

THE FINANCIAL CRISIS AND THE STRENGTHENING OF GLOBAL POLICY COOPERATION

ARTICLES

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The recent global financial crisis has thrown a spotlight on global macroeconomic and financial surveillance. The years preceding the crisis were characterised by unprecedented strong global growth, combined with low inflation rates, low interest rates and low risk premia. However, at the same time, the world economy experienced a formidable build-up of systemic risks, fuelled by the expansion of economic and financial imbalances in countries around the globe as well as excessive leverage by market participants. The multifaceted nature of the crisis has spawned a number of explanations as to its cause and a variety of policy prescriptions for restoring international stability. This article examines the international monetary system in the run-up to the global financial crisis and the extent to which global macroeconomic and financial surveillance is being reformed as a result of the lessons learned. It focuses on the efforts being made to improve the surveillance of the system, to refine crisis prevention and resolution mechanisms, to increase the system's strength and resilience more broadly and to enhance global policy cooperation.

I INTRODUCTION

The international monetary system can be defined as a global framework for cross-border monetary transactions, i.e. the set of rules and broader conditions that underpin balance of payments transactions, such as the issuance and use of international currencies, capital flow and exchange rate regimes, and rapidly rising interconnectedness among countries, including those at different levels of economic and financial development. Ideally, an international monetary system should provide a stable environment to accommodate the global flow of payments, facilitate international financial intermediation, provide liquidity to countries so that they can meet their international obligations, and ultimately support, via flows of funds and investment, sustainable growth and development at both national and global levels. That is, the international public good of external stability should be delivered by a properly functioning and sustainable international monetary system.

The international monetary system is “international” in that it makes global transactions (including local transactions in foreign currency) possible and “monetary” in that it concerns the use of currencies as a means of payment, a unit of account and a store of value. As such, it is different from the international financial system, even though these two systems are strongly interdependent, i.e. the stability of one system cannot be ensured without the stability of the

other. With regard to the term “system”, today’s international monetary system is the outcome of the interaction between the policy decisions of individual countries and market forces and, as such, is not a “system” in the sense of a planned and organised framework. It is thus very elastic and adaptable in nature compared with, for instance, the Bretton Woods system, which prevailed between the end of the Second World War and 1971. This is its strength, but it may also become its weakness if the policies of the system’s main actors pay insufficient attention to longer-term macroeconomic and financial stability concerns and negative externalities affecting other countries.

Against this backdrop, this article examines the international monetary system in the run-up to the global financial crisis that started in summer 2007 (Section 2) and the extent to which it is being reformed – through institutions and fora such as the IMF and the G20 – as a result of the lessons learned from the crisis (Section 3). The multifaceted nature of the crisis has spawned a variety of explanations as to its cause and, consequently, a variety of policy prescriptions for restoring international stability. This article focuses on efforts to improve the surveillance of the system (Section 3.1), the refinement of crisis prevention and resolution mechanisms (Section 3.2), ways to increase the system’s strength and resilience (Section 3.3), and attempts to enhance global cooperation and improve the take-up of IMF policy advice (Section 3.4).

2 THE INTERNATIONAL MONETARY SYSTEM AT THE TIME OF THE CRISIS

FEATURES OF THE INTERNATIONAL MONETARY SYSTEM

In the run-up to the global financial crisis, the international monetary system had a number of defining characteristics that remain prevalent. First, in contrast to previous international monetary systems, the current system comprises a mixture of flexible and fixed exchange rate regimes, with larger, more advanced economies pursuing freely floating exchange rates, and less advanced or smaller economies inclining towards a greater degree of fixity. The stronger form of fixing (pegging) has a clear regional focus, with, most notably, several East Asian economies and major commodity exporters (especially oil exporters in the Middle East) pegging their currencies more or less tightly to the US dollar, and (smaller) economies in or near Europe pegging theirs – again more or less tightly – to the euro.

Second, following widespread capital account liberalisation in the early 1990s, most economies, both advanced and emerging, began to reduce restrictions on inflows and outflows of capital, with the notable exception of China, the dominant emerging market.

Third, notwithstanding the regime change in the international monetary system in 1971, the US dollar retains a very important role in the system for payments, invoicing, pegging and reserve denomination, although since its creation in 1999 the euro has played an important role for economies in the neighbourhood of the euro area.¹ The size of the US economy, its deep and liquid financial markets and its past track record of price stability are important determinants of the US dollar's attractiveness.

Fourth, over the past decade the international monetary system has experienced accelerating growth in the accumulation of official foreign exchange reserves by a relatively small number of countries, the currencies of which are mostly pegged to the US dollar.

Fifth, the international monetary system is interlinked with an international financial system characterised by deregulated financial markets in which prices for and quantities of financial assets are determined by the forces of supply and demand. Viewed globally, financial market development is grossly uneven, as the more established financial markets enjoy a “virtuous circle” of attracting foreign investment for intermediation, which helps to deepen financial market liquidity and spur financial innovation, further increasing demand for their services and thus hampering financial market development elsewhere.²

Sixth, while some of the rules, procedures and policies that support the efficient functioning of the international monetary system have been agreed internationally by policy-makers (such as global, regional and bilateral surveillance, and crisis prevention and resolution mechanisms), other features have developed over time as the outcome of policy decisions by individual countries and market forces (such as the global constellation of exchange rate regimes, the choice of key international currencies, and the discretionary unilateral or coordinated provision of liquidity). In theory, the rules should be designed to support the system's stability, in particular by discouraging actions and activities that are inconsistent with ensuring the international public good of external stability. Countries' obligations towards the IMF and its members are a notable example of such rules. However, as evidenced by the recent crisis, these rules were not adequately enforced. This shortcoming can be traced in part to the widespread, but in hindsight misplaced, faith in the disciplining effect of markets on countries' policy actions, as well as the lack of political willingness and peer pressure to enforce internationally agreed rules.

1 See *Review of the international role of the euro*, ECB, July 2010.

2 See Dorrucci, E., Meyer-Cirkel, A. and Santabárbara, D., “Domestic financial development in emerging economies: evidence and implications”, *Occasional Paper Series*, No 102, ECB, April 2009.

VULNERABILITIES IN THE SYSTEM

The most striking aspect of the international monetary system before the crisis was the increasingly large build-up of current account surpluses in a relatively small number of countries and of deficits in an even smaller number, predominantly the United States. The incentives of surplus and deficit countries, though different, were aligned and mutually compatible, giving rise to widening imbalances. Both relied on growth strategies which focused heavily on a single source of demand.

Several surplus countries relied on export-led growth with the assistance of a peg to the US dollar. The by-product of this was a massive accumulation of reserves as appreciation pressure on their currencies was held in check by the peg. This trend coincided with the desire among Asian countries in the wake of the Asian crisis of the late 1990s to build up precautionary reserves. The degree to which the accumulation of reserves, and the growth path of that accumulation, are determined by precautionary motives, as opposed to being a by-product of the maintenance of an undervalued pegged exchange rate, is the subject of much debate and may have changed over time.

On the flip side, deficit countries relied primarily on consumption for growth, as income growth languished – especially in the United States – and house prices boomed, which led to a massive build-up of household debt. This debt accumulation was accommodated by financial markets that were shifting from an originate-and-hold to an originate-and-distribute model of financing. Financial products became increasingly complex and opaque, contributing to an underpricing of risk. This coincided with a trend by national authorities towards lighter regulation, in the expectation that market discipline would suffice. What followed was a sustained compression of risk premia in the search for yield, leading to asset price bubbles and an ever greater build-up of debt.

Thus, unbalanced domestic growth in both deficit and surplus countries and unbalanced

international payments among key economies were intrinsically linked, and this exposed a major weakness in the system, namely, the inadequacy of corrective mechanisms. International financial institutions, charged with overseeing individual countries and system stability, were aware of growing imbalances, but lacked the authority to enforce policy recommendations. The IMF's multilateral consultation in 2006/2007 identified necessary policies, but was let down by weak implementation by the main economies concerned. Moreover, although the multilateral consultation offered a new approach to coordinating responses to global problems (by involving a small number of key parties in a common dialogue) the countries concerned did not assume the necessary ownership of the process, and the international community did not warm to this approach. In addition, the IMF's 2007 Decision on Bilateral Surveillance over Members' Policies was not able to exert sufficient pressure on the key countries behind the imbalances and, ultimately, its implementation had to be softened to allow the surveillance process to continue. Furthermore, not all countries took advantage of the IMF/World Bank Financial Sector Assessment Program (FSAP), and those that did often paid little heed to the policy recommendations made. Finally, market-based corrective mechanisms could not operate where the exchange rates of key surplus countries were prevented from adjusting sufficiently, and income constraints on debt accumulation in deficit countries were circumvented by innovative debt instruments coupled with weak internal credit controls and insufficiently rigorous regulation and monitoring. In sum, neither financial markets (which were active in intermediating increasing volumes of liquidity), nor national authorities (which were focused on satisfying domestically-oriented mandates) contributed sufficiently to promoting global stability.

As a result, the tensions eventually erupted, not in the international monetary system, but in the domestic financial system of the United States, putting an end to the asset price

rise/debt accumulation spiral and causing some financial markets to seize up. These then spread throughout the global system, ultimately spilling over into the real economy and sending shockwaves throughout the international monetary system.³

The global financial crisis that started to unfold in August 2007 revealed starkly the inadequate appreciation at all levels (in international financial institutions, national authorities and the private sector) of the degree and nature of the integration of economic and financial activities both within economies and across the globe. It became clear that financial sector surveillance sorely lagged developments, that the understanding of macro-financial linkages (the links between financial market activity and macroeconomic developments) was weak, and that macro-prudential linkages (the links between prudential regulations for financial institutions and their impact on macroeconomic developments) were largely unexplored. Addressing these shortcomings – the weakness of corrective mechanisms and inadequate understanding of global interlinkages – should constitute a key element of any reform.

3 THE REFORM OF THE INTERNATIONAL MONETARY SYSTEM

The advent of the crisis revealed that the extraordinary global growth of the world economy over the previous years had not represented a new trend growth rate, but was rather the unsustainable outcome of a combination of misdirected, though aligned, private and public sector incentives, accommodated by an innovative, dynamic financial sector and a very loosely anchored international monetary system. The multi-dimensional nature of the crisis has prompted a multitude of policy prescriptions for restoring the international financial system to health, improving the international monetary system and rebalancing national and global economic growth. The following sections focus on the efforts being made in four key areas: improving the surveillance of the system, refining

crisis prevention and resolution mechanisms; increasing the system's strength and resilience; and enhancing global cooperation and improving the take-up of IMF policy advice.

3.1 THE NEED FOR BETTER SURVEILLANCE

Assessing surveillance is an asymmetric exercise: the quality of surveillance only becomes evident when it fails. The crisis has revealed that surveillance did not succeed in keeping up with the increasing complexity of globalisation. To varying degrees, shortcomings were evident in all areas of surveillance – multilateral, financial sector and bilateral.

MULTILATERAL SURVEILLANCE

The high and increasing degree of interconnectedness of the global economy necessitates a greater emphasis on multilateral surveillance. Since the crisis, several multilateral surveillance exercises have been strengthened, new exercises have been or are being created, and yet more measures are under discussion. The IMF, along with other organisations and fora, in particular the G20 and the Financial Stability Board (FSB), are working on improving the surveillance of the global economy in order to increase its resilience and help promote sustainable growth.

One of the potentially most significant innovations in multilateral surveillance is the G20's Framework for Strong, Sustainable and Balanced Growth, launched at the Pittsburgh Summit in September 2009. Its aim is to ascertain the mutual compatibility of national policies with a view to achieving shared objectives. In essence, the twenty most systemically important economies review each others' policy actions and frameworks using common assumptions and with technical assistance from the IMF in order to identify the global effect of their combined plans (the "base case scenario").

3 For further details on the debate concerning the role of the international monetary system in the global financial crisis, see Dorrucchi, E. and McKay, J., "The international monetary system after the financial crisis", *Occasional Paper Series*, ECB, forthcoming.

Building on this scenario, the G20 explores the scope to improve the global outcome by defining the necessary policy measures and undertakes to make policy adjustments where feasible. This mutual assessment process marks a new approach to global surveillance in that a shared objective is agreed at the leaders' level, and the G20 members then engage in a dynamic process of data and scenario analysis, as well as policy assessment, in order to achieve that objective. The first cycle took place in 2010 and the onus is now on G20 members to act on the mutually agreed recommendations. The process is still insufficiently advanced to judge its contribution to more effective surveillance, but, with its broad scope, the engagement of leaders from the twenty most systemically important economies, and the concomitant high visibility, it represents a concerted effort to improve global economic performance.

Turning to the IMF, it has a unique responsibility to promote the global public good of global monetary stability⁴ and, to this end, it conducts multilateral surveillance. The findings are reported most prominently in its flagship publication, the World Economic Outlook, but also in the Global Financial Stability Report and Regional Economic Outlooks. The crisis brought into sharper focus some shortcomings in IMF surveillance, and since then, various proposals for improvement have been put forward.

One of the first steps taken was to improve the consistency of the World Economic Outlook and the Global Financial Stability Report and to highlight in much greater detail the macro-financial linkages and spillovers. In a new initiative, the IMF will prepare pilot "spillover reports", i.e. reports on outward spillovers from systemically large economies or groups of economies, the policies of which may have an impact on the stability of the international monetary system. Such reports are intended to fill a gap in the IMF's surveillance by focusing on the implications for other economies of one economy's policies, and by consulting with members both where the spillovers originate

and where they have an impact. The trial spillover reports will be conducted for five economies (China, the euro area, Japan, the United Kingdom and the United States) and are to be completed by summer 2011.

Discussions have also taken place regarding the conclusion of a multilateral surveillance decision (akin to the Decision on Bilateral Surveillance over Members' Policies agreed in 2007) to provide guidance on the role of staff and the expectations of members regarding the scope and modalities of multilateral surveillance. Finally, consideration is being given to enhancing regional surveillance. Given that some regional organisations also conduct their own surveillance, possible synergies and complementarities are being explored between the surveillance by the IMF and that conducted by regional bodies.

FINANCIAL SECTOR SURVEILLANCE

When examining ways to improve financial sector surveillance, it was evident that part of the problem was the mismatch between the national locus of supervisory responsibility and the international arena of financial markets and economic interaction. A central institution or forum was needed to address these issues, and the G20 identified the Financial Stability Forum (FSF) as being best placed in this regard. As a result, the FSF was subsequently transformed into the Financial Stability Board (FSB). This involved providing it with its own charter, broadening its mandate to better promote financial stability, expanding its membership and giving it a range of new tasks with specific and ambitious deadlines for completion. The FSB has thus become the overarching body in charge of coordinating financial stability issues at the global level and reports to the G20.

A key feature of the FSB's work is collaboration with other institutions. It collaborates with the

⁴ The IMF has a mandate to "oversee the international monetary system in order to ensure its effective operation" (see Article IV of the Articles of Agreement).

IMF in the field of macro-prudential surveillance⁵ in an “early warning exercise” that flags vulnerabilities, especially with regard to cross-sector and cross-border interlinkages. The results are presented semi-annually to the International Monetary and Financial Committee (IMFC). Together, the IMF, FSB and the BIS have offered guidance to national authorities on how to ascertain whether financial institutions, instruments and markets are systemically important.⁶ This work has spawned efforts to improve the collection of relevant data. The FSB is also working with regulatory bodies to develop recommendations to mitigate pro-cyclicality, and with the BIS and accounting standards bodies to develop macro-prudential tools. It will take time for new coordination and collaboration procedures to become established, but the process is underway, and represents the “globalisation” of surveillance and supervision that is needed in order to keep up with global financial and economic activity.

Given its mandate to promote the stability of the international monetary system, the IMF has over the years moved gradually towards covering financial markets, and the crisis has strengthened the case for it to play a greater role in financial surveillance. The IMF/World Bank FSAP has been overhauled to sharpen the focus on vulnerabilities, allow more regular monitoring through a modular approach to surveillance and off-site monitoring, and ensure a more thorough follow-up of recommendations. The financial stability assessment under the FSAP has been made mandatory for 25 IMF members with systemically important financial sectors and is to feature regularly in their bilateral surveillance. Work is already under way to better integrate FSAP results into Article IV reports.

The IMF also intends to construct a global financial risk map, with a geographic element, to track the build-up of systemic risks and to better identify how financial and policy shocks propagate across markets and economies. Gaps

in financial data will need to be addressed to make this undertaking successful.

BILATERAL SURVEILLANCE

At the international level, bilateral surveillance is the preserve of the IMF. Under Article IV of the IMF’s Articles of Agreement, the IMF has a duty to conduct regular surveillance to ensure that its members comply with their obligations. Over the past two decades the IMF has taken several steps to strengthen its bilateral surveillance in response to critical reviews of its surveillance activities (such as that by the Independent Evaluation Office), for example with the 2007 Decision on Bilateral Surveillance over Members’ Policies. In examining how to improve bilateral surveillance further in response to the crisis, the focus has been primarily on three areas: (i) finding ways to improve the take-up rate of IMF policy recommendations or “traction”; (ii) learning more from bilateral surveillance through the preparation of reports on cross-cutting themes for countries facing similar circumstances; and (iii) moving towards greater monitoring of capital flows.

With regard to the first area, the lack of traction is closely linked to the reasons why the imbalances which built-up in the international monetary system were not corrected. The IMF’s lack of authority to impose policies on its members is not a new issue,⁷ and the IMF has long sought to improve the implementation rate

5 The respective duties and division of responsibilities between the IMF and the FSB were set out in a joint letter by the Managing Director of the IMF and the Chairman of the FSB in November 2008. The IMF focuses on macroeconomic issues and the FSB provides input on prudential issues in line with each institution’s comparative advantage.

6 See “Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations”, FSB/IMF/BIS, October 2009.

7 As far back as 1999, a group of independent experts noted in their External Evaluation of IMF Surveillance, that “surveillance is hardly ever going to be a primary influence on a country’s policy actions.” More recently, the 2010 report by the Independent Evaluation Office on “IMF Interactions with Member Countries” found that traction was lowest in advanced economies and large emerging markets.

of its policy recommendations, mainly by improving its analysis and its method of engaging with members.⁸ The ideas currently being explored include increased engagement with regional organisations or country groups – as the IMF is already doing by providing technical support to the G20 – and closer involvement of ministers in the surveillance procedure,⁹ so as to ensure top-level commitment. More broadly, the quota and governance reform of the IMF is intended to improve the representativeness and legitimacy of the institution, which should also lead to greater relevance and effectiveness.

To better exploit bilateral surveillance and so gain more insight into cross-cutting themes, the IMF produces a number of reports. The most significant is the Fiscal Monitor, first released in July 2009 and now published on a semi-annual basis, which provides a comprehensive analysis of fiscal developments from a global perspective.

With regard to capital flows, a debate is ongoing as to whether the IMF's mandate should be extended to improve surveillance in this area. While there is general support for strengthening the IMF's monitoring of capital flows and its advisory role, there is reluctance to move towards measures that would control flows in view of the fact that the great strides in capital account liberalisation contributed to an unleashing of growth potential. The question remains as to how to maximise the benefits while minimising the risks associated with capital account openness.

3.2 IMPROVING CRISIS PREVENTION AND RESOLUTION MECHANISMS

Since the crisis, much attention has been focused on finding better ways to help countries which, as a result of the crisis, are experiencing payment difficulties, either directly or via contagion effects. Progress has been made at both the international and regional levels.

IMF FACILITIES

In the midst of the crisis, doubts were raised about whether the IMF would have enough resources and the right instruments to support countries facing financial distress. As a consequence, the IMF has increased its lending capacity and overhauled its lending toolkit. With regard to the former, IMF members followed up on the commitment made by G20 leaders at their meeting in London on 2 April 2009 to treble the resources available to the Fund to USD 750 billion. This came initially through bilateral financing and, to that end, several emerging and advanced economies entered into bilateral loan and note purchase agreements with the Fund. These loans will be subsequently incorporated into an expanded New Arrangement to Borrow.¹⁰ In April 2010 the expansion and reform of the New Arrangement to Borrow was approved and is now awaiting ratification by the participating countries.¹¹ In November 2010 the IMF also agreed on a further quota increase which, once implemented, will double the quota resources of the Fund. This will be accompanied by a commensurate reduction in the resources available under the New Arrangement to Borrow in order to preserve the quota-based character of the IMF.

8 These efforts included outreach activities, for example to think tanks, parliamentarians and labour unions, in order to reach stakeholders beyond the policy-makers; adjusting the IMF's human resources policies in order to achieve a more tailored mix of experience; and increasing the leverage from public and peer pressure through greater transparency.

9 There is a proposal to create an International Monetary and Financial Board for this purpose.

10 In addition, G20 leaders agreed to support a new special drawing right (SDR) allocation of USD 250 billion to provide additional reserve assets to the IMF membership. On 28 August 2009 a general SDR allocation equivalent to USD 250 billion entered into force, and was followed on 9 September 2009 by the special SDR allocation of around USD 32 billion, pending since 1997, after the United States agreed to the Fourth Amendment of the Articles of Agreement. Moreover, the London Summit declaration supported "at least USD 100 billion of additional lending by the multilateral development banks, to ensure USD 250 billion of support for trade finance, and to use the additional resources from agreed IMF gold sales for concessional finance for the poorest countries".

11 The total pledges under the new/expanded New Arrangement to Borrow amount to SDR 367.5 billion.

As regards the lending toolkit, in March 2009 the Fund introduced the Flexible Credit Line, raised lending limits and placed stronger emphasis on ex ante conditionality. The Flexible Credit Line is a precautionary lending facility that requires only ex ante conditionality and is intended for top-performing countries with strong policy track records. This instrument was refined in August 2010, with the removal of the access limit and extension of the duration.¹²

Also in August 2010 as part of the lending reform, the new Precautionary Credit Line was created. This is intended for IMF members with sound policies, which nonetheless do not meet the high qualification requirements for the Flexible Credit Line, and is therefore available to more countries.¹³ These changes suggest an increased role for the IMF, with a shift from lending largely on the basis of *actual* balance of payments needs to lending for *potential* balance of payments problems (“precautionary” lending).

Current discussions on how to further enhance the IMF’s lending role are mainly focused on the potential reinforcement of the “global financial safety net” and on how to enhance collaboration between the Fund and regional pools. Views differ on whether the IMF should introduce a mechanism that could be activated in response to systemic shocks and, if so, what its design should be. Views also differ as to whether such a mechanism could reduce the stigma attached to IMF lending and thus avoid the further build-up of precautionary reserves in emerging markets without creating moral hazard. Discussions on how to step up IMF collaboration with regional pools are also ongoing, with proposals for involvement by the IMF ranging from the supply of technical assistance, to the provision of a financial “backstop” to regional resources.

REGIONAL FACILITIES AND SURVEILLANCE

At the regional level, relevant organisations are also developing their crisis prevention and resolution policies. Most prominent among these are the newly created financing facilities

and surveillance arrangements in Europe and the further elaboration of the Chiang Mai Initiative in Asia.

In Europe, prior to the crisis non-euro area EU Member States suffering balance of payments difficulties could obtain assistance from the EU under the medium-term financial assistance facility. In the light of crisis-related developments, the financing capacity of the medium-term financial assistance facility was increased to €50 billion. In May 2010 two new facilities were established which augment lending amounts and extend coverage to euro area countries: the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF),¹⁴ both of which envisage the involvement of the IMF in any programme. To help prevent a crisis occurring in the first place, the EU is overhauling its economic governance and surveillance under the auspices of the Van Rompuy Task Force, in particular the framework to enhance fiscal discipline and the oversight of competitiveness developments.

12 As a result of the changes, Flexible Credit Line arrangements can now be approved for either one year or two years with an interim review of qualification after one year. Previously, arrangements were for either six months or one year with an interim review after six months. The previous implicit cap on access of 1,000% of a member’s IMF quota has been removed, and access decisions will now be based on the financing needs of individual countries. The procedures leading up to the approval of the arrangement have also been modified, with earlier involvement of the IMF’s Executive Board to assess the contemplated level of access and its impact on the IMF’s liquidity position. The nine qualification criteria used both by staff and the IMF’s Executive Board to assess the merits of a country’s application remain unchanged, but a number of relevant indicators have been added to each category in order to provide further guidance on compliance.

13 Qualification will be assessed in five broad areas: (i) external position and market access; (ii) fiscal policy; (iii) monetary policy; (iv) financial sector soundness and supervision; and (v) data adequacy. While requiring strong performance in most of these areas, the Precautionary Credit Line allows access to precautionary resources for members that have moderate vulnerabilities in one or two areas. Other features include streamlined ex post conditions (which may or may not include performance criteria) monitored through semi-annual program reviews, and frontloaded access (with up to 500% of quota made available upon approval of the arrangement, and up to 1,000% of quota in total after 12 months).

14 For further details, see Box 4, *Financial Stability Review*, ECB, December 2010.

In Asia, the Chiang Mai Initiative, a network of bilateral currency swap arrangements set up in 2000, has been further developed. In view of the crisis, the ASEAN+3 finance ministers (representing the ten members of ASEAN plus China, Japan and South Korea) agreed on 3 May 2009 to transform their existing bilateral currency swap agreements into a single regional pooling arrangement by implementing a plan for multilateralisation and increased the resources available. Like the EU and euro area facilities, disbursement of financial assistance to a regional member envisages IMF involvement (for example, access to finance under the Chiang Mai Initiative above 20% of the agreed credit line requires an IMF programme to be in place). Furthermore, plans were drawn up to create an independent regional surveillance agency and enhance regional cooperation beyond mere information-sharing and peer review.

3.3 OTHER AVENUES TO STRENGTHEN INTERNATIONAL COOPERATION

Looking beyond enhanced surveillance and crisis prevention and resolution mechanisms, other avenues to increase the resilience of the international financial system are also being debated or pursued. These include currency issues, as well as improving the regulation and supervision of financial sectors and of the global financial system in order to strengthen monetary stability.

Thought is being given by some observers to developing a global, artificial currency. Such a currency could take one of two possible forms, a currency basket or a supranational fiat currency. A prime candidate for a currency basket would be the SDR. Proponents of an enhanced role for the SDR argue that the SDR currency basket, would: (i) be a more stable store of value and unit of account than its constituent currencies and hence have lower exchange rate volatility; (ii) imply a reduced need for real exchange rate adjustment for pegs to the SDR compared with pegs to a national currency; and (iii) enable investors to take more account

of global monetary conditions in the pricing of assets, rather than the conditions prevailing in the economy of the dominant international currency.

That having been said, for the SDR to develop a truly global role, its liquidity would need to be substantially increased, not merely through greater issuance by the IMF and an increase in the number of countries using it, but also through the development of a private sector SDR market.

The second proposal, which is to create a global supranational currency, raises many questions. First, what could be a really global central bank and where would it derive its authority from. Second, for the currency to be attractive internationally, it would need to be fully credible, which implies that its supply would have to be carefully managed according to an appropriate rule.

FINANCIAL SECTOR REGULATION AND SUPERVISION

The financial crisis has thrown a spotlight on the shortcomings of regulation and supervision by showing that regulators and supervisors were not fully able to detect the accumulation of risks in the financial system. The crisis highlighted the need to supplement the pre-crisis approach to regulation and supervision, which focused on the stability of individual intermediaries (the micro-prudential approach), with an approach that looks at the stability of the whole system by taking more account of the risks stemming from interactions between market players (the macro-prudential approach).

Several recent initiatives go in this direction. At its meetings in July and September 2010, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, endorsed the design and calibration of a package of proposals to strengthen global capital and liquidity regulations. This package, which is also referred to as Basel III, includes measures aimed at strengthening the resilience of the financial

sector by improving the quality and quantity of capital, as well as introducing additional capital requirements in the form of capital buffers, a supplementary leverage ratio, and new rules for a liquidity risk framework. In this context, Basel III is also aimed at mitigating the procyclicality of the financial system by introducing a counter-cyclical buffering mechanism.

In addition, work is ongoing within the FSB to reduce the moral hazard posed by systemically important financial institutions, as well as the systemic risks arising from the interconnectedness of such institutions. Furthermore, consideration is being given to the role of accounting rules requiring marking-to-market measurement as well as backward-looking loan loss provisioning regimes.

The G20 Summit held in November 2010 endorsed the core elements of the new financial regulatory framework, including bank capital and liquidity standards. In addition, it endorsed the measures to better regulate and resolve systemically important financial institutions.

3.4 ENHANCING GLOBAL GOVERNANCE

In the light of the global financial crisis, the need for improved cooperation and collective action has become even more evident. The more integrated the global economic and financial system becomes, the weaker the ability of individual national authorities to steer domestic economic and financial activity towards promoting sustainable growth in a way that preserves systemic stability and, hence, the greater the need for enhanced global cooperation.

The rise of the G20 as the primary forum for global governance, eclipsing the G7, is recognition of the need for enhanced global cooperation. As mentioned above, the G20's Framework for Strong, Sustainable and Balanced Growth is a major innovation in global cooperation. Whereas IMF policy recommendations have often gone unheeded,

the G20's mutual assessment process contains elements that may improve the take-up rate and so increase the probability of success of collective action. First, and most importantly, by establishing this Framework, the G20 focuses attention on the issue, adding political momentum at the highest level,¹⁵ and makes members accountable at every summit meeting for progress towards their shared objectives. Second, the range of participants is broad enough to include all relevant parties, but smaller than the IMF's Board of Governors or the IMFC, which should help to make discussions more manageable. At the same time, these features are no guarantee of traction: recommendations risk being too vague, there are no sanctions or penalties for non-compliance and the level of commitment shown at the height of the crisis may wane as economies start to recover. At a broader level, the legitimacy of the G20 may be challenged as the urgency of responding to the crisis subsides, which could undermine the undertaking.

The transformation of the FSF into the FSB is also recognition of the need for enhanced global cooperation. The FSB is helping to improve dialogue among the authorities responsible for financial sector issues and the implementation, where appropriate, of recognised standards and corrective policies. First and foremost, a potentially important component of the broadened mandate of the FSB is the commitment made by all of its members to undergo periodic peer reviews. These will be based, among other reports, on published IMF/World Bank FSAP reports, and will be used not only to monitor individual countries (e.g. their adherence to policy recommendations in FSAPs and Reports on the Observance of

15 In 2009 the G20 agreed that "members also have a responsibility to the community of nations to assure the overall health of the global economy. Regular consultations, strengthened cooperation on macroeconomic policies, the exchange of the experiences on structural policies, and ongoing assessment can strengthen our cooperation and promote the adoption of sound policies." (see paragraph 3 of the G20 Framework for Strong, Sustainable and Balanced Growth, following the annex to the Leaders' Statement from the Pittsburgh Summit).

Standards and Codes), but also along thematic lines (i.e. monitoring the implementation across members of particular policies or standards agreed within the FSB). Second, the FSB has set up a process of monitoring compliance with international regulatory and supervisory standards for cooperation and information-sharing, in a “non-cooperative jurisdiction” process. This exercise extends beyond the FSB’s membership to have a global reach. Where it finds shortcomings, the FSB highlights jurisdictions “for further evaluation” and draws on IMF/World Bank assessments of compliance with FSAP recommendations or Reports on the Observance of Standards and Codes. It also intends to introduce an incentive system to induce jurisdictions to keep up with reforms. In a third key initiative, the FSB has set up an Implementation Monitoring Network to monitor compliance with G20 and FSB recommendations. These three initiatives represent useful steps that maintain a focus on countries’ implementation record. The use of fora other than the IMF or World Bank to check on compliance with IMF and World Bank policy recommendations increases the pressure on countries to comply.

Finally, with regard to the IMF, work is ongoing to reform and modernise the governance structure of the institution following calls to make it more legitimate and representative. Ultimately, these changes should also improve the responsiveness of members to the IMF’s advice and peer review. To this end, it has been agreed to realign quota shares under the current quota reform and to change the composition of the IMF’s Executive Board. Both steps will strengthen the voice and representation of emerging markets and developing countries. Discussions are also ongoing concerning other aspects of governance, such as reforming the IMF’s advisory body, the IMFC, and the selection procedures for top management positions in the IMF and other international financial institutions. All these efforts seek to strengthen supranational authority in order to better provide the global public good of international monetary and financial stability, given that this goal is beyond the mandate of

national governments and not a natural outcome of the behaviour of profit-oriented markets, which is often biased towards satisfying short-term performance targets.

4 CONCLUSIONS

In conclusion, despite the fact that the crisis erupted within the financial system, its root causes were entwined with the build-up of, and failure to correct, global payments imbalances under the international monetary and financial system. As a result, policy-makers have started to strengthen the functioning of the system. Key among these are measures to bolster global cooperation, enhance surveillance and improve crisis prevention and resolution mechanisms. While this work is unlikely to, and need not, alter the fundamental nature of the international monetary and financial system, it remains important to shape it in such a way that it reduces global and domestic imbalances over time, while preserving international stability to support global growth and development. It calls for global cooperation, as well as greater legitimacy and hence more authority for supranational organisations and fora to protect global stability. It calls for incentives for market participants and national authorities to align themselves with the promotion of systemic stability, and it requires policy-makers to embrace a systemic perspective and to be prepared to implement policies which, while also serving national interests, support a stable international monetary and financial system, and thus contribute to a thriving global economy.