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ANOTHER FINE MESS: REPAIRING THE GOVERNANCE OF INTERNATIONAL FINANCIAL REGULATION

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EXECUTIVE SUMMARY

Five years after the fall, policy makers seemingly continue to believe that the severity of any crisis-led downturn can be divorced from its source. At the global level, the best the international community is able to do is to grudgingly provide the International Monetary Fund (IMF) with greater financial capacity subject to a reweighting of the influence of emerging market economies in the institution. Meanwhile, the Financial Stability Board (FSB) remains in stock-taking mode. It is also hampered by the need to rely on the Bank for International Settlements (BIS) for resources and the heads of government decision not to convert the Board into a treaty-based international organization.

There is too little appreciation that earlier international monetary systems required cooperation precisely because exchange rate systems rendered economies dependent on collaboration between the participants. This paper argues that credibility and trust in any new international regulatory framework must first begin at home with a determination for fiscal and monetary policies to work in harmony. This includes cooperation, if not coordination, of regulatory and supervisory functions to ensure that macroprudential policies effectively complement domestic monetary policy and provide an additional tool to implement a sound macroeconomic framework that will soften the blow from the next financial crisis.

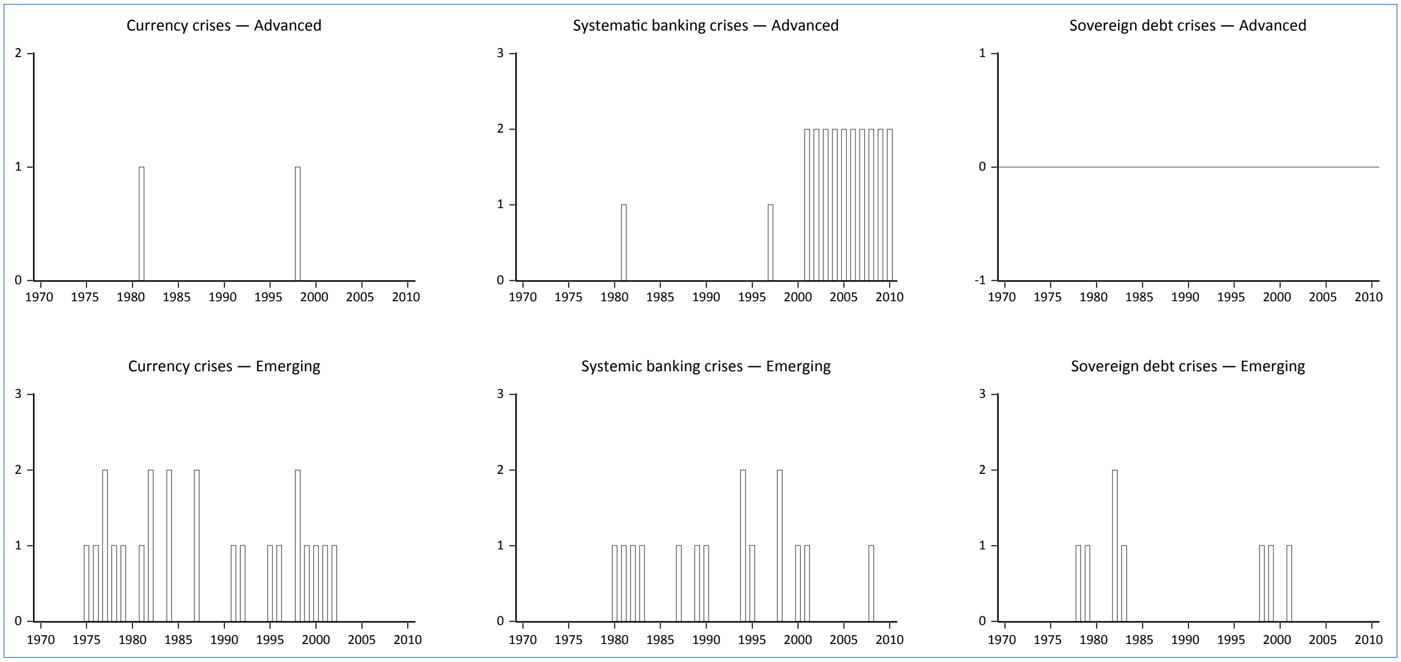
As long as the international community recognizes the potential spillovers from crisis response policies and is convinced that any trade-offs eventually produce a better global solution there is no reason why an international financial system should prevent the adoption of local solutions to problems that have global repercussions. Systemically, and politically important, nations ought to demonstrate some leadership by agreeing on a range of acceptable regulatory frameworks and demonstrate, in a transparent manner and at regular intervals, how each is capable of operating with a minimum of spillovers that might threaten financial system stability. Financial stability and how it interacts with other elements of sound macroeconomic policies, to borrow the words of Winston Churchill, remains "a riddle, wrapped in a mystery, inside an enigma." We should aim for less, not more, in repairing the governance of international financial regulation.

INTRODUCTION: WHAT THE CRISIS HATH WROUGHT

Financial crises are neither new nor are they infrequent, as Figure 1 illustrates with data from 1970 to 2010. When attention is restricted to the Group of Twenty (G20) countries, and these are subdivided into "advanced" and "emerging" market members,[1] three conclusions emerge.

1 Using the IMF's definition.

Figure 1: Financial Crises in the G20, 1970–2010



Source: Author's calculations based on Luc Laeven and F. Valencia (2012), "Systemic Banking Crises Database: An Update," IMF Working Paper 12.163, June; Barry Eichengreen and Michael Bordo (2003), "Crises Now and Then: What Lessons from the Last Era of Financial Globalization" in Monetary History, Exchange Rates and Financial Markets: Essays in Honor of Charles Goodhart, *edited by Paul Mizen. Vol 2. London: Edward Elgar Publisher; and author's calculations.*

Note: Number of crises is the sum of crises in the individual countries according to the classification in Table 1 (see page 30).

First, advanced economies experienced crises almost exclusively of the systemic banking variety. Second, emerging markets have not only known all three kinds of financial crises noted in Figure 1, but have done so more often than their counterparts in advanced economies. Finally, with one exception, the global financial crisis (GFC) was a crisis that originated in advanced economies, but eventually spread beyond that group. Despite convincing research that finds that financial crises are more costly in terms of lost output, and recovery can typically take almost a decade (see, for example, Reinhart and Rogoff, 2009; Jordà, Schularik and Taylor, 2011; IMF, 2012), five years after the fall decision makers seemingly continue to believe that the severity of any crisis-led downturn can be divorced from its source. Instead of limiting the extent to which the financial sector is prone to crises, policy makers have opted to socialize the downside risks of a future financial crisis. Moreover, in some parts of the world, the consequence of the buildup of government debt has led to a more intertwined relationship between banks and sovereigns.

A distinctive characteristic of the GFC is that it first engulfed the advanced industrial world, where best practices in the area of economic policies and governance were thought to originate. Policy makers underestimated the impact global financial markets that know no borders would have when a large negative shock is transmitted globally. They also harboured the belief that the real economy might be spared from any loss of financial system stability. More than a few also entertained the notion that price stability somehow translates into financial system stability.[2]

Policy makers point to various aggregate demand or supply shocks in their explanations for root causes of the crisis although it is unclear whether global factors or a confluence of domestic factors explain how the world economy has unfolded since late 2007. Indeed, a scorecard listing what we know and don't know about the crisis would likely tilt in the direction of items we have yet to fully comprehend. Many economists, however, have a more prosaic explanation for the events since 2007. The crisis was a systemic event and its proximate cause is a failure of the banking system in a financial system that was too highly leveraged. Within months, the financial shock — a channel absent from the New Keynesian macroeconomic synthesis that policy makers and academics relied on at the time — morphed into an aggregate demand shock, first through a collapse of exports and, later, into aggregate demand more generally, as confidence evaporated and the process of

2 Consider, for example, Jean-Claude Trichet, former president of the European Central Bank (ECB), who declared in 2008: "The primary goal of a central banker and certainly of the ECB is to maintain price stability… which is a necessary condition for financial stability, if not a sufficient condition" (Trichet, 2008). There are, however, more serious reasons for preventing central banks from straying into the financial stability area (see, for example, Laidler, 2004). This issue is returned to below.

deleveraging began. Not surprisingly, almost all industrial economies went into a recession. Emerging markets, in contrast, fared much better in economic growth terms before, during and after the crisis.[3] This is, in part, because their financial sectors lagged behind their counterparts in the advanced world, but also because business cycles are not always as synchronous as one might think, in spite of the rhetoric of globalization (see, for example, Siklos, forthcoming 2013a, and references therein).

The advanced economies, and several emerging market countries (for example, China), did respond by stimulating their economies in the "old-fashioned way," that is, by priming the pump of fiscal policy. Later, this reaction would lead to regret, and a U-turn, as "austerity" became an essential element of a sound macroeconomic policy.[4] Another effect of the crisis was the transfer of more responsibilities to some central banks (that is, the United States, the United Kingdom and the euro zone). The task of maintaining financial system stability, involving greater emphasis on regulation and supervision at both the micro (for example, financial institutions) and macro (for example, financial sector) levels, was added. Next, central banks felt the need to engage in several types of unconventional forms of monetary policy. More "radical" measures were adopted, increasingly interpreted by some as politicizing or "fiscalizing" monetary policy. As a consequence, the clear demarcation lines between fiscal and monetary policies, normally the *sine qua non* of a sound macroeconomic policy regime, began to blur. Indeed, it is tempting to view some central banks as picking up the fiscal slack created by the withdrawal of conventional fiscal stimuli. The consequences of central banks "not sticking to their knitting" are, as yet, unknown, but must be part of the discussion concerning the future of international financial regulation. Central banks may well regret their enlarged role in spite of their best intentions to condition any assistance on meeting certain macroeconomic objectives.[5] The retort from these same institutions, in the face of mounting output losses and high or rising unemployment rates, is to ask: if not us, then who?

The belief in a shared purpose quickly evaporated following the April 2009 G20 summit in London. The countries most affected by the financial crisis began to turn their attention to reforming homegrown institutions and revising domestic policies in place prior to the GFC. As a result, international commitments have been given less priority or recast to suit domestic preferences, as in, for example, the adoption of Basel III capital adequacy standards. As will be argued below, these developments need not be viewed as entirely negative for progress in international monetary and financial system reform.[6] Yet, as Hellwig (2010) and Goodhart (2012) point out, it remains unclear whether proposed capital standards represent a minimum — a standard or target that all financial institutions should aim for.[7] Next, the theoretical rationale for capital standards has never been properly articulated. Indeed, the higher capital standards of Basel II, a reaction to earlier financial turmoil, did nothing to prevent the onset of the GFC. Finally, the spread of shadow banking has been somewhat country-specific, even if the investments in question have common names. Consequently, it is difficult to see how a top-down approach will be able to reduce the likelihood of a future systemic financial crisis.[8]

Consider another example, the G20's so-called Mutual Assessment Process (MAP), which is being administered by the IMF. It was never made clear what the individual country submissions would be based on, nor how the IMF would verify the "internal consistency" of the submissions. Since it is unlikely that a single policy framework will be right for all countries, it is no wonder that progress has been unsatisfactory, to say the least. What is required is not an assumption that our existing understanding of the link between macroeconomic and financial conditions is known, but rather, a rethink of what is inherently successful or unsuccessful about existing heterogeneous

3 Note that while real per capita GDP growth turned negative in the advanced economies of the G20, the downturn in economic growth was also felt among the emerging market members of the same group (not shown).

4 Not surprisingly, this turn of events would produce analyses about the benefits and costs of fiscal stimulus and austerity programs. See, for example, IMF, 2010, chapter 3, and references therein.

5 Conditionality in offering financial support to institutions and countries is likely to receive even more scrutiny, not only because of the ongoing euro area crisis, but also in light of past experiences at the international level. Although, on balance, some forms of conditionality (for example, *ex post*) may be successful while others have a more checkered history, it seems that generalizations are not possible. Instead, the ultimate success of conditionality is likely a function of idiosyncratic factors as well as the quality of governance in the recipient country. See, among others, Jeanne and Ostry, 2008; Dreher, 2009; and Acharya and Backus, 2009.

6 International regulators (for example, the Basel Committee on Banking Supervision) responded by introducing new capital standards in an effort to placate those who argued that capital requirements were insufficiently high or wide in scope (for example, the omission of shadow banks). Examples of domestically oriented reforms include the United States' massive overhaul of its financial legislation (that is, the so-called 2010 Dodd-Frank bill), the merger of the activities of the Bank of England and the Financial Services Authority, and the ongoing discussions in Europe about a banking union.

7 Hellwig (2010) summarizes the rationale for capital standards as follows: they exist as a buffer against a shock that could lead to bank failure; to ensure that financial institutions have "skin in the game"; and as protection against transitory losses. The first one of these objectives failed in the GFC, bankers found novel ways to avoid the second and ineffective regulation can actually raise the costs of the third motive.

8 Instruments such as repos, asset-backed commercial or other paper, money market funds, structured investments vehicles and so on, are associated with the shadow banking system. Due to their nature, it is difficult to imagine international standards that are able to manage these complex and myriad types of assets. For a discussion of challenges in Canada, see, for example, Longworth, 2012.

policy frameworks.[9] An obvious example is how some central banks that target inflation reacted at the onset of the crisis. Instead of asking how to square the circle of the nexus between price stability and financial stability, when the former is reasonably well defined while the latter concept has yet to be clearly articulated, some central banks continue to advocate a business-as-usual approach (Carney, 2012). However, this attitude does not address the trade-off between monetary policy and macroprudential frameworks or the division of responsibilities in carrying out the necessary actions when the two goals come into conflict, let alone where accountability rests.[10] Moreover, one has to ask whether a form of Goodhart's law misleads policy makers into assuming that the current regime is as credible as some central banks claim (for example, Canada, Australia and New Zealand) based on how well-anchored inflation expectations appear to be.[11]

Credibility and trust in policy makers is now at low ebb,[12] with few signs that they know the way forward, at least as far as the global economy or international financial regulations are concerned. At the global level, the best the international community is able to do is to grudgingly provide the IMF with greater financial capacity, subject to a reweighting of the influence of emerging market economies in the institution.[13] Meanwhile, the FSB remains in stock-taking mode, with the results of an international survey of "key attributes" of regimes used to deal with failing institutions due at the end of 2012.[14] In addition, while the FSB's remit includes a strengthening of its capacity as an organization, it is also hampered by the need to rely on the BIS for resources and the heads of government decision not to convert the FSB into a treaty-based international organization.[15]

9 As Jenkins and Thiessen (2012) point out, there is a need for improvements in the governance of macroprudential frameworks since agencies with vastly different motives and responsibilities have to coordinate decisions to ensure financial system stability.

10 It does not help the cause of those who wish to find a way out of the crisis that opponents of inflation targeting continued to equate the policy with what Mervyn King called the "inflation nutter" strategy (see, for example, Stiglitz, 2008). If there ever was a "straw man" this is it, and such a position does a disservice to the cause of international financial reform.

11 Goodhart's law (Goodhart, 1975) suggests that targets, once publicly announced, cease to be useful as behaviour changes to meet the target. However, this may not change the type of behaviour that policy makers sought to control in the first place.

12 For US evidence, see, for example, Sapienza and Zingales, 2012.

13 See: www.imf.org/external/np/exr/facts/quotas.htm. Proposed new quotas are not yet ratified as of early January 2013.

14 See: www.financialstabilityboard.org/publications/r_120813.pdf.

15 See: www.financialstabilityboard.org/publications/r_120619c.pdf.

The question, then, is whether these country-specific movements to regulate finance conflict with the desire to build an international financial regulatory system that protects the world economy from the consequences of a future financial crisis. As a consequence, there is an increasing amount of blame shifting.[16]

A now well-established body of evidence supports concerns over financial spillover effects, even if economists cannot easily identify interdependence versus contagion-type effects (for example, see Forbes, 2012; Forbes and Warnock, 2012; Burdekin and Siklos, 2012). Ultimately, what is lacking is an understanding of how we can balance the benefits of a globally integrated financial system against the costs or risks of crises, which, at first glance, appear local in nature but can become global through the systemic elements that underpin them (for example, see Bernanke, 2010; IMF, 2011).

THE PROBLEM: COOPERATION IF NECESSARY, BUT NOT NECESSARILY COOPERATION

In October 2011, the G20 endorsed what were termed "coherent conclusions" on the management of capital flows.[17] On the one hand, the agreement would obviate the need for cooperation among the members. After all, imagine that each G20 member heeded the group's expressed desire to the effect that "sound macroeconomic policies bear the prime responsibility for ensuring overall economic health, and an appropriate structural environment, including effective regulation and supervision, is important for financial stability" (G20 Finance Ministers and Central Bank Governors, 2011). Setting aside the question of what constitutes "sound" policies, it would seem almost tautological to conclude that, if individual economies behaved in a way that would ensure their own financial system stability, the prospect of global financial system stability would be immeasurably enhanced.

The difficulty, of course, is that what's best for an individual country may create unanticipated spillover effects that may potentially undermine the global financial

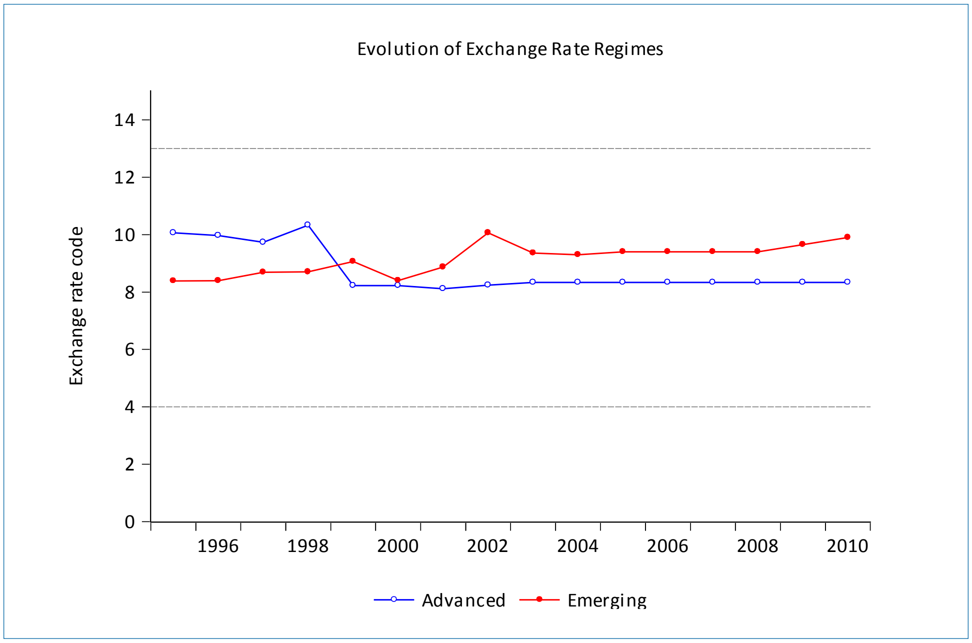
16 There are plenty of illustrations of this kind of behaviour. Consider, for example, German Chancellor Angela Merkel, who, in 2008, stated: "'The German government pointed out the problems early on,'" but added, "'Some things can be done at the national level…but most things have to be handled internationally.'" *Spiegel* staff (2008). "The End of Arrogance: America Loses Its Dominant Economic Role." *Spiegel* Online International. September 30. Available at: www.spiegel.de/international/world/the-end-of-arrogance-america-loses-its-dominant-economic-role-a-581502.html. More recently, Brazilian President Dilma Rousseff is quoted as saying: "Monetary expansionist policies that lead to currency depreciation are policies that create asymmetries in trade relations — serious asymmetries" (Leahy, 2012).

17 See: www.g20.utoronto.ca/2011-finance-capital-flows-111015-en.pdf.

system. A prime illustration is the threat of a "currency war" over the application of unorthodox monetary policies.[18] Since the same G20 also undertook to "move more rapidly toward more market-determined exchange rate systems and enhance exchange rate flexibility to reflect underlying economic fundamentals…from competitive devaluation of currencies" (G20 Leaders, 2011), this would seem to further reduce the need to cooperate, let alone coordinate, among the G20 economies. That is, unless there is: little indication that several of the G20 members will actually permit their exchange rates to float freely in the foreseeable future; there is a shift away from the view by some members that fully flexible exchange rates truly insulate economies against external shocks; and that if "country-specific circumstances have to be taken into account when choosing the overall policy approach to deal with capital flows" (G20 Finance Ministers and Central Bank Governors, 2011), then another avenue exists through which shocks that hit one economy can systematically affect others.

18 This idea was apparently coined by Brazil's finance minister, who has labelled the quantitative easing policies of the US Fed, for example, as protectionist in nature. See, for example, Rathbone and Wheatly, 2012.

Figure 2: Exchange Rate Regimes in the G20, 1995–2010



Source: Raw data from Ilzetzki, Reinhart and Rogoff (2008).

Note: The data were constructed by taking the arithmetic average of the exchange rate codes for advanced and emerging G20 economies. See Table 1.

The exchange rate codes refer to the following classification of exchange rate regimes:

1. No separate legal tender
2. Pre-announced peg or currency board arrangement
3. Pre-announced horizontal band that is narrower than or equal to +/-2%
4. De facto peg
5. Pre-announced crawling peg
6. Pre-announced crawling band that is narrower than or equal to +/-2%
7. De facto crawling peg
8. De facto crawling band that is narrower than or equal to +/-2%
9. Pre-announced crawling band that is wider than or equal to +/-2%
10. De facto crawling band that is narrower than or equal to +/-5%
11. Moving band that is narrower than or equal to +/-2% (i.e., allows for both appreciation and depreciation over time)
12. Managed floating
13. Freely floating
14. Freely falling
15. Dual market in which parallel market data is missing

Figure 2 illustrates that, based on the exchange rate classification scheme of Ilzetzki, Reinhart and Rogoff (2008), it is only the G20 emerging market countries that have moved slightly closer to a free float since the mid-1990s. Indeed, advanced economies have, on average, less flexible regimes than in the mid-1990s. The view emanating from the United States, however, is that currency manipulation is spreading mainly beyond the G20.[19] It is striking that the G20's stated goal (cited above) omits any reference to the failure of some key economies to reign in their habit of accumulating foreign exchange reserves. Yet, there is considerable empirical evidence that reserves accumulation behaviour and financial stability are closely connected (for example, Frankel and Saralevos, 2010). The IMF's own calculations reveal that Brazil, India, Russia and China have excess reserves that exceed what is deemed adequate.[20] There are likely many other economies in this camp.

Fears of the consequences of unfettered capital movements greatly influence the choice of exchange rate regimes. Recent events, of course, have prompted a flurry of new studies that revisit this question. Both the time series evidence, as well as case studies (see, for example, Du Plessis and Du Rand, 2010) suggest that, while there have indeed been successful episodes, there is, on balance, little persuasive evidence that capital account liberalization is harmful to an economy. More recently, attention has turned to the connection between the volatility of capital movements, financial stability and economic outcomes. Here too the conclusions are inconclusive at best. For example, Forbes and Warnock (2012) suggest that policy makers would be better off strengthening their domestic economies so they can withstand volatile capital flows instead of devising restrictions on their movements. Fratzscher (2012) essentially reaches the same conclusion, but he also underscores the impact of US policies on capital flows. These results are contradicted by Ostry et al. (2012) who contend that restrictions on capital movements can be a useful element in a policy maker's toolkit. Since they do not quantify the costs of such policies, nor is their evidence necessarily applicable beyond the emerging markets they examine, it is unclear how this kind of result can translate into concrete policies that improve the cooperation between advanced and emerging market economies.

The IMF has given its blessing to some forms of "prudential" capital controls as a device that internalizes the inherent instability created by individual economies facing a financial crisis, which then spills over into the rest of the world (see, for example, Korinek, 2011). Even if this kind of thinking were sufficient to promote more cooperative behaviour, it remains unclear what prevents economies from excessive reliance on capital controls as an excuse for defending domestic policies that may become increasingly distorted as a result. Moreover, if a series of bad policies by governments is responsible for most financial crises, then it is doubtful that governments can be trusted to implement effective forms of prudential controls on capital movements.

To be sure, there is likely a zone of tolerance when it comes to permitting countries or regions to tailor specific regulatory policies to suit their own needs. Establishing tolerance limits is another area that the MAP approach fails to consider. It does not help the cause of cooperation that two of the largest economic entities, namely the United States and the euro zone, avoid asking how their policies affect the rest of the world. Consider Chairman of the Federal Reserve Ben Bernanke's latest defence of the Fed's unconventional monetary policies, delivered at the 2012 Jackson Hole conference. Bernanke never refers to the potential spillover effects that the Fed's policies have on other economies, particularly among emerging markets. Yet, he goes on to remark that the resulting "strains are most problematic for the Europeans, of course, but through global trade and financial linkages, the effects of the European situation on the US economy are significant as well" (Bernanke, 2012: 17). The message is clear: we will defend ourselves against spillovers that originate from abroad but we evince little concern over how our policies may contribute to the continuing global economic malaise.[21]

Of course, whether the Fed's actions are a reflection of the need for the central bank to "do whatever it takes" in reaction to failures from events outside its control continues to be debated. To the extent that near-zero policy rates may create unintended consequences (see, for example, White, 2012 and Turner, 2011), there ought to be strong incentives to go beyond domestic imperatives alone and consider addressing "vulnerabilities affecting the financial systems in the interest of global financial stability" (FSB, 2012). Consequently, it is necessary to identify the relative importance of the systemic component of sovereign risks. Instead of an emphasis on macroeconomic fundamentals alone, as presumed by the MAP approach, the proximate cause may well be found in the behaviour of financial markets (for example, see Ang and Longstaff, 2011). After all, these unintended consequences can have macroeconomic effects, implications for financial stability or both.

19 See, for example, Bergsten and Gagnon, 2012, who list China and Japan, both members of the G20, as among the group of currency manipulators, along with several other countries in Asia, Europe and the Middle East, none of which belong to the G20.

20 See IMF, 2012. There is insufficient space here to deal with the question of how to measure foreign exchange reserve adequacy. Filardo and Siklos (2012), and references therein, cover the relevant issues.

21 To be fair, establishing the significance, let alone the size, of financial spillovers is difficult. Bauer and Neely (2012), for example, conclude that US monetary policy has had significant spillover effects on financial markets in select countries, including Canada. However, the results are model sensitive. Woodford (2012) also concludes that a great deal of uncertainty surrounds existing estimates.

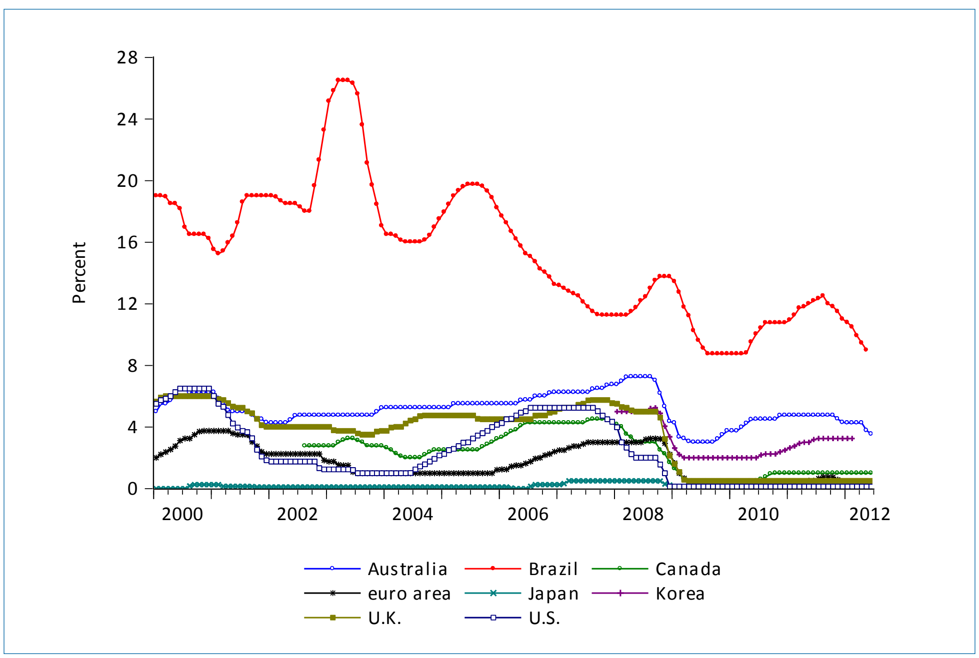
With one exception, central bank policy rates at major central banks in the G20 are fairly similar, as shown in Figure 3. If interest rates and exchange rates combined are the primary drivers of capital movements across countries, then it is hard to see how, under the circumstances, some of the key fundamentals can help solve the riddle of how to tame what is considered one of the destructive features of the international financial system — namely, that, so far, very low yields appear incapable of stimulating economic growth.[22] Moreover, if the IMF or other international bodies focus their attention on consistency in the area of macroeconomic management across countries, it is unlikely that they, or other analysts, will consider the "tail events" that did much to unravel global economic conditions over the past five years.[23] In this kind of environment there is an urgent need to fill a vacuum. Clearly, searching for a set of policies that will encourage meaningful cooperation is necessary. To complicate matters even further, we may well be going through an era when there is no economy, institution or central bank that can "call the tune," as the Bank of England did several decades ago (Eichengreen, 2008: 33) and the US Federal Reserve did until recently. While the rise of China is seen as promising a realignment of sorts in the global economic environment, even the optimists (for example, Subramanian, 2011) believe there are significant economic and financial risks if the United States shares the global stage with China. Nevertheless, it is far from clear whether, for example, the dollar will soon be displaced as a reserve currency (see, for example, Yu, 2012). We appear, then, to be without a "conductor" for the international financial system, with untold consequences. Finally, if higher inflation is not an option for reducing the debt buildup by sovereigns around the world, and middling economic growth is the prospect for the foreseeable future, then micro- and macroprudential policies are the only other means to control "animal spirits."[24] As a result, we have entered a world with a new trade-off — namely, between the degree of monetary ease and the forbearance of regulators, supervisors and central bankers.

22 Not surprisingly, this state of affairs is creating consternation in some circles. Richard Fisher, president of the Dallas Fed, and a lone dissenter on the Fed's board (that is, the Federal Open Market Committee) against additional monetary stimulus, put it bluntly: "Nobody really knows what will work to get the economy back on course. And nobody — in fact, no central bank anywhere on the planet has the experience of successfully navigating a return home from the place in which we now find ourselves" (Fisher, 2012).

23 Macroprudential regulation and supervision may well be intended to deal with this issue, but we remain far away from knowing which tools work and how financial stability and monetary policy can best work together.

24 This term was coined by Keynes in *The General Theory of Employment, Interest and Money* (published in 1936) to refer to how emotion, as opposed to purely rational decision making, could influence consumer behaviour.

Figure 3: Policy Rates in Selected Economies, 2000–2012



Source: International Financial Statistics CD-ROM (Washington, DC: IMF), August 2012.

There is too little appreciation that earlier international monetary systems required cooperation precisely because exchange rate systems, whether of the gold standard or Bretton Woods varieties, rendered economies dependent on collaboration between the participants. Therefore, if the aim of policy makers is to make the exchange rate flexible and allow each economy to decide individually what is "sound" in macroeconomic terms while also recognizing that domestic considerations may well trump global needs when it comes to regulating capital flows, then another mechanism is needed to create incentives for cooperation on reforms of the international financial system. At the moment, then, it is looking a lot like the interwar era when, as the influential report published in 1944 by Ragnar Nurkse concluded, "The piecemeal and haphazard manner of international monetary cooperation sowed the seeds of subsequent disintegration" (Nurkse, 1944: 117). Now, as then, we are living under an extended period of monetary and fiscal experimentation, with little understanding of the long-term consequences of the global rush to ease monetary policy (see Figure 3), while simultaneously restraining fiscal policy with a good measure of macroprudential regulations thrown in.

Other forces that contribute directly to the GFC are still around. Consider, for example, the international reaction to the so-called Volcker Rule,[25] which aims to limit the risk-taking activities of investment banks.[26] The World Trade Organization (WTO) agreement on financial services permits countries to take measures dictated by domestic needs to ensure financial system stability. However, in the same breath, domestic considerations cannot infringe on the agreement to do no harm to others: "Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement."[27] It is this last sentence that has been used by Canada, and other countries, to water down the intent of the Volcker Rule.[28]

NO SINGLE REGULATORY FRAMEWORK IS RIGHT FOR ALL COUNTRIES

This paper argues that credibility and trust in any new international regulatory framework must first begin at home, with a determination for fiscal and monetary policies to work in harmony. This includes cooperation, if not coordination, of regulatory and supervisory functions to ensure that macroprudential policies effectively complement domestic monetary policy and provide an additional tool to implement a sound macroeconomic framework that will soften the blow from the next financial crisis. Nevertheless, it is necessary to ask how much cross-country variations can be tolerated if it is assumed that it is either impractical or undesirable to expect a "one-size-fits-all" international monetary regime. The fear seems to be that policy makers cannot be seen to disagree on the governance of an international monetary system. Why this is the case is not entirely clear. After all, in the early days of inflation targeting, many believed that disagreements inside central bank policy-making committees were detrimental to the cause of a first-rate monetary policy (see, for example, Siklos, 2002). However, disagreement in the economic outlook, when combined with sufficient transparency, can be beneficial (see, for example, Siklos, forthcoming 2013b). The same principle can surely be extended to devising a stable international financial system.

Soundness cannot be defined in a unique fashion. Instead, what is considered good practice in monetary, fiscal and regulatory policies must be evaluated along a range of acceptable metrics. More importantly, as discussed below, the international community needs to more effectively account for spillover effects from individual nations' attempts to determine what is right for them. This pre-condition must be met before institutions entrusted with preserving financial system stability are themselves reformed or their tasks and responsibilities are revisited. Reforming existing institutions, or creating new ones, when some key constituents appear incapable of putting their own houses in order, exemplifies the strategy of "putting the cart before the horse." Indeed, as we are now

25 The rule is aimed at maintaining some separation between retail banking and investment banking. The objective is to prevent speculative investment bets made by banks from spilling over into their traditional banking activities.

26 Another example comes from money market funds, a vehicle used by many banks, especially in the United States and Europe. Any signs of financial stress can prompt large withdrawals; in the United States, attempts to regulate money market funds so that they are required to act more like banks, or place limits on redemptions in times of crisis, have so far failed. See, for example, Gapper (2012). Therefore, systemic-type risks stemming from this source have yet to be tamed.

27 From the WTO Uruguay Round Agreement, Annex 1B: General Agreement on Trade in Services, Annex on Financial Services, available at: www.wto.org/english/docs_e/legal_e/26-gats_02_e.htm#annfin2a.

28 As Volcker (2012) has pointed out, there is considerable irony in the objections raised by Canada, and other countries, about the Volcker Rule. First, Canadian banks rely less on proprietary trading relative to their US counterparts. Second, if others object to some of the elements of the Dodd-Frank legislation, then why is the European Union considering a version of the so-called Tobin tax on foreign exchange transactions and why are UK policy makers devising a system to "ring fence" conventional from investment banking? More generally, what does macroprudential regulation represent, if not a means of potentially avoiding external commitments with the aim of ensuring financial system stability?

witnessing in real time in Europe, creating supranational entities that are capable of disciplining only their weakest members, cannot credibly serve the goal of enhancing financial system stability. That is, unless they are able, in a coherent fashion, to supervise, regulate and otherwise adopt policies across the spectrum of micro- and macroprudential areas. Ultimately, coherency also requires the consent of the sovereign members for these authorities to obtain the legitimacy on democratic accountability grounds. Hence, it is difficult to see how even a partial top-down approach to regulatory reform can succeed.

WHERE ARE WE NOW?

For the issues posed in this paper, it is relevant to ask: if the need for systemically important nations to cooperate is so clear, then — other than the combined size of the G20 (as measured by GDP) — what are the ties that bind them? What economic incentives enhance the likelihood of adopting cooperative solutions to financial problems that have a global dimension (also, see Subacchi and Jenkins, 2011)? Can cooperation extend to the "outsiders" of the G20 process? After all, the FSB already includes important members not in the G20 (Hong Kong, the Netherlands, Singapore, Spain and Switzerland).

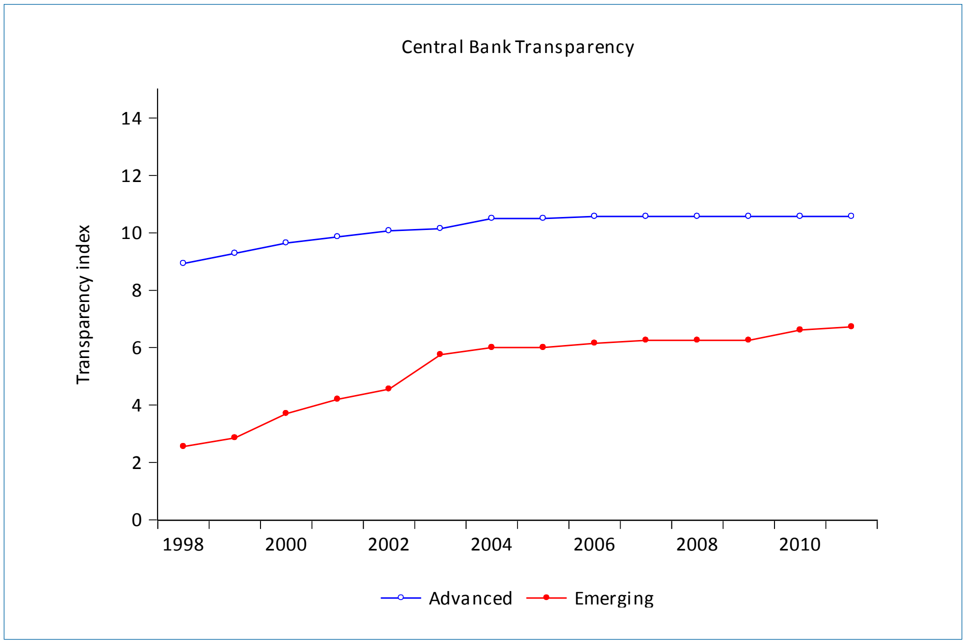
For the sake of simplicity, group the members of the G20 into two separate categories — namely, the advanced market economies (AMEs) and the emerging market economies (EMEs). Table 1 lists the countries that belong in each category. Next, consider a series of institutional and broad economic characteristics that many observers would agree help define the capacity to deliver both sound macroeconomic policies as well as a stable financial system. Figure 4 displays a measure of central bank transparency for the G20 group. Three conclusions are immediately clear. First, central banks in the advanced world remain relatively more transparent than their emerging market counterparts. Second, the gap in transparency has narrowed considerably over the years. If the core of any good policy strategy, whether it is monetary, regulatory or fiscal, rests on transparency, then central banks have certainly shown the way. Nevertheless, there is room for progress. However, it is also legitimate to ask what the record of the last decade and a half has contributed, for example, to achieving the aims of the FSB? Clearly, transparency is not enough.

Table 1: G20 Economies Classification

Advanced
Australia
Canada
France
Germany
Italy
Japan
Korea
Great Britain
United States
Emerging
Argentina
Brazil
China
India
Indonesia
Mexico
Russia
Saudi Arabia
South Africa
Turkey

Source: www.g20.utoronto.ca/members.html and author's classification based on IMF's definition.

Figure 4: Central Bank Transparency in the G20, 1998–2011



Source: www.central-bank-communication.net/. Update by author from data that originally ended in 2009.

Note: The individual transparency estimates are averaged according to the subdivision given in Table 1. The transparency scale is based on values ranging from 0 (no transparency) to 15 (complete transparency). The overall index of transparency consists of the arithmetic aggregation of five sub-indices, each of which attempt to isolate a specific area of monetary policy. The subgroupings consist of economic transparency, which refers to the quantity and type of information released by a central bank (for example, an inflation forecast); procedural transparency signals how much information about the internal workings of the central bank is made public (for example, voting records); policy transparency provides an indication of how central banks announce their decisions (for example, explanations of policy rate setting decisions); political transparency refers to the openness of the central bank – government relationship; and operational transparency indicates the extent to which the monetary authority opens itself to assessments of its conduct (for example, policy assessments and reviews).

Figure 5 plots two of the three elements of the so-called "trilemma" or "impossible trinity" that is the foundation of international macroeconomics. The left-hand side of Figure 5 displays Aizenman, Chinn and Ito's (2010) monetary independence (in relation to a "base" economy, typically the United States) index, which essentially supports some of the earlier findings based on the Ilzetzki, Reinhart and Rogoff (2008) exchange rate classification system (see Figure 2). AMEs in the G20 have retreated over time from their express desire for greater monetary independence through exchange rate flexibility. Turning to the EMEs in the G20, they are seen as being rather opportunistic in their willingness to accept monetary independence. In the aftermath of the 2000-2001 bursting of the tech financial bubble, monetary independence declines precipitously, recovers and then reaches a peak just before the GFC, only to begin showing signs of another rapid decline, at least until 2010, the last available observation. One might have expected EMEs in the G20 to aim for greater monetary independence in the midst of the crisis. Assuming that the index is informative about the true underlying degree of monetary independence, this supports the coupling of economies in "bad" times and ought to provide an incentive for the G20 to design and supervise each others' policies more effectively.

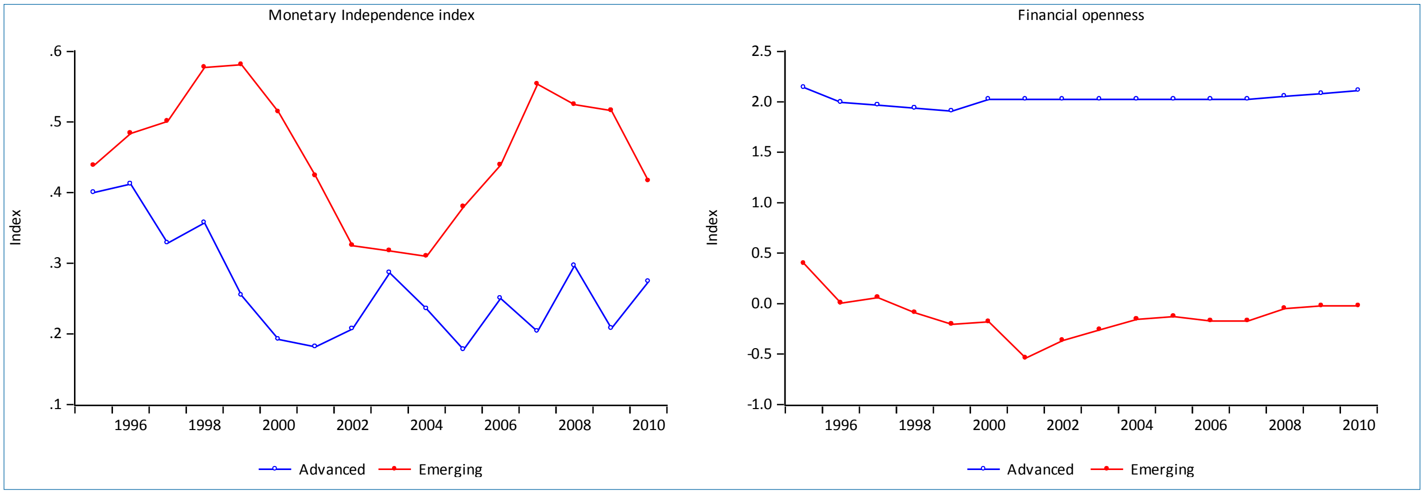
The right-hand-side plot in Figure 5 shows the extent to which the G20 economies are open to cross-border capital account transactions. Remarkably, there is virtually no change in openness among the AMEs, whereas openness remains noticeably lower in the EME camp, especially in relation to the advanced economies but also over time, at least compared to the mid-1990s, in spite of a modest rise beginning in the early 2000s.[29] It is striking that the GFC has not led to a collapse in capital account openness, or rather, that the behaviour of capital account openness was not matched by the dramatic drop in trade in the immediate aftermath of the events of 2007-2008.[30] No wonder credit booms are pro-cyclical, but the problem eludes a satisfactory solution since policy makers cannot agree on how to define the credit cycle.[31]

29 The Asian financial crisis of 1997-1998 clearly produced a steady decline in capital market openness until 2001.

30 See the IMF's *World Economic Outlook*, 2008. Trade has since recovered, although the precise sources remain a matter of debate. See, for example, www.econbrowser.com/archives/2010/10/a_postmortem_on.html for a discussion of various points of view.

31 The Basel Committee has recommended that the warning signs should to be based on the difference between the private credit-to-GDP ratio and a "trend" indicator. See: www.bis.org/bcbs/.

Figure 5: Monetary Independence and Financial Openness in the G20, 1995–2010



Source: Aizenman, Chinn and Ito "Trilemma indexes," available at: http://web.pdx.edu/~ito/trilemma_indexes.htm.

Note: See also Figure 2 above for the construction of series for advanced and emerging market economies. "The extent of monetary independence is measured as the reciprocal of the annual correlation between the monthly interest rates of the home country and the base country. Money market rates are used for the calculation." By construction the index ranges between 0 and 1. Financial openness "is the first standardized principal component of the variables that indicate the presence of multiple exchange rates, restrictions on current account transactions, on capital account transactions, and the requirement of the surrender of export proceeds" (Aizenman, Chinn and Ito, 2010).

The bottom line is that it is not difficult to find inconsistencies in macroeconomic and financial policies. It should then be plain enough that there has to be a meeting of minds, beginning with the G20 and the FSB, if a coherent international financial system beyond the crisis can be properly designed. The foregoing brief exploration also suggests that the two groups considered here are far apart along most of the characteristics considered. This is not to say that all EMEs are far apart from all AMEs. Indeed, it is possible to find some AMEs that are as distant from another AME as the distance that separates a particular AME from a chosen EME. The point is simply that it is far from obvious that the goal of bringing together this group of economies, simply because they are believed to be systemically important, is sufficient to generate cooperative behaviour, especially in the area of international financial regulation.[32]

WHERE DO WE GO FROM HERE?

Unless policy makers in the G20 and the FSB recognize that their regulatory frameworks and policies cannot operate independently from each other, individual attempts to "ring fence" parts of the financial sector from each other or protect the real side of the economy from negative shocks emanating from the financial sector will come to nothing. As long as the international community recognizes the potential spillovers from crisis response policies and is convinced that any trade-offs eventually produce a better global solution, there is no reason why an international financial system should prevent the adoption of local solutions to problems that have global repercussions.

The announcement at the June 2012 G20 summit in Los Cabos that the working group on international financial architecture would enhance both the resources available to the IMF and its governance are clearly positive steps. The agreement dealing with how members would cooperate via enhanced surveillance, while helpful, represents a missed opportunity to advance the cause of better international governance. First, if the methodology of surveillance follows the Article IV approach, it does not inspire confidence. After all, these regular consultations failed to identify elements that would map an individual economy's state into the possibility of a global impact.[33] In other words, it is the failure to address the sources of systemic shocks that needs to be addressed, among other necessary reforms. Exactly how this kind of approach is supposed to, in the words of the working group, "help achieve a better integration of bilateral and multilateral surveillance, with a focus on global domestic and financial

32 See Cooper (2012) for a broad discussion of the concerns over the legitimacy of the G20.

33 In 2011, the IMF introduced the *Consolidated Spillover Report:* "Spillover reports explore the external effects of policies in five systemic economies: China, Euro Area, Japan, United Kingdom and the United States." Available at: www.imf.org/external/np/pp/eng/2011/071111.pdf. The calculations are partly based on a dynamic general equilibrium model called the "Global Integrated Monetary and Fiscal Model" (Kumhof et al., 2010). This is a welcome addition, even if the approach so far is to assume that spillovers are only from systemically important economies.

stability, including spillovers from policies"[34] is not spelled out, nor has thought been given to either sanctions or remedial steps if a nation's policies fail to deliver the desired outcome.

Systemically, and politically, important nations ought to demonstrate some leadership by agreeing on a range of acceptable regulatory frameworks and demonstrate, in a transparent manner and at regular intervals, how each is capable of operating with a minimum of spillovers that might threaten financial system stability. In this sense, the FSB's approach to take stock of what works, and why, is emblematic of the correct strategy to persuade policy makers to reform. Transparency, by its nature, is more likely to be achieved within a simple framework and when there is formal recognition of the following: there are "unknown unknowns" that, from time to time, require an economy to step out of an international policy strategy in place, but with due allowance and accountability for the spillover costs that may be created under the circumstances. This is best achieved by allowing each member country to issue a "directive" to the international community when it is incapable or unwilling to follow the range of standards set by the international community. If what works between certain central banks and their governments (see, for example, Siklos, 2002) can be extended to international regulatory questions, then a mechanism will have been created wherein it is the country that disagrees or wishes to opt out that has to explain why it chooses this route. Under current arrangements, the burden rests largely with international institutions and these can be circumvented or ignored behind the principle of sovereignty.

Just as sovereign nations have devoted decades to finding the right macroeconomic strategy to deliver stable prices, a growing economy and financial stability, since the end of World War II, there has not been much thought given to what a coherent global macroeconomic and financial regulatory strategy might look like. If this rests on the priors of a pure float, unfettered capital movements and free trade, then an international framework is, arguably, of second-order importance. If, however, there are unintended consequences from these choices, establishing a range of acceptable domestic policies and an understanding of how the resulting spillovers operate may help the next time economic shocks, particularly of the financial variety, are transmitted globally.

Policy makers should also reconsider the status of the FSB. In terms of global finance, the group is more representative than its G20 cousin. Finally, international cooperation ought to recognize that a single set of acceptable standards is unlikely and unreasonable. The potential for a mutually assured destructive financial crisis of the Great Depression variety ought to be sufficient to concentrate minds on open and cooperative behaviour in regulating global financial markets.[35] Bretton Woods failed, in part, because it never spelled out how the system would function, and there is the same danger that the international monetary system will again fail because there is little agreement or understanding of how financial system stability is attained and maintained over time. Financial stability and how it interacts with other elements of sound macroeconomic policies, to borrow the words of Winston Churchill, remains "a riddle, wrapped in a mystery, inside an enigma."

If the last several decades have taught us anything, it is that, overall, policy making has improved. Economic systems have not collapsed as they once did, demonstrating some resilience, but financial crises remain far too commonplace. The real danger is complacency, because we then surrender our ability to develop tools to understand how to lessen the sizeable economic losses from singular bad events. If the answer lies with taming the systemic elements in global finance, then the way ahead is clear: focus on improving our understanding of real financial links and policies that mitigate their ability to destabilize the global economy.

34 From *G20 International Financial Architecture Working Group Report*. Available at: www.g20mexico.org/images/stories/canalfinan/deliverables/financial_architecture/IFA_Working_Group_Report_Final.pdf.

35 Corsetti and Pensenti (2005) argue that gains from international cooperation are higher, but only for intermediate degrees of exchange rate pass-through. Indeed, pass-through effects that are either too small or too large are detrimental to the cause of cooperation. Since pass-through effects have declined globally, more so among the AMEs than in EMEs (see, for example, Sekine, 2006 and Ca'Zorzi, Hahn and Sánchez, 2007), this represents a thin reed on which to argue in favour of international policy coordination as the only way to solve the GFC. Nevertheless, it is an approach that merits further study.

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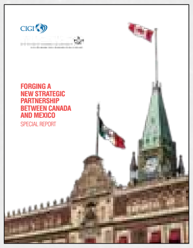
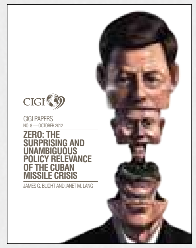


FORGING A NEW STRATEGIC PARTNERSHIP BETWEEN CANADA AND MEXICO

Andrés Rozental and Perrin Beatty

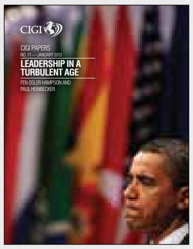
This report offers substantive recommendations that point to the benefit of efforts that will intensify bilateral partnerships, not only in their own right, but also in strengthening both Canada and Mexico's ability to deal more effectively with the United States in pursuing matters of mutual concern..



ZERO: THE SURPRISING AND UNAMBIGUOUS POLICY RELEVANCE OF THE CUBAN MISSILE CRISIS

James G. Blight and janet M. Lang

Drawing on a quarter century of research on the Cuban missile crisis, this paper argues that given what is now known about what actually happened in Cuba by October 1962, the escape from nuclear catastrophe seems even more miraculous and the drive to rid the world of nuclear weapons is even greater.



LEADERSHIP IN A TURBULENT AGE

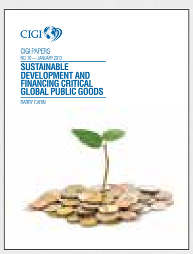
Fen Osler Hampson and Paul Heinbecker

Sound economic policies, which are in short supply in most key nations of the world, are fundamental to national security and international leadership. The United States must work alongside others — and accept that others will sometimes work together without it — to deal with a wide range of persistent and emerging global problems and issues.

FROM BRETTON WOODS TO THE EURO: HOW POLICY-MAKER OVERREACH FOSTERS ECONOMIC CRISES

Pierre Siklos

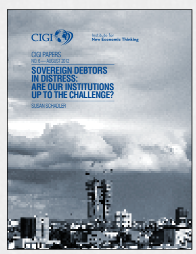
This paper considers the relevance of the Bretton Woods system for the prospects of reform of the international monetary system and in the context of the ongoing euro area financial crisis, exploring the challenges that must be met in attempting to reform the current international monetary system and euro area policies.



SUSTAINABLE DEVELOPMENT AND FINANCING CRITICAL GLOBAL PUBLIC GOODS

Barry Carin

The idea of a "Green Super Fund" can be framed as a positive sum game, with a win-win-win allocation that would garner widespread global support and ultimately be accepted by all the major players.



SOVEREIGN DEBTORS IN DISTRESS: ARE OUR INSTITUTIONS UP TO THE CHALLENGE?

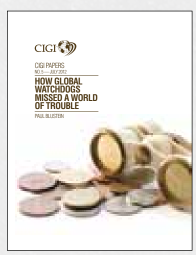
Susan Schadler

A CIGI and INET conference brought together global experts on sovereign debt crises. This paper expands on the ideas put forward during the discussion, highlighting relevant recent history and research, and proposes an action plan.

A POLICY MISMATCH: CANADA AND THE UNITED STATES IN THE ASIA-PACIFIC REGION

James Manicom

The United States and Canada, two of the world's closest allies, have reinvigorated their diplomatic and military postures toward the Asia-Pacific region. On balance, however, Canada may not be an ideal Pacific partner for the United States.



HOW GLOBAL WATCHDOGS MISSED A WORLD OF TROUBLE

Paul Blustein

Based on interviews with scores of policy makers who worked on the Financial Stability Forum (FSF) and thousands of pages of previously undisclosed documents, this paper examines the FSF and brings to light the failure of regulators to keep pace with the globalization of the financial system.

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