Towards a new architecture of the international financial system

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The Bretton Woods agreements left the subject of creation of international liquidity unsolved. It was the deficit in the US balance of payments that provided liquidity to the international payment system. After the 1960s an important part of international liquidity broke away from government control and went its own way. Its increase and freedom led to different crises during the 1980s and 1990s. This situation led to think of the need of creating a new international financial architecture (NIFA), though with little success. The present crisis has raised again the interest for a NAFI on which little progress has been made so far except in some technical aspects, yet without political support right now. The clash between an Anglo-Saxon and a European vision, quite opposed as to strict regulation, suggests that progress of the new NAFI will be slow and perhaps modest.

All that is occurring in the international economy cannot be understood without looking back to the end of World War II and the creation of an international monetary system, called Bretton Woods after the place where the agreements were signed. In these treaties, which set the base for reconstruction and prosperity in the post-war economy, there was no reference to how to provide for international liquidity, that is, means of payment accepted by all countries.

It was the deficit in the US balance of payments what eventually provided liquidity to the international payment system. Until the early 1960s, despite the weakening dollar due to its assumed global burden of being the single reserve currency, the international monetary system worked reasonably well. The problem came up when in the early 1960s the dollar drifted away from monetary authorities and started going its own way by creating the eurodollar market, which was made of US liabilities – dollars – managed by banks located in Europe using them in their regular banking brokerage tasks, so by applying the multiplier of such activity, international liquidity in dollars managed from Europe increased consistently and increasingly fast.

After World War II, the US balance of payments provided liquidity to the international payment system. The problem came up when the dollar drifted away from monetary authorities.

This liquidity beyond governmental control soon shook off its basic function, namely to serve the real economy in its international aspect, i.e. serving the current account and capital balance. And this occurred after all because the amount of such uncontrolled international liquidity, together with the one still in governmental hands, became higher than what the international economy required to work properly. In that moment a new era started in international economic relations.

The 1980-1998 crises and the new international financial architecture

Without exaggerating, it can be said that the story of international financial economy since the first oil crisis (1973) is that of ups and downs in international liquidity become an economic branch with own management and goals, looking for profitability of its own. Hence those managing this international liquidity (banks, retirement funds, investors, etc.), often termed speculators with good or bad reason, are out for benefits through normal opportunities and also by taking advantage of imbalance in national economies.

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These manipulations initiated a period of financial crises stretching over the last two decades of the last century. The first and most relevant one was the debt crisis of developing countries, especially Latin American ones, bred in the 1970s and broke out in 1982. It was followed by the crisis of the European Monetary System in 1992-93, that in Mexico in 1994, Southeast Asia in 1997-98 and the Russian rouble one in 1998. In all cases, the international financial system mobilised resources that had made these crises possible.

Due to all these events, the need to find a so-called new international financial architecture (NIFA) was started to be dealt with in order to make free capital movements compatible with national stability and progress policies as the former were becoming generalised from the 1980s. Also, the question was which role should international bodies play in this new architecture, especially the International Monetary Fund (IMF). Of course, the ultimate and basic goal

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was to avoid financial crisis that was striking the world economy so often.

There was a need to find a so-called new international financial architecture in order to make free capital movements compatible with national stability and progress policies as the former were becoming generalised from the 1980s.

This issue created a big interest in the 1990s and virtually all big political and academic institutions had their say in it. In this respect, we would like to point out the 1999 Meltzer report ordered and submitted by US Congress and the report of a taskforce sponsored by the Council on Foreign Relations, also from 1999. Based on these recommendations and the created atmosphere, some progress was made. The need for more transparency was accepted, and in this respect, the IMF started a quick programme to collect and disseminate data published in the internet on a monthly basis (Special Data Dissemination System). There was also progress towards so-called «codes of good tax and monetary conduct» the IMF also took charge of.

Although all these proposals and other similar ones were on the right track, the underlying idea was – wrongly, as it has turned out – to foster maximum freedom of capital movement and financial deregulation. It was considered that most problems were coming from vulnerability of national banking systems and it was the latter that had to adapt to the new international framework to get the maximum out of globalisation of international financial markets. Economic *Reaganism* was thus fully validated.

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The present crisis

If this efforts made in the 1990s to create a NIFA had materialised, could the present crisis have been avoided? It is difficult to say. What we do know is that the root of the problems was never addressed. Instead, the certainty that freedom and transparency were the best food for international financial markets became a commonly assumed idea. The markets, they said, regulate themselves and much care had to be taken not to interfere with this process.

The 2000-01 technological stock crisis helped in completing the foundations of this philosophy. This was done by Alan Greenspan, the then president of the US Federal Reserve. His attitude towards finding the way out of that crisis was to trigger an aggressive policy of cheap and abundant money. This permissive monetary policy was joined by an expansive tax policy under the Bush administration (2001-09). All in all, the foundations were laid to create the credit bubble that is at the base of the present crisis. The expansive American policy became general all over and capital flows from surplus countries (China, Japan, oil exporting countries, etc.) were feeding fellow bubbles: real estate in different countries (US, UK, Spain, etc.), commodities (oil, food, etc.) and stock exchange, these being the most prominent ones.

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The halt of he housing price increase in the United States was the trigger that burst the different bubbles, unleashed by the infamous subprime mortgages, with effects that have reached the four corners of the world. The financial instruments used to create the great expansion after 2003 have turned out to be worthless, causing the economy to collapse, with the severe consequences this has had on our lives. That construct had been huge. McKinsey & Company estimated that in 2005, overall international financial assets had increased to 316% of global GDP, when in 1995 they were at 109%. The genius that had come out of the bottle in the 1960s, that is, that international liquidity that, as we have seen, escaped from control by monetary authorities had become a big monster, just like in the famous fairytale of the thief from Baghdad. The problem is how to control it now it has clearly shown how dangerous and destructive it is.

A new NIFA: so far, words and ideas

As far as we can see, the discussions and proposals on the NIFA in the 1990s were quite useless. In fact, they were counterproductive to a certain extent as they did not expect the effects of full freedom of movement of capital and deregulation without any hurdles that for instance exempted hedge funds from supervision; they were already causing some troubles, such as the Long Term Capital Management fund that had to be rescued in 1998.

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The present crisis and the strong involvement of the finance sector in it has again triggered efforts to find a second version to the NIFA. All alarms are on, and the task to rethink the international financial system is on the roll again; this effort had been left half way as things were improving again, or at least they seemed to.

As opposed to the NIFA in the 1990s, politicians have taken the lead now. Then it were the experts who were at the forefront of the NIFA and the countless reports published, of which we have mentioned the two most important ones. Now the situation is more theatrical, with governments in the headlines day after day. Within this somehow exhibitionistic trend, a G-20 conference was held in Washington in November 2008. Its outcome was quite a long notice containing demands of specific studies to forward suggestions to bring more order into the world economy, more precisely to the international financial system.

Some meetings at the highest level of eurozone and overall EU countries have created some initiatives. There are also some interesting reports like those by Otmar Issing and Jacques de Larosière. However, the whole process of the second NIFA has not gone beyond words and ideas yet.

I think it is interesting to describe the most important items upon which a given technical consensus seems to be built, though it is difficult to know if it is also shared at political level given the great amount of unclear statements by governments.

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The first point in this possible agreement is the need of systematic supervision of the financial system. So far, supervision was done within each institution and did not seize the implications of the dense network of financial relations between institutions from different countries. It seems obvious that only a global vision of the system can provide information on its systematic risks.

The second possible point of consensus is very much related with the first one. It is the now apparent need of regulation with a global reach. In this respect, the existence of a supranational regulating body would be a top goal difficult to meet. The alternative idea is therefore stronger coordination between national regulating and supervising bodies. It would be desirable that such collaboration had an institutional framework, either the IMF, the Bank for International Settlements in Basel, the Financial Stability Forum or any cooperative arrangement between the three. At eurozone level, this coordination task could be taken over by the European Central Bank (ECB). What the present crisis has made clear is that the current fragmented regulatory and supervisory system cannot live up effectively to a global financial system.

New systemic supervision of the financial system and the establishment of global regulation needs to be reached.

The third point on which there seems to be consensus, at least at technical level, is the need of extending regulation and supervision to all financial activities, sectors and organisations. In the present crisis, many problems have arisen from a lack of supervision of very large market segments such as hedge funds, derivatives, investment banking and other financial stakeholders having played a relevant role in creating the crisis. This means of course to extend financial regulation and supervision far beyond its present borders.

The fourth point that seems to gain advocates is the need to count with mandatory higher capitalisation levels in all segments of the system, especially banking. The current crisis has proven the fragility of the banking system and the importance of having a good capital base instilling more confidence. This should be combined with more demanding requirements of risk management and a policy of provisions that are increased in times of expansion, as has been done in Spain.

A fifth point of agreement, this time also at political level, is to establish a less abusive remuneration system in the finance sector, much more related to benefits and the medium and long term. The current crisis has made it clear that the incentive system in the finance branch has been extremely perverse as it has been stimulating quick and easy profit.

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A sixth important point is wide support for enlarging the IMF related to both its resources and its future mission in a wider and stricter regulatory framework. This is not an easy matter as any change in the Fund means an alteration of the political balance. The apathy the IMF used to work with has been shaken by the needs of many countries that have had to ask help from it. It is therefore thought that it will be necessary to at least double its resources, a goal reinforced by European leaders in the February meetings.

Conclusion

The present economic crisis has led to consider, for the second time in the last twenty years, the need of looking for a new international financial architecture able to set the foundations of a system that avoids crises like the present one and allowing harmonious growth of the world economy. Little progress has been made, though the crisis has been around for a year and a half. And progress will be slow and difficult because changing such a complex system as international finance is not easy at all and, as occurred already in the 1990s, there are two hardly compatible philosophies facing each other: the Anglo-Saxon, refusing too wide and strict regulation, and the European, looking for more control over the system. It is possible that these two attitudes eventually meet in the middle in the best of cases, thus not changing things a lot, as it already occurred the first time the issue was addressed twenty years ago.

Change in international finance confronts two hardly compatible philosophies: the Anglo-Saxon, refusing too wide and strict regulation, and the European, looking for more control over the system.

The noveltles of the summit

The second G-20 meeting held in London ended with a notice dated on April 2. Its most relevant novelties are the following:

At the G-20 meeting in London a new Financial Stability Council has been established and reinforcement of international financial institutions agreed.

Regarding supervision and regulation, a new Financial Stability Council is established, which is a continuation of the Financial Stability Forum but with enlarged membership (the G-20 countries, all the former Forum members, Spain and the European Union) and a new mandate. It is specifically asked to restructure regulating systems to better identify and struggle against macroprudential risk; extend regulation and supervision to all major institutions, including hedge funds; implement the principles on compensation in the banking sector proposed by the Forum; take action to enlarge the capital base in the banking sector; take action against tax havens and other non-cooperating jurisdictions; improve asset assessment and procurement standards; and extend regulation and supervision to credit rating agencies.

The other major contribution is reinforcement of international financial institutions. IMF resources are trebled to 750 billion dollars, and it is agreed that this institution will issue 250 billion worth special drawing rights. Regarding multilateral banks of development, there is agreement on enlarging their capital by 100 billion dollars. This commitment and further included in the notice amounts to a resource injection of 1.1 trillion dollars, although a relevant part had already been committed previously, according to analysts.

As to the rest, there are no relevant news. As can be stated, many supervision and regulation issues on which there was consensus appear in the notice. However, the intensity of such regulation and the procedures to implement it are blurred. As to the 1.1 trillion dollars in new funds, it is considered that they compensate the lack of agreement to go on increasing the tax packages due to Europe's opposition.

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