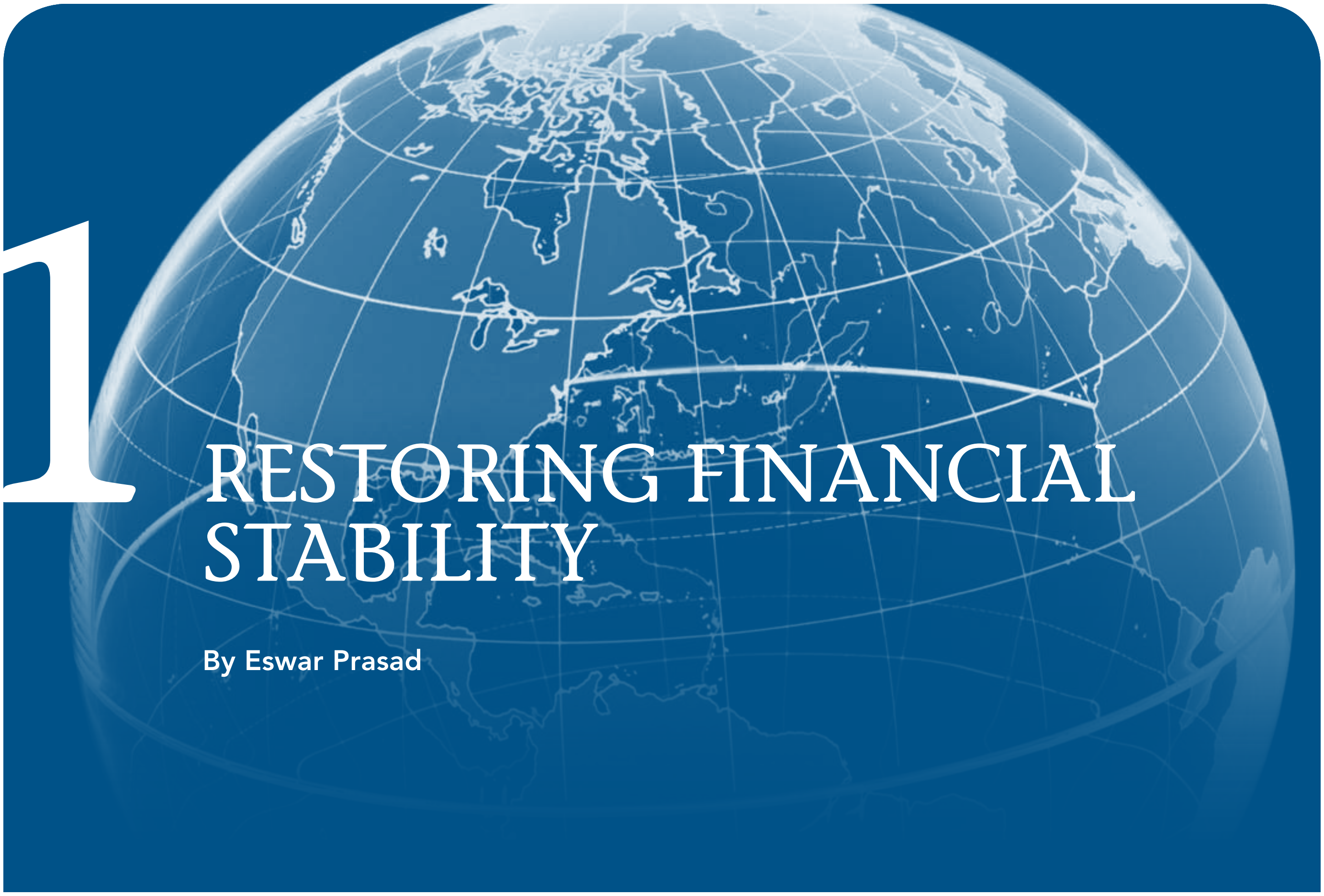

1 RESTORING FINANCIAL STABILITY

By Eswar Prasad

During the fall of 2008, the U.S. financial system careened on the edge of a meltdown, with the U.S. government effectively becoming the guarantor, lender and even investor of last resort. Whatever the final outcome of the ongoing turmoil on Wall Street, one thing is certain: The rest of the world will no longer be as enthusiastic about adopting the free market principles that have guided U.S. financial development. And current massive U.S. government interventions will also make it difficult to convince other nations that the state should stay out of the workings of the financial system.

THE GLOBAL CONTEXT

For years, credit in the U.S. has been easy and regulation has been light, with a resulting explosion of questionable lending practices and novel, poorly understood financial instruments. The famous "ninja"—no income, no job and no assets—mortgage loans were as clear a sign of regulatory negligence as any. But these obvious signs of malfeasance were all too easily ignored when times were good and the policy culture was hostile toward regulation.

Clearly, financial innovation without effective regulation does not work well. In the new world of more sophisticated financial markets, dangers lurk in hidden places. Central bankers and policymakers from Brazil to China have so far been spared the worst. Having resisted these lightly regulated financial innovations to some degree, they can now be grateful that their economies have not yet been pummeled by the unfolding crisis as much as America's has been.

In this decade, the emerging markets have become major players in international finance, not only receiving large inflows of private capital but also exporting large amounts of capital. Indeed, since 2000, industrial countries as a group have been running a current account deficit, which has been financed by the emerging market countries and, according to the International Monetary Fund, has reached more than $450 billion annually. Meanwhile, the proliferation of new financial instruments and the rising prominence of new players—sovereign wealth funds, hedge funds and institutional investors such as pension funds—have also changed the landscape, raising a number of challenges as the world becomes more financially integrated.

One thing the U.S. financial crisis proves is that fraud, corruption and government interference can eat away at the foundations of even the deepest financial systems, especially when these problems are compounded by a regulatory system that is too narrow and rule-bound in its outlook and that, at times, turns a blind eye to obvious rot in the system. As they embark on their own financial sector reform agendas, emerging markets such as China and India will learn much from the lessons of the painful U.S. experience.

THE CHALLENGE

In this context, the next U.S. president faces a challenge with several dimensions:

> **Lessons from the financial crisis:** The U.S. financial crisis confirms that some types of government involvement in financial markets—especially through the implicit backing of ostensibly "private" institutions—generates bad outcomes that inevitably end up with taxpayers footing the bill. The real lessons from the Fannie Mae and Freddie Mac debacle should be about the dangers of implicit government guarantees coupled with moral hazard and weak regulation, and the risks that lurk even in advanced financial systems.

> **New players:** The proliferation of hedge funds and mutual funds, and the amounts of money now controlled by them, have created concerns about the higher volatility of capital flows. Indeed, the increasing integration of international financial markets has, if anything, increased the risk of herding behavior, where capital flows are driven more by sentiment than by fundamentals. At the same time, it is equally plausible that institutional investors such as pension funds have a longer-term investment horizon and can add stability to the markets.

> **Political agendas:** Certain new players—such as sovereign wealth funds, which collectively control more than $3 trillion, by some estimates—are raising concerns about countries using these institutions to further their own political agendas. This has also generated worries in countries such as the U.S. that allowing domestic assets (firms, real estate) to be taken over by SWFs could create a threat to national security and broader national interests. Thus, the increasing size of SWFs and their attempts to make investments in some of the "crown jewels" of countries such as the U.S. makes investment protectionism a politically combustible issue, especially in view of their lack of transparency.

> **Currency issues:** A number of emerging market economies, while ostensibly moving toward more flexible exchange rates, seem to have a "fear of floating." This is evident in intensive management of the nominal exchange rate through intervention in the foreign exchange market. This results in the rapid accumulation of foreign exchange reserves when countries are trying to manage currency appreciation. Not only do these countries deprive themselves of a shock absorber; they also create ground for instabilities in international capital markets.

> **Common platforms:** It goes without saying that the traditional international financial institutions, such as the International Monetary Fund and the World Bank, still have a potentially important role to play in the smooth functioning of the international financial system. However, these institutions have been enervated by their small capital base relative to the volume of international capital flows. Moreover, the relatively modest share of total voting rights that emerging markets and developing countries have in these institutions has further undermined their effectiveness because these countries do not see these institutions as being advocates for their own interests.

AMERICA'S OPPORTUNITY

The next U.S. president should work with the international community to develop a common agenda for managing capital flows. Though each group of countries, depending on their level of development and openness to international financial flows, will have a different perspective on the agenda, joint action can be based on themes of common interest. As the largest economy in the world and one of the key players in international financial markets, the U.S. also has its own obligations to keep the system working well. The current U.S. financial crisis indicates that a set of rigid rules allows resourceful financial institutions to mask riskiness in their portfolios or shift things around to make standard risk metrics appear better than they really are. Instead of a regulatory framework that accounts for every specific financial instrument and institution, it would be preferable to develop a "principles-based" framework that can adapt to the evolution of financial markets and can adopt a broader approach to managing systemic risks. This framework should address several issues:

> **The U.S. fiscal problem:** One of the factors behind the large U.S. current account deficit and the vulnerability of the dollar to a sharp fall in value is the high level of the U.S. budget deficit. The U.S. current account deficit also creates the risk of a disorderly adjustment in world exchange rates; this turmoil could be especially harmful to emerging markets. Getting its own house in order will be important for the U.S. to be able to exercise an effective leadership role.

- **Managing capital flows:** The U.S. administration should encourage initiatives, for instance those undertaken by the International Monetary Fund, to create a set of standard operating procedures for SWFs. This would allow them to be better monitored, in exchange for fewer restrictions on the investment opportunities made available to them. Mechanisms for managing official capital flows in a more transparent way would be useful. For its own part, the U.S. needs to think about more efficient ways of delivering foreign aid that boost growth, minimize resource loss in the process of making aid transfers and do not create aid dependence in recipient countries.

- **Currency issues:** Countries like China should be encouraged to allow greater flexibility in their exchange rates. There is a case to be made that prolonged intervention in currency markets creates instabilities in international financial markets, which could ultimately hurt the very countries that are trying to forestall currency fluctuations. Moreover, many Asian countries as well as Gulf states that have tied their currencies to the dollar are facing complications in domestic macroeconomic management, particularly the control of domestic inflation. More important, exchange rate flexibility can play a key role in advancing countries' own reform priorities, including financial sector reforms and monetary policy frameworks that can respond more nimbly to domestic needs.

- **Global governance:** The U.S. should support further changes to the governance structure of international financial institutions such as the International Monetary Fund and the World Bank. To maintain the relevance of these institutions, emerging market and poor countries must be given a more prominent say in running them and institutions may make them more effective, it will also be necessary for the U.S. to support steps to increase their capital bases to enable them to respond more effectively to instances of global financial turmoil.

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