Evolving Institutions and Transatlantic Relations

Reforming the Global Financial Architecture

by Philippe Maystadt

Financial stress and crises are rarely contained by national borders. Yet, financial regulation remains largely in the domain of the nation-state. The international financial crises of the past decade, in particular, have raised calls for increasing international coordination of financial regulation and supervision.

The world came dangerously close to a global financial meltdown in the autumn of 1998, as the currency crisis in emerging markets spread quickly to developed countries. The mechanics of that crisis, detailed elsewhere,[1] have fuelled a renewed debate on whether the "global financial architecture" needs to be reformed. The focus of this debate has largely been on the need to introduce sufficient checks and balances to avoid financial near-meltdowns in the future. But a revamped global financial architecture can also be justified from a longer historical perspective, not only to reduce the risk of crisis but also as a conduit for global economic growth and prosperity.

Given their dominant positions in the world economy and financial system, the United States and the European Union (EU) will inevitably play leading roles in efforts toward reform. Any agreement on standards, supervision, or regulation reached between these two blocs is likely to create a benchmark for the rest of the world. But there are also a host of problems between the United States and EU in this area. The habit of insisting on national sovereignty in the area of financial regulation and supervision dies hard, even when the benefits of coordination may be obvious.

Balancing Institutional Competition and Harmonization

One can interpret the evolution of the international financial architecture and financial organization as the synthesis of two opposing forces: competition for savings and technological innovation. These forces combine to create and refine financial instruments best suited to the needs of end users and to push financial sector productivity upwards. They are at the same time tempered by the regulatory and supervisory constraints that aim to reduce the systemic risks associated with the expansion of the global financial system. The need for balance is paramount. If there is too much regulation, the financial sector will be unable to adjust to a changing world, which will in turn hamper economic growth. If there is too little or inappropriate regulation, systemic risks will threaten financial stability.

The many lessons from the convulsions of the global financial system over the past three decades have gradually led to a reassessment of the financial architecture

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inherited from the Bretton Woods era. In retrospect, it is clear that the heavily regulated financial sectors were largely unsuitable for a world of free capital mobility. Capital markets were rudimentary, which meant that international capital flows were mostly channeled through the banking system. This lack of diversification generated significant systemic risks. Such shortcomings convinced policymakers that financial deregulation was needed to make financial systems more flexible and adaptable. Most countries accept today that capital mobility, financial liberalization, and institutional competition have brought substantial benefits to the functioning of their economies.

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Excessive regulation of financial sectors during the Bretton Woods era led to static conditions. Government-controlled regulation is slow to adjust to a changing economic environment, and it is not clear that political decisions always result in greater efficiency. Whereas the evolution of financial institutions was largely driven and constrained by the political decision-making process for much of the postwar period, it is now increasingly determined by market forces. "Institutional competition" is the acceptance—very much recognized within the EU—that centralized attempts at harmonizing legal and regulatory frameworks risk undermining the creative and efficiency-enhancing aspects of competition. By allowing competing legal and regulatory regimes to coexist, competition might over time allow the most efficient frameworks to survive at the expense of the less competitive. This has also been referred to as "institutional Darwinism."[2] Competition thus introduces a dynamic creative element in the evolution of institutions that is a key driver of efficiency gains that boost economic welfare. The international mobility of skilled labor and capital makes economic growth prospects increasingly sensitive to relatively small differences in institutional competitiveness. In order to avoid a drain of capital and skilled labor, second- or third-tier governments are forced to adopt best practices.

As the EU experience has shown, institutional competition may also be a pragmatic solution to otherwise insurmountable differences in regulation across countries. Rees and Kessner have studied the prospects for harmonizing insurance industry regulation in Europe.[3] While in the United Kingdom the insurance industry has been relatively loosely regulated, German regulation has been much more restrictive. Strong national traditions and the opposing characteristics of the two models made swift convergence in national legislation difficult to achieve. Neither country would willingly abandon its model in favor of the other.

Under these circumstances, allowing both regulatory frameworks to coexist became the only feasible way to integrate the different systems. In the end, institutional Darwinism may come up with a winner. Rees and Kessner predict that the tightly regulated markets of Germany will eventually become more like the loosely regulated U.K. market, but *ex ante* a superior model can be extremely difficult for legislators to

determine. In the meantime, international harmonization efforts will focus on establishing a smaller set of minimum standards for all to follow, guarding against systemic risks while not trying to micromanage institutional development.

The above-mentioned example is largely applicable to financial institutional development on a global level. Apart from the likely gains in efficiency to be expected from institutional competition, attempts at detailed harmonization of regulatory and supervisory frameworks are likely to fail on practical grounds. The regulatory frameworks of individual countries largely developed in isolation during the postwar period, since little international harmonization was called for when capital mobility was negligible. This has left the world with large cross-country differences that are deeply ingrained in national traditions and culture. Choosing a single superior model to supersede these national frameworks would require that countries could agree on a single model. In a world of second-best solutions, however, there are usually several equally worthy models. Individual countries may also be deeply convinced of the superiority of their own model, even though they may fail to convince others to follow. A country considering itself to be at the forefront of institutional progress and competitiveness could rightly have a skeptical attitude towards international regulation that would pull it back from best practice and its institutional lead. Such a country would be most likely to adopt the attitude of conforming only to international standards that exactly replicate its own. To the extent that the laggards have reason not to adopt best practice from the leader, they would be the ones pushing hardest for an international standard to be adopted by all, thus softening the leader's competitive edge. Obviously, the leader would never agree to this. Allowing different frameworks to coexist and compete is likely to be the only politically viable solution under these circumstances, hoping that those with inferior models would eventually be forced to adopt the best practice solutions of the leader in order to close the growth gap and stem the drain of capital and skilled labor.

The Road to Reform

Some minimal standards may be imposed through agreements by national governments to level the playing field and reduce systemic risks, but following the reasoning above, these are likely to be limited in scope. Therefore, there is a role for both voluntary agreements between financial institutions themselves and governmental regulation.

Private Agreements on Standards and Self-Supervision. A lack of standards may be associated with higher transactions costs for all parties. Entering a new market with unknown and different standards in areas such as accounting involves a steeper learning curve that tends to discourage international transactions. Different uses of financial tools introduce extra transaction costs for anyone crossing a national border to make a financial investment. But just as private manufacturers of electronic equipment often join each other around a common standard to attract a maximum number of customers, financial institutions (and national regulatory authorities) can volun-

tarily agree on standards for their international interaction in order to reduce these transaction costs.

One example of such voluntary agreements was introduced by Goldstein, who suggested that financial institutions could alleviate the problem of asymmetric information by supervising each other in a global club with rigid membership criteria.[4] Any member willing to make the sacrifices should be allowed to join the club, and thus enjoy the better access to funds. Members have a strong incentive to make sure that others meet the standards, since the value of being a member would be undermined by the failure of any one member. Voluntary clubs among private institutions thus represent a form of regulatory and supervisory development that is not imposed by governments and thus should not undermine gainful institutional competition.

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Government Agreements. Politically generated agreements to set standards on an international level would be the reserve for cases where private agreements cannot be reached. Negative externalities would be the typical situation. Market imperfections such as moral hazard and adverse selection give rise to recurring crises in both the domestic and international arena. To the extent that such crises take on a systemic form, it is unlikely that private agreements can be reached that would reduce these risks sufficiently. This provides a key justification for government intervention in the area of regulation and supervision but would be limited to minimum standards, alleviating the worst risks rather than engaging in detailed micromanagement of the regulatory framework. This suggests that agreements of this kind are more suitably focused on establishing principles of conduct rather than trying to impose long lists of rules for individual situations.

Broadly speaking, national or international regulation can be justified by some form of market failure, such as moral hazards and coordination failures.

Moral hazard is the most commonly cited form of market failure in this context. An example is when expectations of a future bailout of the financial system by developed countries prevent local authorities from taking painful but needed action to avert crisis in its early stages. Financial fragilities can then build up through excessive and poorly allocated lending, resulting in overexposure that raises the risk that one bank failure will spread to the whole banking sector. The grave costs to the domestic economy of a widespread collapse of the banking sector mean that few governments can credibly commit not to bail out banks in such an event. Anticipating that the government will bail out the banks, foreign creditors become confident that their claims on banks can be treated as implicit sovereign claims. This tends to increase capital inflows to banking sectors that on their own merits would not deserve such preferential treatment. The local banks themselves are similarly affected by the dis-

torted incentives created by expected future government bailouts, generating behavior that raises the likelihood that a bailout will indeed be necessary.[5]

This kind of moral hazard cannot be easily averted but can be alleviated through regulation that prevents the imbalances from arising in the first place. Tying the hands of government is one way to change expectations of future bailouts, but since a government may not be able to do so on its own, international agreements can be helpful. The financial sector itself must also be regulated and supervised so that imbalances are discovered at an early stage. Regulation such as a minimum capital ratio can also change the incentive structure of the banking sector by making sure that the owners of banks stand to lose significantly by allowing a crisis to emerge. Moral hazards associated with explicit or implicit guarantees of banks and their depositors might be alleviated by creating narrow banks, where deposit insurance would only apply to banks holding relatively risk-free assets. More risky lending would be conducted by uninsured finance companies. On the other hand, the bailout of Long-Term Capital Management (LTCM), a major U.S. hedge fund with highly leveraged positions across a broad range of markets and linkages to many other financial institutions, showed that once systemic risks are present, governments may be forced to bail out nonbanks as well. Narrow banking alone thus would not eliminate all moral hazard problems.

Coordination failures occur when competitive regulatory policies result in an equilibrium that makes all parties worse off, or one that is associated with substantial systemic risks. For example, if countries were being pushed into weakening their regulatory protection of banks, or if their ability to tax capital were undermined as a result of international competition, international coordination may be justified to "level the playing field." If used only where coordination failure truly gives rise to inefficient solutions, such coordination could augment rather than undermine the benefits of institutional competition, boosting efficiency and growth.

The Role of International Standards

There are several areas where minimum international standards are likely to be beneficial.

- *Bank Regulation.* The Bank for International Settlements'[6] 1988 Basel Accord—with its 8% minimum capital requirements—and 1997 Core Principles—which added standards for sound supervision and regulation—stand as a high-water mark of the international financial standards process, but rapid progress in this area is impeded by the consensus-based decision process. While providing some protection against insolvency in developed banking systems, the minimum capital requirements are often insufficient in emerging markets, where a higher capital share might be required to offset the weaker regulatory and supervisory capacity.
- *Securities-Market Regulation.* Coordinated action among creditors was easier when most international lending was conducted through

a limited number of large international banks. In recent years, the growing role of bond markets in international lending has undermined the scope for coordination among the now much greater number of creditors in the event of a debt crisis. Attempts by governments and international organizations to impose collective-action clauses on bond markets have been resisted by the private sector.

- *Data Dissemination.* The International Monetary Fund has issued data dissemination standards aimed at making countries seeking to draw on international capital markets provide sufficiently good and timely data for investors to assess the strength of their economy, institutions, and finances.
- *Corporate Bankruptcy Reform.* Adequate bankruptcy procedures are important also within a national context, and thus may not need international coordination. In the international setting, however, coordination and regulation has the additional function of compensating for the lack of a transnational legal system. Indeed, the inability to use the legal system of one's home country to enforce contracts abroad is a key element in what is generally referred to as *country risk.*

Harmonization steps should not be seen in isolation. The overall financial architecture in most developed countries and at the worldwide level should not be seen from the narrow angle of institutional classification only. A clear convergence of financial organization is visible, and various forms for channeling finance from savers to borrowers are in constant competition. This is often described as the "Americanization of finance": the trend for market-based intermediation to gain to the disadvantage of traditional bank intermediation, which has been the mainstay of the continental European and Japanese financial models.[7]

The Financial Stability Forum (FSF) represents an attempt to rectify the notable lack of coordination—or even communication—between national governments and regulators with respect to financial supervision and regulation. It is essentially a semi-independent discussion forum composed of:

- national authorities responsible for financial stability in significant international financial centers, namely, treasuries, central banks, and supervisory agencies;
- sector-specific international groupings of regulators and supervisors engaged in developing standards and codes of good practice;
- international financial institutions charged with surveillance of domestic and international financial systems, as well as monitoring and fostering implementation of standards; and
- committees of central bank experts concerned with market infrastructure and functioning.[8]

The FSF's creation in 1999 followed the LTCM meltdown, which showed that mature markets are not immune to financial crisis originating in emerging markets and that the rapid expansion of nonbank financial institutions is creating new sources of risk to financial stability. Hans Tietmeyer, who played a leading role in the FSF's creation, identified a lack of coordination among national governments, financial regulators, and international institutions as one of the weaknesses threatening the stability of the global financial system.

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It would be presumptuous, however, to think that the FSF represents the foundation of a global financial regulator. National governments continue to see financial regulation and supervision as their own domain and are extremely reluctant to hand this responsibility over to an international body. Progress in achieving tangible results at the FSF has been slow for similar reasons. Some agreement has been reached in the area of offshore financial centers, which is one of the less contentious issues. Other FSF working groups face greater obstacles to reaching international agreement. The working group on hedge funds recommended greater disclosure and supervision of these institutions in light of their ability to destabilize the entire financial system. Hedge funds are not regulated the way banks are, and their investors are not protected by deposit insurance. Nevertheless, their sheer size and widespread links to other institutions produce notable systemic risks that may warrant their regulation in the future. Another FSF workshop has been looking at international capital flows, an issue where international agreement is likely to be highly contested. But the fact that these areas are not easily subjected to international agreement does not mean that no progress can be made. On major issues, partial agreement on the need for regulation and supervision may be enough to generate action at national levels. Marginal differences in national measures are probably less serious than no action at all. This suggests that an international discussion forum can bring progress in coordination where this is possible and still allow some healthy and necessary institutional competition to continue.

WHO STANDS TO GAIN?

The efficiency gains from having a more developed and competitive global financial system are likely to be substantial, at least for the more advanced countries of the world economy. Based on neoclassical growth theory, however, the greatest benefits from internationally mobile capital should be enjoyed by emerging markets. Free international capital mobility allows the world's savings to seek out the best investment opportunities, that is, the investment projects with the highest rate of return. Since less developed countries should have ample opportunity to adopt existing tech-

nologies, they should be the ones offering the highest rates of return. All other factors equal, persistent current account deficits in developing countries that are financed by net capital inflows should in this context be a way to achieve faster economic convergence across countries. However, this idealized and long-term positive state is not necessarily what is observed in practice.

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In reality, institutional differences across countries are so large as to often dwarf the excess returns envisioned by neoclassical growth theorists. One of the key lessons of the Asian crisis was that a massive inflow of foreign capital into economies with weak financial systems risks being squandered on projects with low rates of return, sometimes fuelling real-estate bubbles rather than productive investment. The short-term nature of a large portion of that capital also tends to weaken the link to the long-term growth potential of the capital-importing economies. Foreign investors with a relatively short-term investment horizon are more likely to take short-term movements in interest rates and exchange rates into consideration, rather than an economy's long-term growth potential, when determining where to put their savings.

The last few years are particularly illustrative of how different short-term expected rates of return can be from what is predicted by neoclassical growth theory. The sum total of all current account surpluses in the world can be said to represent excess savings in search of investment projects elsewhere. In the late 1990s, the United States absorbed as much as two-thirds of these flows. Its high level of economic development and its role as a technological leader would suggest that the United States should not be able to offer as high a return on investment as emerging markets. Investors have been of a different opinion, pouring capital into the economy on a scale that has put a persistent upward pressure on the dollar and financed an ever widening current account deficit. In the eyes of investors, the United States is apparently the world's greatest "emerging market."

Whether the U.S. economic expansion will eventually turn sour remains to be seen, but the very perception by foreign investors that U.S. assets offer a better rate of return nevertheless suggests that a number of institutional factors—including the effectiveness of the domestic financial sector—play an important role in determining the actual rate of return on investment. This also raises the question of how much emerging markets with weak institutions actually benefit from the globalization of finance. To benefit, emerging markets need long-term capital, rather than the volatile portfolio flows that they have mostly received. But such long-term flows are more sensitive to country risk (for instance, interpreted as the enforceability of contracts with respect to sovereigns also in the presence of systemic financial crisis). In order to make all emerging markets benefit from globalization, efforts to set minimum standards for the international financial architecture need to focus on how such country risk can be reduced and on ways to promote long-term capital flows that are more conducive to development.

Conclusions

The overall success of the global economy in recent decades is partially the result of increased globalization. However, recurring crises indicate that there is much scope for improving the international financial architecture. Although there is no set rule as to how such progress will be made, one can argue that there is some optimal balance between international regulatory harmonization and institutional competition that will yield the best results. A fine balance must be maintained between the creative forces of institutional competition and excessive transaction costs.

Recurring crises indicate that there is much scope for improving the international financial architecture.

Cooperation and coordination between the United States and the EU is vital. The difficulty in yielding national sovereignty in this area is visible enough within the EU itself, which, despite the creation of a common currency, has refrained from creating a common financial regulatory and supervisory agency. Merger attempts in the financial sector often turn out to be regulatory nightmares, which slow the pace of healthy financial sector consolidation. The increasingly integrated global financial system needs a more consistent approach to how it is to be regulated and supervised, but this realization will need to be more readily accepted by national governments.

Notes

[1] For example, see Bank for International Settlements, *A Review of Financial Market Events in Autumn 1998* (Basel, Switzerland: Committee on the Global Financial System, 1999); and *International Capital Markets* (Washington, DC: International Monetary Fund, 1999).

[2] For example, see Gordon C. Rausser, "Fueling the Research Engine," *California Monthly,* vol. 109, April 1999 (available: http://www.alumni.berkeley.edu/monthly/monthly_index/apr_99/research.html).

[3] R. Rees and E. Kessner, "Regulation and efficiency in European insurance markets," *Economic Policy*, vol. 14, no. 29, 1999.

[4] M. Goldstein, "The Case for an International Banking Standard,“ *Policy Analyses in International Economics,* no. 47 (Washington, D.C.: Institute for International Economics, 1997).

[5] See B. Eichengreen, *Toward a New International Financial Architecture* (Washington, D.C.: Institute for International Economics, 1999), pp. 40–42.

[6] For more information, see Bank for International Settlements (online: www.bis.org).

[7] See A. Steinherr, *Derivatives: The Wild Beast of Finance* (New York: Wiley, 2000), ch. 2.

[8] Financial Stability Forum (online: http://www.fsforum.org/About/Home.html).