards in the FSB and Basel Committee risks being interrupted by a growing body of politically-motivated new proposals that do not fit comfortably into the G-20 road map—for instance, to impose financial transactions taxes and restrict certain lines of business, such as proprietary trading and derivatives transactions.

What does all of this suggest about the regulatory part of the global financial architecture? There is a significant and influential body of opinion which says: (a) that the benefits of large, global-integrated financial institutions—indeed, of globalization in general—are overstated; (b) that large global firms are—and always will be—too complex to manage, supervise, or resolve effectively; and (c) that when these firms run into difficulties, the effects are inevitably catastrophic. Their conclusion is that we should break up large, global firms and retreat into a form of regulatory autarky. I would strongly challenge every step of this analysis, as well as the conclusion. It is a counsel of despair which, if followed through, would cause great damage to the global economy.

It is clear that large, global firms pose governance and regulatory challenges which need to be addressed. But they are also very important for the functioning of the global economy. They help to make markets deeper and more liquid. They promote financial sector development through the diffusion of new technologies and best practices. And they play an indispensable role in promoting international trade and investment and expanding growth potential. Policy makers need to remain mindful of these benefits as they consider ways to address the challenges posed by large, global firms.

Regulatory reform needs to be tackled with the type of vision and ambition that the global community brought to the creation of the Bretton Woods institutions and the WTO—one that seeks to preserve and build on the benefits of global integration, while finding ways to manage the risks. By combining well-calibrated and internationally-coordinated regulatory reform, more effective supervision, and improved industry practices, it should be possible to enhance the resilience of the financial sector while safeguarding its essential contributions to economic growth and employment. This will require action in four areas.

First, the financial services industry has a profound responsibility to correct failed market practices and structures. Improvements in the areas of governance, risk and liquidity management, clearing mechanisms, and compensation are essential to improve the functioning of markets and restore trust. The IIF has worked with its members to identify best industry practices and encourage their adoption. And we would encourage supervisors to step up their monitoring of these ongoing improvements, taking action when necessary to ensure that they are sustained and deepened.

Second, we need to make sure that global standard setters are able and permitted, without political interference, to do what is necessary to produce timely, proportionate standards whose impact has been fully and fairly evaluated.

Third, we need a similarly forward-looking and cooperative approach to supervision. It is clear that supervision needs to be coordinated and strengthened—not least, to ensure that all institutions that could cause major vulnerabilities are supervised, and that there are not gaps in the oversight of foreign branches and subsidiaries. New techniques for macro-prudential supervision are needed, to identify when market dynamics and the collective behavior of otherwise-sound firms may be creating risks for the system as a whole, and to find ways to reduce them.

Fourth and crucially, we must create the conditions in which national authorities will be willing and able to let large, global firms fail. Reducing the likelihood and potential costs of failure through more effective regulation and adequate supervision of such firms—and improvements in firms' own practices—is an important part of this. National authorities also need to harmonize their laws and procedures for dealing with the winding up of financial institutions, and to put in place an internationally-agreed mechanism for ensuring that failing firms are dealt with cooperatively not on the basis of confrontation.

It is conceivable that much of this can be accomplished through the development of more effective mechanisms for coordinating the work of national supervisory and regulatory bodies, building on the work of the Financial Stability Board. Indeed, in the past the IIF has suggested the formation of a global regulatory coordinating body, bringing together the work of the FSB, the Basel Committee, and IOSCO, to monitor and coordinate financial regulation and supervision on an internationally consistent and convergent basis, for systemically important firms.

But the FSB and other similar bodies operate mainly through peer pressure, and past experience with the workings of mechanisms without teeth is not very encouraging. So on balance, I think it is worth considering whether what we really need is a trans-national supervisory and regulatory authority—created, perhaps, by enshrining something like the role of the FSB in a formal treaty. The debate now underway in Europe, regarding the creation of new regulatory agencies with significant powers, reflects some of this spirit. Perhaps the time has for a similar debate at the global level.

Coordination of economic policies

I would like to move now from global coordination on financial regulation, to coordination of macroeconomic policies. Persistent macroeconomic imbalances created the conditions under which the recent global financial crisis became increasingly likely. And while the risk was recognized long before the crisis, initiatives to develop a coordinated policy approach to correct this problem failed to produce meaningful results. Since the outbreak of the crisis, global imbalances have been reduced dramatically, but this was mostly the result of extraordinary and costly temporary factors—the disruption of domestic lending and cross-border capital flows, deep recession, and the collapse of world trade. Unless action is taken to address the underlying causes, there is a risk that the imbalances will re-emerge quickly in the recovery, sowing the seeds of future crisis and instability.

Indeed, concerns about fiscal sustainability are already leading to market pressure for sharp fiscal retrenchment in a number of mature market economies, at a time when growth prospects remain fragile. This has not yet spread to the United States, but one could well imagine a scenario in which the prospect of large and sustained US fiscal and external deficits could weaken confidence in the world's central reserve currency. Emerging markets generally face more favorable growth prospects, and many have begun tightening monetary policy in response to signs of growing inflationary pressure. However, when this is juxtaposed against weak performance and prospects elsewhere, it could lead to further surges in capital inflows and the risk of future boom/bust cycles.

Changes in exchange rates clearly have a major role to play in resolving these dilemmas and reducing global imbalances. Unfortunately, so far international efforts in this area have generated more heat than light. Policy coordination discussions in the G-7 over a period of decades were largely ineffective. Attempts by the IMF a few years ago to put in place a system for identifying currency misalignments were derailed by lack of support from its major member countries. But trying to reduce global imbalances without real appreciation in surplus countries and depreciation in deficit countries would require excessively deflationary policies—a very risky approach under present circumstances, and one that is unlikely to be politically sustainable in any event.

The leadership of the G-20, as more representative body that includes the largest mature and emerging market economies, has given new impetus to global coordination on many fronts. The new G-20 Mutual Assessment Process, intended to bring about macroeconomic and structural policy changes needed to put in place more balanced growth models and reduce global imbalances, is a particularly encouraging initiative. And maybe this time, and in this body, policy coordination will succeed.

But I think it is more likely that the working methods and sheer size of the G-20 will work against this. As in the area of regulatory reform, peer pressure alone may not be enough—economic policy coordination will also require a clear set of objectives and sources of effective pressure, to help induce movement in the desired direction. And such a large group may also be ill-suited to the sort of give-and-take and tradeoffs that are necessary to reach concrete agreements on sensitive issues. At the same time, recent experience suggests that raising currency matters in bilateral negotiations can entangle these with extraneous political issues and harden opposition to reasonable alternatives.

To increase the chances of success, I believe that the G-20 should consider establishing a smaller coordinating body that would carry this issue forward on behalf of the entire group. Such a Global Macroeconomic Coordinating Council could be composed of Heads of State from no more than ten mature and emerging market economies. With the support of the IMF and other international organizations, the Council would assess the need for policy changes, recommend remedial measures, monitor their implementation, and report regularly to the full G-20 Summit for appropriate follow-up action. In this way, it would be possible to combine a more agile process for agreement on policy changes with the enhanced legitimacy of the G-20 in considering and adopting the resulting strategy for balanced and sustainable growth.

Institutionalizing consultation with the private sector

As a global association of globally-active financial institutions, the IIF is at the center of an extensive network of information and well-informed views on market developments, policy challenges, and global issues. At times we have useful opportunities to interact with government officials and international organizations. But over the years I have had a growing impression that we are not taking full advantage of the potential for public-private sector dialogue to improve economic performance.

Now I know that some might say that the last thing we want is for public officials to be forging closer ties with powerful private firms as an end in itself. But my interest in more systematic interaction between the public and private sectors in not about regulatory capture or revolving doors. Simply put, I think that the operation of the global financial system has become so complex, and the roles of policies and markets so intertwined, that better mutual understanding and timely exchange of views on evolving issues is essential. Let me give a few examples.

First, I have already discussed the importance of effective coordination among national authorities and international organizations in developing new financial regulatory standards. But it is also clear that the high stakes and incredible complexity of this task oblige us to mobilize the best possible information and talent in assessing alternatives and calculating costs and benefits. Indeed, the FSB has shown awareness of the potential importance of input on such issues.

But traditionally there have been no significant, formal interactions between the Basel institutions and the private sector, and the willingness to consider it in the current circumstances has been blunted by the amount of time required for cooperation among national authorities, and by public suspicion about contacts with financial institutions in this context. I believe these difficulties can be overcome, and that institutionalized consultations with the private sector can be carried out in transparent ways that enhance the overall efficiency of the regulatory reform effort and allay public suspicion.

Second, the crisis made it clear that there are missing dimensions in existing approaches to supervision of financial institutions. One of these is the lack of effective supervision of systemically important firms that fall outside the traditional regulatory network. Another is the need to complement the supervision of individual firms with macro-prudential supervision, aimed at detecting and correcting systemic vulnerabilities that may arise from the interactions of firms and market trends. In this area, we believe the private sector has a great deal to offer. Last year the IIF created its Market Monitoring Group—an independent body of expert practitioners co-chaired by Jacques de Larosière and David Dodge—was created to perform regular assessments of emerging sources of systemic vulnerability and ways to address them. The MMG has met regularly since then, communicating its views to our membership and, more recently, to the public. In addition, the MMG has established a dialogue on these issues with official bodies, including the FSB and the IMF, and we would like to see the institutionalization of regular, structured exchanges of view.

Third, I believe that globally-active firms have a great deal to offer in interactions on other issues with the IMF, World Bank, and other international financial institutions. Indeed, nearly a decade ago the IMF put in motion a series of regular meetings with leaders from the private sector, called the Capital Markets Consultative Group. After a promising start, the CMCG has been dormant over the past few years. I hope we will be able to revive this, or some similar form of regular consultation with the IMF, and extend it to other international institutions.

These are important examples, but there are also possible applications in many other areas, such as trade policy and anti-corruption policies. With so much to gain, I would urge international organizations and public officials to be open to making fuller use of the potential offered by reaching out to the private sector.

Conclusion

I am grateful for the opportunity to participate in this discussion, and to benefit from the insights of so many expert scholars and practitioners on the reform of the global financial architecture. We are coming out of a very difficult episode, and a lot needs to be done to restore confidence in the possibility of sustained and broadly-shared improvements in human welfare. Global financial firms have important responsibilities for strengthening industry practices, to help restore trust and improve the functioning of markets. And there is a truly formidable agenda for economic policy makers. Their chances for success will depend importantly on the ability to resist pressures for inward-looking approaches and find the vision to re-energize global economic cooperation.