

Crisis, Collaboration, and Confidence:

The Global Economy and the Future of the Bretton Woods Institutions

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Introduction

Two economists were walking down the street when they noticed two women yelling across the street at each other from their apartment windows. They will never come to agreement, stated the first economist. And why is that, inquired his companion. Why, of course, because they are arguing from different premises.

This story encapsulates my thoughts as I go where angels fear to tread: a political scientist speaking at an economics conference. The truth is that I started my academic career as an economist, and much later, after a career in the real world of money and banking, switched to political economy and international relations. Why? Because I preferred other premises. The world of financial risk management, it occurred to me during the oil crisis of the 1970s and again during the developing country debt crisis of the early 1980s ultimately rested on coercive state power and, when we were lucky, on the self-interested cooperation of states. One of my mentors, Susan Strange, shared that premise, and I suppose that is what drew people like me to her at the London School of Economics, when the field now called international political economy was just coming together.

Susan's first book, for which she had to share credit with Andrew Shonfield was *Modern Capitalism*. One of her last she called *Casino Capitalism*. The extreme financial turbulence that began in the summer of 2007, would not have surprised her, for it had once again exposed the faultlines running through the terrain of money and banking. Steered by the economic logic of

integrating markets, the gathering crisis rapidly spilled across national borders. As in every analogous instance in recent decades, however, the political authority to manage the crisis revealed itself to be stubbornly, even rigidly, bounded by those very same borders.

And yet, hints of something new, or at least something more distinctly hopeful also emerged. The leading states in the system recently endorsed what would have been considered a radical proposal even ten years ago, namely the fully collaborative supervision of nationally licensed but globally active financial intermediaries. Because of the implied sharing of financial burdens in the wake of disaster, the very idea of a 'college of supervisors' constructed for each such entity suggested a breach in the bulwark of state sovereignty, even as state sovereignty continues to constitute the ultimate foundation for any regulated financial institution.

This very idea applied to policy at the micro-level, paralleled an older idea enshrined in-principle at the macro-level: the idea that in an integrating international economy, collaborative institutions are needed to help sovereign states, at best, to coordinate their macroeconomic policies, and, at the very least, to help coordinate their responses to crises related to the failure of macroeconomic cooperation. The Bretton Woods institutions, and especially the International Monetary Fund, deservedly remain at the center of debates on reforming the architecture of a global system now deeply influenced by integrating capital markets. Although I will mention the World Bank in the balance of this paper, the macroeconomic and macropolitical challenges now confronting the IMF lie at its core.¹

Economic context

Ever since the disastrous decade of the 1930s, when financial contagion spread misery around the world and helped create conditions conducive to global war, states have seen the financial institutions chartered by them, especially banks, as strategic instruments requiring great care. Controlling their ability to move capital across national borders played an important role after the subsequent world war. During the post-war years, the gradual relaxation of that regime was a long and difficult process. While the grand struggle between democratic capitalism and state-directed socialism was underway, even leading states opened their capital markets cautiously, protected national champions, and built firewalls around financial economies now supporting expansive social welfare programs.

As the Cold War was ending, financial openness expanded rapidly around the world. Eventually the most prosperous developing countries moved in the same direction, and in this regard India was an obvious leader. Nevertheless, all states, not least India, continued to treat the financial circuits into and out of their national economies as vital but delicate. On the one hand, openness stimulated economic growth by supplementing domestic savings. On the other hand, it exposed national economies and treasuries to new risks. Exogenous shocks transmitted through open capital markets could disrupt local development, and liquid capital could exit at politically inopportune times. John Maynard Keynes long ago recognized the Janus-face of global finance, and many events since the early 1970s reinforced the image.

Especially after they gave up on the post-war system of pegged exchange rates, leading states exhibited in their policy practice if not always in their policy pronouncements their view that more open capital markets that could encourage the necessary adjustment of increasingly interdependent national and regional economies were both 'better-than-any-practicable alternative' and inherently fragile.

The curious current structure of flows through those markets is worth noting at this point, since it raises questions to which I return. One might imagine that open capital markets would facilitate the movement of capital from capital-rich countries to capital-poor countries. Although this does happen to some extent, the most significant capital importer had for quite some time been the United States and the top capital exporters are China, Japan, Germany, and petroleum producers. Beyond that group, capital imports into the most prosperous emerging industrial and developing countries recovered a few years ago from their post-Asian crisis lows, but they were again battered during the larger crisis of 2007-9. Lucky countries, like India, managed throughout the crisis years to sustain pro-growth current account deficits with accommodating and apparently sustainable imports of capital, not least through multinational corporate channels.

SLIDES ON THE GLOBAL MACROECONOMY

Before the crisis of 2007 fully developed, the capital recycling mechanism suggested by these figures and tables did have its advantages, and it certainly was not working in an

unintended manner. US consumption was the engine of the global economy, and it remained in the interests of states pursuing essentially mercantilist (or, more politely, export-led) economic strategies to finance that consumption. In turn, it remained in the American strategic interest to allow non-petroleum exporting states to export far more than they import, given the conviction that the social stability thereby generated would continue to underpin regional political stability. As for the petroleum exporters, it is doubtful that the United States fully internalized the deleterious long-term consequences of its short-term but still readily financeable consumption strategy. Partly because of the risk that the United States itself may not be able politically to recover or sustain its recent level of consumption, more balanced trade and investment patterns across the industrial world would clearly be preferable in the long run. In recent decades, leading governments have certainly deepened the institutional channels for capital recycling, but that should only be a means to an end. Surely the point is global prosperity, with excess savings anywhere in the world deployed in the cause of a more efficient international division of labour.

Nationalism, open markets, and political authority

Efficient markets in general depend upon stable, confidence-generating foundations. The economics of opening and liberating markets for the long term requires attending to the more immediate politics of financial stabilization. Where intergovernmental cooperation on regulatory initiatives may advance the former cause, such mechanisms are pushed to their limits on the latter. Stabilization ultimately requires reliable tools for crisis management and

resolution. When they are in place and clearly understood, their very existence assists in crisis prevention. Even in days not long ago when financial markets were more readily characterized as national and financial intermediaries were more clearly differentiated by sector (banks, insurance companies, investment companies), the design and deployment of those tools were often messy—often involving central bankers, financial supervisors, legislators, and, ultimately, ministers of finance. Today, it is more complicated not only because of the breakdown of geographic barriers but also because of the erosion of sectoral differences within financial markets. In many places today, financial conglomerates with corporate structures that merge various types of financial activities and sometimes also permit the ownership of non-financial firms are rapidly emerging. Complicated would hardly begin to describe efforts to adapt regulatory systems to render their operations not only competitively efficient but systemically safe.

Today, especially with regard to the far-flung operations of the world's largest financial intermediaries, the consequent questions are straightforward. Who is the lender-of-last-resort, and what actual powers does it possess to force solutions to the collective action problems associated with institutional illiquidity and insolvency? Is the lead supervisor, or at least the consolidating supervisor, the same as the lender-of-last-resort? In the end, whose taxpayers will finance bailouts ultimately necessary to prevent financial contagion from spreading? If contagion does spread across political boundaries, how will the financial burdens required to restore confidence be shared among debtors and creditors? Finally,

since crisis prevention is the essential policy objective, can the requisite political authority to manage emergencies and curtail moral hazards be pooled convincingly beforehand?

In contemporary Europe, and incipiently across the relatively open financial markets of all advanced capitalist countries, the bonds of financial integration are now strengthening understandings verging on political obligations, obligations on the one hand to keep markets open and on the other to intervene in certain common ways to stabilize those markets when required. While states publicly remain ever vigilant in the defense of their ultimate political authority, the puzzle is why they would allow such obligations even to begin to develop. The puzzle deepens when we probe the vital core of contemporary international capital markets, the concatenation of elements comprising the machinery of systemic crisis prevention and crisis resolution, again the ultimate source of the market participants' confidence in the future. As we shall see, that machinery must necessarily rest on an implied commitment of access to the fiscal resources of the state. Aside from the commitment of military resources, such a commitment comes as close as one can get to the economic root of sovereignty; as political economists would put it, the sovereignty costs of making any such commitment are very high.

If it is true then that more integrated financial markets are coming into existence in Europe and perhaps more broadly, then are we not already entering a world where those national roots are becoming inextricably intertwined? If, conversely, we are not entering such a world, the puzzle would disappear by definition. The implication, however, would be that markets that today appear to be integrating will at some point, under readily imaginable

circumstances, fail. Europe is ahead of other regions in thinking this possibility through and in attempting to craft the requisite political remedies. That the challenge is complex, and that meeting it sometimes requires saying one thing and doing another, should come as no surprise to anyone who studies politics or political economy. ²

The nature of crises in integrating markets

In 1974, the first great banking crisis of the post-1945 era occurred, when Bankhaus I. D. Herstatt of Germany failed to honour its foreign exchange contracts and a subsequent cascade of defaults brought down the Franklin National Bank of New York. This time, however, a depression was avoided when the American and British finance ministers and central bankers improvised a successful response and soon thereafter directed bank supervisors to initiate regular consultations on the appropriate division of responsibilities between the home and host states of internationally engaged financial institutions.

Ministers and legislators became seriously interested in the new dialogue on banking supervision after the 1982 developing-country debt crisis threatened large banks at the core of national payments systems. The IMF played a key coordinating role in that crisis, the worst since 1931, but it was not the lender or investor of last-resort. Certainly with regard to Mexican debt, the largest and most prominent debtor country, everyone knew that the central bank and ultimately the Treasury of the United States would have to play exactly those roles for its key money-centre banks if an actual run began. In the summer of 2007, an old-fashioned run on relatively small bank occurred in the United Kingdom. Although the failure of Northern Rock in the UK and especially

Lehman Brothers in the US were handled inelegantly, there was no ambiguity as to the identity of the responsible central bank and government. When it happened in a turbulent systemic environment, however, buried memories of 1931 stirred once more. During the following troubled period of tightening credit and collapsing confidence, the evident fragility of much larger and much more globally expansive financial intermediaries exposed once again the political dilemma glimpsed during the Herstatt crisis.

At the extremes of analytical debates since 1974, it was commonplace to depict international financial markets either as poised on the brink of integration so intense that a global financial regulator backed by last-resort lending capability was now required, or as so delicate that they required careful dis-integration if the stability of national economies was to be preserved. In the world of actual policy, finance ministers, central bankers, and legislators encouraged the development of an intergovernmental supervisory regime to cope with the awkward reality of powerful interests desiring both the benefits of globalization and the autonomy of separate statehood.

The explosion of international financial intermediation after the 1980s and the rising incidence of financial crises with cross-border effect were obviously related. For policy makers, the principal questions were what they have long been: when real economic growth rates were sought in excess of those capable of being generated by domestic savings, how were the benefits and costs of financial openness to be distributed? In principle, inward flows of privately owned capital make it possible for real economies to grow more rapidly than if they rely solely on domestic resources. In practice, the extra costs associated with crisis-induced capital outflows, bailouts, and the lost

confidence of investors occasionally threatens to undermine real economies, set back the process of industrialization, and disrupt underlying political and social orders. As we are experiencing again today, the immediate costs of financial crises can be huge, their social and political effects insidious and lingering.

Nevertheless, by the 1980s states constructing the international economy had collectively moved away from one set of policy trade-offs and toward another. Clearly, capital mobility and monetary autonomy were now privileged, and states were willing to tolerate floating exchange rates as well as a degree of volatility in their expanding financial markets. Despite a clear trend toward capital market liberalization, however, no binding or broadly based international treaty analogous to that governing trade flows emerged to codify an underlying political understanding on the trade-offs implied by financial openness. Although some promoters of liberalization saw the necessity of new and enforceable rules, most apparently hoped that global markets would remain resilient over a full economic cycle. That hope rested on the idea that the main role of governments was simply to reinforce confidence by pursuing sound macroeconomic policies, an idea that would soon be sorely tested.

Before the Asian financial crises of the late 1990s hit, prominent voices advocated an explicit amendment to the 1944 Bretton Woods Agreement that would have had the effect of extending the IMF's formal jurisdiction over restrictions on current account transactions to a full range of imaginable restrictions on capital account transactions. When calm returned after financial emergencies spread rapidly from Asia to Russia to Wall Street, the broad movement toward capital market openness continued, even as governments refused unambiguously to expand the Fund's

formal mandate or to embrace the principle that capital had an inviolable legal right to cross borders or the idea that an ultimate global authority was required to manage shared risks. National authorities instead opted to allow the financial institutions they themselves continued to license reciprocally to expand their international operations on the understanding that emergencies could be prevented or managed by national regulators collaborating more efficiently but only to the extent necessary. Their collaboration motivated not so much by the pursuit of mutual gains, as by the fear of catastrophic losses.

The main multilateral consultations on systemic risk focused on banks at the core of vital payments systems. Struggling with the tension between risk mitigation and leveling competitive playing fields, this led the Basel Committee on Banking Supervision to clarify the responsibilities of 'consolidating' supervisors, and still later to accommodate legislative changes in the United States and the European Union by strengthening the role of host supervisors of banks from countries deemed weak in their capacity for consolidated supervision. The Committee also initiated protocols for minimum standards for back-up capital reserves to be held by banks.

In 2006, the 'Basel II agreement' allowed internationally active banks to bring sophisticated risk-management techniques into the calculation of capital requirements. In contrast to the straightforward calculations of its predecessor, capital requirements were more carefully calibrated with the risk profiles of different kinds of banking assets and with diverse portfolio choices. For the largest banks, heavy reliance was now placed on internal value-at-risk models maintained by the banks themselves. Under the terms of Basel II, smaller banks and banks not based in advanced industrial states typically faced the less flexible capital requirements of Basel I. The fact that this

seemed to provide a new source of competitive advantage for the largest money-centre banks was not the only controversy engendered by the new accord, and immediately stimulated calls for a 'Basel III' agreement. In any case, along with the stabilizing 'pillar' of minimum capital requirements, the Basel II agreement stressed the importance of two additional pillars: adequate supervisory review and 'market discipline.' To improve the latter and to provide signals that might prompt early intervention by official overseers, the agreement recommended various mechanisms for increasing the disclosure of information by banks, information that would allow credit rating agencies and market counterparties to render judgments on their ability to meet their obligations.

Dilemmas of cross-border adjustment

The fragility of globalizing financial markets, occasionally glimpsed, makes necessary a high degree of cooperation even among leading states if their ultimate regulatory power—and relatively progressive but still nationally-focused economic strategies—are not to prove illusions. If such cooperation fails, self-sustaining markets of global or even regional scale would be a highly unlikely outcome. The vital interest in systemic crisis prevention is spreading, but so too is the interest in ensuring that the benefits of more open financial markets are not excessively concentrated. Can the authority required to meet that interest be constructed? There are encouraging signs.

It would be hard to sustain the argument that the main architects of today's international capital markets did not make progress in the years before the summer of 2007. The Herstatt crisis, the Latin American debt crises of the 1980s, the American savings and loan disaster of that same

decade, the later BCCI and Barings Bank failures, the Asian and Russian crises of the next decade—all caused much pain but none presaged systemic meltdown. The sub-prime mortgage crisis in the United States followed the familiar pattern, and the damage was extensive.

SLIDES ON THE CRISIS OF 2007

When doubts began emerging in 2007 about the sustainability of US real estate prices, and therefore about the security of global markets directly or indirectly linked to US mortgages, banks in Germany and the United Kingdom were among the first to begin failing. When a shocking bank run occurred in the UK in September 2007, it foretold much that would follow. The sense of crisis mounted in January 2008, when US authorities acquiesced in the purchase of the country's largest mortgage originator, Countrywide Financial, by Bank of America. Then, in a series of emergency moves beginning late in 2008, the Fed and the US Treasury effectively began extending the official banking safety net into the investment banking sector. As the Fed flooded the system as a whole with liquidity, with obvious Treasury support it forced and subsidized the merger of Bear Stearns into JP Morgan Chase. The situation nevertheless continued worsening around the world, despite *ad hoc* coordination on massive interest rate cuts by the major central banks of the world and despite an array of dramatic market interventions undertaken by regulatory authorities.

In September, the US Treasury nationalized Freddie Mac and Fannie Mae, the largest insurers of mortgages in the United States. That same month, it and the Fed made what looked in retrospect

to be a near-catastrophic mistake, when they allowed the 158 year-old Lehman Brothers to declare bankruptcy instead of engineering another Bear Stearns-style takeover. One day later, on September 15, they reversed course and forced the merger of the giant Merrill Lynch brokerage into Bank of America. On September 16, the Fed then lent insurance giant American International Group (AIG) \$85 billion in exchange for nearly 80 percent of its stock. Two days later, the Treasury went to Capitol Hill for the cash necessary to recapitalize banks that still threatened to fail and for legislative cover for the range of highly unusual extensions of public authority that it had undertaken and would likely continue to undertake in the period ahead.

The first draft of the Treasury's bailout plan was three-pages long; among the purposes to be served by a breathtaking expansion of executive authority, it promised to make up to \$700 billion in US taxpayer funds available to any financial institution with "headquarters in the United States."³ That, and much else, changed within 24 hours, after the Treasury was apparently reminded that nearly 25% of the US domestic financial system was now managed by foreign-headquartered intermediaries. Nevertheless, the amended bill was defeated in the House on September 28. An extraordinary display of executive and legislative collaboration followed as markets plummeted around the world. The Emergency Economic Stabilization Act, now quite voluminous, now very quickly passed the House and Senate and was signed into law on October 3, 2008. In Section 3.5, it authorized the flow of funds from the Treasury to all 'institutions with significant operations in the United States, excluding foreign central banks or institutions owned by foreign governments.'⁴

In the fullness of time, it became clear that the bailout of AIG alone had fully covered many domestic and foreign bank counterparties—from Goldman Sachs to Deutsche Bank, which were ultimately able to unwind associated contracts at par, that is, without a discount. The goal may have been system stabilization, even if specific transactions could be interpreted as egregious evidence of regulatory capture. But the fact is that when they were done and when they were disclosed, they proved to be both effective in terms of stabilizing global markets and politically tolerable inside the United States.

Canada and Japan, key US allies since 1945, had suffered through earlier financial crises, but this time they happily stayed on the sidelines; they had no vital reasons for resisting US actions and they were basically supportive. Europe was not so lucky, and although much noisy rhetoric surrounded reactions to financial turmoil within many European states, the US policy line clearly helped stabilize markets on the continent. The European Central Bank worked closely, if informally, with the Fed. Hardly smoothly but ultimately effectively, European finance ministers also collaborated in an *ad hoc* fashion among themselves, and they prevented a reprise of the Creditanstalt debacle of 1931. The idea of building a single pan-European market less affected by turbulence emanating from the United States, however, seemed to move further into the distant future. After the crisis subsided, the trans-Atlantic partnership of the post-1945 period looked no more and no less stable than ever. The problem of systemic fragility remained for Canada, Japan, and Europe, that is, the United States could continue to generate serious difficulties for them, but crisis management by the United States could apparently still be relied upon to help address those difficulties.

On balance, for industrial countries the opportunities created by integration in a US-led system obviously still outweighed the costs of serious resistance. Although during the crisis international economic organizations did little to ameliorate those costs, informal networks did help coordinate separate national policy actions. As usual, the IMF and the World Bank were mobilized to help countries hard hit by the crisis, but not to address the core problem at its root. The response was not entirely adequate. The pain inflicted on countries like Iceland, and on relatively weaker and less mobile people within them, was not obviously or self-evidently distributed fairly. But in comparative historical terms, the response was definitely an improvement. In the absence of the resources of the Fund and the Bank, would the pain not be even more extreme and even more unfairly distributed?

Currencies and crises

The longer term systemic challenge after the recent crisis subsided came from rising states across the Pacific. A key question remained whether the emergency would perversely encourage the building up of reserves, rendering more difficult the leadership of a collaborative and integrating system—and marginalizing international economic organizations. The most serious doubts focused on a system built around exchange rates that could but might not float freely after the pegged rate arrangement agreed at Bretton Woods in 1944 was abandoned in the early 1970s. To substitute for the earlier commitment on exchange rates aimed at the avoidance of competitive devaluations, Article IV of the IMF's Articles as amended and finally ratified in 1976 mandated the organization to "oversee the

international monetary system" and to "exercise firm surveillance over the exchange rate policies of members." The Article also specified the obligation of all members to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." A 1977 decision of the Fund's Executive Board re-articulated the obligation as a formally binding principle--that members *shall* avoid manipulating exchange rates or the system as a whole to avoid adjustment or to gain a competitive advantage. Two non-binding principles complemented it: that members *should* intervene in exchange markets to counter disorderly conditions and that members *should* take into account in their intervention policies the interests of other members. Regular surveillance by Fund staff was to track and evaluate actual national practices in this regard.

Soon after 1977, it became clear that capital markets and not IMF-monitored exchange rates would become much more significant in structuring the way national economies would henceforth influence one another. As national financial policies through the 1980s and 1990s moved ever more decisively in the direction of openness and liberalization, exchange rates became less relevant as long as countries did not try to peg them. That is precisely the issue that China and its East Asian neighbors now poses.

In 1995, after the succession of financial crises in emerging markets where pegging was still attempted, the Executive Board of the Fund amended its 1977 Decision. To a list of developments that could mandate special discussions between the Fund and a member, it added "unsustainable flows of private capital." The Board also directed Fund staff, "in the

context of promoting broader market liberalization, to pay increased attention to capital account issues . . . and to give more attention to the soundness of financial systems" (*IMF Survey*, October 23, 1995, 314-15). Twelve years later, on the eve of the financial shocks more threatening to systemic stability than any experienced since 1945, the Board again amended the 1977 Decision to widen the scope of the Fund's surveillance authority. To the three basic commitments of Fund members, it added a new proscription against "exchange rate policies that result in external instability" (Decision on Bilateral Surveillance over Members' Policies, June 15, 2007).

At that point in time, this seemingly innocuous phrase was widely understood to target China, which many in the US Congress in particular suspected of repressing the value of the renminbi in order to stimulate exports. By using the Fund in this way, the US Treasury could deflect pressure for direct retaliation, ultimately coming from struggling American exporters and import-competing industries. China, in turn, nevertheless saw itself as unfairly accused of currency manipulation. It objected inside the Fund but was overridden. As soon as the decision was announced, China immediately closed the doors of its finance ministry and central bank to Fund staff. For the next two years, precisely during the crisis of 2007-2009, those doors would remain closed. Tim Geithner actually made the accusation of manipulation explicit during the January 2009 Senate hearings on his nomination to be Secretary of the Treasury. By that time, however, the US posture on the issue was already shifting. In the context of crisis, US policymakers switched their overt policy preferences from naming and shaming China to currying its favor. As their own financial system was crumbling

from within, they found themselves desperately needing emergency capital transfusions, not least from reserve-rich China.

By mid-2009, it had become clear that the idea of placing negative labels on members' currency policies was undermining the effectiveness of Fund surveillance. "Manipulation" was out, and even the term "fundamental currency misalignment" was removed from operational guidance given by Fund management to staff. China once again welcomed an IMF surveillance team, and July 2009 the Executive Board discussed the resulting staff report. The minutes concluded diplomatically as follows:

Directors welcomed the important progress made in the past few years in increasing the market's role in determining the exchange rate, as well as the consequent substantial real appreciation that has been achieved since the exchange rate reform in 2005. Some Directors nevertheless supported the view that the renminbi remains substantially undervalued. Looking ahead, many Directors considered that a further strengthening of the renminbi would be part of a comprehensive strategy to rebalance the economy by increasing the purchasing power of households and the labor share of income, and reorienting investment toward non-tradable sectors. Exchange rate flexibility would also allow monetary policy to focus more clearly on price stability. A number of other Directors pointed to the methodological difficulties of making exchange rate assessments. These Directors generally considered that exchange rate appreciation would only play a supplementary role in supporting reforms to reorient the Chinese economy and should be pursued in a gradual manner, as and when conditions permit.⁵

One month earlier, the Fund had announced that China was considering buying US\$50 billion in notes issued by the Fund. Through this innovative operation, it could diversify its reserves and shift some of the risk of future dollar depreciation to the Fund. In line with the G-20 commitments of the United States and other creditor-members made at the April 2009 G-20

summit meeting in London, this signal Chinese contribution to Fund liquidity promised to put the institution in a stronger position to assist members in need.

The vital question of whether the growing imbalance in the Chinese capital account was sustainable now precisely mirrored the question of whether the policies lying behind the post-1970s US current account deficit—arguably, the engine pulling the global economy—were any longer sustainable. Global financial—and political—stability now turned on the as-yet unknown answer.

The continuing failure of the United States and key followers to coordinate their macroeconomic policies directly left the politics of financial emergency management, partly mediated through international institutions, the actual linchpin of the post-1970s system. More practically, and perhaps only for the moment, those institutions still held the promise that adjustment and development could be mutually reinforcing. True, given the vagaries of power as it exists, they also accommodate and all-too-partially compensated for the fact that most of that adjustment would be borne by the weak, while most of that development benefited the strong. Without requiring even lukewarm supporters to relinquish any ideological priors, their continued if troubled existence speaks to a less-than-transparent broader objective: a stable and reasonably efficient international economy led by the United States. It is no coincidence that tension between principles of efficiency and justice at the international level continued to evolve in a manner parallel to a similar and enduring struggle inside American society itself, a struggle only masked periodically by booming markets.

That said, the outlines of a feasible if undesirable challenge to the US-led post-1945 economic order are becoming clearer in the gathering erosion of normative solidarity represented by a proliferation of regional competitors and alternative fora with selective memberships and weak or non-existent secretariats. After the emergence of the euro, European members understandably shifted some of their attention away from Washington toward Frankfurt, even as they demonstrated little interest in reducing their formal stakes in the now less-relevant Bretton Woods institutions. In this context, the efforts of China and other East Asian states to insulate themselves with excessive monetary reserves and bilateral deals on reserve-sharing take on special meaning. If rising states cannot be encouraged to remain in the system still led, albeit more weakly than had once been the case, by the United States, the now ever-present threat is that they would gradually opt out.⁶ Ted Truman, a former senior Fed and Treasury official asked the key question just before the crisis of 2007 erupted: “Can the global monetary system function effectively with more than one set of understandings, conventions, and rules, for example about the trade-off between financing and adjustment or about the ultimate goals of capital account liberalization?”⁷

The reform agenda

Although much has obviously changed since 1931, the failure of key financial intermediaries under imaginable conditions could still call into question the creditworthiness, fiscal capacity, and confidence-generating political commitments of the states at the core of the post-1973 experiment in financial and capital market integration. The emergence of a global polity with effective and

undoubted instruments for emergency financing, the orderly disposition of failing enterprises, and systemic resource redistribution would change things profoundly. Integrating markets might then be more certainly efficient and more durably resilient. Until then, realists count on the logic of market deepening being matched by the progressive development of what Europeans recognize as the complex politics of ‘co-responsibility’, or what might also be called ‘solidarity.’

In just such a context, we come back to the perennial issue of reforming the best universal political instruments for economic collaboration available—the IMF and the World Bank. Post-crisis commentaries sympathetic to bolstering their legitimacy and effectiveness generally agree on the objectives of any serious reform effort. First, Fund surveillance needs to be adapted better to identify sources of systemic risk, especially within the largest national economies. Staff analyses must provide better coverage of developments within financial markets, and they must not shy away from shining a spotlight on potential bubbles in financial asset prices. Since financial markets and exchange-rate systems are now more deeply integrated, explicit and practical guidance for national policymakers, including central bankers, needs the multilateral framing that should be the Fund’s strength. In post-crisis discussions within the more limited fora of the G-7, the G-20, and the Financial Stability Board, the idea of macro-prudential policy coordination became prominent. If this idea is to gain traction, it implies that the kinds of micro-prudential policies cooperating financial supervisors can implement for specific intermediaries must be reliably raised to the level of the system. In light of broader macroeconomic objectives, the Fund and the Bank should then be expected to identify regulatory and supervisory gaps in the system as a whole and to propose feasible measures to close them. Moreover, in dealing with the global consequences of financial

market turbulence, the facilities of the Fund and the Bank should be expanded and deployed more quickly to provide liquidity to members in need. In particular, both are in a position to assist members hard hit by sudden and unexpected stops in external financing flowing through financial markets. In this regard, they are capable of facilitating communication across a widening range of fiscal authorities, monetary policymakers, and financial supervisors. This capability should be better exploited to prevent crises and to manage them when they nevertheless occur. As has been the case in the past, it should also be deployed more assertively to help members struggling with draconian debt-service requirements, which means encouraging flexibility among ultimate creditors.

Finally, if system-stabilizing reform is to take place and to evolve in tandem with a global economy that keeps growing and keeps integrating key national and regional markets, the representation and recognition of shifting economic power needs to be both fairer and broadly perceived as fairer. To be blunt, India, China, and other rising powers must be allowed to play larger and more visible roles within the management, the staff, the executive boards, and the governing committees of the Fund and the Bank. At the same time, those members must bear more of the responsibility for systemic stability. Once again we may reasonably ask, would such an outcome be more likely in the absence of multilateral intermediaries, adequately staffed, ably led, and at least minimally financed? Upon what historical evidence could anyone seriously answer in the affirmative? If the Fund and the Bank did not exist, we would be hard pressed to invent them now. They should be used as they were originally intended to be used, as necessary and legitimate instruments for multilateral collaboration and burden sharing.

¹ This paper draws on and develops themes from my recent articles: “The Old and the New Politics of International Financial Stability,” *Journal of Common Market Studies*, forthcoming in January 2010; “The Institutional Legacy of Bretton Woods: IMF Surveillance, 1973-2007,” in *Orderly Change: International Monetary Relations Since Bretton Woods*, edited by David Andrews, Ithaca, NY: Cornell University Press, 2008, pp. 189-210; and “Financial Crisis Management in Europe and Beyond,” *Contributions to Political Economy* (Journal of the Cambridge Political Economy Society), vol. 27, no. 1, July 2008, pp. 73-89.

² For insightful analyses of the broader European context and of specific European challenges in the banking arena, see André Sapir, ed., *Fragmented Power: Europe and the Global Economy*, Brussels: Bruegel, 2007; and Nicolas Véron, Adam Posen, “A solution for Europe's banking problem,” *Bruegel Policy Briefs*, 12 June 2009.

³ US Treasury (2008). “Legislative Proposal for Treasury Authority to Purchase Mortgage-Related Assets,” *New York Times*, September 20.

⁴ US Congress (2008), “Emergency Economic Stabilization Act,” H. R. 1424, 110th Congress of the United States of America, Second Session, October 3.

⁵ “IMF Executive Board Concludes 2009 Article IV Consultation with the People's Republic of China,” *Public Information Notice* (PIN) No. 09/87, July 22, 2009.

⁶ For useful background, see C. Randall Henning, *The Future of the Chiang Mai Initiative: An Asian Monetary Fund?* Policy Brief PB09-5, Washington, D.C.: Peterson Institute for International Economics, 2009.

⁷ Edwin M. Truman, *A Strategy for International Monetary Fund Reform: Policy Analyses in International Economics 77*, Washington, DC: Institute for International Economics, 2006: 31.