Special Report

The Financial Stability Board: An Effective Fourth Pillar of Global Economic Governance?

Edited by Stephany Griffith-Jones, Eric Helleiner and Ngaire Woods

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The Centre for International Governance Innovation
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Addressing International Governance Challenges

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Acronyms and Abbreviations

AIG	American International Group
APRM	African Peer Review Mechanism
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BRIC	Brazil, Russia, India, China
CCP	central counterparty
CGFS	Committee on the Global Financial System
CPSS	Committee on Payment and Settlement Systems
DAG/UNEG	Development Assistance Committee/United Nations Evaluation Group
ECLAC	Economic Commission for Latin America and the Caribbean
EE	emerging economy
EFO	Economic and Financial Organization (League of Nations)
ESCB	European System of Central Banks
EU	European Union
FSA	Financial Services Authority (UK)
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSF	Financial Stability Forum
GDP	gross domestic product
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IFI	international financial institution
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee (IMF)
IOSCO	International Organization of Securities Commissions
OECD	Organisation for Economic Co-operation and Development
OFC	offshore financial centre
OTC	over-the-counter
ROSCs	Reports on the Observance of Standards and Codes
SME	small and medium-size enterprise
SSB	standard setting body
TPRM	Trade Policy Review Mechanism (WTO)
UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund
UPR	Universal Periodic Review
WB	World Bank
WTO	World Trade Organization

Introduction and Overview

Stephany Griffith-Jones, Eric Helleiner and Ngaire Woods

At their April 2009 summit in London, the G20 leaders announced their first major international governance innovation: the creation of the Financial Stability Board (FSB). This body replaced the Financial Stability Forum (FSF) which had been created almost exactly ten years earlier in the wake of the 1997-1998 East Asian financial crisis. Responding to the 2007-2009 global crisis, the G20 leaders gave the FSB a stronger mandate to promote global financial stability, a wider membership and a more sophisticated internal organizational structure than its predecessor. The FSB was even described soon afterwards by US Treasury Secretary Geithner as "in effect, a fourth pillar" of the architecture of global economic governance, alongside the International Monetary Fund (IMF), the World Bank and the World Trade Organization (WTO) (US Treasury, 2009).

Expectations are high for the new institution. Its creators hope it will be more effective than the FSF in encouraging compliance with international standards. Some hope that the FSB will lead the way on global macroprudential regulation, jointly with institutions like the Basel Committee on Banking Supervision (BCBS). Many are now beginning to ask what kind of power and authority the FSB should have, and with what implications for its governance structure. This new pillar of global economic governance is being further shaped as this publication goes to press. Our hope is that this compilation of short memos, produced a year or so after the FSB's creation, will promote further debate over the mandate, legitimacy, governance and effectiveness of the institution. Before summarizing their arguments, let us provide a brief overview of the FSB's existing mandate, membership and organizational structure.

What is the FSB?

The FSB is mostly a coordinator. According to its Charter, the FSB has been established "to coordinate at the international level the work of national financial authorities and international standard setting bodies (SSBs) in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. " In addition, the institution is to work with the international financial institutions to "address vulnerabilities affecting financial systems in the interest of global financial stability. "

The FSB's mandate includes: 1) <u>assessing vulnerabilities</u> affecting the global financial system and the regulatory, supervisory and related actions needed to address them; 2) <u>promoting coordination and information exchange</u> among authorities responsible for financial stability; 3) <u>monitoring markets</u> and advising on the implications of market developments for regulatory policy; 4) <u>generating best practices</u> by advising on and monitoring best practice in meeting regulatory standards; 5) <u>undertaking joint strategic reviews</u> of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities and addressing gaps; 6) <u>helping to establish supervisory colleges</u>; 7) <u>assisting cross-boarder crisis management</u>

by supporting contingency planning particularly with respect to systemically important firms; 8) conducting Early Warning Exercises in collaboration with the IMF; 9) enhancing coherence among standard-setting bodies by helping to coordinate their activities and address overlaps or gaps between national and regional regulatory structures relating to prudential and systemic risk, market integrity and investor and consumer protection, infrastructure, as well as accounting and auditing.

To perform these tasks, FSB has only a tiny staff compared to the IMF, World Bank and WTO. It reports to the G20 leaders, but lacks any formal power and its creation has not been ratified by any national legislature. It is designed to act more as a loose network of various national policy makers (from ministries of finance, central banks, supervisory and regulatory authorities) and international officials concerned financial stability issues rather than a substantial inter-governmental institution along the lines of the other three pillars of global economic governance.

The membership of the FSB expands significantly on that of the FSF. The small club of countries - the G7 countries, Australia, Hong Kong, the Netherlands, Singapore, and Switzerland (the European Central Bank has also been a member) – has now been joined by the rest of the G20 countries, Spain and the European Commission. Like the FSF, the FSB also includes representatives of international financial institutions (the IMF, WB, Bank of International Settlements (BIS), Organisation for Economic Co-operation and Development (OECD)) as well as key SSBs and central bank bodies, including the BCBS, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Committee on Payment and Settlement Systems (CPSS), the International Accounting Standards Board (IASB) and the Committee on the Global Financial System (CGFS).

Decisions are made using a more formal structure than the FSF. All the members participate in the FSB's plenary which operates on the basis of consensus. The FSB has a full-time Secretary General, Secretariat, Chair, Steering Committee, various Standing Committees and working groups. The FSB's Charter also includes provisions for "other stakeholders including private sector and non-member authorities" to be consulted and for non-members to be included, on an ad hoc basis, in its working groups, standing committees and plenary meetings.

The FSB imposes certain responsibilities on its members (the FSF did not). Jurisdictions commit to "pursue the maintenance of financial stability" and "maintain the openness and transparency of the financial sector." More specifically, they also agree to "implement international financial standards," including 12 core standards that had been promoted by the FSF since the late 1990s as well as new standards that the FSB creates. They must also "undergo periodic peer reviews, using among other evidence IMF/World Bank public Financial Sector Assessment Program [FSAP] reports. "In January 2010 FSB members also agreed to undergo an FSAP assessment every five years, and to publicize the detailed IMF/WB assessments used as a basis for the IMF's Reports on the Observance of Standards and Codes (ROSCs) which summarize countries' compliance levels with international standards. In March 2010 the FSB members outlined their ultimate goal "to promote adherence by all countries and jurisdictions to regulatory and supervisory standards concerning international cooperation and information exchange."

What Challenges Does the FSB Face?

The memos in this collection identify a number of key challenges for the FSB. Although their analyses are interrelated, we have divided the memos into three broad categories. The first set address some broad issues relating to the authority and governance of the FSB. The second set are concerned principally with the role of the FSB in encouraging compliance with international standards. The final group focus on challenges relating to FSB's efforts to address macroprudential issues.

Authority and Governance

The FSB's potential does not look bright when viewed through a historical lens. Louis Pauly's opening essay notes that the FSB shares some similarities with the ineffective League of Nations' Economic and Financial Organization (EFO) which also had a tiny staff, operated with consensus rules, and focused on the promotion of best practices. He recalls how policy makers at the 1944 Bretton Woods conference had improved on the EFO's weaknesses by creating the IMF with substantial resources, a large secretariat, rules-based collaboration and political legitimacy. With its small secretariat and focus on non-binding networked-based cooperation, the FSB looks to Pauly like a "historical reversion" to the League model and he worries that it lacks sufficient authority to play a significant role in global financial governance. For this reason, he argues that the IMF must remain the core of global financial governance, and urges that the FSB's work on prudential regulation be embedded in larger macroeconomic policy collaboration.

Some of Pauly's concerns are echoed in Andrew Baker's memo. Ruthless truth-telling is the key to effective peer review and early warning, yet these are unlikely to occur unless the FSB is enabled to convey messages that are politically unpopular to member countries, especially the major powers. These messages might include the highlighting of regulatory or supervisory weaknesses or the need to "lean against the wind" during financial booms. The consensus rule of the FSB's plenary could prevent it from performing these functions effectively because countries may stifle or dilute the FSB's warnings or prevent the institution from playing an independent and active role. Baker recommends that a bar be set where vetos can be exercised over specific findings or messages only when a critical number of states is opposed. We would note that the strongest form of this is the reverse consensus rule deployed for accepting the adjudication of disputes in the WTO where rejection requires consensus. Baker also suggests that the BIS research department be given a more formal role in supporting the FSB, given the high quality of its analysis in the lead-up to the 2007-2009 crisis.

Developing countries' participation has been neglected in the debate over the FSB. Alejandro Vanoli from Argentina focuses on representation within the organization. He applauds the widening of the membership of the FSB but notes that many developing countries still remain excluded from its discussions. Because international financial stability is of concern to all countries, he calls for a more representative model of governance. He highlights the fact that although the membership of the FSB has widened, this has not yet brought about much change in terms of the issues discussed. The FSB is still focused on subjects that are most relevant to developed countries. Vanoli calls for developing countries to work together to push for a wider agenda that reflects their common problems and helps recover the original spirit of Bretton Woods which put the international financial system "at the service of the balanced development of trade, production and employment. "

Eric Helleiner focuses on a number of governance challenges associated with the FSB's role vis-à-vis international prudential standards. He notes that the FSB has tried to overcome the weaknesses of the FSF through its wider membership, its new mechanisms to promote compliance, and its greater focus on macroprudential issues. He strongly underlines the importance of Vanoli's call to re-examine the narrow country membership of the FSB and to increase the voice of new developing country members within the organization. These concerns are also strongly shared by the two co-editors, Stephany Griffith-Jones and Ngaire Woods who also note that all the FSB's Standing Committees are chaired by developed country representatives. Helleiner also identifies important weaknesses in the FSB's capacity to achieve its main goal – the promotion of compliance with international standards. He notes that the FSB has four new mechanisms for promoting compliance with international standards: the mandatory regular FSAPs; the membership obligations to implement international standards; the peer review process; and efforts to tackle non-cooperating jurisdictions. But each suffers key flaws. Finally, in discussing macroprudential regulation, Helleiner highlights the ambiguous relationship of the FSB to the international standard-setting bodies, and the risk of "capture" of the regulatory process by private actors. All in all, these concerns highlight the urgency of evolving the governance of the FSB to ensure its effectiveness.

Surveillance, Peer Review and International Standards

The next three memos explore the FSB's capacity to encourage compliance with international financial standards. Andrew Walter focuses on the political difficulties associated with this task. Because aggressive enforcement regimes will be resisted and are unworkable, he notes that attention must be devoted to surveillance regimes. The main targets of international financial surveillance since the late 1990s were the emerging market countries and offshore centres. In the wake of the 2007-2009 crisis, Walter argues that the focus must now be more squarely on the major powers. Before the crisis, the FSAP process was weakened by the refusal particularly of the US and a number of other G20 countries, (such as Argentina, China and Indonesia) to participate. Peer surveillance within the G7 was too often simply a "cease-fire agreement to avoid sensitive policy issues. " If the FSB is to be successful, Walter (in agreement with Baker, mentioned above) argues that it must establish an independent and robust surveillance process that applies especially to major powers. One of its first key tests, he suggests, will be the FSAP that the US has committed to.

The politics of policy coordination and surveillance are also the focus of Bessma Momani's memo. As the crisis moment wanes, she worries FSB members may no longer uphold commitments they have made to undergo FSAPs and release the results because of sovereignty concerns. The peer review process and commitments to international standards will also be complicated by domestic and international politics. Domestic politicians and interest groups are likely to balk at the idea of accepting advice from the FSB. International political rivalries and distinct national interests may also undermine the FSB's efforts to encourage information sharing and oversight of national policies. On top of the problems caused by these intractable political realities, Momani highlights the challenges of coordinating IMF and FSB work in this area given their different locations, sizes and organizational cultures.

A more positive outlook is sketched by Tony Porter who focuses on the FSB's new peer review process, arguing that there are lessons to be learned from the experiences of transnational peer reviews in other contexts. Porter notes that transnational peer review processes can establish shared expectations and commitments in ways that are more effective than traditional international law in a world in which problems, interests and the relevant actors are not clearly defined and are changing rapidly. They can also reduce the risk of capture by business interests by forcing policy makers to justify their conduct to knowledgeable peers. If FSB members are to engage seriously in the process, however, the choice of thematic topics must reflect the concerns of different powerful subgroups of G20 members over time. Porter also suggests that this serious engagement could be encouraged by making membership in the FSB renewable every five years, and by establishing gradations in membership rights linked to records of compliance. This could be an innovative way to enforce the membership obligations embodied in the FSB's Charter but which, as yet, have no enforcement mechanism. Porter proposes that in order to allow peer reviews to encourage learning, collegiality and trust, part of the review process should be confidential and any compliance mechanisms should not be linked too directly to any specific peer review but rather to good faith efforts of states to engage with peer review processes over time. Porter also stresses the importance of the FSB having a strong secretariat, with staff from diverse backgrounds that can support the whole process.

The Challenge of Macroprudential Regulation

The final four memos explore the challenge of macroprudential regulation. Before the 2007-2009 crisis, international financial regulation had a microprudential focus that concentrated on the health and stability of individual institutions. The crisis highlighted the need to complement this approach with a macroprudential one that addressed systemic risks. The G20 leaders have assigned the FSB (along with other institutions such as the BIS and SSBs, especially the BCBS) the task of developing specific macroprudential tools, such as those mitigating pro-cyclicality and addressing the treatment of systemically important institutions, instruments and markets. While there is strong political support for the new macroprudential philosophy, its implemention is raising some technical challenges and political resistance from financial interests that would be affected.

Philip Turner explains how the new macroprudential regulation rests on a recognition of the existence of both externalities and pro-cyclicality in the financial system. The former can arise from interconnections, network effects, and market power, while the latter refers to the tendency of financial systems to amplify macroeconomic or global financial shocks. He identifies three unresolved policy challenges relating to the implementation of macroprudential policies: Should prudential ratios vary through the cycle, or be fixed? How many instruments should be chosen and should they be sector and/

or bank specific? What is the relationship between macroprudential and macroeconomic policies? Turner notes that international consensus may be difficult to reach on these questions because policies that work well in one jurisdiction may not do so elsewhere. He also notes the difficulties posed by sparse evidence on how different instruments have worked, and by the complexities of measuring systemic risks and the impact of macroprudential policies. For these reasons, he suggests that new policies will involve trial and error and that policy makers need to be ready to reassess as new information appears.

Stephany Griffith-Jones focuses more specifically on counter-cyclical regulation that is designed to discourage booms and busts. She highlights the need for both rules and global coordination. Possible policy initiatives in this area include rules relating to capital, loan loss provisioning (as the Spanish have used for almost ten years rather successfully), leverage ratios, and liquidity. She argues that counter-cyclical regulation needs to be applied comprehensively across all institutions, markets and instruments to prevent regulatory arbitrage. She also highlights the need for regulation to be based on rules, rather than discretion, in order to reduce the risk of regulatory capture by financial interests and by the over-enthusiasm characterizing booms; she argues that rules could be tightened when circumstances require it (for example, very strong growth of credit) but not relaxed. Because counter-cyclical regulation may affect access to credit, instruments may need to be developed to ensure adequate supply of longterm credit to small and medium-sized firms. Although counter-cyclical regulation needs to be implemented nationally via host countries, Griffith-Jones argues that the FSB has an important role to play in coordinating broad criteria internationally to prevent contagion from poorly regulated jurisdictions and to address incentives that firms may face to borrow abroad.

Emerging economies are the focus of Roberto Zahler's analysis. Although many favour rules over discretion in the implementation of counter-cyclical policies, Zahler notes that discretion is needed in emerging economies because of the speed and strength of cycle phases. He also notes that macroprudential regulation in emerging economies must move beyond just addressing the economic cycle and banks' maturity mismatches to focus on ensuring that key macro prices (especially the real interest rate and exchange rate) do not become outliers. He argues that the macroprudential agenda must allow for the legitimacy of national regulations on short-term financial inflows in emerging economies because they can create destabilizing asset price bubbles. Zahler also highlights the need for the FSB to be independent in carrying out its assessments of macroprudential risks and proposing policies. FSB analyses, evaluations and proposals relating to macroprudential risks should also be incorporated into FSAPs, and the surveillance of all countries – including the US, UK and eurozone – needs to be strengthened.

Finally, Pierre Siklos steps back to highlight the need for maintaining internally consistent core principles of sound macroprudential management that are periodically evaluated. He also calls our attention to the importance of monetary policy frameworks and the need for clarity on the relationship between financial stability goals and monetary policy. Rather than seeing financial stability as a separate objective for monetary policy, Siklos argues that central banks should seek alternative monetary policy strategies that minimize the occurrence of conditions that threaten financial system stability. He suggest that serious consideration be given to price level targeting as one such alternative. Siklos also suggests that the FSB could play a useful role in ensuring that appropriate distance exists between central banks and the fiscal authorities, by encouraging the clarification of the location of accountability during crisis situations and the limits of monetary policy interventions in private markets.

Conclusion

Taken together, these memos identify some serious challenges ahead for the FSB. They also highlight some concrete directions for developing the institution. Most agree that to be an effective monitor for all countries pursuing financial stability, the FSB needs a loud whistle, and the authority, expertise and support of its members to blow the whistle, even if the offender is a powerful country. Perhaps here the FSB will draw strength from numbers, underlining the need for the institution fully to engage and gain support from a wider membership. The FSB could begin more fully to leverage the experience of peer review in other forums, to build up its capacity, and to formalize its authority. If rapid efforts are not made to address weaknesses, the FSB may suffer the fate of its predecessor, the FSF, an institution that clearly failed to meet the high hopes of many of its creators, even though it produced often excellent studies warning of systemic risks that were not acted upon. If these challenges are met effectively, then the FSB will stand a better chance of emerging into the role of a more substantial fourth pillar of global economic governance. This could be of great benefit to achieving greater national and global financial stability.

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The Financial Stability Board in Context

Louis W. Pauly

Jacques Polak almost lived long enough to celebrate his 96th birthday. One of the most distinguished macroeconomists of his generation, and a founding father of international monetary economics, his career began in the League of Nations in 1937. In 1947 he joined the International Monetary Fund (IMF) as chief of the statistics division. In 1958 he took over its Research Department and turned it into an intellectual powerhouse. In 1981 he became the Dutch Executive Director, and from 1987 until 2007, eminent adviser and teacher to many managing directors and staff members. For me as well as for many others, Polak and his equally distinguished legal counterpart, Sir Joseph Gold, embodied an era, a global liberal ethic and a great tradition of international public service.

On one historical and analytical point, Polak and I had a longstanding difference of opinion, and we would return to it in public and in private many times over the years. I think that difference is quite relevant to the subject of this volume: the mandate and the prospects for the Financial Stability Board (FSB) as a fourth pillar of global economic governance.

In my dialogue with Polak, I depicted the history of global economic and financial governance – of the post-war history of the Fund, and the UN system of which it remains a part – as continuous with the history of the League. The connection was not just symbolic. The League's economic and financial files, for example, were passed on to the UN, and certain officials, like Polak and his friend, the late, great Canadian, Louis Rasminsky, took their League experience with them directly into the Bretton Woods negotiations and then into the nascent IMF.

Polak, on the other hand, saw a significant turning point occurring with the establishment of the Fund. The word he and Gold preferred to use to describe the Fund's basic function neatly encapsulated the different character of post-war monetary arrangements. The word was "regulation. "When the Bretton Woods exchange rate system finally broke down in 1973 and there was nothing for the Fund to regulate, Polak and Gold regretted the situation but, along with the future managing director, Jacques de Larosière, they embraced without enthusiasm the looser notion that the Fund would provide "firm surveillance" of a stable system of exchange rates. Where Gold emphasized the fact that a novel legal basis for this function remained distinctive, Polak believed that by virtue of its mandate, staff, and financial resources, the Fund remained in an historically unique position to promote collaborative balance of payments adjustment.

In contrast, he felt that the League had been too "political," as in not professional and not in a strong position to advocate the subordination of narrow national interests to common global interests. The League lacked clear authority. Its consensus decision-making practice made it too cautious, and it often could not rise above petty concerns. Despite some modest successes in the 1920s, when systemic financial emergencies arose, it found itself on the sidelines, without resources and without legitimacy. Its small economic staff, of which Polak was a member, had by the 1930s mainly an analytical mission, and in the end it contributed little to the cause of systemic stabilization in practice. More than once, Polak recalled for me the image of Alexander Loveday, the last head of the economic and financial organization of the League, spending a lot of time in the lobby of the Mount Washington Hotel, with no one paying him any attention. In fact, Polak disliked what historians had long ago come to call the EFO (that is, the League's Economic and Financial Organization). He felt that acronym was too grand, and he believed that no such organization ever existed notwithstanding important work by League staffers on issues like public health, child nutrition, and human trafficking, work to which Rasminsky contributed and work that would continue after the war in various agencies of the United Nations.

The Fund, on the other hand, was different. Polak and Gold both insisted so. Again, it had authority delegated by ratified treaty, a decision-making process unbound by a unanimity principle, financial resources to support its mandate, and, most importantly, a highly qualified, knowledgeable, technocratic, legally independent and politically neutral staff.

Although I very much valued and respected the ideal lying behind that perspective, I interpreted that result differently. That the League staff seemed "political" was a function of the character of the dominant civil service bureaucracy lying behind it, namely the British civil service with its tradition of gentlemen generalists seeking consensus and doing whatever needed to be done. Pragmatism ruled, and principles often had to be stretched to cover facts. Certainly the League reflected the rather open-ended liberal internationalist ethos of the post-1918 era, and the Fund was shaped by a more directive Keynesianism. But Keynes himself was unhappy with the way his ideal was in fact translated into reality. That the Fund was structured very differently from the League, I argued, was mainly a function of now-dominant American bureaucratic norms; that is, the attempt to resolve fundamental distributive contests through formally transparent legal and market mechanisms and, in all but exceptional circumstances defined mainly by overriding American security policies, to limit direct political interference by delegating authority to technical experts.

Nevertheless, I think that Polak and I agreed that the fundamental objective of both the League and the Fund was the same — ever more open economies converging on relatively liberal principles, boundless prosperity, at least among those human populations capable of disrupting international security, and resource redistribution sufficient to keep nationalist/mercantilist alternatives at bay. I think we agreed that the world was better off with the Fund than without it—especially during emergencies, when its staff was available to facilitate burden-sharing by member-states and to serve as scapegoats for unpleasant decisions taken within those states. With such a practical legacy, the Bretton Woods Agreement and its amendment in 1976 did represent signal evolutionary steps toward a more integrated world.

Although the League may have foreshadowed those steps, joining the Fund did mean that member-states accepted obligations to account to one another for the external consequences of national economic policies.

Since they remained ultimately responsible only to their own citizens, the key to making those obligations substantive and as effective as possible was the Fund staff, even if they were and had to be "political" in a more subtle sense than their predecessors in the League. Only they, following norms made legitimate by their conformity with the way the leading member of the system made basic decisions of political economy, could make operational the idea of meaningful accountability without final responsibility. They were the institutional memory, they kept the files, they compiled the facts, they gathered the data, they recorded promises made, and they could monitor compliance. In short, as permanent employees of an intergovernmental organization that would be difficult to deconstruct, only they could hold as disinterested a position as possible, and from that position only they could credibly hold the feet of national leaders as close as possible to the fire on commitments easy to make in a global setting and even easier to forget back home. Perhaps the staff of the Fund became too certain of themselves after various successes in defusing sovereign debt crises in the 1980s. Perhaps they were pushed too far by American policy makers in the Asian and Russian crises of the late 1990s. But they remain today in a unique position to help steer a system grappling with old and new risks in a still-integrating world economy.

It is precisely in this light that the main flaw of the multilateral process leading to the establishment of the FSB becomes visible. Without disrespecting the admirable work of the sincere and qualified people now associated with it, the small, impermanent and very loosely mandated staff of the FSB suggests an historical reversion. I do not know what Polak would have said about it, but it is only too easy to imagine the equivalent of the FSB being created by and within the League, say around 1922, when Arthur Salter became director of the Economic, Financial, and Transit Section of the Secretariat. A plenary body agreeing on policies by consensus, a chair dealing with the politics associated with the quest for unanimity, a secretary general with very limited powers, a tiny and mainly analytical secretariat, and the expectation of the voluntary implementation of "best practices" by autonomous national authorities. This was the essence of the League's core economic and financial machinery.

With memories of what happened to that machinery after 1931 deep in the background, the Fund's macroeconomic mandate was adapted in 1976 to take account of what was by then becoming the main driver of global integration, namely more open capital markets and a vast expansion in international capital flows. Despite the failure of an attempt to actually amend the Articles to make the Fund's mandate in this regard explicit, Polak contended that the Fund by then already had all the delegated power it needed to incorporate finance into its surveillance activities. Ultimately, global finance has consequences for national current accounts, the Fund's core terrain. The problem is that many members bridled at this idea then, and they continue to do so today. A focus on macroeconomic outcomes cannot fail to implicate the need for better financial regulatory and supervisory policies and for better coordination of those policies across national borders. Underneath such macroprudential concerns, however, there is no denying the fiscal and monetary bedrock upon which they rest. That connection became crystal clear in the rolling crisis that began in US housing markets in the summer of

2007. At the point of maximum systemic danger and successful containment, decisive fiscal and monetary actions were required and delivered. Aside from military actions, nothing comes closer to the heart of state sovereignty. In short, prudential failures in integrating financial markets necessitate the most sensitive political responses. As Charles Goodhart and Dirk Schoenmaker have long argued, it would be better for the system if a recognition of this reality led to ex ante understandings on fiscal and monetary burden-sharing during financial emergencies. Our recent experience, however, suggests that even in limited regional settings like Europe, where such coordination should by now be routine, the best that national authorities are thus far able to deliver is ad hoc and contentious burden sharing at the moment of most extreme danger. In the shadow of 1931, this may be understood as modest progress. Moving much further, however, takes institutional machinery, not informal, good-faith understandings.

Domestic political sensitivities surely explain why even states leading the charge toward financial globalization have for many years now preferred to deal with prudential policies and their implications in very restricted fora. They also surely help explain their reluctance seriously to empower the international staff required to hold them accountable to one another on financial regulatory and supervisory issues. A close observer recently told me that the professional economists in the secretariat of the FSB now number eight. That staff is planned to increase to12 and eventually to as many as 16. As far as I know, moreover, there are no plans to make permanent even that embryonic core of a potential future organization. Those economists are seconded for relatively short periods of time from national central banks, from the still-small staff of the Bank for International Settlements, which hosts the FSB, and perhaps in the future from national financial supervisors. A pretty narrow base for a fourth pillar!

It is nevertheless hard to argue that the transformation of the Financial Stability Forum into the FSB is not a good development. Surely given the complicated technical issues involved, more and higher-profile scrutiny of macroprudential issues must be positive. But if its work allows member-states to render even more obscure the intimate connection between financial regulation and supervision and core macroeconomic policies, the risk is that we may not be so lucky during the next global emergency. How easy it was to reach agreement at the level of principle on the importance of free competition and sound markets at the Geneva summit of 1927. How easy it was then to pass on responsibility for implementation to the inadequate staff of the League. When they failed, how easy it was to convene a new conference of leaders at London in 1933.

We are, I trust, in more fortunate global economic circumstances today. But the emergency of 2008 did succeed in reminding us that a stable global economy ultimately requires a robust and reliable system for fiscal and monetary coordination. At the same time, it called into question the wisdom of relying on certain assumptions based on our recent experience: that US taxpayers directly or indirectly will in the future be willing to bail out foreign financial intermediaries, as they did in the case of AIG's counterparties; that the US Congress will always be willing to go along with the US executive at the moment of maximum system fragility; that central bank communication networks and the policy consensus upon which they are based will remain robust; and that the fiscal implications of coordinated liquidity and solvency operations will ever again be easy to obscure.

In short, member states should let the FSB do its modest work with its modest staff but then accept the necessity of embedding that work deeply into a larger collaborative macroeconomic policy arrangement. This should not simply be acknowledged rhetorically or ritualistically during semi-annual International Monetary and Financial Committee (IMFC) meetings, but directly in the continuing and routine work of the robust staff of a global institution committed to deep macroeconomic policy collaboration. My guess is that the high-water mark for making that institution the Bank for International Settlements, the central bankers' central bank, occurred during the past decade. The crisis of 2008 reminded us how important coordinated central bank liquidity operations could be, but it also refocused attention on the murky borderlands between systemic liquidity and individual institutional solvency as well as between monetary actions and fiscal consequences. It underscored, in short, the difference between technical, operational independence and actual political independence. Central banks often have the former, but none have the latter. Balancing effectiveness and legitimacy is crucial if collaborative and reliable adjustments in sensitive macroeconomic policies are required to manage systemic risks. The coordinating institution must therefore be the one that fully engages the attention of heads of government, finance ministers and key legislators. That institution is the IMF.

The construction of a bridge between prudential policy making and macroeconomic policy making at the system level began in 1999 with the Financial Sector Assessment Program of the Fund and the World Bank. The United States initially agreed to allow its own financial system to be scrutinized, the Bush administration reversed course, and in the wake of the crisis of 2008 that reversal was reversed. So now all G7 countries will go through the FSAP process every five years. In addition, the states represented in the FSB have agreed to undergo periodic peer reviews, using among other evidence FSAP reports prepared by the Fund and the Bank. If members follow through, this is all to the good. But surely the idea behind these less-than-binding procedures bears a family resemblance to the commitment already embodied in the IMF, namely mutual accountability for national contributions to systemic risk. The difference, of course, lies in the legal obligation underpinning Fund surveillance in both its national and multilateral settings, in the number of states involved, and in the nature of the preparatory staff work that would amount to more than just technical advice to a "process. "But having already accepted such an obligation, one must ask, why shouldn't all participants in integrating financial markets be expected actually to live up to it?

As long as we remain unwilling to move seriously away from the objective of global markets — that is, as long as our governments at the very least remain unwilling to break up, control the linkages between and quite definitively regulate and supervise the national operations of the 30 private financial institutions identified by the FSB as potentially posing the most significant systemic financial risks– then surely we must have more ambitious political objectives. For some years now, international economists, economic geographers and political scientists have tried to put an optimistic spin on the notion that "networked governance" can be appropriate for an integrating global economy. In the wake of the recent financial crisis, the term begins to sound like "no government, except the national one. "I doubt that is adequate, especially in a world where the imperfect substitute for global government since 1945, the United States, may be increasingly reluctant to play that role.

Rasminsky once said to me, "At the League, we were expected to catch fish, but we had no bait. "We do not need to re-learn our history lessons the hard way. In the wake of the crisis of 2008, it is time for some serious fishing. We should not shy away from naming the big fish honestly. It is global government, including deep, binding, and well-staffed arrangements for cross-national fiscal and monetary burden-sharing adequate to sustain integrating financial markets. If we really cannot imagine the bait that will help us catch it, then we should abandon the dream of global markets. And since the dream was originally dreamt in response to military insecurity, we must then not flinch at the consequent challenge of imagining feasible alternatives at this most basic level of world order. If we are not that brave, then it is far preferable to return seriously to the hard work of realizing the dream. We may then discover that Polak, Gold, and Rasminsky were just ahead of their time.

Mandate, Accountability and Decision Making Issues to be faced by the FSB

Andrew Baker[1]

Just over 12 months ago I wrote a short briefing note for Chatham House on the subject of the reform of the Financial Stability Forum (FSF), the predecessor of the Financial Stability Board (FSB). In that note, I wrote that when the FSF was established ten years earlier it had been a spectacularly good idea because it brought macroeconomic policy makers together with financial regulators in one venue, creating the potential for multi actor/multi perspective dialogues. But I also argued that the FSF had largely failed to realize that potential. This was not a popular message. The largely private sector consensus in the room at a subsequent meeting was that the FSF had performed rather well and was an example of a well-functioning, successful institution unencumbered by that dirty word "bureaucracy. " My relatively negative verdict on the FSF was, however, based on two things that remain relevant in the context of any informed discussion of the FSB. First, it was unclear precisely what it was the FSF had spent the previous ten years doing. Second, related to this, the FSF had not been given a clear mandate, and consequently its precise role, function and powers had been shrouded in ambiguity and confusion.

The problem with making assertions about the institutional nature of the FSF/FSB is that they are largely based on anecdotal evidence. No systematic comprehensive studies of the FSF/FSB as an institution exist and most of us have only an anecdotal appreciation of what goes on behind closed doors at FSF meetings and the full range of institutional and social dynamics at work. In relation to the anecdotal nature of knowledge about the FSF/FSB, the two problems identified above came together in one of the few insiders' observations on the FSF. The former head of the UK's Financial Services Authority (FSA), Howard Davies, wrote that for most of its existence the FSF had been prevented by the United States from doing any work of its own, other than reporting on the work of other bodies (Davies and Green, 2008). In other words, the lack of a clear mandate for the FSF had led to institutional drift, thwarting the forum's potential, with the US operating a power of veto over the institution, as in many other global economic governance settings. For a body that is supposed to play a pivotal role in contributing to "financial stability," it is problematic to allow large countries to have a power of veto, especially when they have the capacity to generate huge destabilizing financial crises with enormous negative externalities for all sectors and countries.

The recent crisis revealed that contemporary financial systems are inherently pro-cyclical. Mitigating pro-cyclicality has become a major concern for the new FSB. Pro-cyclicality, however, is not simply an economic, financial or market-based phenomenon. A financial boom is also

1 I would like to thank Eric Helleiner for some comments on an earlier draft of this note, while acknowledging that the thoughts contained in it are my responsibility alone.

a psychological, intellectual and political construction, reflecting politicians' incentives for booms to continue well after an election has been successfully contested. Any institution charged with mitigating pro-cyclicalty and leaning against the wind of the psychological, political and market dynamics of a boom will prove to be something of a nuisance to politicians. For a body like the FSB this makes the whole issue of mandates, accountability and decision making particularly pressing and delicate. These issues will be integral to the ability of the FSB to perform its function in the public interest. They are also very tricky questions. In what follows, I seek to tease out some of the issues concerning questions of mandate, accountability and internal decision making at the FSB.

The Mandate Issue

What tasks and function should the FSB perform and what form of institutional organization is required to best enable it to perform those functions? My current observations are that the FSB looks set to perform three principal tasks or functions. First, the FSB is now carrying out work of its own. At the behest of the G20 leaders, finance ministers and central bank governors, the FSB prepares specialist reports on various themes as requested. The FSB is consequently acting as a permanent secretariat or working group whose priorities and agenda are set by the G20. Second, the FSB is the venue for a form of peer review borrowed from the Organisation for Economic Co-operation and Development (OECD)'s peer review process. Third, the FSB (and this last area is least clear) looks set to perform some sort of early warning function, identifying or sniffing out incipient financial booms or potential systemic financial difficulties.

The first of these areas is relatively straight-forward, but given previous history it might be worth formally acknowledging that the FSB now has a knowledge generation function as directed by the G20, and is not simply a forum for dialogue and coordination between a range of other institutional actors.

The second and third areas are far more complicated. In relation to peer review, the OECD's peer review process and the Reports on the Observance of Standards Codes (ROSCs) conducted by the International Monetary Fund (IMF) and World Bank have in the past both allowed for the country under review to veto the publication of the eventual report. In this respect, there is a sense that the peer review exercises generally might be more about policy dialogue than the enforcement of specific standards. Some sort of explanation or signalling of the purpose of the peer review process in the mandate of the FSB might be helpful in this regard.

It is also crucially important that the FSB remains focused on monitoring domestic progress towards meeting the new "macroprudential" priorities in areas such as "mitigating pro-cyclicality" and compensation practice reform so as to support financial stability, adequate capital provisioning and capital buffer requirements for banks, and functioning central counterparties (CCP) for OTC derivatives trading. What is unclear is how and whether the FSB will signal concerns about inadequate reform progress in these areas in specific member countries.

Other questions include how critical judgments would be reached and crucially whether any mechanisms or safeguards will exist to prevent critical messages from being diluted, or removed, due to political pressure from a particular member state. How to protect the autonomy of the FSB's critical voice, and its ability to publish critical findings in the context of the peer review exercise is an issue that needs and deserves further attention.

Finally, in relation to its third function, the FSB would also appear well placed to provide early warnings about incipient financial problems given its focus on macroeconomic and monetary data and financial regulatory questions. Other surveillance and early warning mechanisms already exist at other institutions and, as the FSB brings these institutions to the table at the same time, it might be a good place for comparing various analyses. Given their track record in diagnosing the current crisis long before other actors, and given their Basel location, it might make sense to mandate the FSB to structure their forecasting and surveillance discussions around the data and analysis of the Bank of International Settlements (BIS) research department. Much as G7 surveillance began with a presentation by the managing director of the IMF and the director of research at deputies meetings, FSB meetings might be led by an initial presentation and assessment by the BIS.

The BIS is well placed to undertake this role in the FSB context, due to its access to central bank data and a well developed interest in the relationship between financial regulation, financial sector performance and developments, and macroeconomic policy and outlook. The relative lack of voice for the BIS research department in important institutional settings was exposed by the crisis, because its prescient analysis and warnings fell on largely deaf ears. Giving the BIS a specified institutional presence and voice in the FSB may be a way of overcoming this. The mandate of the FSB should make reference to its relationship with BIS staff, given their close proximity on a day-to-day basis, and the recent track record of the BIS in making the correct calls on financial stability issues.

Note that the current mandate of the FSB as outlined at http://www. financialstabilityboard. org/about/mandate. htm remains vague and fails to get to grips with some of the institutional issues listed here and below.

Accountability Issues

Scholars in the field of international relations are often concerned about unaccountable and unresponsive technocrats operating in exclusive networks. The issue is potentially far more complex in the case of the FSB. It is now established that the FSB is accountable and answerable to G20 leaders, who in turn set priorities, agendas and ask the FSB to conduct certain work. But the FSB's role is to provide unpalatable messages, to lean against the wind, to highlight shortcomings in regulatory reform, and to voice concerns about unsustainable financial booms and the build up of dangerous sets of conditions. Or at least it should be.

Performing the role of "Cassandra" in this way will not always be compatible with the political business cycles in systemically important G20 countries. If the FSB writes bad news reports, or produces findings that G20 politicians do not want to hear, and if peer review turns up potential problems in domestic practice, and if the FSB warns about the build-up of a systemically dangerous sets of financial conditions, G20 politicians may face incentives to muffle and silence those messages. For a body concerned with catalyzing and encouraging counter-cyclicality, it is important that it has some autonomy, or protection from political pressure and control. In other words, the accountability relationship between the FSB and the G20 needs to be handled sensitively and flow both ways. That accountability relationship needs to be specified in such a way that, while the G20 can set priorities and agendas for the FSB, neither the G20 nor any of its members should be able to silence or stifle FSB findings. The G20 should have an obligation to publicise FSB findings, regardless of whether their content might be potentially politically unpalatable for G20 powers.

FSB Decision Making

The informal, networked exchanges, which the FSB is supposed to facilitate, mean that the least politically contentious and most attractive mode of operation is to plump for consensual decision making. But given the counter-cyclical function of the FSB, consensual decision making is also potentially problematic and riddled with tensions. The problem with decision making based on consensus is that it effectively hands a right of veto to any member state. In some settings, this mode of operation makes sense and the consensus of every member is vital. But in the case of the FSB, if it is to perform its countercyclical role properly, it will be very difficult to avoid politically unpopular messages.

In this respect, the FSB needs to decide, given the nature of its tasks, whether one member state could object and veto the overall majority position. Consensus is desirable and is the route of least political resistance, but it may dilute and undermine the FSB's capacity to perform its proper function. In this sense, not all FSB states are equal, both in terms of representation or status. Veto will be easier for some than others. The FSB should consider whether a critical number of oppositional states is a requirement for a veto to hold over a particular finding, or message, and where the bar should be set in this regard. A failure to consider this issue carefully could result in the FSB being stifled and muzzled by a single powerful state, as its predecessor was in the recent past. If that were to happen, the FSB, like the FSF, would fail to realize its potential.

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FSB: Current Structure and Proposals for a More Balanced Integration

Alejandro Vanoli

The history of the Financial Stability Board (FSB), although it has made some improvements in seeking a more important participation of the less developed countries, still shows some gaps in terms of broadening that representation to the rest of the countries that are still not members, and in terms of setting a deeper and more diverse agenda of the issues to be discussed.

Also, the Board's lack of resources to guarantee a balanced and symmetrical enforcement on the different countries puts on the table the delicate balance existing between the respect to sovereignty of each of the countries and the need that all nations, beyond their sizes, comply with certain rules in a globalized world.

Background

The origin of the Financial Stability Board can be found in its predecessor, the Financial Stability Forum (FSF), created by the G7 members in 1999, and at that moment, formed by Germany, Canada, United States, France, Italy, Japan and United Kingdom.

The purpose of that forum was to provide an international discussion forum to increase the levels of cooperation among the different financial institutions and the supervisory agencies, both at national and international level, with the ultimate goal of guaranteeing global financial system stability.

The FSF gathered national authorities responsible for the financial stability (ministries of economy, central banks and securities regulators) of the most important financial centres, certain specific groups of international institutions, regulators and supervisors (International Organization of Securities Commissions (IOSCO), International Association of Insurance Supervisors (IAIS), Bank of International Settlements (BIS), International Monetary Fund (IMF),Organisation for Economic Co-operation and Development (OECD), the World Bank (WB), Basel Committee on Banking Supervision (BCBS)), and so forth), and expert committees (from the central banks) specialized in the markets' operations and infrastructure.

The crisis that began in 2007 and was caused in the central countries ended up affecting the whole world, forcing the broadening of the representation mechanisms in the organization.

FSB Make-Up and Operation

In November 2008 the G20 members called for an increase in the number of countries that were participating in the forum. In this way, the FSB's new structure tries to represent in a more reliable way the interests of a broader group of nations, and certain countries that had not participated in the predecessor, the FSF, were included in the new organization.

Currently the forum is composed as follows: the aforementioned G7 countries, the BRIC countries (Brazil, Russia, India and China), Argentina, Australia, Hong Kong, Indonesia, Mexico, Netherlands, Saudi Arabia, Singapore, Spain, South Korea, South Africa, Switzerland and Turkey.

The FSB's organization includes a chairman, a steering committee, a secretariat and a plenary that includes representatives of the member countries, standards setting groups and the international financial institutions.

The plenary meeting is the body in charge of adopting decisions, by consensus. The number of seats assigned to each member jurisdiction reflects: a) the size of the economy, b) the activity of the financial market; and c) national financial stability arrangements (level of adherence to international standards and codes, participation in the international evaluation programs and the level of disclosure given to them), resulting in the following distribution: countries with one seat in the plenary are Argentina, Hong Kong, Indonesia, Saudi Arabia, Singapore, South Africa and Turkey; countries with two seats in the plenary are Australia, Mexico, Netherlands, South Korea, Spain and Switzerland; countries with three seats in the plenary are Brazil, Russia, India, China, Canada,France, Germany,Italy, Japan, United Kingdom and United States.

In the case of those countries with only one seat, the representation is performed by the national monetary authority. In the case of those countries that have two jurisdictional authorities as members, the seats are occupied by the monetary authority and a treasury's representative. Finally, in the case of those countries that have three seats in the plenary, a representative of the local securities regulator is added to the monetary authority's and the treasury's representatives.

Completing this list of plenary members, the FSB also includes the European Central Bank, the European Commission, the standards setters' representatives, and the international financial institutions (IFIs), as follows: Bank for International Settlements (BIS), International Monetary Fund (IMF), Organisation for Economic Co-operation and Development (OECD), World Bank, Basel Committee on Banking Supervision (BCBS), Committee on Payment and Settlement Systems (CPSS), Committee on the Global Financial System (CGFS), International Accounting Standards Board (IASB), International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO).

Additionally, the plenary has the possibility of creating standing committees and working groups with the purpose of assisting the organization to carry out its missions. Currently, the FSB has three standing committees (the Standing Committee on Assessment of Vulnerabilities, the Standing Committee for Supervisory and Regulatory Cooperation, and the Standing Committee for Standards Implementation) and three ad hoc working groups (the Cross-border Crisis Management Working Group, the Expert Group on Non-cooperative Jurisdictions, and the Working Group on Compensation).

The members of the different committees are appointed by the plenary meeting, with the chairman's prior recommendation. The chairman is elected by the plenary for a three-year term, and can be re-elected only once.

The regulations currently set forth that the decisions are taken by the plenary's consensus. However, there are no definitions about the decision mechanisms in those cases where there is no consensus.

Governance – Critical View

The discussion about the governance of the IFIs, and particularly the recently created FSB is very broad, but I would like to point out two issues: the scope of the representation that the FSB has today, and the depth and relevance of the subject matters that have been discussed.

In terms of the countries' participation, we can say that the launch of the FSB has brought an important improvement in the representation that the organization has, comprising 70 percent of the world population and 90 percent of its GDP (the G8 included 14 percent of the world population and 65 percentof the GDP). This broader representation still does not include all the countries.

Although some point out that the "technocracy" that is part of the FSB is composed of the same actors that did not foresee the crisis, others hold the particular interests of the principal governments that are part of the G20 as responsible for not moving the agenda forward in the way this moment requires. The recent postponement of the discussion within the European Union about hedge funds regulations, a consequence of the opposing interests between the governments of the United Kingdom and the United States on one side, and the governments of France and Germany on the other side, is a good example of this problem.

It is also worth pointing out Eric Helleiner's and Tony Porter´s (2009) opinion on the accountability of the transnational networks of financial regulators. They identify three different accountability problems associated with these networks: (i) those related to the uneven representation of the countries, (ii) those relating to their technocratic character, and (iii) those related to the risk of capture of the regulator by the financial industry.

Some voices, such as Stiglitz (2004) and Eichengreen (2008), argue that part of the problem is that a partial representation is a less than optimal status, and that the governance of global finance should advance towards a WTO-style model, where the member countries actively participate in taking decisions in an organization that has enforcement mechanisms which ensure effective compliance with the adopted resolutions.

With reference to this, Stiglitz (2004) refers to the IFIs – that, as we said, are part of the FSB – as incapable of regulating the decisive failures of the market, stating that they keep themselves as opaque and poorly democratic organizations. At the same time, economists such as Eatwell and Taylor (2006) have been asking for years for the creation of a world authority that regulates the financial system in a global way.

Obviously, this discussion involves the level of sovereignty that the countries are willing to give up, since, although the broadening of representation is good news, it seems there are not many changes in the agenda that are being discussed internationally in terms of financial stability. In this respect, it would be necessary to complement the implementation of the national legal systems and the cooperation agreements, in order to reconcile the delicate matter of the sovereignty of the countries with effective international regulation, which implies raising the minimum regulatory standards of each country in a uniform manner.

In this regard, there are some issues related to the rules of the game of the international monetary order about which the FSB has not moved forward yet, and those are very important issues for worldwide financial stability in particular, and for the underdeveloped countries.

In this sense, the FSB replicates the same deficiencies that other international entities show that focus on subject matter relevant for the developed economies, putting aside or including only partially matters such as global imbalances, the monetary and exchange regimes, capital controls, the US dollar's international role, and the existence of a lender of last resort. The key role of the state in financial regulation is an issue that the G20 has not raised yet in a sufficiently strong manner; despite the recent crisis, some still believe in self-regulation as the answer to the asymmetries or the regulatory gaps,. In this way, the FSB should respond to a clearer mandate given by the G20, aimed to obtain a comprehensive, consistent and stricter public regulation for agent/brokers, markets and products.

Another qualitative issue referring to members' representation is the balance existing among the treasuries, the central banks and the securities regulators. The recent international crisis brought about the necessity of regulating in a comprehensive way the different actors that participate in each financial system (banks, securities, insurance, and others). This should make us rethink whether the current actors that represent each of the countries include the subjects that are sought to be analyzed, or whether it is necessary to include new participants.

These are fundamental issues that should be thoroughly discussed in order to make sure that the broader democratization of the international organizations' governance proposed at the meetings held by the G20 is finally reflected in facts. As an example of this, we can mention, among others, the pending job to be done by the countries about the regulation of offshore jurisdictions.

Therefore, it becomes necessary to increase the number of countries involved in the discussions. The underdeveloped countries should work jointly in a shared agenda that reflects their common problems.

The strategic purpose should be to achieve a new balanced content of the international financial institutions' agenda, leading to the search for solutions to the above-mentioned problems.

Conclusions

Although the crisis has caused focus on the coordinated search for policies that ensure economic recovery, it has also shown the necessity of advancing towards more democratic and representative international governance systems.

As Stiglitz points out, international financial stability should be considered as a worldwide public interest, and therefore its positive characteristics are desirable and should be equally distributed among all the nations, raising the minimum regulatory standards of each country in a uniform way in all the countries.

The level of international cooperation and coordination that this requires meets strong resistance on the side of the international financial lobby that finds a threat to its status quo originated in the consolidation of more than three decades of neoliberalism as a dominant ideology.

In the face of not only financial, but also political, economic and social consequences caused by the last crisis, there are some attempts to reform the international financial architecture, but those are cosmetic and are based on the same rules that led to the debacle of the financial system.

Consequently, the emerging countries should insist on their claims for greater participation in the IFIs' governance, so as to achieve a change of the paradigm that will allow for a recovery of the original spirit of Bretton Woods, that considered that an international financial system was at the service of the balanced development of trade, production and employment.

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Governance Issues Relating to the FSB and International Standards[2]

Eric Helleiner

The Financial Stability Board (FSB)'s basic structure and mandate builds directly on that of its predecessor, the Financial Stability Forum (FSF), an institution that failed to live up to the hopes of many of its founders. Will the FSB meet the same fate in its efforts to strengthen international prudential standards? Three features of the FSB will help it overcome some of the weakness of the FSF, but each raises governance issues that need to be addressed.

Membership and Legitimacy

The larger membership of the FSB should help it to address some of the legitimacy issues that the FSF faced. When the FSF was created in 1999, it was assigned the task of coordinating and promoting worldwide a variety of international prudential financial standards. But its narrow country membership undermined its legitimacy – and thus its effectiveness. Developing countries, whose domestic financial regulation and supervision the FSF sought to improve, were excluded from the organization. They also had limited or no influence in many of the bodies that had developed the standards that the FSF was promoting.

2 For more details on the issues raised here, see Helleiner (2010).

This legitimacy problem has been partially addressed by widening the membership of the FSB (and of many of the standard-setting bodies) and by the new accountability of the FSB to the G20 leaders. But the inclusion of new countries at the decision making table needs to be followed by measures that allow these countries to make their voices count within the FSB. The organization's committees and working groups might consider following the model of the G20 working groups that involve co-chairs from developed and developing countries. Developing country governments might also benefit from the provision of greater technical and research support, perhaps via a body controlled by the developing countries such as the G24.

Because many new members bring distinctive perspectives to international regulatory discussions, their commitment to the FSB would likely be strengthened by more emphasis being placed on core principles in international standard-standing rather than detailed harmonized rules. This approach would leave more policy space for national authorities to interpret standards according to local conditions and preferences.

Even with its larger size, the FSB still needs to confront the fact that its country membership remains very narrow in comparison to the International Monetary Fund (IMF), World Bank or World Trade Organization (WTO). Because the FSB has the ambition of promoting worldwide compliance with the standards that it endorses, its legitimacy vis-à-vis non-members may become politicized quickly.

Under the FSB's Charter, non-member countries may be consulted and may be included, on an ad hoc basis, in its working groups, standing committees and plenary meetings. At a minimum, the FSB should formalize its willingness to consult with non-member countries by promising to request comments from non-members on any issue discussed by the plenary.

The more thorough-going solution to the FSB's legitimacy problem, however, would be to expand its membership further. The FSB's Charter allows the plenary to expand the membership, as long as new countries accept certain commitments. A considerable expansion need not result in the FSB becoming an enormous and unwieldy body. It could have a strong executive body, building on the FSB's steering committee, that could involve regional representation or IMF-style constituency systems.

Governance Issues Relating to Compliance Mechanisms

The FSB has also been assigned four new mechanisms to encourage compliance with international standards that were not available to the FSF. Each mechanism could be improved further.

To begin with, FSB members have agreed to undergo an assessment under the IMF and World's Bank Financial Sector Assessment Program (FSAP) every five years, and to publicize the detailed IMF/WB assessments used as a basis for the Reports on the Observance of Standards and Codes (ROSCs). Because FSAPs and ROSCs had been voluntary before the FSB's creation, this change is significant. Now that FSAPs and ROSCs have been assigned a more prominent role in the compliance process, however, the IMF and World Bank need to coordinate these programs more closely with the FSB's objectives.

Second, unlike the FSF, the FSB imposes an obligation on members to implement 12 core international financial standards as well as new standards that the FSB might itself create. The significance of this provision remains unclear, however, because of the lack of clarity about the consequences of non-compliance by a member and the processes that might generate a judgment of non-compliance. If this membership obligation is to be significant, this ambiguity needs to be cleared up.

Third, FSB members have committed to undergo peer reviews that are both country and theme-based. The new peer review process is potentially important, but successful international peer review processes elsewhere have been supported by a strong international secretariat. The FSB's tiny staff is unlikely to be able to provide this kind of support. The effectiveness of the FSB peer review mechanism would also be strengthened if the countries conducting the reviews were at similar levels of financial market development and regulation as those they were reviewing.

Finally, FSB members have decided to be more active than the FSF ever was in encouraging compliance among all countries and jurisdictions not complying with core international prudential standards. The achievement of this goal may be complicated not just by the legitimacy issues noted above but also by reliance onthe FSB plenary as the ultimate judge of non-compliance. Consensus in that forum may not always be easy to reach.

The Governance of Macroprudential Regulation

The final area on which the FSB looks set to improve over the FSF's experience has to do with efforts to address macroprudential concerns about systemic risks. In the decade preceding the current crisis, international standards focused too narrowly on microprudential issues concerned with the stability of individual institutions, products and markets. It is encouraging that the G20 have mandated the FSB to tackle macroprudential issues much more directly, but the latter's capacity to do so may be undermined by two governance issues.

First, the FSB's relationship with the other principal international standard-setting bodies remains ambiguous. The FSB has been empowered to conduct "joint strategic reviews of the policy development work of the international standard setting bodies" and "promote and help coordinate the alignment of the activities of the SSBs. " The standard setting bodies are also now required to report to the FSB on their work in order to provide "a broader accountability framework" for their activities. However, the FSB Charter notes that "this process should not undermine the independence of the standard setting process. " The last line creates considerable ambiguity about this aspect of the FSB's mandate.

Because of their cross-cutting nature, some parts of the macroprudential regulatory agenda require close coordination with the activities of standard setting bodies. If the FSB cannot play an effective coordinating role, the international macroprudential agenda will be weakened. The resistance of bodies such as the International Accounting Standards Board (IASB) to some elements of this agenda has already revealed the limits of the FSB's influence.

Second, to implement effective macroprudential regulation, the risk of the "capture" of the regulatory process by private actors needs to be addressed more squarely. Macroprudential regulation requires regulators to take a strong stance against market trends, such as cyclical booms or growing concentration and risk-taking within the financial system. If regulators' relationships with private market actors are too cosy, this role cannot be performed well.

Specific international regulations that might help to address the capture issue include initiatives that would reduce complexity and opacity (for example, simple leverage rules, or forcing credit derivatives onto exchanges). The peer review process may also help to counteract private lobbying by bolstering the independence of national authorities. But the FSB could also address the private capture issue more directly. It could, for example, develop standards for regulators that minimize the problem of "revolving doors" by outlining mandatory public disclosure on the websites of regulatory bodies of all past and present industry ties of individuals on those bodies, and/or rules specifying a minimum number of years before regulators can shift to private-sector lobbying and vice versa.

The FSB could also develop procedures to address the role of private sector influence within its own deliberations. The FSB's Charter states that, when developing its medium- and long-term goals, the FSB "will consult widely amongst its Members and with other stakeholders including private sector and non-member authorities. " By restricting its choice of societal actors to the "private sector," the FSB leaves itself open to the charge that private financial interests could have privileged access. This impression is reinforced by another part of the Charter which states: "In the context of specific sessions of the plenary, the Chair can also invite, after consultation with Members, representatives of the private sector. ”

If private sector actors are being invited to contribute to the FSB’s activities in these ways, active efforts should be made to counter-balance their influence by encouraging participation from other civil societygroups as well. Transnational groupings of legislators and non-financial officials could also play a counter-balancing role. In addition to being consulted, these policy makers could be encouraged to monitor its work, as could an arms-length body similar to that of the Independent Evaluation Office of the IMF. Peer review processes could also invite input from wider official circles.

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Can the FSB Achieve Effective Surveillance of Systemically Important Countries?

Andrew Walter

This memo argues that we should answer the question in the title by reviewing the recent past record of policy surveillance. This record is marked by failure to achieve the objectives of promoting system stability through policy coordination and compliance with international standards. In the past, effective surveillance was weakest where it mattered most: in identifying international standards that would effectively promote stability, and in coordinating and constraining the policy choices of the major countries. In what follows, I focus on the latter issue rather than that of how to set appropriate international standards. Effective Financial Stability Board (FSB) surveillance would need to overcome these basic weaknesses, but there are few reasons to believe that the political constraints and incentives have changed sufficiently to achieve this. Effective surveillance is likely to remain a work in progress and an aggressive stance on enforcement is unlikely to be workable.

The History of International Surveillance

Economic policy surveillance has, since 1945, been the primary responsibility of the International Monetary Fund (IMF) and has been relatively narrowly confined to the external consequences of national macroeconomic policy choices. From the early 1960s, the G10 and later the G5/7 usurped some of this authority, to the detriment of IMF policy surveillance. Neither form of surveillance was effective in coordinating macroeconomic policy choices and in preventing the emergence of large and persistent payments imbalances. Macroeconomic policy choices were largely shaped instead by domestic economic and political forces.

In the early 1990s the focus of international surveillance began to shift with the decision to monitor compliance with a series of international financial standards. The first of these was the Financial Action Task Force of the Organisation for Economic Co-operation and Development, which reviewed and promoted compliance (in part by naming, shaming and sanctioning) with its anti-money laundering standard. After the Mexican and Asian financial crises, the G7 assigned to the IMF and World Bank the tasks of surveillance and promotion of compliance with a much larger number of "best practice" international standards on macroeconomic policy and data transparency, institutional and market infrastructure, and financial regulation and supervision. In all cases, relevant international standards were set by institutions dominated by the major developed countries (though in some cases the standard-setters were quasi-private organizations). The same was true, of course, of the international institutions monitoring and promoting compliance with these standards, primarily through the joint IMF-World Bank Financial System Assessment Program (FSAP) and related technical assistance. Reports on Standards and Codes (ROSCs) were intended to promote compliance through external assessment and transparency.

The record of international financial institution (IFI) promotion of convergence on international financial standards was very mixed. As the Table 1 shows, there are conspicuous gaps in the FSAP/ROSC assessment process (the table only shows FSAPs and ROSCs for G20 countries in the area of financial regulation, on which the FSB intends to concentrate). Some countries undertook IFI reviews but did not publish the reports (for example, Brazil and India); in about a quarter of all cases, the national authorities chose to suppress ROSC publication. Even more preferred to excise sensitive parts of published reports, including most quantitative assessments of compliance with international standards. ROSCs were also very infrequent and thus often outdated. The IFIs were sensitive to their relationships with national authorities, and published reports were often not very frank about the sometimes high levels of "mock compliance" with international standards— where there are large and often hidden gaps between the formal adoption of international standards and real compliance (Walter, 2008). The Japanese FSAP/ROSCs of 2003 were a conspicuous

G20 ROSC/FSAP modules published

1 Conducted & Published | Unpublished or No Information | Unpublished (Information from US GAO, 2003)

	FSAP/FSSA		Banking Supervision		Insurance Regulation		Securities Regulation		Total ROSCs - Published	Compliance Rate (%)	
		date		date		date		date			
Argentina			1	15/04/1999					1	33%	
Australia	1	23/10/2006	1	23/10/2006	1	23/10/2006	1	23/10/2006	3	100%	
Brazil		01/01/2002		?		?		?	0	0%	
Canada		01/01/2000	1	30/06/2000	1	30/06/2000	1	30/06/2000	3	100%	
China									0	0%	agreed to FSAP 2008
France	1	23/11/2004	1	23/11/2004	1	23/11/2004	1	23/11/2004	3	100%	
Germany	1	06/11/2003	1	06/11/2003	1	06/11/2003	1	06/11/2003	3	100%	
India		01/01/2000		?				?	0	0%	
Indonesia									0	0%	
Italy	1	14/03/2006	1	14/03/2006	1	14/03/2006	1	14/03/2006	3	100%	
Japan	1	05/09/2003	1	05/09/2003	1	05/09/2003	1	05/09/2003	3	100%	
Republic of Korea	1	19/03/2003	1	19/03/2003	1	19/03/2003	1	19/03/2003	3	100%	
Mexico	1	25/10/2001	1	25/10/2001	1	25/10/2001	1	25/10/2001	3	100%	
Russian Federation	1	30/05/2003	1	30/05/2003	1	30/05/2003	1	30/05/2003	3	100%	
Saudi Arabia	1	05/06/2006	1	05/06/2006					1	33%	
South Africa		01/01/2000		?		?	1	22/10/2000	1	33%	
Turkey									0	0%	
United Kingdom	1	03/03/2003	1	03/03/2003	1	03/03/2003	1	03/03/2003	3	100%	
United States									0	0%	agreed to FSAP 2008
Average Compliance Rate	53%		63%						58%	58%	

exception to this generalization: there was considerable criticism of Japanese compliance failures in these reports, which may have deterred participation by other Asian countries. Some important G20 countries, including Argentina, China, Indonesia, Turkey and the US, simply chose not to participate at all.

The particular stance of the US significantly inhibited the deepening of the surveillance norm since 1945. The US has had an exceptionalist attitude towards international macroeconomic surveillance, seeing it mainly as a source of constraint on countries other than itself. The same was true of the FSAP process on financial regulation, in which the US refused (until 2008) to participate itself, even while urging the major emerging countries to submit to such review. The US domestic political process has also been a substantial constraint on America's ability to converge upon international standards as the tortured path to implementation of Basel II demonstrated (Foot and Walter, forthcoming).

In short, for a variety of reasons it is small wonder that IMF surveys of market participant attitudes towards ROSC reports suggested both poor knowledge and substantial levels of disinterest (FSF, 2001: 29-32). Private firms sometimes complained that the IFIs needed to do "naming and shaming," but the IFIs were reluctant and national authorities often prevented it (IEO, 2006: 41). Compulsory participation in the FSAP and publication of ROSCs was sometimes mooted but proved politically unworkable. The basic problem with past surveillance, in both the areas of macroeconomic policy and financial regulation, is that it was weakest where it mattered most. This applied particularly to the major developed countries, where the demand for policy autonomy has been strong and where the leverage of intergovernmental organizations has been weak. "Peer surveillance" in groups like the G7 in practice increasingly amounted to an implicit cease-fire agreement to avoid sensitive policy issues. It is also worth noting that as regards compliance with core international financial standards, the IMF's own researchers have found no relationship between country compliance and banking sector risk (Demirgüç-Kunt and Detragiache, 2010).

Will FSB Surveillance be Different?

The FSB's new surveillance strategy was outlined after the London G20 leaders' summit. The initial focus was on adherence to international cooperation and information exchange standards to prevent gaps in the global regulatory and supervisory framework. But it is far from evident why we should expect the FSB to be more independent and robust in its surveillance than were the IMF and World Bank, or why peer surveillance within the FSB or G20 should overcome the problems associated with the G7.

In September 2009 the FSB said it would establish "criteria for identifying jurisdictions of concern by November 2009" (FSB, 2009: 12). Given the obvious systemic importance of the US and UK and, especially in the former case, the strong likelihood of domestic politics-driven delays in regulatory reform, a possible litmus test of the FSB's credibility as regards effective surveillance might be whether one or both of these two major jurisdictions are subject to (confidential) FSB dialogue over the remainder of 2010 – and whether such dialogue has any measurable effect on policy outcomes. We have yet to see the results of the long-promised US Financial System Stability Assessment, but to be credible it will need to conduct a robust assessment of (among other things) the weaknesses of the US financial supervisory architecture, delays in implementation of Basel II, divergences between US and IASB accounting standards, and the considerable uncertainties of post-crisis regulatory reforms. Furthermore, if the FSB designates US adherence to international standards in most areas as "compliant" or "largely compliant" (the top two categories), as seems likely, will this do much to prevent future large crises? The FSB has stated that its peer surveillance will rely heavily on FSAP assessments of G20 countries (FSB, 2010: 1-2), but ROSCs have been an ineffective tool for promoting compliance in the past; nor did they prevent the build-up of financial fragility in the major centres before 2008.

Emerging markets and offshore financial centres (OFCs) have, since the 1990s, been the main targets of financial sector surveillance. They would be justified in demanding that this asymmetry should be reversed, given that the key regulatory failures that contributed to the 2008-2009 crisis occurred in the most advanced countries. Is the FSB's new commitment to symmetry in international surveillance and enforcement credible, given that the major developed countries will remain in a strong position to resist external pressure for policy convergence? Chinese officials, for example, are openly sceptical that countries such as the UK took much notice of the content of ROSC reports or any recommendations that followed the related peer discussion (Foot and Walter, forthcoming). More importantly, the strong aversion in emerging countries such as China to international surveillance that involves targeted naming and shaming is clear from the historical record. China has been more relaxed about convergence towards international financial standards than about macroeconomic policy surveillance, but its basic view is that countries should be free to choose their own pace and style of reform. Given the demonstrated failures of past international standard-setting and surveillance, China is unlikely to be alone in this view among major emerging countries in the G20. The failure of international surveillance to promote financial stability in the major countries was costly for China and other new entrants to the inner circle of global economic governance, but they – like the major developed countries – are likely to prefer the retention of a soft version of international surveillance in practice.

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The IMF and the FSB: Intractable Political Reality and Organizational Mismatch

Bessma Momani

The G20 has given the International Monetary Fund (IMF) and the Financial Stability Board (FSB) the tremendous task of promoting global financial stability and preventing a repeat of the errors preceding the international financial crisis. To further coordinate the complex layers of the global financial, and monetary system, the G20 revamped the FSB, a small and once-obscure forum located in Basel. Then, with the re-energized and added funding of the IMF located in Washington, these two organizations are to realize a new and better coordinated international financial system. While the efforts of the G20 initiatives are commendable and a step forward in the realization toward enhanced coordination, there are limits to what these two organizations can achieve.

One of the glaring challenges to coordinating IMF and FSB work is organizational. In addition to the logistical challenges of coordinating two organizations separated by an ocean, the IMF with more than 2,000 staff remains a mammoth compared to the dozen or so staff currently at the FSB. The IMF is a universal institution that has undergone a great transformation toward transparency; the FSB is a selective institution of G20 members that remains unknown. The technocratic work of IMF staff is subject to review of the politicized Executive Board; the FSB has no clear hierarchy but reports to the G20 leaders. Putting these organizational challenges aside, this memo seeks to highlight a greater challenge: old-fashioned politics. Like other political-economy scholars, I raise the unaddressed issue of external political interference and the domestic incentives to shirk responsibilities.

On the matter of improving coordination of surveillance, the G7 had already developed a series of international financial standards that were designed to avert a repeat of crises in the 1990s and early 2000s. Specifically, the G7 asked the IMF (with the assistance of the World Bank) to monitor country compliance with the Financial Sector Assessment Program (FSAP) and the Reports on Observance of Standards and Codes. Many countries, however, insisted that the process be voluntary which ultimately made the exercise futile as global economic heavyweights like the United States delayed or refused to commit to an FSAP– an obvious problem in light of the fact that the US financial system was the epicentre of the last international financial crisis. Those that did commit to IMF oversight were often under the political thumb of the institution by needing access to financing or had little to lose or gain in their disclosures. It has been noted that the failures of these international financial standards lay in the fact that disclosure was voluntary for some and that many emerging market economies had no ownership in the standards, as they had not been part of the decision-making process. The hope of an expanded G20 is that the new members of the club will add legitimacy to the process and have a greater stake in mutual coordination. The G20 has also made both the ROSCs and FSAP mandatory and subject to disclosure;

but I have doubts that members will continue to abide by these commitments as international and domestic politics get in the way.

The G20 envisions IMF and FSB coordination on monitoring of member countries' compliance with international financial standards and on standardizing regulatory standards in banking and other financial services. The IMF will be, in the words of its managing director, the monitor of the "basic plumbing through which global capital flows;" the FSB will be the coordinator of information on what national regulators are allowing through the drain. The idea, then, is to use moral suasion of a G20 mutual assessment process where countries are essentially encouraged or shamed into providing full disclosure of nationally sensitive information, all in the interest of maintaining global financial stability. While this is a step forward, the author cautions that it will not be long before the G20 honeymoon ends and the skirting of responsibilities returns to the fore. The core of the problem lies in the potential for country free-riding: countries will each paddle less of their share in the row toward financial stability. Herein is the problem of voluntary disclosures of national authorities to international bodies: there are political and market incentives to domestic and international constituents to appear as stable as possible. The crisis in Greece today underscores these problems and has greatly affected the European Union and the eurozone. International economic coordination will always face the reality that national officials and markets will act in their own interest and first meet the needs of their constituents and stakeholders above all else.

In addition to not clarifying how the two organizations will deal with the intractable problem of self-censure of members, it could be imagined that soon the G20 will lose its honeymoon bliss and enter the ho-hums of an international marriage. One can imagine the potential for historical sensitivities in having members preached to by rivals, and then envision the potential for self-censure. Can the US come to the G20 table and reprimand China or Russia? Japan, of China or Korea? Germany, of Turkey? United Kingdom, of Argentina? And so on. What is the likelihood that the G20 will devolve into a forum more like the UN Security Council, rampant with historical grudges? One cannot help but look at the IMF Executive Board to see how international political stakes are played out in a seemingly technocratic organization to know that there are risks of having the G20 slip into becoming another dysfunctional international body. This is further complicated by the problem of sending G20 political leaders, as opposed to economic ones, to the table.

In some respects, the G20 is entrusting the IMF and FSB not only to coordinate information sharing and provide oversight, but also to provide the technocratic weight of their staffs to keep national and market interests in check. The reality, however, is that neither organization will be immune from external politicking, particularly when powerful members intervene to challenge IMF and FSB analyses. Moreover, imagine the uproar of legislatures, unions, banking, or business interests at the mention of regulatory changes at the national level coming from the advice of either the FSB or the IMF, or from the diktat of the G20 and its powerful members. Can national regulators return from G20 working groups and implement policy? Chances are more likely that they will all face uphill battles with legislatures and bureaucracies. One would be remiss to not point out that the Basel II accords have yet to be implemented by the United States. Moreover, will the private bankers in Buenos Aires, Toronto, New York or London accept a supranational voice, or will they use their political and financial muscle at home to sway legislators?

Ultimately, neither the IMF nor the FSB have the power to challenge a country's sovereignty. Both these organizations, and their regulatory interlocutors, will remain dependent on moral suasion. Despite the efforts of the G20, both the IMF and FSB will be hampered by the political realities of countries wanting to preserve their national interests and politicians wanting to preserve their domestic support base. Effective international economic and financial policies may not work or sell in a politicized world of states. But it sure is worth a try.

Making the FSB Peer Review Effective

Tony Porter

The adoption of transnational peer review is one of the Financial Stability Board (FSB)'s most important potential improvements relative to its predecessor, the Financial Stability Forum. Article 5(1)(d) of the new FSB Charter requires members to "undergo periodic peer reviews, using among other evidence IMF/World Bank public Financial Sector Assessment Program reports. " This implies that FSB members will make problems more visible and hold each more other accountable to solving these problems, and thereby help avoid financial crises. Despite the rapid growth of the use of peer review in a variety of transnational settings, its effectiveness is far from guaranteed. Indeed, the mixed performance of peer review in these different settings suggests that there are variations in the organizational properties of peer reviews that are important to consider if peer review is to be used successfully by the FSB.

Drawing on a growing literature on transnational peer review and on insights from a recent workshop organized by Thomas Conzelmann and Kerstin Martens that compared peer review processes[1], this note highlights a challenge in the use of peer review that should be addressed if it is to be successful at the FSB. Peer review has two aspects, both of which are important but not easily reconciled. One aspect involves the exercise of power and accountability, and the development of linkages with actors and institutions external to the peer review process. All of these can involve control, threats and interests. The other aspect involves the learning, collegiality, autonomy and trust that can develop among a group of like-minded officials, and that can be crucial to the genuine dialogue that is needed in peer review. These also can lead the process to be unaccountable, however, and weaken its external influence. Peer review is unlikely to be successful if these two aspects of peer review are not reconciled adequately. It is important to address this challenge early in the development of the FSB's peer review.

It is useful first to reflect on the reasons for the upswing in reliance on transnational peer review in many settings in recent years. Traditional international law, which usually involves very lengthy formal negotiating processes that then lock in commitments at a particular point in time, is not well suited to a world in which problems, interests, and the relevant actors are not clearly defined and are changing rapidly. In contrast, peer review, when it works, can establish new shared expectations and commitments on an ongoing basis by engaging states in a collective process that simultaneously produces learning and accountability. Traditional formal international law and institutions ultimately rely for their effectiveness upon their support from states and other actors, and there is no reason in principle that collective action coordinated informally could not be as effective at deterring irresponsible behaviour.

1 For more information, see http://www. fdcw. unimaas. nl/staff/files/users/277/Programme-Workshop_ Peer_Reviews_final. pdf

Power and Accountability

It is clear that power and accountability can play an important role in peer review. This is evident, for instance, in the way that incentives provided by powerful states and deployed outside the peer review process can encourage weaker actors to engage in peer review. The Organisation for Economic Co-operation and Development (OECD)-initiated Global Forum on Transparency and Exchange of Information for Tax Purposes, which has recently adopted a strong form of peer review that prevents reviewed states from blocking mandatory publication of reports, has enjoyed remarkable success in its work against tax evasion, but non-compliant offshore centres are strongly motivated to participate by the threat of the G20 and other states taking action against them if they do not.

Demands for accountability for funds provided by wealthier states are a crucial motivation for the DAC/UNEG Peer Reviews of Evaluation Functions in Multilateral Organizations, which has reviewed UNICEF, UNDP, the UN Office of Internal Oversight Services, and the Global Environment Fund. The promise of funding conferred momentum on adhesion to the African Peer Review Mechanism (APRM). When EU funding linked to the APRM ran out, the review process in countries that were attracted by the promise of more money slowed noticeably. [2]

The EU has also been able to require potential members to the Union to engage in peer review as a condition of accession. The OECD's peer review originated in the process of "confrontation" that developed through its predecessor's involvement in the distribution of Marshall Plan funds. These examples of the role played by power in peer review should encourage careful consideration of the role of power in the FSB's own operations.

Since the FSB membership corresponds so closely to the most powerful group of states, the G20, it is clear that no group of states can provide the types of external incentives noted above to make the FSB's peer review of its own members work. There are ways the power associated with the FSB's members can be linked to peer review to address this problem. First, the choice of thematic topics can foster accountability and compliance if, over time, they reflect the concerns of different powerful subgroups of G20 members. Any set of powerful members can then exercise the implicit threat to not engage seriously with a topic of primary concern to others if other powerful members do not engage seriously with topics of primary concern to them. Ideally the topics would motivate subgroups that vary enough in their membership to not solidify into longer-term blocs.

Second, the membership of the FSB should not be fully fixed. Ideally all states' membership rights should automatically lapse over a cycle of five years and require renewal. Similarly, explicit or implicit gradations in membership rights should be established. For instance, only members engaged in good faith efforts to comply should be allowed to serve on the Steering Committee, peer review teams, Standing Committees or working groups. Challenging membership renewals or restricting membership rights are more credible threats than expulsion. The appointment of FSB members to influential roles in other standard-setting bodies could increasingly be linked to their good faith efforts to engage in FSB peer review processes.

2 Comments on the APRM are informed by the work of Faten Aggad.

The role of power in the relationship of the FSB to non-member states is also important. Over time, the FSB can follow the OECD's example by involving expanding numbers of non-members in its peer reviews. Conditional access to FSB consultations and other FSB processes can provide an incentive for non-members to engage in such reviews. This would be enhanced if there was some turnover in FSB membership and engagement in such reviews was a condition for entry into the FSB.

Reconciling Learning and Accountability

While it is important to mobilize power to support the effectiveness of peer review, if power, interests, and demands for accountability are pursued too aggressively, this can undermine the learning side of peer review. The Trade Policy Review Mechanism (TPRM) at the World Trade Organization (WTO) appears to provide less genuine opportunities for learning than comparable reviews at the OECD because of worries by states that admissions of weaknesses could be used against them in formalized WTO disputes. The less assertive role of the secretariat in the TPRM exacerbates this (Conzelmann, 2008).

The FSB could address this problem by ensuring that part of its peer process is confidential, making the boundary between this and what is made public something that the reviewed member has to justify and negotiate in each case. The compliance mechanisms mentioned above should not be linked too directly to any particular peer review, nor to any particular shortcoming revealed by a review, but rather to the good faith efforts of states to engage with peer review processes over time. A strong secretariat that is committed to the learning aspects of peer review has played a crucial role in the successful use of peer review at the OECD. Attention should be given to further strengthening the FSB's secretariat while avoiding the insularity for which IMF staff has been criticized (Momani, 2007). Appointing staff from diverse backgrounds, including some with a strong record of independent research, will help.

How can linkages to other actors and institutions be configured to maximize the effectiveness of the FSB's peer review? The Universal Periodic Review (UPR) conducted by the UN Human Rights Council addresses sensitive issues, and yet states have agreed to webcasting of their responses to the reviews. Similarly, one of the more successful aspects of the APRM is the way that it has engaged civil society actors in some countries. By having knowledgeable officials challenge one another, requiring reasons for their conduct, and thereby allowing external actors to understand and respond to the issues at stake, peer review can reduce the risk that networks of officials will be unaccountable or captured by business interests (Sabel and Zeitlin, 2008).

It is important for the FSB that enough of the debate that is produced by the peer review process be made public so that non-state actors, including media, can amplify and develop it. The recent thematic FSB peer review on compensation provides valuable information about differences in implementation across G20 members, but there is a risk that even with this potentially more newsworthy topic it will not be picked up and amplified by non-state actors unless links with those actors are actively encouraged.

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Macroprudential Policies and the Cycle

Philip Turner

The term macroprudential was first used in Basel Committee discussions at the Bank for International Settlements (BIS) in the late 1970s but its precise meaning remains elusive. The idea was to get bank supervisors to look beyond the risk position of individual institutions to risks affecting the system as a whole. There are many reasons why such risks are not simply an aggregation of individual risks. Two words are frequently used to characterize these reasons: "externalities" and "pro-cyclicality. "

"Externalities" covers many distinct dimensions.

- Interconnections between banks and between different markets. Nowadays banks do not deal with each other in atomistic, perfectly competitive markets – if they ever did. Many of the over-the-counter (OTC) derivatives markets in which banks trade are dominated by a few large players. We discovered in the crisis that these markets had created such large but opaque links between banks that the failure of a single major counterparty could threaten the whole system ("contagion").
- Network effects, which are imperfectly understood, can mean that the failure of even a small bank or even an obscure market can trigger a cascading effect through the whole system. Common exposures or uniform responses to shocks can magnify such effects.
- Market power. Banks try to develop new products that will allow them to earn (possibly temporary) economic rents. The greater the heterogeneity or opacity of their products, the easier it is for them to earn rents from price discrimination between customers.

Because such externalities are so widespread in these markets, it is not enough for regulators to look only at the risk profiles of individual banks or at the workings of specific markets.

"Procyclicality" refers to the tendency of the financial system to amplify macroeconomic or global financial shocks. The bank regulatory system is only one possible source of cyclicality. Real capital formation is likely to be cyclical because it is stimulated when demand outruns existing capacity; market prices are cyclical; accounting conventions that are backward looking can accentuate pro-cyclicality … and so on and so forth. The simple point is that the aim of public policy cannot be to eliminate cyclicality but rather to protect the financial system from it.

All agree on the need for such a broader vision – but the problem is to design operational policies. The list of policies that could be used in a macroprudential way is very long. Table 1 below summarizes 10 measures that are at present in force in some countries or are under consideration. Note that measures that have in the past been used tend to be country-specific, often because basic features of the structure of financial intermediation differ from country to country.

The very diversity of this list is itself instructive. Consider this advice: a good prudential regulator should pay particular attention to limiting aggregate risk exposures which build up during booms and which create problems when conditions turn adverse. It is not difficult to construct a plausible narrative weaving in several quite distinct elements of risk:

- As demand rises above trend, firms become more optimistic about future sales – and banks, as defaults on loans fall, become more willing to lend;
- When borrowing conditions in markets become unusually favourable, local firms and banks find they can borrow more easily or more cheaply at (low) short-term rates or in foreign currency. When the interest rate or exchange rate cycle turns, however, they find themselves exposed to currency mismatches or maturity mismatches or both;
- Higher asset prices give borrowers extra collateral against which to borrow, and often bloat bank balance sheets with unsustainable capital gains; and
- Lower price volatility of financial assets during upswings leads to reduced haircuts on wholesale funding contracts, facilitating increased leverage. When volatility rises during downswings, haircuts rise and force investors to scale back their leverage, implying a sharp contraction of their positions. The decline in asset prices that results has further feedback effects on the balance sheets of banks and other investors.

Ten examples of macroprudential instruments

Rules governing	Measures
Bank loans	Caps on loan-to-value for mortgages
	Caps on the ratio of debt-service-to-household income
	Rules on the reference interest rate used for mortgage lending
	Rules on currency mismatches of borrowers
Bank balance sheets	Countercyclical capital ratios
	Adjustment to risk weights
	Rules on loan-loss provisioning
	Caps on loan-to-deposit ratios, core funding ratio and other liquidity requirements
	Bank reserves deposited with the central bank
Collateral used in wholesale funding	Prevention of procyclical variation in minimum margins or haircuts (or making such variation countercyclical)

This simplified narrative raises at least six elements that could destabilize the economy – the cyclical path of GDP, asset price volatility, currency mismatches, maturity mismatches, bank balance sheet management and collateral practices in wholesale markets. One implication of the existence of so many distinct elements is that macroprudential policies cannot be characterized in a unidimensional way. Such policies are bound to be multidimensional. This makes designing an operational framework challenging. Three strategic questions seem important: how far prudential ratios should change through the cycle; how the mix of instruments should be decided; and how such policies would relate to macroeconomic policies.

Three Strategic Questions

i) Ratios to Vary With the Cycle?

A first, major issue is whether prudential ratios or standards should be fixed or should vary with the cycle. Such variation could be based on a predetermined rule. Or it could be decided in a discretionary way by the authority responsible for prudential oversight.

One important point to bear in mind is that fixed ratios can themselves act as automatic stabilisers. [1] The tax system works as an automatic stabilizer: indeed, many studies of fiscal policy have shown that automatic stabilizers have worked better in stabilizing the economy than discretionary policy actions.

Setting prudential ratios that vary with the cycle could in theory make them more powerful stabilizers. But there are formidable technical difficulties. Is it the real economic cycle (i. e. GDP) that is to be stabilized or is it some form of financial cycle? There is no shortage in the supply of statistical variables suggested by economists to proxy the financial cycle – bank credit, asset prices, borrowing conditions in capital markets and so on. But how should these different elements be weighted together? Is there a way of extracting in a timely manner the financial cycle (i. e. “excesses” of credit growth, “overshooting” of asset prices, “overabundant” liquidity) from normal cyclical variation and longer-term trends? Financial innovation and the rise of new industries mean that models based on past behaviour need to be used with discernment.

The official sector may not be any more able to forecast the cycle than is the private sector. Because diversity of opinion is more likely to be stabilizing than uniformity, there is some presumption against having a single official body judge the cycle. Will it prove possible to act quickly enough for measures taken to have countercyclical effects? There is a danger of being inadvertently pro-cyclical given the length of recognition, decision and implementation lags of regulatory policies. The longer it takes to bring new prudential ratios into force, the greater the risk that measures are mistimed.

There are also limits to the capacity of the official sector to persuade the public about the cycle. In a deep recession, for instance, a macroprudential-focused regulator might want to relax prudential ratios on banks. But the general public’s worries about the future may discourage banks from following such easing. The old adage of monetary policy “pushing on a string” might well apply to regulatory policy easing in a slump.

One compromise in the debate about fixed ratios versus those that move with the cycle might be to define quite wide “corridors of stability” within which the target (such as GDP) would be stabilized. When the target is within that corridor, the ratio would remain fixed. Only when the target goes outside that corridor would a cyclical change in the ratio be considered. Judgement could still be required to set aside a rule or to calibrate policy action. And a major exercise in public persuasion would still have to be undertaken.

(ii) Choice of Instruments

A second issue concerns the strategy that should guide the choice of instruments. As noted, there are very many

1 Whether particular ratios are or are not stabilizing is an empirical question. One useful approach is to use macroeconomic models to back-test particular ratios and examine whether a particular ratio would have stabilized the real economy or not.

instruments that might qualify for macroprudential use. This strategic choice has many dimensions:

- *Many or few instruments?* By analogy with the welfare economics of taxation, the use of a greater number of instruments in a modest way could be less distortionary than heavy reliance on just a few instruments. As a lower tax rate applied over a wider field (e. g. income, consumption, wealth, etc.) is less distortionary than a high tax rate narrowly applied, milder regulatory imposition on a large number of financial markets/products can be more efficient. On the other hand, there are major drawbacks in having too many instruments. One is that a greater number of instruments could make calibration much harder – particularly since we have little or no historical experience of the complexity of the interactions between rules on different instruments. A second drawback is that the imposition of too many macroprudential constraints runs the risk of inadvertent overregulation.

- *How sector specific?* One temptation is to target sectors deemed to be most "overheated. " But this runs the obvious risk of official credit allocation. So it seems better for any target to be defined broadly (e. g. total property lending).

- *How bank specific?* It would be difficult to explain to a bank a tightening of regulation dictated purely by macroeconomic developments. The banker would say, "Yes, I am also concerned about (say) overheated property markets, which is why I've already directed loan officers to tighten lending standards. But my competitor has not. " This may mean that some bank-specific elements will have to enter into any macroprudential policy.

(iii) Relation with Other Policies

A third issue is the relationship between macroprudential and macroeconomic policies. In many cases, financial excesses will be the symptom of lax fiscal, exchange rate or monetary policies. So there is a risk that addressing the symptoms of such policy failings by tightening rules on banks and others may just delay effective macroeconomic correction.

In other cases (perhaps rare), macroeconomic and macroprudential policies may need to move in opposite directions. In the event of a positive productivity shock, for example, monetary policy might need to ease in response to a decline in underlying inflation pressure, while macroprudential policy may have to tighten if a productivity shock has increased financial risks by promoting speculative borrowing in new, uncertain areas.

Matters would be further complicated if macroprudential settings were to be adjusted in response to cyclical developments. Central banks setting monetary policy would need to know how and when cyclical developments are likely to influence macroprudential policies, which in turn affect economic prospects.

Macroprudential settings will in general influence credit supply conditions, and therefore monetary policy transmission. Successful macroprudential policy may reduce the amplitude of the business cycles that involve significant financial cycles. At the same time, such policies could also reduce the potency of interest rates in managing aggregate demand. Inducing movements in asset prices is one way monetary policy influences aggregate demand – attempting to moderate such effects could weaken monetary policy transmission.

Conclusion

There is no simple answer that would apply in all circumstances to any of the three strategic questions – Should prudential ratios vary with the cycle? Which instruments would work best? How will other polices be affected?

The evidence about how different instruments have worked is rather sparse and much of it is country-specific. Therefore policy makers considering macroprudential policies will have to make the best decision on the basis of very imperfect information. Many policies that work well in one jurisdiction may not work well in another – so there will not be an international consensus that covers all instruments. There will be no lack of public criticism – particularly when policy makers decide on restrictive policies. The inherent uncertainties both in measuring systemic risks and in any quantification of the impact of new preventative measures will make it hard for regulators to justify their policies to the public.

Are these reasons for doing nothing? No. They do of course constitute good reason for realistically limiting ambitions. The economic or financial cycle cannot be abolished. Macroprudential is not an easy substitute for other policies. But the intellectual case for a macroprudential perspective is nevertheless compelling. What is needed, however, is dispassionate analysis of the policy options and a willingness to adapt as new information emerges.

A recent report of a Committee on the Global Financial System (CGFS) (2010) study group led by David Longworth, former Deputy Governor of the Bank of Canada, is an excellent example of such analysis. This group examined how changes in margining practices in OTC derivative markets could reduce procyclicality in the financial system. The terms on which leveraged market participants get lending for their position taking in securities markets can be extremely pro-cyclical. Hence consideration of this is absolutely central for macroprudential policies. The report recommended six policy options. Four were recommended outright. But two of them were recommended "for consideration" – indicating the need for further thinking, including about implementation. Each recommendation had its pros and cons clearly laid out.

The suggestions made are practical and specific. Among them: haircuts and initial margin requirements should be set more conservatively but should be more stable throughout the cycle; settlement through risk-proofed central counterparties would reduce destabilizing market reactions due to worries about counterparty risks; capital requirements on securities financing for banks should normally be relatively stable through the cycle. Of course banks and policy makers would go through a learning-by-experiment process in implementing such proposals.

The conclusion to draw from this is quite general: give well-reasoned proposals for reform a try. Be ready to reassess as new information comes in. New policies inevitably involve trial and error – and the lack of decisive prior evidence on how they would work in practice is not a reason for not acting when the likely alternative is worse.

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Counter-cyclicality: The New Consensus, How it Could be Implemented[2]

Stephany Griffith-Jones

Financial regulation is very important in a market economy, given its influence on the level of credit and its evolution through time. Greenwald and Stiglitz (2003) emphasized that the level of credit is the critical variable in the determination of output and employment. Indeed, the important role of credit has been underestimated by academics and policy makers. To the extent that credit is an important macroeconomic variable, good and effective regulation becomes an essential policy tool.

The need for regulation to be counter-cyclical was initially recognized by only a small and fairly isolated group of academics and some international institutions, like the United Nations Economic Commission for Latin American and the Caribbean (UN ECLAC) and the Bank of International Settlements (BIS). However, after the global crisis which began in 2007 became acute, international commitment by policy makers to counter-cyclical regulation became widespread.

2 This note draws on the paper written jointly with Jose Antonio Ocampo and Ariane Ortiz "Building on the countercyclical consensus: a policy agenda," www. policydialogue. org, funded by the Foundation for European Progressive Studies (FEPS) and Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ). I am also grateful for valuable discussions on this subject with Jane D'Arista.

Counter-cyclical regulation needs to be an important part of economic strategies aimed at stabilizing the economy by reducing the pro-cyclicality of finance and its effects on the real economy. It does so by explicitly incorporating the impact of macroeconomic risks, and changing crucial regulatory variables in a counter-cyclical way to discourage lending booms and prevent credit crunches.

As rhetorical agreement on implementing counter-cyclical regulation is very broad amongst policy makers, there is also ever-growing consensus that it is not enough to reduce pro-cyclicality of existing regulations (like Basel II). It is also essential to design strictly counter-cyclical regulations, to offset the natural tendency of banking and financial markets towards boom-bust patterns. The key questions are now practical; how best should counter-cyclical regulation be implemented?

Initially, there was a debate about what instruments would best be used to achieve regulatory counter-cyclicality, especially in solvency requirements, but also for liquidity. There is now increasing agreement that several instruments need to be used in parallel.

In the case of solvency, those instruments would include counter-cyclical capital requirements and loan provisioning or non-distributable reserves, as well as counter-cyclical leverage ratios and loan-to-value ratios. An alternative for the latter are rules to adjust the values of collateral for cyclical price variations, especially for real estate prices.

The only problem with using such a large array of instruments may be their excessive complexity, which partly reflects the complexity of problems posed by the financial system. An alternative, more direct approach would be for regulators to limit the growth of bank credit. This could become relevant if the more indirect counter-cyclical regulation instruments discussed above were not sufficiently effective.

Counter-cyclical provisions have the virtue that they have already been implemented successfully by the Spanish authorities for almost ten years. They provide an excellent precedent for other countries. They are clearly very valuable, especially for strengthening banks, though apparently less effective in curbing excessive expansion of credit. One problem has been tensions between implementing counter-cyclical provisions and accounting rules, initially moderated in Spain because the Banco de España designs accounting rules. However the dialogue between international regulatory bodies and accounting associations after the global crisis is helping ease this problem more widely. It is also interesting that, though availability of good and long-term data eased the implementation of counter-cyclical provisions in Spain, Spanish experts argue that simulations may be used for countries that do not have such good data.

An important choice is whether counter-cyclicality should be implemented through rules or in a discretionary way. There seems to be an overall preference for predetermined rules that will reduce the risk of regulatory capture, either by narrow interests or by the over-enthusiasm that characterizes booms. It seems best if rules could be tightened, in special circumstances, but never loosened during booms. Appropriate indicators (such as growth of credit and/or asset prices) need to be chosen to ensure counter-cyclical capital buffers vary effectively with the cycle.

Though assuring enough capital, provisions and reserves are key for financial stability, so is liquidity, even though the latter has been less discussed. Prudential regulation needs to ensure adequate levels of liquidity for financial intermediaries. One good way of doing it is to set liquidity requirements based on the residual maturity of financial institutions' liabilities.

As solvency and liquidity are complementary, there may be a case for implementing requirements jointly, which would imply requiring more capital in a counter-cyclical way for institutions with large maturity mismatches. However, as capital will never be enough to deal with serious liquidity problems, there is a clear case for having a separate liquidity requirement.

As regards accounting disclosure rules, these should satisfy both the needs of investors and those of financial stability. An optimal approach may be to rely on a dual disclosure approach, where both current profits and losses are reported, as well as profits after deducting forward looking provisions or a non-distributable Economic Cycle Reserve that set aside profits in good years for likely losses in the future.

There are some important trade-offs between stronger and more counter-cyclical regulation and access to credit. Such stronger regulation will result in higher spreads in domestic financial intermediation. They may result in a suboptimal supply of financing, especially in the supply of long-term credit for small and medium-sized enterprises (SMEs). Therefore, additional instruments may be necessary to provide sufficient and sufficiently long-term, credit – particularly to SMEs, such as public development banks. Higher spreads may also generate incentives for corporations with direct access to international capital markets to borrow abroad, thus increasing the likelihood of currency mismatches in the portfolios of these agents. Hence there is a need for international coordination of regulatory policies, as well as specific policies to deal with currency mismatches in financial portfolios.

To avoid regulatory arbitrage, the comprehensiveness of counter-cyclical regulation is an important issue, both nationally and internationally. The best approach is equivalent comprehensive counter-cyclical regulation for all institutions, instruments and markets. This would include also all non-banking financial institutions, such as hedge funds and investment banks (the so-called "shadow banking system"), as well as all instruments within banks by consolidating all activities onto the balance sheet. It should also include counter-cyclical margin and collateral requirements on all securities and derivatives instruments.

Counter-cyclical regulation needs to be implemented nationally, as cycles vary by countries; they should be implemented by host countries. However, the broad criteria need to be defined nationally or regionally (for example, within the European Union) but coordinated internationally, as markets are subject to contagion. Thus, a crisis in another important country (especially if an important creditor, debtor, or trade partner) can seriously harm financial stability or output in countries that themselves have not accumulated systemic risk. Therefore, in a globalized economy, all countries have a legitimate concern to avoid pro-cyclical excesses in other countries.

The case for international coordination for defining broad criteria for counter-cyclical regulation is therefore strong. This requires a considerable strengthening of regional and global regulatory institutional arrangements. A global financial regulator, though hard to achieve, may be an essential institutional development, if global financial markets and institutions are to be effectively regulated, and international regulatory arbitrage avoided. It is important that such a global regulator is broadly representative, including of developing countries. The FSB provides the basis for such a global financial regulator.

A final point relates to the timing of introducing counter-cyclical and stronger regulations. It is important to agree on such regulations in the wake of a crisis, when the political appetite for regulatory reform is highest. This will also help restore confidence in the financial system. However, such rules should begin to operate gradually and only after the economy is clearly recovering and financial institutions have become stronger. This will prevent the undesired effect of tighter regulation worsening or prolonging a credit crunch in the immediate aftermath of a crisis.

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The FSB: Macroprudential and Counter-Cyclical Regulation

Roberto Zahler

A. Conceptual Issues

The financial crisis showed that, in practice, financial regulation has been founded on a fallacy of composition, assuming that making each bank safe makes the financial system safe.

Microprudential regulation, the main component of traditional financial sector regulation and a necessary condition for sound bank regulation, is a "bottom-up" approach that focuses on the health and stability of individual institutions, examining their response to exogenous risks. However, microprudential regulation does not incorporate endogenous risk and ignores the systemic importance of individual institutions resulting from factors such as size, degree of leverage and interconnectedness across intermediaries and markets, both domestically and internationally.

Macroprudential surveillance should aim at preserving systemic financial stability by identifying vulnerabilities in a country's financial system early, and triggering policy and regulatory actions in a timely and informed manner so as to reduce economy-wide risk associated with the working of the financial system as a whole. It is a "top-down" approach that focuses on the macroeconomic, regulatory and legal environment in which the financial system operates.

A critical macroprudential concern is the state of the business cycle, and more specifically, the credit/asset price cycle. This derives from the high correlation that exists between the economic cycle up (down) phase and rising (falling) market asset prices as well as with falling (rising) risk measurement in the markets, which tend to amplify the cycle by the endogenous behavior of individual financial entities. Furthermore, during booms (busts) both financial institutions and products appear to be safer (riskier) than they are.

Most consensuses on macroprudential regulation have evolved around the need (a) that capital requirements (to cover unexpected losses) and loan-loss provisions (to cover expected losses) should have a counter-cyclical component; (b) that rules should be preferred to discretion (to minimize political pressure on supervisors); and (c) that these rules should include limits on banks' leverage ratios and liquidity buffers.

Regarding (a), most of the proposals suggest relating banks' capital requirements (i) to the growth of bank credit (by comparing the actual growth to some value coherent with a country's inflation target or other macro target or anchor). Many proposals add that capital requirements should be determined differentially according to banks' activities (additional capital should be required when engaging in risky proprietary trading activities, off balance sheet operations and re-securitizations, which tend to be procyclical); borrowing sectors (real estate lending is prone to generate a price bubble) and/or direct borrowers (changing maximum loan-to-value ratios on commercial and residential mortgages for risk weighting purposes, according to market conditions); and (ii) to the maturity mismatch of bank assets and liabilities. Regarding provisions, considering that risks tend to build up undetected during expansions and then materialize in downturns, most of the proposals suggest introducing forward-looking ex-ante provisions for loan losses at the moment in which the loan is granted; these "dynamic" provisions should work as automatic stabilizers and mitigate pro-cyclicality of standard loan loss provisioning.

Regarding (b), the experience of Emerging Economies (EE) suggests that discretion should not only be allowed but encouraged, since on many occasions rules cannot capture in a timely and forceful way, the speed and strength of cycle phases which require an extra-discretionary – force to make counter-cyclical regulation more effective.

In addition to variables specific to the banking/financial sector, recent research in developed countries shows that very low interest rates over an extended period of time may be conducive to under-pricing of risk, excessive increase in leverage, increase in bank risk-taking and the emergence of asset price bubbles. This suggests that bank supervisors should strengthen the macroprudential perspective to financial stability by intensifying their vigilance of sustained low interest rates, particularly when accompanied by other signs of risk taking, such as rapid credit and asset price increases.

This latter finding is coherent with EE experience: if key macro prices (mainly real interest rates and exchange rates) become outliers, their reversal could seriously affect the financial system soundness and solvency. Therefore, macro prudential regulation should go further than incorporating the economic cycle and banks' maturity mismatches in the financial regulation scheme.

In particular, the real exchange rate has on several occasions moved dramatically away, and for quite a long period of time, from any reasonable long-term equilibrium value, contributing not only to a balance of payment crisis but also to a banking crisis. More specifically, even when the fiscal position is sound, unsustainable booms have been generated by increases in aggregate demand "financed" by short-term foreign financial inflows. The latter magnitude and speed overheats the economy, creating asset price bubbles and artificially maintaining inflation low and the domestic currency appreciated.

With increasing globalization, short-term foreign inflows are not always intermediated by the domestic financial system, going directly to non-financial enterprises and/or the stock market. Thus, although banks may not show higher leverage or rapid growth in credit, price assets equally increase and the current account of the balance of payments equally deteriorates. When the boom ends and capital inflows are replaced by capital outflows, domestic currency devaluation usually affects bank debtor's capacity to serve their debt. And so, even if banks did not intermediate the bulk of short-term capital inflows, did not have a maturity mismatch and appeared not to have a currency mismatch, a significant devaluation may originate or amplify a banking crisis. This occurs especially if domestic debtors, engaged in non-tradable activities, have their bank liabilities in foreign currency. To minimize this effect, bank regulation should incorporate a limit to currency mismatch, which should consider the sensitivity of banks' borrowers to exchange rate movements.

EE experience has shown that targeting the capital account of the balance of payments (appropriately adjusted for the stock of foreign debt and international reserves) and sending early warning signals when it exceeds certain critical values, has helped smoothen the economic cycle and prevented the real exchange rate from deviating significantly and/or for a long time from its equilibrium value, thus contributing to the health of the banking system.

To face an "excessive" appreciation of the domestic currency originating in huge short-term capital inflows, standard policy measures include an improvement in the fiscal accounts, increasing international reserves, lowering domestic interest rates and allowing for more capital outflows. However, in EE there is not much room for tightening fiscal policy or for increasing the level of international reserves, while lowering domestic interest rates acts against the control of inflation, and liberalizing capital outflows may end up stimulating even further capital inflows. If these standard policy measures are not available, countries need to regulate the amount and speed of short-term capital inflows. In summary, EE should be prepared, when first-best macro policies are not available, to put "sand in the wheels" (taxes) to short-term capital inflows, including carry-trade transactions. These not "first-best" policies may be the only real and pragmatic option to reduce the probability of a major financial shock originating in excessive short-term capital inflows.

Considering that many EE have been opening their capital accounts and that new internationally tradable financial instruments are to a major extent nontransparent and difficult to trace, the institutional set-up and technical capabilities to formulate and implement efficient regulations on short-term capital inflows are quite demanding.

In short, preventing financial sector instability and crisis in EE requires more than appropriate local financial micro and macroprudential regulation addressed at dampening the pro-cyclicality of the domestic banking sector. It requires some sort of international financial flows regulation, currently non-existent. The role of the IMF on multilateral supervision of global imbalances, which started in 2006, went in the right direction but lacked both enforcement and accountability. Lacking international financial flows regulation, the agenda on macroprudential regulation should incorporate the legitimacy of national policies to apply regulations on short-term financial inflows.

B. Institutional Issues

After the Asian crisis of 1997-1998, the principle that financial liberalization should be accompanied by stronger prudential regulation and supervision became generally agreed. Although there were many meetings and papers on a "new international financial architecture," and while some progress was made on issues such as formulating standards of good practice in corporate governance, bank supervision, financial accounting and data dissemination, the main structural weaknesses of the international financial system were not properly addressed. In particular, although financial regulation – domestic and international – should have been comprehensive regarding institutions, instruments and markets, so as to minimize them being circumvented by non-banking intermediation, the recent financial crisis exposed the weakness of the international financial architecture.

Global institutions failed to conduct effective macrofinancial surveillance of systemically important economies (US, UK and the eurozone) and to provide compelling warnings; and fragmented international arrangements proved to be ineffective regarding regulation, supervision and resolution of internationally active financial institutions, instruments and markets.

The present voluntary cooperative efforts at the international level are not adequate. The international financial community needs to make progress with a binding global financial order. The crisis has demonstrated that even countries with strong financial systems can feel the effects of inadequate regulatory regimes elsewhere. In fact, countries may hesitate to impose new appropriate requirements on their own institutions if these measures will create competitive disadvantage. This reinforces the importance of strengthening international coordination, review and surveillance.

One main challenge is that regulatory reform will take time since the issues are not only technically very demanding but politically complicated, considering the reduction of sovereignty in the regulation of national financial markets that might and should come from stricter global rules. And the reform proposals of the European Union – with the soon-to-be established European System of Central Banks (ESCB) – and the US, which have been advancing quite rapidly, are not necessarily coherent with the required global criteria for financial regulation.

Another challenge at the international level, and very probably for the FSB, is to turn high-level commitments to improve early warning systems, surveillance and peer review into robust international arrangements which will empower the FSB to produce wholly independent analysis of system-wide risks, and which will require major countries, whose financial systems have systemic international impact, to take such reports seriously as inputs to domestic macroeconomic and macroprudential policy decisions.

The FSB, to be responsible for assessing macroprudential risk worldwide and proposing counter-cyclical regulatory policies, should be independent in carrying out its tasks and pursuing its objective. The fact that the FSB would probably not be involved in the implementation of these recommendations strengthens the argument for its policy independence.

The final responsibility for implementing the FSB recommendations would probably remain with national supervisors. This implies that a main institutional challenge relates to the effective monitoring of the follow-up of the FSB warnings and recommendations and their consistent and timely implementation; this will be crucial for the performance and credibility of the new macroprudential supervisory framework.

The FSB should work in close cooperation with the BIS and IMF; this would ensure an appropriate interplay at the international level between the macro and micro prudential levels. Furthermore, the FSB could be initially assisted by the BIS and the IMF in the provision of analytical and statistical support.

The FSB, regarding macroprudential and counter-cyclical policies, could be assigned the task of being consulted prior to the new responsibilities which will probably be assigned to the IMF: surveillance of all domestic financial markets with no exceptions (i. e. including those of advanced economies); development of an early warning system; and the possibility of overriding the veto of a member to have a surveillance report made public.

The FSB analysis, evaluation and proposals to mitigate macroprudential risk should be incorporated into the IMF-World Bank financial sector assessment programs, which should be required to be mandatory and the results made public.

The FSB: Where Do We Go From Here?

Pierre L. Siklos

As we approach the second half of 2010, the best that can be said about the global financial crisis of 2007-2008 is that it focused policy makers' attention on the need to match frequently uttered words about the purported benefits of financial globalization with deeds evaluated in terms of greater international cooperation in the area of macroprudential regulation and financial supervision. To be sure, at several levels, all the warning signs about the likelihood of a financial crisis on a global scale were there. Fortunately, and in spite of institutional and policy failures, governments and central banks responded forcefully and, by and large, successfully. It is, of course, too early to declare victory.

How will the very policies that prevented a recurrence of a Great Depression be unwound? Will the same determination to prevent a catastrophe lead to an under-reaction as the global economy returns to strong economic growth? It is striking that, while the FSB captured the world's attention, and cemented a desire on the part of the G20 to exchange information and revisit the question of what ingredients are necessary to ensure that a repeat of the string of events of 2007-2008 is avoided in future, the world is no closer to effective cooperation in developing governing principles for a new international financial system than at the height of the financial crisis. The publication of a process, including the creation of a "toolkit" or " principles," for cooperation in the event of a future financial crisis with global implications is welcomed; but what is left out in FSB documents (for example, "Promoting global adherence to international cooperation and information exchange standards," and "FSF Principles for Cross-border Cooperation and Crisis Management") is perhaps more interesting than what has, to date, been agreed to.

Economic theory is able to demonstrate quite convincingly that a cooperative solution is often superior to a coordinated solution. In this sense, the accomplishments of the FSB represent a promising start. However, economic theory has its limitations. Unfortunately, it ignores two important truths of the "real world. " They are: democratic accountability, which requires, in Ronald Reagan's famous words, that nations "trust, but verify," and an understanding by all countries that expect to fully participate in the global financial system that they all play by the commonly applied rules of the game. The first requirement suggests perhaps the creation of an authority to monitor and report on the performance of macroeconomic policies, while the second requirement is based on the assumption of a set of "core" beliefs about the essential ingredients of sound economic policies.

In principle, there were plenty of institutions capable of meeting both objectives but, as we are all too aware, both policies and institutions did not serve the international community well and may well have been doomed to do so from the start. The International Monetary Fund (IMF) was born out of an internal inconsistency, namely the ability of governments to contain capital flows deemed undesirable, combined with limited exchange rate flexibility that set out a role for the United States as a permanent lender, a position that was simply unsustainable. For all the talk of reviving a version of the Bretton Woods era, the fact is that it amounted to a policy regime with a very short life (1959-1973) and is arguably a case study of the failure of the international coordination of economic policies as the sine qua non of proper policy design. Other institutions, such as the Bank of International Settlements (BIS), born out of another global crisis early in the 20th century on a global scale, also did not meet the challenge of convincing policy makers that a financial crisis of global magnitude was inevitable, in spite of being one of the most vocal groups in pointing out that the weight of global imbalances would produce a disastrous outcome.

Indeed, as the crisis developed and, as major economies worried that they were careening toward an economic precipice, there was talk of creating a new set of institutions, perhaps even a college of overseers, to replace the failed existing ones. This kind of talk is, thankfully, heard less frequently now but the unhappiness of what has transpired over the past few years has not abated. The desire to replace something old with something new is a constant refrain from politicians. Many have perhaps already forgotten that the IMF was heavily criticized well before the latest financial crisis. However, just as the BIS was able to recover some influence and find relevance among the panoply of institutions that have an international mandate, so has the IMF found a new voice as an international lender of last resort and potential macroprudential supervisor.

Contrary to some who bemoan that a crisis is an opportunity for reform, and that the world has already lost this opportunity, the slow and steady return to some semblance of normalcy in economic activity is itself a chance to design a framework that is capable of harnessing all that has been learned about crisis management and resolution and ensure better outcomes in future. The FSB is simply the natural recognition that several economies have emerged as powerful players on the international stage ready and willing to challenge the "old" economic powers. One should not, however, underestimate the contribution of the international consensus on the desirability of low and stable inflation, fiscal rectitude, the free movement of capital and goods. It is doubtful that many of the BRICs who now rightfully occupy a seat at the table would have been able to justify their place had they not, to differing degrees,agreed on several aspects of the core beliefs of what one might call a desirable economic policy strategy.

With the limitations of the past and, mindful of existing political constraints, what can the FSB accomplish, and how should it be governed? Regarding the former question, the FSB should:

- Lead by example. The FSB publications referred to above suggest that it aims to follow such a strategy;
- Assist existing institutions with responsibilities for managing the financial system to understand the sources of financial system stability and the limitations of economic policy strategies that seek to maintain it. There is little indication so far that the FSB is explicitly seeking to meet this challenge;
- Promote the transparency and accountability of economic and financial policies and offer assessments that indicate the extent to which

individual countries can meet agreed-to standards of best practice. There is limited progress on developing a report card of sorts on how much transparency has been achieved.

As far as the FSB's governance is concerned, a few principles going forward might include:

- Limiting sanctions for non-compliance to naming and shaming. The lessons from the failed attempt at a Stability and Growth Pact for the euro area should be sufficient to prevent a recurrence of attempts to impose explicit financial penalties on wayward countries.
- Ensure that the core principles of sound macroprudential management are maintained, internally consistent, and are periodically evaluated. If they stand the test of time, credibility will be enhanced and the negative repercussions of a future global crisis will be more muted. The lesson from the successful operation of monetary policy strategies geared to achieving low and stable inflation is surely an example of how credibility can buy flexibility and success when crisis management is required. More importantly, there needs to be clarity when it comes to the role of financial system stability and monetary policy. To be sure, financial system stability should be a principle to be followed but not a separate objective for monetary policy. Monetary policy ought never, of course, compromise financial stability. Instead, central banks ought to be encouraged to seek alternative monetary policy strategies that minimize the occurrence of conditions that threaten financial system stability. Price level targeting, for example, might be one such alternative that deserves serious consideration. The ability of policy makers to weather the next crisis rests on what monetary policy frameworks will look like in the coming years.
- The FSB can be a useful voice to ensure that appropriate distance exists between central banks and the fiscal authorities. Where it is absent, the location of accountability in crisis situations needs to be clarified. Central banks cannot be open to the threat of retaliation or loss of autonomy because, in the absence of "rules of engagement," legislatures perceive the central bank as overstepping the normal bounds of monetary policy. Moreover, the limits of monetary policy interventions in private markets need to be more clearly defined. The experience with quantitative or credit easing in many parts of the world has left many observers uneasy, with considerable justification, because the lines of responsibility between fiscal and monetary policy were perceived to have become blurred. This means, for example, that rules of indemnification that exist to cover "…unusual and exigent…" (Section 13(3), Federal Reserve Act) circumstances need to be clarified and codified in central banking legislation.

Contributors

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About CIGI

The Centre for International Governance Innovation is an independent, nonpartisan think tank that addresses international governance challenges. Led by a group of experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate, builds capacity, and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events, and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

CIGI conducts in-depth research and engages experts and partners worldwide from its extensive networks to craft policy proposals and recommendations that promote change in international public policy. Current research interests focus on international economic and financial governance both for the long-term and in the wake of the 2008-2009 financial crisis; the role of the G20 and the newly emerging powers in the evolution of global diplomacy; environment and energy, including climate change; and issues related to global and human security.

CIGI was founded in 2002 by Jim Balsillie, co-CEO of RIM (Research In Motion) and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario. CIGI gratefully acknowledges the contribution of the Government of Canada to its endowment fund.

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