Stronger Hopes and Renewed Fears: The Governance Legacy of The Global Financial Crisis

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August of this year marks the fifth anniversary of the outbreak of the global financial crisis, which began with problems in the subprime mortgage market in the U.S. At this juncture in most recessions, economies are once again growing strongly and the downturn a distant memory. As the introduction to this volume notes, however, the fifth anniversary of the Great Recession finds strengthened hopes struggling against renewed fears in the world economy. This mix of optimism and pessimism is not surprising given the prevailing economic conjuncture.

Five years later, the global financial crisis continues to weigh on a global economy that remains dangerously unbalanced and threatened by new fragilities. While growth was quickly restored in the dynamic emerging economies outside of the core of the global financial system, concerns remain about the pace of exchange rate adjustment and potential asset price bubbles in China; at the same time, many emerging economies worry about a possible new round in the currency wars unleashed, they contend, by the monetary policies of key central banks. In contrast, the advanced economies that entered the crisis with the greatest financial sector problems, and that have the most work to do rebuilding balance sheets, have experienced a more restrained recovery. Tepid employment growth in the U.S., continuing stagnation in Japan, and the spreading European sovereign debt crisis, which has contributed to Great Depression levels of unemployment in some countries, underscore the fragile nature of the global economy.

In this respect, the past five years represent a reversal of the so-called "Great Moderation" that prevailed prior to the crisis. We now know that beneath the apparent tranquility preceding the crisis fundamental problems were festering in key countries at the very core of the global economy. In mid-2007 these problems began to appear as cracks in the façade of global finance. By September 2008, these cracks had spread and widened, threatening the very foundations of the international financial system.

The Challenge Ahead

If there is one key lesson from the crisis it is that the evolution of financial markets and the integration of financial systems outpaced the development of international regulatory frameworks for the governance of global capital. Prior to the crisis, financial markets were internationally integrated, while prudential regulation and supervision was largely national. In this environment, financial institutions exploited gaps in legal and regulatory frameworks in a process of regulatory arbitrage, both across regulatory authorities within countries and across different jurisdictions, to engage in excessive risk-taking that put the entire global economy at risk.

The negative spillover effects associated with this process underscore the importance of getting the right international regulatory framework for global financial integration—in effect, globalizing regulation as the counterpart to globalized capital.[1] Such a framework would reduce the risk of future crises, yet ensure financing for the innovation and research that will drive growth going forward. Not surprisingly, addressing weakness in regulatory frameworks that contributed to the global financial crisis has dominated international policy discussions over the past five years.

At the same time, the remarkable global response to the crisis refuted Hegel's assertion that "the lesson of history is that mankind does not learn from history." Drawing on the lessons from the 1930s, G-20 countries agreed to:

- provide massive liquidity support in the face of a globally-unprecedented liquidity shock;
- adopt counter-cyclical fiscal stimulus programs; and
- eschew protectionism (trade and financial) and avoid beggar-thy-neighbor policies that would only beget even more harmful policy responses.

In addition, several countries adopted a range of "non-traditional" policies intended to stabilize markets and anchor expectations in the face of pervasive uncertainty that threatened to create an option value of waiting and a "wait and see" economy. The challenge in late 2008 and through the first half of 2009 was to prevent households and firms acting in a manner that may have been individually rational (reducing consumption; deferring investment), but was collectively irrational in that it propagated economic stagnation.

This unprecedented level of cooperation early in the crisis was facilitated by a common threat: faced with the prospect of a global financial and economic collapse that would harm all, a common, coordinated response was essential. Meanwhile, the "2 percent solution" proposed by the managing director of the International Monetary Fund, under which countries were encouraged to provide new fiscal stimulus equal to 2 percent of GDP, helped foster a sense of a shared response to the crisis and provided a benchmark against which efforts could be monitored for possible free riding.

As countries came out of the crisis at different speeds, however, the nature of the required responses changed. Rather than a common response to the common threat of collapse, differentiated policy responses were needed to rebalance global demand so that countries undertaking difficult fiscal and financial sector adjustment did not impart deflationary pressures to the global economy.

Analytically, the problem is to avoid an asymmetric international adjustment process in which the full burden of adjustment is borne solely by countries with current account deficits. Unfortunately, this is precisely the specter now haunting the global economy, as individual countries pursue self-interest to the potential detriment of all.

The objective must be to promote a more felicitous outcome, in which everyone is better off. But to secure such a Pareto improvement, cooperation is necessary; some monitoring mechanism is also needed to support a cooperative equilibrium. Successful global rebalancing requires policy responses that are both more difficult to agree on and more difficult to monitor compliance with. In effect, the level of interconnectedness in the global economy and the nature of the economic problems are such that purely national policy responses are inadequate.

Perhaps in recognition of this fact, leaders at the Pittsburgh Summit designated the G-20 as the "premier forum for our international economic cooperation" and established the Mutual Assessment Process (MAP), which seeks to promote "strong, sustainable and balanced growth" through multilateral review of and consultations on members' policies. However, the effectiveness of the MAP exercise has been constrained by a number of factors.

Most significant is the continuing "triple crisis" in Europe, as banking and sovereign debt crises, together with a crisis of growth, cast a pall over the continent.[2] At the source of these crises are monetary arrangements that, in some respects, resurrect the "bad" gold standard of the inter-war years, which propagated stagnation through an asymmetric adjustment process, as surplus countries sterilized gold accumulation, while the "old lady of Threadneedle Street" (the Bank of England) was too feeble to provide the public good of international financial stability.

As Charles Kindleberger and his student Barry Eichengreen have stressed, governments returned to the gold standard following World War I as an article of faith. This faith was based on the belief that the pre-war monetary arrangements provided symmetric, automatic external adjustment.[3] In the circumstances in which it was reintroduced, however, the gold standard led to a global economic catastrophe. What governments did not appreciate at the time was that, far from being some automatic, market-driven *deus ex machina*, the pre-war gold standard was supported by high degree of adherence to the "rules of the game" enforced by a dominant player—the Bank of England.

The problem today is that Europe does not satisfy the conditions for an optimal currency area; nor does it have risk-sharing institutions or the dominant player that is both willing and able to support the single currency. As a result, the full adjustment burden is on deficit counties and those undertaking draconian fiscal adjustment to restore "confidence" discover that, rather than rewarding them for their perseverance, financial market confidence is further eroded. This, too, was the experience in the inter-war period.

The situation in the U.S. is also troubling. Five years ago, Ben Bernanke confidently dismissed the possibility of the U.S. following Japan into a decade of stagnation. It is not clear that he can be as adamant today. The problem is that the polarization of the political process has handicapped fiscal policy as an effective tool of stabilization policy. The fiscal response to the crisis, it is argued, has been too modest and calls for fiscal tightening premature, particularly with interest rates at the zero nominal lower bound in an environment eerily reminiscent of the Japanese experience and textbook treatments of the canonical Keynesian liquidity trap.[4] The burden of adjustment has therefore fallen disproportionally on monetary policy.

At the same time, because the "black box" of traditional channels of the monetary transmission mechanism is not working as a result of the financial crisis, the Federal Reserve and other major central banks have resorted to "exceptional measures", including quantitative easing. One result of this has been large-scale capital flows to countries that are growing more quickly and which offer the prospect of higher returns. But these countries are both reluctant to absorb the accompanying appreciation of their exchange rates, and fearful of fueling asset price bubbles, particularly when some others have tied their currencies to the dollar through heavily managed exchange rates. As a result, these countries have resorted to controls on capital inflows, deemed prudential regulations, to limit the appreciation of their currencies.

The impact of all this has been to limit nominal exchange rate adjustment. And this, in turn, implies that the real exchange rate adjustments required to facilitate the needed rebalancing must either come from inflation in surplus countries or deflation in deficit countries, or some combination of the two. Given the potential costs associated with excessive asset price booms on the one hand, and the threat of a debt-deflation spiral in heavily indebted economies undergoing deflation, on the other, this outcome is not in anyone's interest. The goal should be a timely rebalancing of global demand that promotes strong, sustained and balanced growth, consistent with the MAP objectives. This rebalancing would reduce the risk of inflation in countries that did not experience a severe downturn in the crisis, for which the expansionary monetary conditions of the Fed are inappropriate, and dissipate the threat of deflation/disinflation in countries that need to undertake difficult, sustained fiscal adjustment.

Failure to secure these adjustments could cloud global economic prospects and undermine support for the open, dynamic international financial and economic system erected over the past 60 years, which has raised living standards for so many around the globe. Put differently, the threat is a retreat from global cooperation, as individually countries resort to policies intended to insulate themselves from global risks, but which collectively constitute beggar-thy-neighbor "measures destructive of national and international prosperity."[5] That

was the experience in the 1930s as country after country sought to shift the "hot potato" of adjustment to others through trade and financial protectionism. The result of these measures to escape the exigencies of an asymmetric adjustment process was economic stagnation, the fraying of the social fabric, and the radicalization of politics with horrific consequences for millions around the globe.

The Governance Legacy of the Crisis

The threat of a possible retreat from international cooperation is the key governance legacy of the global financial crisis and avoiding this outcome is the major governance challenge. In this regard, policymakers today would do well to reflect on the past.

Surveying the damage wrought by the dysfunctional monetary arrangements of the inter-war period, the architects of the Bretton Woods system sought to facilitate timely, orderly balance of payments adjustment, while allowing its members to pursue policies to maintain full employment. The IMF played a key role in promoting the public good of international financial stability by encouraging timely policy adjustments and identifying potential risks through its surveillance of members' policies. At the same time, it provided short-term balance of payments financing to smooth the adjustment process, reducing the likelihood that members would "defect" from the cooperative equilibrium of sound policies and open markets.[6] In effect, the IMF was created to assist its members strik a judicious balance between financing and adjustment.[7]

Under the Bretton Woods arrangements, IMF members "coordinated" through their adherence to the obligations and responsibilities in the IMF Articles of Agreement. After the collapse of the Bretton Woods system, efforts to cooperate (usually around crises) were centered on country groupings that have gradually expanded in size, as the process of global integration has progressed.

In this respect, the G-20 and the MAP are the latest attempt to facilitate policy cooperation. But, given the divergent positions of its members and the differentiated policy requirements, the process has a formidable obstacle to overcome. Not to put too fine a point on it, the U.S. strongly supports the MAP because it needs external demand if it is to grow at a reasonable pace while the difficult, painful process of (public and private) balance sheet restructuring is in process. This underscores the need for a symmetric adjustment process. Yet, under the rules of the Bretton Woods system dictated by the U.S., the burden of adjustment was squarely on deficit countries. From the perspective of other countries, therefore, attempts to rebalance global demand are viewed with suspicion—as an attempt, in effect, to pass the adjustment burden to others.

Conclusion: Completing Bretton Woods to Promote Effective International Cooperation

The IMF has a key role to play in supporting the cooperation of its members to rebalance global demand by identifying policy adjustments and monitoring members' implementation. But to be fully effective in supporting and sustaining the vision articulated at the Bretton Woods conference, the IMF must be viewed as credible, effective and legitimate.

There are two challenges here. The first is to ensure that the IMF is capable of assisting its members deal with the challenges of the evolution in global financial markets that has occurred over the past 30 years. Over this time, private capital flows have increased to such an extent that the IMF cannot operate under the simple, transparent and incentive-compatible rules of the Bretton Woods system. Instead of filling balance of payments gaps and thereby providing members breathing space to smooth the adjustment process, the IMF now tries to influence the expectations of a heterogeneous group of private creditors to "catalyze" private sector investment. Even the most ardent supporter of the fund would concede that it is less than fully effective in this new role. Moreover, to do this, the IMF has had to quite literally "throw out the rule book" in terms of access to its resources and now operates in a world of discretion and not rules.

This is the source of the second challenge. National governments jealously guard their sovereignty and are only prepared to delegate sovereignty to a supranational organization under restricted conditions identified in advance. Members' obligations in the Articles of Agreement, which also clearly spell out the consequences of non-compliance, are a good example. In contrast, the *quid pro quo* for the exceptionally large programs associated with past financial crises was an expansion of conditionality—the policy commitments required to access IMF funds—that reach deep into structural issues. In many cases, these reforms entail decisions over the allocation of rents that involve political considerations. It is no coincidence that the IMF's legitimacy has been questioned in the wake of crises in which access limits were ignored. While efforts are now made to limit the reach of conditionality, the erosion of legitimacy suffered by the fund as a result of the financial crises of the past two decades reduced its effectiveness and its credibility.

Addressing these challenges requires that the international community complete the institutional arrangements under which the IMF operates. This is the benchmark against which measures to strengthen the Financial Stability Board and reduce the opportunities for excessive risk taking through regulatory arbitrage should be measured. The goal must be the efficient pricing and bearing of risk. Of course, the sound pricing of risk requires that investors wanting the higher returns associated with higher risk must bear the consequences of their risk taking. If investors fail to discipline imprudent borrowing *ex ante* by limiting access to debt markets, they have to bear the risk of sovereign default, *ex post*.

But absent a framework for the timely, orderly restructuring of sovereign debt, these governments and their citizens may face the prospect of a long period of immiserizing fiscal austerity or a protracted period of uncertainty, both of which constrain growth and lead to the adoption of policies destructive of national and international prosperity. In these circumstances, the IMF is less able to assist its members strike the right balance between financing and adjustment. The development of a framework for the timely, orderly restructuring of sovereign debt should therefore be a key objective in terms of filling the governance gap for global capital.

In a sense, this entails completing some unfinished business from Bretton Woods. Yet, getting the governance arrangements for global capital right is only a necessary, and not a sufficient condition for reanimating the spirit of Bretton Woods: the governance arrangements of the fund must reflect the realities of the global economy of the early 21st century and not the relative economic position of members in the mid-20th century. An institution that does not mirror the relative roles of its members will not be viewed as legitimate. And by lacking legitimacy, it will not be as effective and as credible as it needs to be.

Here too are grounds for stronger hopes and renewed fears. There is a growing appreciation that a realignment of members' relative positions in the fund is required as the first step toward getting governance reforms that would return the IMF to the center of international monetary cooperation. Unfortunately, too few countries have implemented the governance reforms agreed to at the Pittsburgh Summit to enhance the role of emerging market and developing countries—reforms that would help secure their commitment to the obligations of the Articles of Agreement to an open, dynamic international trade and payments system.

Endnotes

[1] Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System* (Second Edition), Princeton University Press (2008).

[2] Jay C. Shambaugh, "The Euro's Three Crises." *Brookings Papers on Economic Activity Spring 2012*.

[3] *In theory at least*, the mechanics of the adjustment process are described in Hume's price-specie flow: countries recording current account deficits would suffer a loss of gold and downward pressure on prices, facilitating real exchange rate adjustment (depreciation); conversely, gold reserves of countries in current account surplus would rise, putting upward pressure on prices and resulting in real exchange rate appreciation. As long as both surplus and deficit countries responded passively, according to the "rules of the game", the process was both symmetric and automatic.

[4] J. Bradford Delong and Lawrence H. Summers, "Fiscal Policy in a Depressed Economy." *Brookings Papers on Economic Activity Spring 2012*.

[5] Article I of the IMF's Articles of Agreement states, *inter alia*, that the purpose of lending by the IMF is "...to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."

[6] Supra Note 6.

[7] In its early years, the Fund was able to provide this judicious balance because most countries adopted capital controls, which limited balance of payments imbalances to differences in national investment and saving rates. Over time, however, capital controls became porous as markets found ways to evade them and were eventually removed as governments sought the benefits that capital account liberalization promised. Capital flows increased in size, impairing the IMF's ability to assist it members by smoothing the adjustment process in the wake of shifts in investor confidence. The result has been financial crises of escalating virulence. While these crises were initially viewed as "manageable" (though not by the individual countries subjected to the outflow of capital and the draconian adjustment that was required), as demonstrated by the Asian and the global crises, they are now truly global, posing genuine systemic threats.