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DG INTERNAL POLICIES OF THE UNION
- Directorate A **-**
ECONOMIC AND SCIENTIFIC POLICY
POLICY DEPARTMENT

MONETARY DIALOGUE JANUARY 2009
Summary of Monetary Experts' Panel Briefing Papers
for the Preparatory Meeting – 19 January 2009, 15.00-17.00hrs, ASP 3E3

The following summary presents the respective topics of the briefing papers followed by brief points on the main answers of the experts to the questions asked. Only selected main points are mentioned here. For a complete argumentation, please refer to the subsequent papers.

1) Danger of Deflation or Stagflation?

Recent months since October 2008 brought about an outright reversal in the assessment of risks to price stability in the euro zone. Whereas until the summer of 2008, monetary policy was concerned with surging commodity and energy prices with imminent upward pressure to price stability, now that trend is reversed. The ECB has recently repeatedly decreased interest rates to accommodate to the slowdown of growth and the danger of recession. At the same time, inflation has eased on the back of falling commodity prices and weak demand.

Throughout the year 2008, all major organizations (ECB, IMF, EC, OECD etc.) had big problems in predicting growth and inflation. The estimates had been subject to high uncertainties. Although most observers would today subscribe to the view that we are to expect a global slowdown in both growth and inflation, some argued not long ago that we were on the brink of deflation (or stag-deflation), while still others argue that stagflation could be the true concern in the mid- and long-run. Both views, obviously, hold in them very different consequences for ECB policy recommendations.

The experts were asked which scenario (inflation, deflation, stagflation) was the most likely one. The general consensus seems to be that despite currently observed disinflationary processes, a general deflation is rather unlikely. (Deflation being defined as the *persistent* decline in the *general* level of prices, which is *expected* by economic agents). However, if nothing was done to alleviate this biggest crisis and downturn since the Great Depression, some argue even deflation could eventually become a worry (Horn, de la Dehesa). This could e.g. happen in a situation of a downward spiral in wages and prices following broad-based (fiscal) inaction by European governments, and where the ECB would refuse to continue decreasing the nominal interest rate. The necessity for coordinated monetary and fiscal policy stimulus now, in greater magnitude than has been done until this moment, is therefore imminent to prevent deflation.

Others argue that nothing special needs to be done (Eijffinger, Krämer), as the ECB still has a lot of room for manoeuvre (through interest rate cuts and open market operations), and eventually inflation will automatically return to the agenda after the worst phases of the recession and when demand picks up. Evidence for this can be seen e.g. in the very steep yield curve for the euro zone (Eijffinger), or in the fact that liquidity and the money supply growth remains rather high (while deflations are characterized by decreasing money supply). Moreover, increasing demographic pressures will contribute to inflation in the long-run as the temptation to reduce the debt burden through inflation will be high (Krämer).

Guillermo DE LA DEHESA – The ECB has done an excellent job in liquidity management but lags "behind the curve" in its interest rate policy

The ECB should make very clear that it is fighting deflation just as hard as it would be fighting inflation and also, it should be ready to use unconventional and innovative tools in this unprecedented environment. All research institutes have been notoriously wrong in their estimates in 2008. Many theories and models need to be rewritten now.

At the moment, both the risks of deflation and inflation are rather low. The risk of deflation will remain low provided the ECB continues to reduce its rates aggressively and Member States provide fiscal stimuli. Inflation expectations are very subdued due to the recession and will remain so in 2009, despite a slight increase in the second half due to "base effects" (the comparison with 2008).

Sylvester EIJFFINGER – In this damaged environment monetary policy will not be very effective, therefore the ECB prefers to wait

The danger of deflation is exaggerated. All considerable research shows that deflation is not at all a real danger at present. Relative prices are falling, and a disinflationary process is at work, but this is by no means deflation. The comparison with Japan in the 90s is not justified, as the situation there was very different. Overall prices, not only asset or oil prices, were driven up very high and they had to come down a long way.

A steepening yield curve for the euro zone is evidence of the fact that in the mid-term, inflation will become an issue again and that economic agents expect that to some degree. At the moment, the ECB prefers to wait and see whether price decreases in oil and commodities are permanent or temporary, and then act on that knowledge. A too activist behaviour now may create a deflationary bias, as people may start to expect deflation. In the long run, the risk of inflation remains higher than that of deflation.

Gustav HORN - With no (coordinated) action taken, the otherwise unlikely case of deflation could become reality

The fear of inflation has turned into a fear of deflation in just a few months. Headline inflation has been declining at an amazing speed, but this decline of relative (not aggregate) prices does not as such constitute a deflationary process.

However, in order to fend off the risk of (stag-)deflation (or stagflation), the economic "exit strategy" needs to be appropriate. In the first place economic policy needs to stabilize the economy in order to avoid a deflationary process mainly in wages. Secondly, this expansionary course needs to be given up in time as soon as the crisis is over. If this process is managed, future instabilities either in inflation or deflation can be avoided.

Jörg KRÄMER - Deflation is very unlikely and the ECB has many tools in its hands to prevent this

The primary objective must be to prevent a liquidity squeeze at the moment and to ensure credit in the economy. Even after a rate cut to zero, the ECB could expand the money supply via open market transactions. Therefore, even for the unlikely case of deflation the ECB has appropriate tools. In the future, when growth picks up again, inflation will return to the agenda. High liquidity, demographics and the shaky independence of the ECB all remain risks for fighting inflation effectively.

2) How to restructure the international financial architecture?

The G20 summit held in November last year was widely seen as an opportunity to reform the international financial architecture. The participants pledged to introduce some important measures to strengthen the financial system. However, on the longer term institutional reforms less progress was made, the summit turned out not to be a new Bretton Woods. Also the experts have different opinions on how best to reform the international financial architecture.

First the role of the IMF (International Monetary Fund) is considered. All experts felt there is a need to enhance international cooperation, and the IMF is seen as the institution most up for that task. How large the future role of the IMF should be is a point of discussion, some argue for a very important role (Patat, Fitoussi), some think it is not feasible to give such a supra-national institution more power (Sibert, Walter). Also on the status of the FSF (Financial Stability Forum) opinions differ, with some arguing for keeping the two institutions strictly independent from each other (Podkaminer, Walter) and some wanting to completely integrate the two (Patat). All experts are in favour of making the governance structure of IMF more in line with the growing importance of emerging markets.

Other proposals for reform of the financial architecture include a return to narrow banking (Podkaminer), downsizing the G20 and making contact less formal (Wyplosz), international exchange rate coordination (Walter, Patat) and an independent crisis warning body (Sibert).

On the future role of central banks, the experts' opinions are very much in line with each other. They generally agree that central banks should be responsible not only for monetary stability but also for financial stability. Some (Walter, Patat) also suggest the monitoring of asset prices. At the same time, involving the ECB is seen by most (Wyplosz, Patat, Walter) as the most practical way to install financial supervision at the EU level. However some (Podkaminer) doubt the political feasibility of such a plan.

Jean-Paul FITOUSSI - The IMF is the obvious candidate to ensure global financial stability by building standards, rules and checking national financial regulation

The problem of financial stability is global, and individual governments are unable to deal effectively with it. Thus, we need a global institution in charge of monitoring and coordinating national regulatory activities. A reformed IMF, whose governance should reflect today’s world, seems the appropriate institution for such a role, and would have both the expertise and the credibility to act as an effective regulator of world’s finance.

Central banks have for the past quarter of century successfully maintained monetary stability; however this proved neither a sufficient nor a necessary condition for macroeconomic stability, as the current turmoil shows.

Jean-Pierre PATAT – A reformed IMF, with the FSF as a subcommittee, will have to monitor new standards and codes

The IMF will have to be given a role in maintaining financial stability. Redistribution of voting rights is also essential. The FSF can then be integrated as a committee of the IMF. Additionally, it is crucial that central banks worldwide, including the Chinese, cooperate in the future to prevent large fluctuations in exchange rates.

Central banks worldwide, including the ECB, should in the future be responsible not only for monetary stability but also for banking supervision. In their policy making, they should use information on the evolution of real estate and stock prices. All reforms concerning the central bank will have to be embedded in international standards and codes.

Leon PODKAMINER – The G20 proposals will make the global financial system more resilient, but nothing can be expected in terms of new supranational authorities

The FSF and the IMF each have their own area of expertise, so they should not be forced to cooperate too closely in the future like the G20 proposes. The proposed colleges of supervisors are also a bad idea, but are unlikely to ever materialise. An expanded membership of emerging countries in the FSF is a good thing though. In general, a return to narrow banking based on the traditional principles would be a positive development. The increasing conglomeration and consolidation in the financial sector should be assessed critically.

The ECB has no powers yet in the area of financial supervision and as it will be hard to organise this even in the few countries that form the EU, talking of international financial supervision is useless.

Anne SIBERT - Better crisis prevention, warning and management will have to come from improving existing institutions, not from the creation of a global supervisor

Global financial supervision may not be possible, but there should be more roles for the FSF and the IMF in the future. The FSF cannot supervise large financial institutions itself but can, as an independent body, provide ideas and assess the supervisor. The IMF can play a role as international lender of last resort to small countries and by promoting cooperation but it is not the right institution for providing an early warning system for future crises.

The Euro area should have one single supervisor/regulator charged with maintaining financial stability. Whether that should be the ECB depends on the outcome of the current debate on whether monetary and financial stability can be maintained by the same authority.

Norbert WALTER - A satisfactory reform of the International Financial Architecture is not feasible politically, but progress could be made

Efforts at reforming the international financial architecture will have to be based on the following principles: openness, international consistency, consensus on objectives, inclusiveness, principles-based regulation and political accountability. A grand reform is not politically feasible however. In the process, clear separation of the tasks of the IMF and the FSF would be beneficial, as they have different core competencies. The IMF should lead macroeconomic policy coordination efforts. In line with these reforms, an exchange rate framework will have to be set up.

Central banks, also the ECB, should be in charge of both monetary stability and macro-prudential supervision, while close contact with micro-prudential supervisory authorities.

Charles WYPLOSZ - The IMF should be reformed, but global macroeconomic policy coordination will have to be organised through more informal contacts

The IMF has to be reformed by strengthening its independence and accountability. It has to take account of emerging markets in its governance structure not by redistributing voting rights but by changing its executive board structure. Regarding the newly created G20, it includes too many countries with insignificant financial systems to be effective. Informal contacts similar to those that central banks have long nurtured would be a better way.

As regarding the role of the ECB in the new financial architecture, once EU representation on the executive board of the IMF is reduced to a single seat, the ECB could provide the representative. Inside the EU, the ECB will eventually have to assume responsibility for financial stability next to monetary stability.

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Topic 1

Danger of Deflation or Stagflation?

Deflation and Inflation Risks in the Euro Area

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Guillermo de la Dehesa

Both risks need first to be put into perspective because the world is facing not only the first financial crisis of the twenty first century but the deepest since the Great Depression and the most global ever. Many politicians thought at the beginning that it was going to produce another recession, similar to the past ones, which could be dealt again much more effectively due the greater knowledge and experience accumulated by central banks on how to deal with business cycle smoothing as it happened in the years of the Great Moderation. But it has not turned out as they thought. On the contrary, many economists think that this crisis is the result of keeping too lax a monetary policy and for too long in order to avoid recessions which were necessary. Even more, as historic empirical evidence shows (IMF, 2008) recessions produced by financial crises tend to be deeper, longer and more difficult to deal with than normal ones and the present one is, by far, the most complex in economic history.

A clear example of this complexity is that never before policy makers, international financial institutions, economic analysts of major private banks and professional macroeconomic forecasters were so inaccurate about their predictions of world's and Europe's inflation and growth for 2008. There is of course a major reason for that. This crisis, as some other in the last eight centuries of "financial folly" (Carmen Reinhart and Kenneth Rogoff, 2008) is one of total loss of confidence on financial markets, where uncertainty, panic and hysteria have become rampant and consequently, most economic agents have behaved more irrationally than usual.

Irrationality is even larger when it is a response to uncertainty. Risk can be measured but not uncertainty. Uncertainty is a situation in which there is no certitude about anything, thus, no risk probability can be computed. Pure risk is a situation in which there is at least the probability that it can oscillate between 0 and 1. Pure certainty is a situation in which we know that probability is either 0 or 1. In most cases and under normal situations, our knowledge tends to oscillate between pure uncertainty and pure risk, but in this crisis the situation has been the closest to the first for a long time.

We have seen this time how most of the basic conventional principles of finance have failed to apply. For instance, since the start of the crisis we have witnessed a huge blow to the Efficient Market Hypothesis (EMH) of financial markets (Eugene Fama, 1970) where financial markets allocate savings to the best risk adjusted return investments and where their financial agents are rational individuals who take optimal decisions given present available information. As a result, all asset prices reflect their fundamental value, that is, their present discounted value of future earnings.

In the last year and a half, most theories about irrational or less than rational behaviour of agents in financial markets, which were considered unfashionable during the financial and credit bubble, have now found massive support from actual empirical evidence, which in turn has shown major failures in most of the EMH tenets. The traditional problems of financial markets such as: "moral hazard" (Kenneth Arrow,1971); "asymmetric information" (Sanford Grossman and Joseph Stiglitz ,1980); "adverse selection" (Joseph Stiglitz and Andrew Weiss,1981) or "the market for lemons" (George Akerlof, 1970); "herd behaviour" (Abhijit

Banerjee, 1992); "irrationality" (Daniel Kahneman, Paul Slovic and Amos Tversky,1982), (Werner De Bondt and Richard Thaler ,1985) and (Lawrence Summers, 1986) or more recently (Andrei Shleifer ,2000) and (Robert Shiller, 2000) and even the return of Keynes' "animal spirits" (George Akerlof and Robert Shiller, 2009), have all been well confirmed and ratified by the recent behaviour in financial markets before and during the present crisis.

As a result of this crisis major individual and institutional failures, some of Neo-Classics and New-Classics macroeconomics basic theoretical tenets have been put into question, mainly its famous "fife neutralities" (George Akerlof, 2007) which had become the dominant paradigm during since the mid 1970s when Keynesian macroeconomics in general and especially its Phillips curve were not able to explain stagflation. By contrast the crisis is producing a clear switch to a New-Keynesian-New-Classic synthesis that it is emerging.

According to Akerlof, these fife New-Classics neutralities are the following: First, "The permanent income hypothesis": changes in current income, which leave wealth constant, are neutral to consumption (Milton Friedman, 1957). Second, "The Modigliani-Miller theorem": changes in firm financing are neutral to current investment, (Franco Modigliani and Merton Miller, 1958). Third, "The natural rate of unemployment": changes in the monetary-fiscal policy mix, affecting long term inflation, are neutral to long term unemployment", (Milton Friedman, 1968 and Edmund Phelps, 1968), Fourth, "rational expectations": monetary policy reactions to the business cycle are neutral to economic stability, (Robert Lucas, 1972 and Thomas Sargent, 1973) and Fifth, "Ricardian equivalence": debt financed social transfers are neutral to current consumption" (Robert Barro, 1974)

Therefore, this crisis is going to produce a major change not only in how to deal with this crisis and its credit crunch but also in the way theoretical models, empirical techniques and policy making is going to address financial and macroeconomic issues in the future.

Two special cases of prediction and policy making failures, in 2008, are the IMF's World Economic Outlook macroeconomic estimates in October and the decision by the ECB to raise rates in July respectively. Both institutions, in spite of having a staff of outstanding economists, were not able to see that the commodity price boom was going to be short-lived because of its accelerating negative effects on growth. Both these predictions were discounting that world and European rates of growth were going to be much higher than they have turned out to be, so that the impact of commodity inflation on consumer inflation was going to be large and have second round effects.

First, the IMF (2008) estimated in October 2008 that world growth was going to be 3.9 percent in 2008 and 3.0 per cent in 2009 and in the Euro Area 1.3 and 0.2 per cent respectively. One month later, in November, IMF estimates of world growth was down to 3.8 in 2008 and 2.2 per cent respectively and Euro Area's growth was down to 1.2 and -0-5 per cent respectively in both years. As regards, oil dollar prices per barrel, in October, were supposed to be $50.8 in 2008 and -6.3 in 2009. In November, IMF estimates of oil dollar prices per barrel were down to $40, 2 in 2008 and -31.8 in 2009. Finally, in October, IMF consumer prices for advanced countries were estimated at 3.6 and 2.0 per cent respectively for both years and in November, 3.6 and 1.4 per cent respectively.

Second, the ECB has done an excellent, proactive and flexible job in managing and providing liquidity in unprecedented amounts during this financial crisis, which stands in sharp contrast with its backward looking interest rate policies, which have been always behind the curve. This can only be explained by a problem in the institutional set up where interest rate decisions are taken. When the financial crisis erupted in the summer of 2007, the ECB put on hold, rightly so, expected gradual rate hikes, but warned that it was not abandoning them and continued with an increasing hawkish rhetoric in winter and spring.

Finally, the ECB raised rates in July 2008, apparently because HICP had reached 4% in June, even in a situation in which the Euro Area economy was showing already clear signs of an incoming recession. It kept in that position in August, when additional signs of recession appear and even after the collapse of Lehman in mid September until finally in October it joined the FED, the BOJ and the Bank of England in cutting rates drastically and collectively.

Charles Wyplosz (2008) tried to explain, in its briefing paper (and I tried to do the same in my meeting with the ECON Committee), the important distinction between inflation, which measures the overall price index and changes in relative prices within the index, which have only a temporary effect on the inflation rate. Oil and food strong increase in prices were affecting only to around 25 per cent of the Euro Area HICP basket, while most of the rest of its items were not showing price pressures. Therefore, in order for the HICP to increase again in that proportion, oil and food prices had to double again in 2009, otherwise, if they did not, HICP will rise a little or stay put, and, if the commodities would fall, HICP will fall as well, that is what has eventually happened.

Moreover, this sudden commodity inflation was not the result of an increase in its demand in the Euro Area, but it was, partly, the result of its higher emerging market demand and, partly, the result of temporary shortages in its supply. Therefore, raising interest rates was dangerous because at that moment, the probabilities of recession were higher than the probabilities of inflation. The ECB decision to raise rates was, apparently, based on its worry about the high probability of second round effects from this commodity price boom on wages. Nevertheless, after the commodity boom went bust very quickly, as predicted, wage negotiations in 2009 are going to be based the very small increase in the Euro Area HICP for December 2008 of, most probably 1.8% down from 2.1 % in November. The ECB ended the year with still high rates at 2.5%, but even then its President began to argue that the floor for nominal rates is not zero, but something around the long-run inflation level, just to avoid negative real rates, and that the process of convergence to these rates was going to be gradual.

Does it mean that the ECB has now to worry about deflation? In my personal opinion, the Euro Area can avoid a deflationary situation provided the ECB keeps lowering interest rates aggressively and as soon as possible (since it has still room to do it) and the fiscal policy stimulus is effective. A few points about deflation:

First, it is important for the ECB to understand that deflation should not be defined as having a negative HICP during a few months, but only after staying negative for a year or more or when economic agents have already built up expectations of a longer period of falling prices, making consumers to postpone purchases and keep its income in cash and employees to begin to accept declines in their nominal wages, which are the real mark of a deflation.

Second, deflation is one of the worst situations that can be achieved by any economy, mainly because, once an economy falls into deflation is extremely difficult to get out of it, even if policy makers have learned a lot from previous historical examples of the Great Depression and Japan. Zero bound nominal interest rates in an indebted economy makes impossible for households and companies with falling income and earnings to pay their debts, which in turn produces a larger banking crisis which forces a strong credit crunch.

This is one of the reasons why the US, which is much closer to deflation and to a liquidity trap than the Euro Area, is privileged and lucky to have Ben Bernanke at the helm of the FED, who is probably, not only a great economist, but also the best expert on how to avoid the same mistakes of the FED and of the BOJ in their previous deflationary experiences. We should learn from how Ben Bernanke is dealing with the probability of having a deflation in the US, by going close to the zero bound and by using highly innovative and, for the time being, effective measures to address such a problem.

In the case of the Euro Area, a counterfactual can be made: if the ECB would have continued raising rates after the July 2008 increase it could have ended provoking a stronger recession and probably a deflation. This is what the FED did in the Great Depression, when it raised rates to fight the financial asset price boom, producing a recession and later increased rates again to avoid leaving the Gold Standard helping recession turn into depression. A similar situation developed in Japan in the early 1990s when the BOJ raised rates to fight its huge real estate price boom and kept them high for too long provoking a recession, a banking crisis and a subsequent credit crunch which ended in deflation.

Third, today, the Euro Area HICP is clearly heading down. Oil prices dropped dramatically and are now stagnant, food prices went down as well, while recession is already widespread in advanced countries. The same is happening in the Euro Area, which rate of growth is already negative, quarter on quarter elevated to year, and, in 2009, is expected to be negative, year on year (the consensus of private analysts estimated a Euro Area GDP growth of -1.4%). Moreover, the dominant view is that this recession is going to be more prolonged than normal recessions due to the present "credit crunch" provoked by the financial crisis.

This is not another normal recession. This time is not only the result of falling asset prices after a very large boom which it was not tackle by a "leaning against the wind" monetary policy on time, but also is a combination of very negative animal spirits of investors deceived by false ratings and fraud and a credit crunch derived from a large de-leveraging by banks after so many years of easy and cheap credit and mounting levels of leverage. Therefore, in this abnormal situation, the policy of the ECB should be: first, to make very explicit that it is ready to fight deflation expectations as hard as it has been fighting inflation expectations (instead of saying that it will not get rates down to close to zero but to long-run inflation levels to avoid negative real rates) and second, to be ready to use, if necessary, unconventional and innovative policies to avoid it.

The probable reason for such an ECB argument is that a negative real rate of interest is an undesirable subsidy to its recipients. But it is not right given that first, it can do it temporarily and then when deflation expectations are over to go back to positive rates. Second, its recipients are commercial banks which enjoy the privilege of access to the central bank in return for being regulated. Third, such an argument would only valid if the cost of the subsidy for a short period would be larger than the cost of positive real rates in times of distress.

Nevertheless, the ECB President's argument was later softened by Vice President Papademos who gave a more forward looking and reassuring statement when he said: "further Euro Area interest rate cuts may be warranted to prevent economic recession from spilling into damaging deflation… and if the downside risk to price stability increased… an easing of monetary policy could be warranted in order to keep price stability low but close to 2 per cent" That is, meaning, for the first time, that the inflation target is symmetrical, which is very good news.

Fourth, deflation can also be latent and waiting to be triggered by a monetary policy mistake. In a country like Japan, deflation is latent for the following reasons. Its population average level of age is very high, due to having the world's longest life expectancy, one of the lowest fertility rates globally and also a highly homogeneous ethnic population that is quite reluctant to accept immigrants other than the descendants of previous Japanese migrants to the rest of the world (only 1.5% of the population is foreign). On the one side, its labour force (15-64) is shrinking fast (now 64% of the total versus 67% in the OECD) and its older population (65+) is increasing even faster (now 22% of the total versus 14% in the OECD).

Therefore, Japanese households are very reluctant to consume, not only because many have a high age and old people consume very little, but also because they see their futures pensions at high risk, given the growing miss-match between the falling number of people contributing to pensions and the increasing number of retirees and also because they see that the government debt to GDP ratio is 180% and it will have difficulties to bridge the pension system growing financial hole. These are the main structural reason why Japan is more prone to deflation than other countries.

Fifth, in the Euro Area, the only Member State that could be somehow closer to the Japanese situation is Germany. Germans are also aging a little bit faster than in Italy or Spain, but they are not as reluctant as Japan to accept immigrants from Eastern Europe or Turkey and their government finances, only 60% debt to GDP; are much better off than those in Japan. Moreover, Germany is the most competitive European Member State, the largest exporter in the world and the only country that has a trade surplus with China, although its export markets are now shrinking because of the financial crisis.

Nevertheless, Germany is having a major structural problem with its domestic household consumption. German households prefer to save rather than to consume because they also think that their future pensions could be in jeopardy, mainly because they tend to be very forward looking and to plan for long-term horizons, unlike Italians or Spanish, which have similar aging population situations but tend to be less forward looking and to have much shorter term horizons. Nevertheless, in these two latter countries, families play a larger safety net role than in Germany, which may explain part of their myopic stance. This structural problem that Germany is suffering is the reason why it seems paradoxical to see some German policy makers being against ECB reducing rates and trying to avoid large coordinated fiscal stimulus in the Euro Area.

Does the Euro Area have a problem with inflation expectations? In my view, in the short to medium term there is almost no probability of any inflation expectations surge. In the long term, it will depend on the net result of, on the one side, how deep and long will the present recession turn out and on the other, on how large the fiscal programs to bail out banks and to smooth out recession are going to keep within a reasonable debt to GDP ratio.

Looking onto the short to medium term, the ECB's December 2008 Monthly Bulletin shows the latest Eurosystem staff macroeconomic inflation projections, where average HICP inflation is estimated to lie between 1.1% and 1.7% in 2009. Let us suppose that the true eventual rate of inflation for 2009 ends in the middle of that range (1.4%) In that case, it will be the lowest since October 1999, well below the ECB target! The OECD expects HICP inflation in 2009 to be 1.4% as well and the IMF, 1.9%. For 2010, Eurosystem staff projections estimate 1.8% as the middle of their range, the European Commission expects 2.1%, the OECD only 1.3% and the consensus among forecasters is 2.0

Nevertheless, the existence of what is called "base effects", that is, the contribution to the change in the year-on-year inflation rate in a particular month that stems from a deviation from its usual pattern of the month-on-month rate in the base month one year earlier. HICP in 2008 was subjected to wide deviations form the normal inflation patterns and thus is going to produce large base effects. In the first part of 2008, HICP surged, due to a large jump in food and oil prices, reaching 4% in June and July, and, in the second part of 2008, oil and food prices started to fall as fast as they did jump in the first half, ending at a low point in December of probably 1.8%.

Therefore, in 2009, the cumulative impact of these base effects on the HICP will tend to reduce the month-on-month inflation rate in the first seven months when they will be compared to the surging month-on-month inflation in 2008, where the base was higher.

And by contrast, to increase the month-on-month inflation rate from August to December 2009 when compared to the falling rates in 2008, where the base was lower. Therefore, the shape of HICP in 2009 will tend to be of inflation falling faster than normal in the first seven months maybe getting closer to zero or negative in July and then growing faster than normal in the last fife months. These base effects will tend to continue in 2010 but will be smoother and will tend to shape the inflation year curve in the opposite way than in 2009.

Nevertheless, the consensus estimate by private analysts on Euro Area inflation for 2009 is, at this moment, of 0.5% while for 2010 are of 1.9%, that is, within the inflation target. This estimates are based on Euro Area budget balances being negative in 2008 (-1.5% of GDP) and even more negative in 2009 and 2010 (-2.7% and -3% of GDP respectively), that means that the Stability Pact ceiling will not be surpassed for the whole of the Euro Area. Some Members will be above, notably Spain with -5.2% in 2010 and some others much below, notably Denmark with a surplus of 1.4%, Sweden with a surplus of 0.7%, the Netherlands with a deficit of 1.5% and Germany with a deficit of 1.8%. The Eurosystem staff macroeconomic projections show a lower budget deficit for the Euro Area, both in 2008 (-1.3%) and in 2009 (-1.8%) than that of private forecasters.

Finally, the Eurosystem staff macroeconomic projections for long-term interest rates are assumed to increase slightly, from 4.2% in December 2008 to and average of 4.5% in 2009 and of 4.7% in 2010. Compared with their June 2008 projections the 2009 new ones have been revised downwards by about 15 basis points.

As a conclusion, on the one side, the risk of deflation in the Euro Area has more probabilities than that of inflation in the next two years and mainly in 2009, but still its probability remains low, provided the ECB continues reducing aggressively rates in the next quarter and projected fiscal stimuli by its Member States start to be implemented. On the other, inflation expectations in the Euro Area seem to be very subdued, the recession is being stronger and longer that it was expected only a few months ago, so inflation will be able to be kept within the ECB inflation objectives both in 2009 and 2010. That means that both risks seem to be low.

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Danger of Deflation or Stagflation?

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Sylvester C. W. Eijffinger

Executive Summary

Recent months have brought about an outright reversal in the assessment of risks to price stability in the Eurozone. Whereas until summer 2008, monetary policy was concerned with surging commodity and energy prices with imminent upward pressure to price stability, now that trend is reversed. The ECB has recently repeatedly decreased interest rates to accommodate to the slowdown of growth and the danger of recession. At the same time, inflation has eased on the back of falling commodity prices and weak demand. Throughout the year 2008, all major organizations (ECB, IMF, EC, OECD etc.) have had big problems in predicting growth and inflation. The estimates have been subject to high uncertainties. Although most observers would subscribe to the view that we are to expect the risk of a serious global slowdown in both growth and inflation (i.e. traditional recession), some argue that we are on the brink of deflation (or stag-deflation), while still others argue that stagflation could be the true concern in the mid- and long-run. Both views, obviously, hold in them very different consequences for ECB policy recommendations. In Section 2 we refer to various sources, which state that the deflation danger is exaggerated and in Section 3 a closer look is taken at deflation in the Eurozone. In Section 4 we analyze the empirical evidence on inflation and deflation risks and we make our own update up to November 2008. Section 5 investigates the steepening of the yield curve in the Eurozone since the failure of Lehman and during the year 2008. Section 6 concludes with some remarks on central bank policy in the Eurozone and the US. In the short run the ECB has to act in an environment with major flaws in the financial system (disfunctioning money and credit markets) under a lot of macroeconomic uncertainty. Therefore, its monetary policy actions will not probably work as expected and the ECB's option value of waiting will be high. In the medium term (the ECB's policy horizon) the risk of excessive inflation is (much) higher than the risk of deflation. By the globalization of monetary policy it will be hard for the ECB to shield the Eurozone from the quantitative easing by the Fed and other central banks in the world.

1. Danger of deflation or stagflation?[1]

Recent months have brought about an outright reversal in the assessment of risks to price stability in the Eurozone. Whereas until summer 2008, monetary policy was concerned with surging commodity and energy prices with imminent upward pressure to price stability, now that trend is reversed. The European Central Bank (ECB) has recently repeatedly decreased interest rates, in December 2008 by an unprecedented 75 basis points, to accommodate to the slowdown of growth and the danger of an ongoing recession. At the same time, inflation has eased on the back of falling commodity prices and weak demand. Throughout the year 2008, all major organizations (ECB, IMF, EC, OECD etc.) have had big problems in predicting growth and inflation. The estimates have been subject to high uncertainties. Although most observers would subscribe to the view that we are to expect the risk of a serious global slowdown in both growth and inflation (i.e. traditional recession), some argue that we are on the brink of deflation (or stag-deflation), while still others argue that stagflation could be the true concern in the mid- and long-run. Both views, obviously, hold in them very different consequences for ECB policy recommendations. Indeed, a deflationary spiral is in many ways potentially the least attractive scenario as it contains the danger of liquidity traps and sustained expectations of lower prices, which can lock-in for a long time, what in extreme form, can lead to a repeat of the Japanese experience in the last two decades. What are the chances of a Japan-style deflation in the Eurozone? The most likely source of a potential large-scale deflation in the Eurozone is likely to be stemming from asset prices, but possibly also certain commodity prices, if the current trend continues. In Section 2 we refer to various sources, which state that the deflation danger is exaggerated and in Section 3 a closer look is taken at deflation in the Eurozone. In Section 4 we analyze the empirical evidence on inflation and deflation risks and we make our own update up to November 2008. Section 5 investigates the steepening of the yield curve in the Eurozone since the failure of Lehman and during the year 2008. Section 6 concludes with some remarks on central bank policy in the Eurozone and the US.

2. Deflation danger is exaggerated

Deflation has not been in the news as much as today since 2003, when the last global recession took place. The 2003 deflation scare was rooted in the belief that the negative output gap at that time would push already low rates of US (core) inflation into negative territory. *The Economist* figured that, from August till November, 50 news stories in the *Wall Street Journal*, *International Herald Tribune* and *The Times* have mentioned the term deflation[2]. By now, this number has increased tremendously, although most of these news stories were referring to the US and not so much to the Eurozone. However, this deflation danger is far from imminent, as expectations are not reflecting this. This has been stated by the ECB, the OECD and the European Commission. President Jean-Claude Trichet and Executive Board Member Jürgen Stark have both indicated that the ECB does not see trends or signs of deflation arising in the Eurozone[3][4]. The ECB is happy with the easing of inflation as this gives room to central banks for lowering interest rates and for governments to apply fiscal stimulus to their economies. President Trichet did warn, however, that this stimulus must stay within the limits of the Stability and Growth Pact.

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[1] The author gratefully acknowledges the very helpful comments of Prof. Hans Blommestein, Dr. Willem Verhagen and Mr. Edin Mujagic, MSc and the excellent research assistance of Mr. Rob Nijskens, MSc.

[2] *The Deflation Index*, The Economist, 20-11-2008, http://www.economist.com/daily/chartgallery/displaystory.cfm?story_id=12652688

[3] *No Sign of Eurozone Deflation – ECB*, Agence France Presse, 19-11-2008

[4] *ECB's Stark Sees Little Deflation Risk for Euro zone*, Thomson Financial, 22-12-2008

Those countries that do not have room to manoeuvre probably suffer from a lack of confidence, still caused by the credit crisis. Given the weak fiscal position of some countries, there are also rising concerns about the ability of these countries to service their debt in the future.

OECD Secretary General Angel Gurria also stated that there is no big deflation risk present[5]. Although he did not rule it out completely, he said that the OECD does not see it at the moment. Only some products and commodities have declining prices; there is no general price decline.

European Commissioner Joaquin Almunia said deflation is not a real risk in the Eurozone[6]. He also attributed the drop in prices to oil, commodities and the recession. Additionally, he said the Eurozone is structured differently from other major economies: “We have a labour market that is organized in such a way that makes it extremely, extremely difficult to go towards deflation." Presumably, he refers to the higher degree of nominal and real wage rigidity in the Eurozone. The resistance to nominal wage declines is an important line of defence against deflation. The recession should be mitigated by using both fiscal and monetary stimulus, and Almunia foresees a return to growth in the second half of 2009.

We can even go further and say that the danger of deflation is exaggerated. Thomas Mayer (2008), Managing Director at the Global Economics division of Deutsche Bank, states that the future will bring very low growth in the large industrialized economies of the world, together with a long-term rise of inflation[7]. He argues that, due to global imbalances, the consumers in the large economies were no longer able to repay their debt. The government had to step in to take over bad debts, as to prevent mass bankruptcy and avoid deflation due to faltering demand. Additionally, monetary policy has to be eased. This has already happened in the US, and the Eurozone may be following. This should avoid a very deep recession and thus deflation and, given the amount of monetary stimulus, might lead to inflation instead in the medium to long run.

However, new growth cannot be sustained only on fiscal impulses. Therefore, Mayer (2008) argues that the renewal of global demand will come from the growing middle-classes in emerging markets such as China, India and Brazil. Until this new structure has taken hold, growth rates may swing as slowdowns will be countered by fiscal expansion in the industrialized countries. Additionally, it is argued that as global capital flows decrease, the global financial sector will become much smaller.

The fiscal stimulus packages currently administered will hurt public finances, and might lead to excessive debt despite the Stability and Growth Pact (since these are special circumstances). When governments then obtain funds from their central banks, this over-supply of liquidity will lower exchange rates against emerging markets, which are growing faster. The lower exchange rates will induce wage and price increases, and thus fuel long-term inflation.

3. A closer look at deflation

Deflation is defined as a *persistent* decline in the *general* level of prices, which is *expected* by economic agents. It is often associated with a reduction in aggregate demand.

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[5] *OECD Chief Does Not See Big Deflation Risk*, Reuters, 15-12-2008

[6] *EU’s Almunia: Deflation Not Real Risk in Eurozone*, Reuters, 3-12-2008

[7] “The Reports of Deflation Are Greatly Exaggerated” by Thomas Mayer, *Wall Street Journal Europe*, 8-12-2008

When mentioning deflation in the news, however, the media often do not merit the three main characteristics of deflation: it is generalised, persistent and expected by economic agents.

Lorenzo Bini Smaghi (2008), Executive Board Member of the ECB, has stated that the discussion of deflation has been imperfectly informed, and that the way in which it is discussed is imprecise[8]. He additionally states that "it is much more useful for market participants to have a good understanding of the analytical framework supporting policy decisions, than for them to try to dissect each and every speech of the various members of the policymaking body to detect any indication of the next policy move", which motivates his intention to not influence market expectations but to clarify the analysis done by the central bank. Deflation can indeed lead to severe problems, especially due to its self-perpetuating nature; the expectation of future price reductions makes consumers reluctant to buy. This reduces aggregate demand, putting additional pressure on prices. This can result in a downward spiral. It is often accompanied by a sharp drop in asset prices and thus loss of wealth, which amplifies the initial disturbance. Additionally, the real interest rate will be pushed *up* by deflation expectations.

However, as Bini Smaghi (2008) points out, not all declines in the level of prices are deflation. Individual prices do fall, but do not lead to a general decrease in price level. Even if the consumer price index (i.e. the HICP for the Eurozone) decreases from time to time, this may just be disinflation to adjust to the equilibrium price level (i.e. due to a shock). The difference between deflation and disinflation is, however, that in a deflation scenario the *expectations* of price changes become negative, leading to the abovementioned problems.

What do the forecasts say about deflation? The commodity boom of the recent year has turned into a bust that has influenced inflation expectations, with mainly the energy price component decreasing. However, this does not reflect the fundamentals of the commodity markets: there is a structural shortage of supply and thus prices will have to rise in the long term. The present analysis of the ECB does not indicate a fall in prices over a prolonged time period either: the latest Eurosystem Staff macroeconomic projections set average annual HICP inflation between 1.1% and 1.7% in 2009 and between 1.5% and 2.1% in 2010[9]. Also the OECD[10] does not forecast deflation, merely less inflation: it will lie at 1.4% for 2009 and 1.3% for 2010, and the European Commission[11] is even more optimistic: 2.1% for 2009 and 2% for 2010.

Additionally, a long and deep recession is not forecasted: GDP growth for the Eurozone is estimated 0.1% for 2009 and 0.9% for 2010 by the European Commission, and -0.6% and 1.2% by the OECD in its Economic Outlook. The recession is expected to be worse for the US during 2009: GDP growth is forecast to be -0.5% for 2009 and 1% for 2010 by the European Commission, and -0.9% for 2009 and 1.6% for 2010 by the OECD.

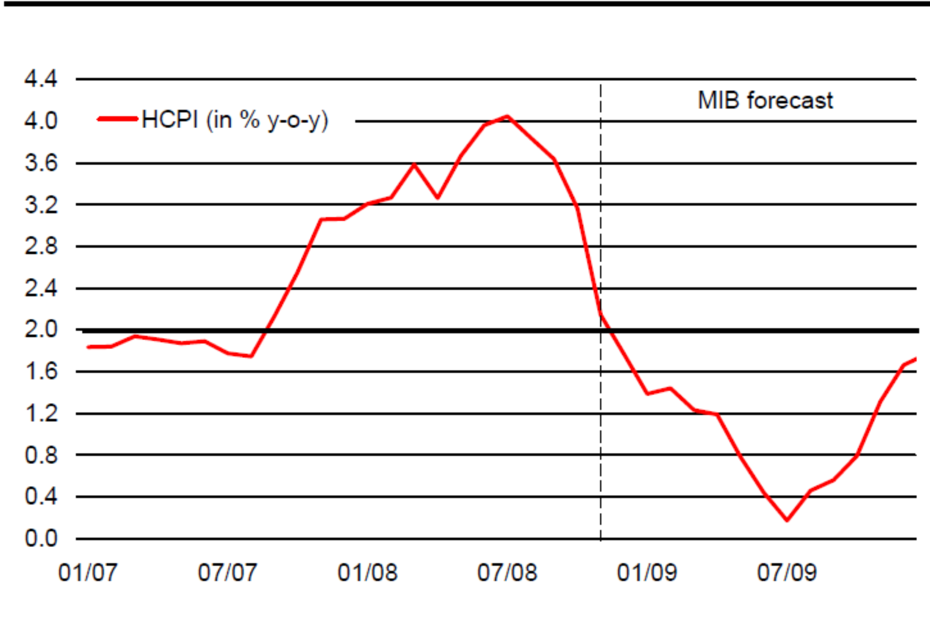
Furthermore, the often-made comparison with Japan is not justified, since the situation there was different. Overall prices, not only asset prices or oil prices, were driven up very high, and they had to come down a long way. This happened since monetary policy was too lax during the creation of the Japanese asset bubble. This has not been the case in the Eurozone, although the present situation in the US may be more similar to that of Japan.

[8] *Careful with (the "d") Words!*, Speech by Lorenzo Bini Smaghi, Venice, 25-11-2008
[9] *Monthly Bulletin*, European Central Bank, December 2008
[10] *OECD Economic Outlook No. 84*, OECD, November 2008
[11] *Economic Forecast*, European Commission, Autumn 2008

4. Empirical evidence on inflation and deflation risks

UniCredit Research has devoted a section to deflation in their research notes. They forecast inflation to be very low during the first half of 2009, and going up afterwards. See Figure 1 for the UniCredit inflation forecast. Additionally, UniCredit attributes the decrease of inflation mainly to weaker-than-expected energy and food prices.

Figure 1: UniCredit inflation forecast



Source: Eurostat, UniCredit Research

They also see the still high inflation at the moment as stickiness in prices, which will respond to the recession later. This can be compared to the dot-com bubble in 2001-2002, when inflation took 13-14 months to respond to the decline in GDP growth. Using futures information on energy and food (both part of non-core inflation), UniCredit forecasts a decline in both markets during the beginning of 2009, but a pickup afterwards and price increases in both markets during 2010. This does not correspond to a deflationary trend.
Kilian & Mangianelli (2007)[12] have proposed formal, quantitative measures of deflation risks. They have assumed that the risk preference of the private sector with respect to inflation matters for the assessment of *(excessive) inflation or deflation risks*. Using data on inflation from 1960 to 2002, they have estimated the risks of deflation and inflation for the United States, Germany (as a proxy for the Eurozone) and Japan for horizons of up to 2 years, using a sophisticated forecast model based on GARCH estimation. Since deflation was also an issue in 2002, it is surprising that there is no evidence of substantial deflation risks for the United States or Germany when forecast using the abovementioned data. The authors do find evidence for substantial deflation risks in Japan. Figure 2 below illustrates their result. Deflation risks for the US and Germany have been around zero for almost the whole time period (only around 1987 and 2000, after the stock market crash) and they have never actually approached the deflation risks in Japan during the 1990s.

[12] Kilian, Lutz and Simone Manganelli (2007), "Quantifying the Risk of Deflation," *Journal of Money, Credit and Banking*, vol. 39(2-3), pp. 561-590.

Figure 2: Excessive inflation risks and deflation risks: the US, Germany and Japan

Note: EIR denotes excessive inflation risks and DR denotes deflation risks

When we update the data used by Kilian and Manganelli (2007) including data up to November 2008, we find similar estimates of risks to price stability. These estimates are denoted in Table 1 below. In this table, EIR denotes the *excessive inflation risk*, DR denotes the *deflation risk* and BR denotes the *balance of these risks*, a measure for the optimality of the distribution of risks. Inflation risk is large when EIR is a large positive number, deflation risk is large when DR is a large negative number and BR is optimal when it is close to zero. Note that we have taken the lower and upper bound of acceptable inflation to be 0 and 2 respectively, corresponding to the range made acceptable by the ECB. Kilian and Manganelli (2007) use the bounds 1 and 3.

Looking at the table, we see that the same picture still holds. For all countries in the sample, there is positive inflation risk. Also the balance of risk is tilted towards inflation (except for Japan). However, when we look at deflationary risks, we see that only Japan faces a substantial deflation risk over 2 years; the ones facing Germany (proxy for the Eurozone) and the United states are almost negligible, especially over the 1-year horizon.

We can conclude that, using historical data and a sophisticated forecast model, there is no evidence of substantial deflation risks in Europe or the US. This conclusion is supported by current evidence on break-even inflation rates derived from inflation-linked bonds showing also a larger risk of negative inflation rates in the US than in the Eurozone.

Table 1: Excessive inflation risk (EIR), deflation risk (DR) and their balance (BR) including data up to November 2008 based on Kilian and Manganelli (2007)

		Horizon of 1 Year	Horizon of 2 Years
EIR	United States	1.76	1.80
	Germany	0.88	0.00
	Japan	0.41	0.23
BR	United States	1.77	1.80
	Germany	0.88	0.20
	Japan	0.20	-0.55
DR	United States	0.01	0.00
	Germany	0.01	0.20
	Japan	-0.21	-0.78

5. A steepening of the yield curve in the Eurozone

In Figure 3, we can see that the yield curve on a *monthly* basis in the Eurozone has become steeper since the failure of Lehman Brothers in September 2008, and even more if we take into account the whole year 2008 on a *quarterly* basis in Figure 4.[13] The ECB has accommodated banks by making the yield curve steeper, so they can borrow short-term at low rates and lend long-term at high rates. They can thus cheaply clean up their balance sheets by rolling over their bad debts into good ones at better rates. However, since in this way consumers do not profit from the lower interest rates, demand will not rise when central banks lower interest rates. This alone thus does not avoid a recession; there is even a fear that policymakers will go too far with lowering interest rates, and reach the lower bound of the interest rate[14]. Once the lower band is reached and the central bank switches to a policy of *quantitative easing* yield curves tend to flatten as was the case in Japan. The reason for this flattening is that either the banking system starts to invest in government bonds and/or the central bank starts to buy bonds outright.

The monetary policy transmission thus does not work well enough. Financial markets appear to be waiting on the ECB to cut rates even further to fend off a recession. However, president Trichet said that confidence is returning on financial markets, adding as a side note that "the entire financial system still needs to be improved to achieve more transparency of financial markets, instruments and institutions"[15]. The credit default swaps market, for instance, is still very opaque. There cannot be a stable international economy without proper regulation.

[13] Based on the Fisher equation we could decompose the nominal interest rates in the (expected) real interest rate and the expected inflation (during the terms to maturity). If we assume that the (expected) real rates are sticky in the short run (from month to month or from quarter to quarter) then we could interpret the steepness of the yield curves as the expected inflation (deflation) in the future. I.e. a steep yield curve means increasing inflation expectations in the future.

[14] *Depressing Times*, The Economist, 13-11-2008

[15] *Trichet: Must Mull Oil Price Effect on Deflation, Expansion*, Dow Jones, 23-12-2008

Figure 3: A steepening Eurozone yield curve since October 2008 (monthly data)

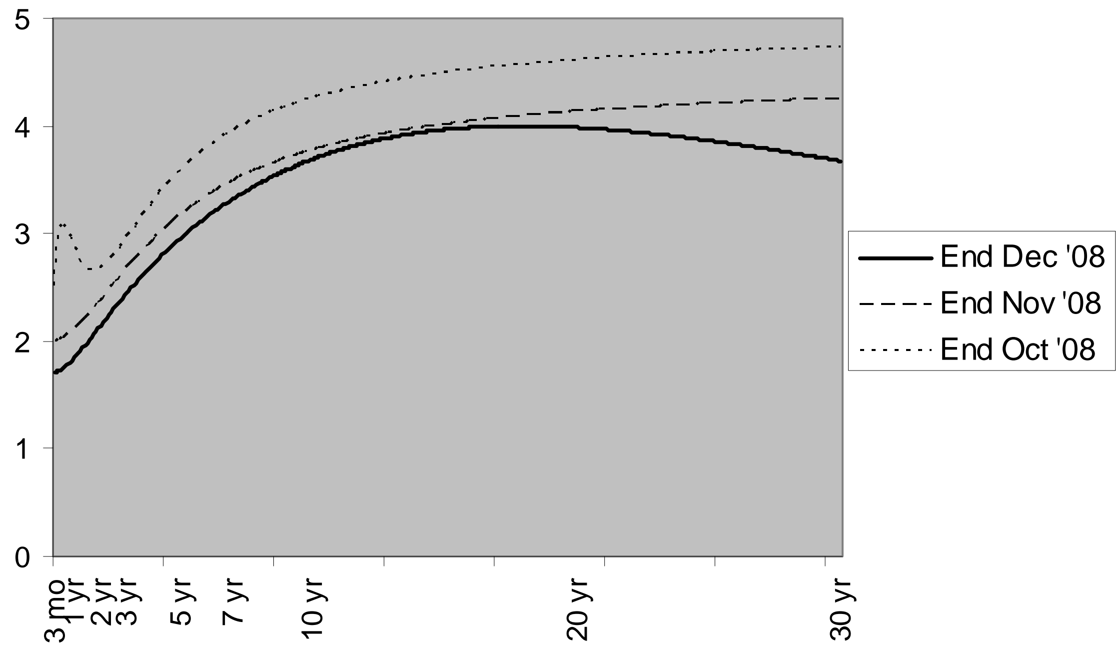
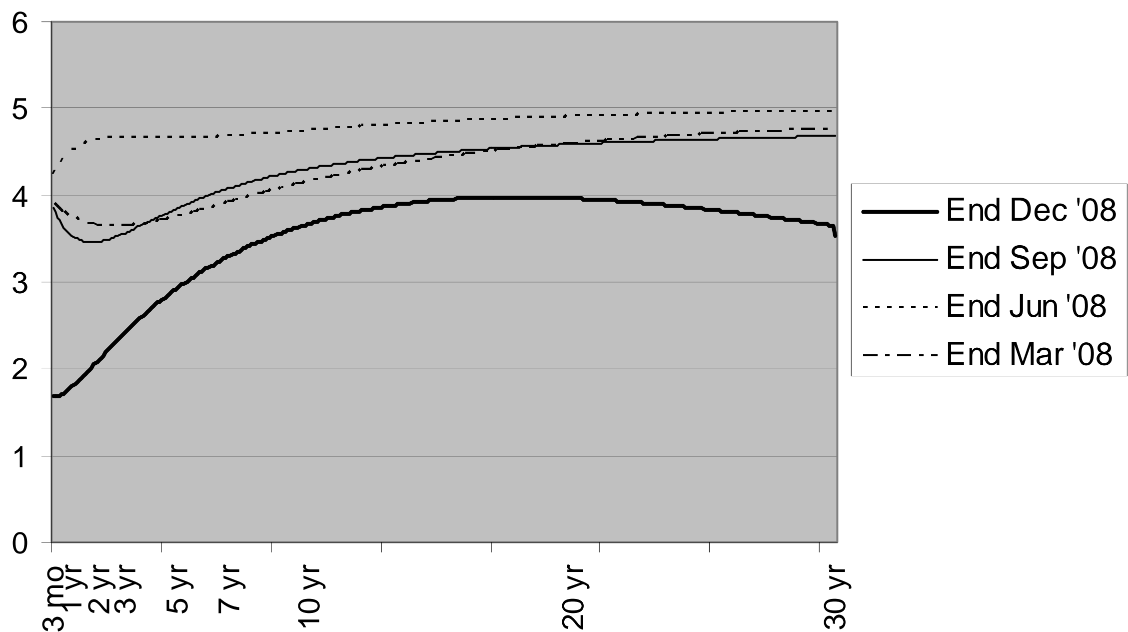


Figure 4: A steepening Eurozone yield curve since March 2008 (quarterly data)



6. Central bank policy in the Eurozone and the US

What should a central bank do to avoid deflation? When looking at the Fed and ECB courses of action, which one is best to avoid deflationary expectations? Eijffinger, Schaling and Verhagen (2007)[16] have introduced a small menu cost in decision making for central banks. They find that there is an *option value of waiting* for changing interest rates: taking action is costly, so it may be better for a central bank to wait and see if the economy moves to target inflation on its own[17]. Additionally, activism may create a deflationary bias, as acting too much to prevent deflation may lead the public to believe that deflation may actually be a danger and they will adjust their expectations.

In this respect, the Fed is much more active than the ECB in changing the interest rate. This may have these adverse consequences, and additionally the Fed will have used all its options when the recession really kicks in. Even the worse situation in the US, mainly in the real estate market, does not justify such activist behaviour.

The ECB may use the option value of waiting to see whether the price decreases in oil and other commodities are permanent or temporary, and then act on this new knowledge. Only if they are permanent, the ECB will have to take further action. Bini Smaghi (2008) has explained the course of action for a central bank to avoid deflation as follows according to the policies of the ECB[18]. First, the ECB anchors expectations by a quantitative definition of price stability and transparency in decision-making. It also acts preventively on deflation to make the probability of a zero bound constraint in interest rates as small as possible, but here the ECB also has to make use of the option value of waiting. It may affect the market sentiment adversely if it acts too quickly, and thereby create a deflationary bias in expectations of economic agents.

Additionally, when the interbank money markets do not work as they should (which happened after the failure of Lehman Brothers), lowering policy rates may not be effective. This can undermine confidence in the monetary policy effectiveness of the ECB. Moreover, when all ammunition is exhausted in the pre-emptive action, there may not be enough when a shock actually occurs. The ECB, in this matter, has more ammunition left than the Fed, since the Federal Funds rate is almost at 0%, while the ECB rate is still at 2.5%.

Finally, and very important in the light of the current crisis, renewed excessive risk taking, the main cause of the current economic problems, can be induced by too low interest rates and bring us back to the beginning of the credit crisis. The excessively low interest rates were one though important factor in the forces shaping the global credit crisis. However, there is a natural tendency to postpone tightening of interest rates in a period of recession, until the point where solid recovery is taking place. We do not have to go far in the future to see an example of this. The Fed was very quick to reduce its interest rate after the dot-com bubble, but it took years for the Fed to bring the interest rate back to where it was. This is likely to be repeated. Indeed market participants now expect the Fed to bring the Federal Funds rate to 1,5 % only at the end of 2010. This tendency is higher when more agents have invested in risky assets on expectations of low interest rates, as the tightening would then involve a disruption in capital markets. Additionally, when interest rates have been low for a long time period, the central bank has to increase them more sharply to bring interest rates back in line with inflation expectations.

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[16]Eijffinger, S.C.W., Schaling, E., Verhagen (2007), W.H., "Interest Rate Stepping: Theory and Evidence," *Journal of Economic and Financial Sciences*, vol.1(1), pp..67-93

[17] In normal times central banks like to move gradually, but some central banks (e.g. Swedish Riksbank) have explicitly stated that this preference for gradualism is deemed inappropriate in extraordinary times.

[18] *Careful with (the "d") Words!*, Speech by Lorenzo Bini Smaghi, Venice, 25-11-2008

In the short run the ECB has to act in an environment with major flaws in the financial system (disfunctioning money and credit markets) under a lot of macroeconomic uncertainty. Therefore, its monetary policy actions will not probably work as expected and the ECB's option value of waiting will be high. In the medium term (the ECB's policy horizon) the risk of excessive inflation is (much) higher than the risk of deflation. By the globalization of monetary policy it will be hard for the ECB to shield the Eurozone from the quantitative easing by the Fed and other central banks in the world.

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Danger of Deflation and Stagflation

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Gustav A. Horn

Executive Summary

Less than half a year ago the debate was about the danger of inflation and the ECB even raised interest rates in order to suppress seemingly unfolding inflationary expectations. Now, the fear of inflation has turned into a fear of deflation. The inflation impact during last year was almost exclusively caused by oil and raw material prices. Presently headline inflation is declining at an amazing speed. But this is just a dramatic decline of relative and not of aggregate prices. Therefore it would be wrong to call the present situation a deflation.

Scenarios show that the answer to the question whether there will be stagflation or stagdeflation crucially depends on wage developments and expansion exit strategies of economic policy. In the first place economic policy has to stabilise the economy so quickly such that deflationary wage movements are avoided. Secondly the expansionary policy course has to be given up timely and in an appropriate manner as soon as the crisis is over. If that would be the case the crisis could be overcome without initiating future instabilities.

1. Introduction

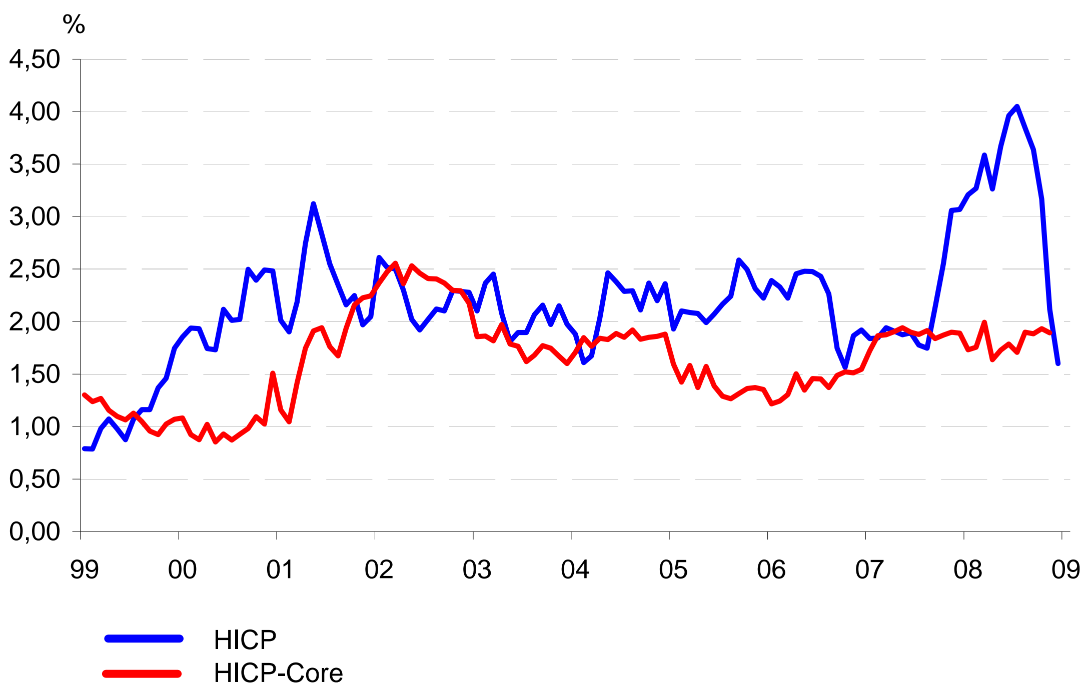
What a change! Less than half a year ago the debate was about the danger of inflation and the ECB even raised interest rates in order to suppress seemingly unfolding inflationary expectations. What a misjudgement! Now concerns have moved to a completely different direction. There is widespread agreement that the world is about to face one of its most severe crisis. Moreover, the fear of inflation has turned into a fear of deflation. Now, there are only debates on how deep the crisis will be and how long it will last. Furthermore there is a discussion whether major economies may even end up with a deflation.

In the following it will be analysed in the first section, how price movements we are seeing now and that we have seen during the recent past should be interpreted. Then growth prospects for 2009 and 2010 will be outlined. After that several scenarios will be discussed. In the light of previous results the question will be answered whether the Euro area is on a path to inflation, deflation, stagflation or stagdeflation. By outlining the scenarios it will become clear what economic policy should do.

2. Is Inflation followed by Deflation?

Until summer last year the ECB was very much concerned about inflation. The reasons for these concerns were obvious. Headline inflation was soaring to 4 % for the Euro area, well above the target rate of 2 %. What was increasing the ECB's vigilance was that inflation expectations seem to creep upwards slightly above the target rate as well. In addition to that the ECB was concerned about a minor acceleration of wage bargaining agreements.

Figure 1



All these concerns have proved unfounded and it was foreseeable that matters would go this way. In the first pace there never was any inflation at that time. As Figure 1 shows, it was headline inflation that moved upwards so steeply whereas the core rate stayed more or less unchanged. Since the core rate is headline inflation excluding oil, raw material, seasonal food and tobacco, one has to conclude from this finding the increase of prices must have been concentrated in the excluded items of the core price index. Inflation however is defined as a continuous and potentially accelerating increase of general price level. Thus in order to have inflation, prices must go up on very broad scale. That was clearly not the case as the resilience of the core inflation rate shows. On the other hand figures 2 and 3 show where the price rise came from.

Figure 2

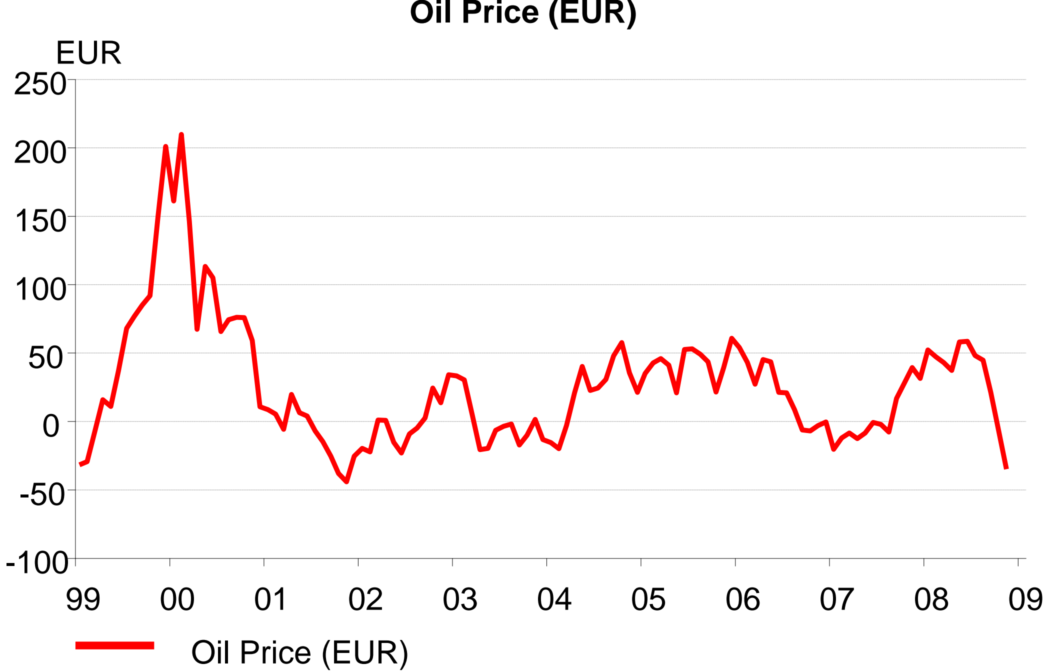
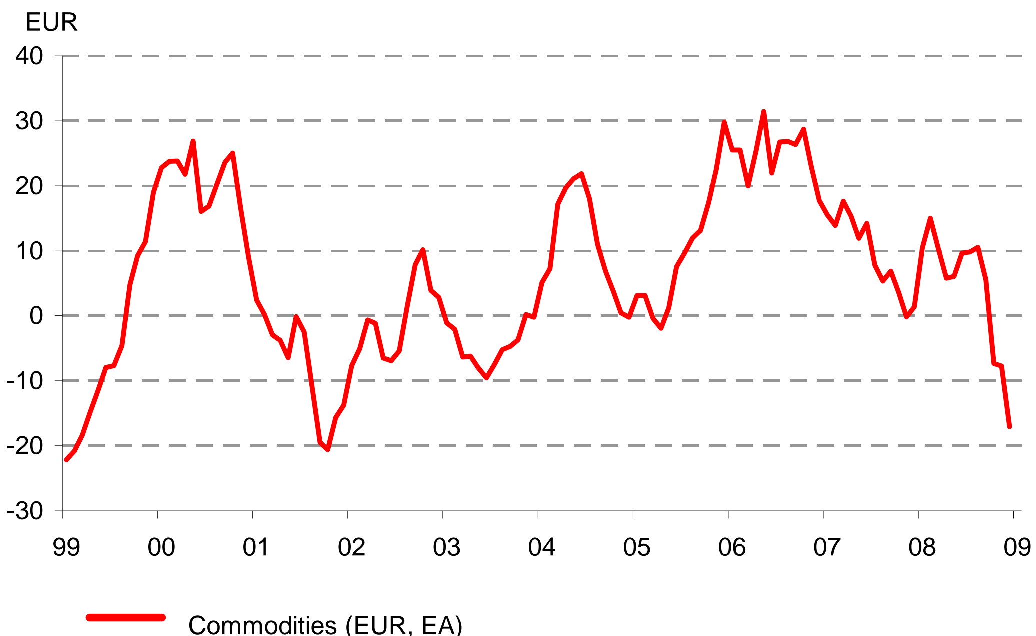


Figure 3



The inflation impact was almost exclusively caused by oil and raw material prices. Both prices are shown here in Euro. That diminishes the price level change, since the Euro appreciated during that time. At its peak the oil price raised by 50 % compared to the previous year despite the appreciation of the Euro and the price of raw materials was 30 % higher. That is a dramatic rise of relative prices rather than a general increase of the aggregate price level. The reason was the buoyant growth of the global economy that obviously influenced expectations on the limited resources of oil and raw materials. People seemed to believe that these resources were too limited to go along with the relative strong growth at that time. These considerations influenced their investment behaviour on financial markets and people expected these prices to increase in the future. Hence financial markets made them rise already in the present.

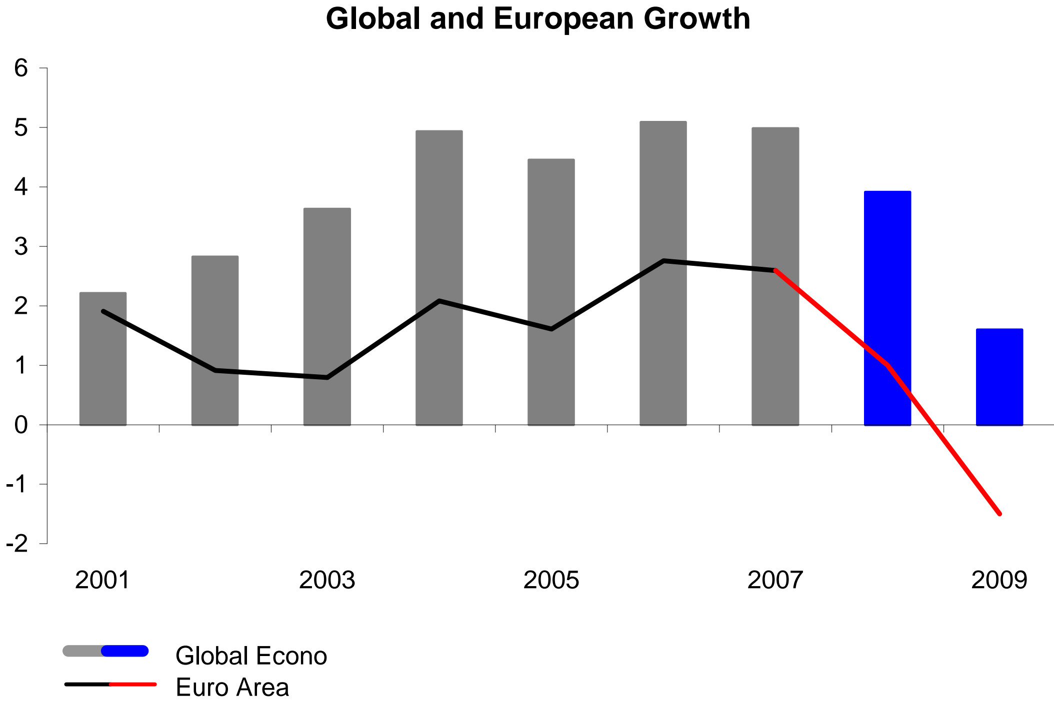
Now, with a global decline of growth rates expectations have also changed dramatically to the opposite direction. And this again is reflected in the respective price indices shown in figures 2 and 3. Accordingly headline inflation presently is also declining at an amazing speed (figure 1). This is just a dramatic decline of relative and not of aggregate prices. Therefore it would be wrong to call the present situation a deflation. The argument is completely symmetrically to the above one only with respect to inflation. The core inflation rate is still staying constant. Therefore in general, price stability is preserved.

An interesting question is why the core rate stays so unabated from these otherwise dramatic developments. The main reason is that wages neither did pick up the previous price hike nor up to now the decline the very same prices. Therefore these price shocks could not spread all over the economy, where they would have triggered a detrimental wage - price spiral. Such a spiral indeed would have led to inflation and for the very same reason the present situation is not a deflation. Presently the still rising wages ensure price stability. The decisive question is whether this is also the case for the near future. That is the question whether the probability of a deflationary scenario is high. The answer to this question depends on the economic prospects of the Euro area and will be outlined in the following scenarios.

3. Economic Prospects of the Euro area

Present data show a dramatic fall of economic activity on a global scale. The Euro area will also be hit by this global shock (figure 4).

Figure 4



Sources: IMF; Eurostat; from 2008 IMK-Forcast.

Primarily exports and private investment will suffer from these developments. In addition to that there are a few countries in particular Spain and Ireland where the bursting of speculative bubbles in the real estate sector and the banking sector will require structural adjustments. Therefore these economies will be particularly hard hit. But also those economies where growth during the past years was rather unbalanced towards exports will suffer more than others. In this respect Germany must be mentioned. There domestic demand still is so weak that it cannot compensate by far the expected losses from foreign trade. All major forecasting institutions predict that the Euro area will show negative growth and a low but positive inflation rate in 2009. This scenario means there will be a deep recession, but neither stagflation nor stagdeflation not to speak of inflation.

Table 1

Total Growth Prospects

Percentage Change

	GDP			Inflation			Unemployment Rate		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Euro Area	2,6	1,0	-1,5	2,1 [2]	3,3 [2]	1,4 [2]	7,4	7,5	8,4
USA	2,0	1,3	-1,1	2,9	4,0	1,2	4,6	5,7	8,8
Asian Emerging Markets	5,9	4,4	3,3	2,4	5,5	3,7	-	-	-
China	11,4	9,6	7,5	4,8	6,3	4,0	-	-	-
Japan	2,1	0,3	-1,2	0,1	1,5	0,2	3,9	3,9	4,4
Central and Eastern Europe[4]	6,1	4,8	2,7	5,1	7,6	4,6	-	-	-
Total	3,1	1,5	-0,7	-	-	-	-	-	-

[2] HICP.
[3] South Korea, Taiwan, Hongkong, Singapur, Malaysia, Thailand, Indonesia.
[4] Poland, Russia, Czech Republic, Hungary.

Source: IMK-Forcast.

But this can only be a preliminary answer to the central question of this paper. The year 2009 could be an intermediate phase on the road to one of above mentioned scenarios. Whether this is the case crucially depends on the economic policy answer on these forecasts. In the following several scenarios will be outlined.

The first scenario is one of doing nothing. There it is assumed that – what is from a present point of view highly unlikely - there would be no further policy reaction to the crisis in the Euro area. Then there will be no economic turn around. The dramatic fall of economic should fade, because stimulus packages elsewhere in the world especially in the US, the UK and Asia will have some positive impact on global trade. In addition to that also monetary policy will work to some extent. From all this Europe would benefit, but only to a minor extent since the domestic market is very dominant for the Euro area. In such an environment unemployment would still rise putting trade unions under pressure. With a diminishing bargaining power of employees and a still looming crisis, wages would tend to grow less and less. Wage cuts will spread in due time. Then a negative wage price spiral is triggered leading to deflation and thus a long lasting depression in the Euro area. This scenario shows that there is an urgent necessity for economic policy action.

A second scenario assumes – what seems to be very likely – there is an economic policy reaction. But the reaction is uncoordinated as far as fiscal policy is concerned and comes very hesitantly and late as far as monetary policy is concerned. In this case there will be no turn around in 2009. The effects of monetary policy always come slow. It takes about a year after interest rate changes when the main impact is being felt.

Under the present circumstances a further delay must be expected. First the banking system will have to be consolidated. Only then firms and private customers will benefit from lower interest rates. The uncoordinated fiscal stimulus also leads to a diminished effectiveness. In particular, those economies that are the first to start with a package, will achieve at best only modestly positive results. A lot of the stimulus will get lost by higher imports. This undermines confidence in these economies making a recovery much more difficult to achieve. In this case a turnaround will not happen before mid 2010. Then monetary policy should become effective and fiscal stimuli should finally work to some extent. But until then wages have come under increasing pressure and deflationary dangers have risen. Monetary policy then has to do more to avoid this and possibly has to follow the quantitative easing approach of the US- Fed. In other words a relatively slow approach enhances dangers and makes it more difficult to achieve stabilisation. In addition to that confidence in public finances of some countries within the EU like Greece or Italy will have decreased more and more. As a consequence governments have to pay higher interest on their fiscal policy actions. This risk premium too makes it more costly to stabilise their economies. In particular the danger of deflation then will have become much higher. This could end up in a stagdeflation.

After a still possible turn around, economic policy must follow appropriate expansion exit strategies that also avoid instabilities. The expansionary fiscal policy of governments then should be reversed as fast as possible by cutting the extra expenditure immediately and then fiscal policy should enter a smoother consolidation path. Monetary policy should then take back all the quantitative easing immediately by starting appropriate open market operations. Interest rates then should be increased only slowly as long as the upturn is not steady. Wages will then possibly return to a productivity oriented path and inflation can be avoided.

The ideal scenario would be that all member countries would have attacked the crisis in a co-ordinated approach at the beginning of 2009. Co- ordination means that the stimulus has about the same size in each country and becomes effective simultaneously in each country. According to IMK calculations, this would increase the effectiveness of e.g. a German stimulus package by 30- 40 %. In other countries in particular small and very open economies the effect should even be larger. However in particular because of the German resilience with respect to a European stimulus package this timeframe is no longer feasible. The best one could achieve now is that Germany acts swiftly and with a stimulus larger than on average in the Euro area. That means it should about 2.5 % of German GDP. Doing so Germany may have only a minor recession. Therefore German imports would not go down as much as in the other scenarios. That would help all other member countries, especially those countries like Spain where domestic demand is very difficult to stimulate because of the crisis in the construction sector. Furthermore the ECB swiftly reduces interest rates, potentially down to zero. Under this assumptions a turn around may occur already towards the end of 2009. Until then pressure on wages may not have become so strong that a deflation is likely. They have rather served to achieve more or less price stability. Therefore an additional quantitative easing on behalf of the ECB may not be necessary.

As soon as the turn around is achieved, expansion exit strategies should be applied too. Fiscal policy should proceed as in above scenario. Monetary policy should increase interest rates until the real rate is about zero. That could be as high as 1.5 to 2 pc When the upturn is steady it should continue to raise rates to avoid inflation. Otherwise an inflation scenario could come true.

The scenarios show that the answer to the basic question of this paper whether there will stagflation or stagdeflation crucially depends on wage developments and expansion exit strategies of economic policy. .In the first place economic policy has to stabilise the economy so quickly such that deflationary wage movements are avoided. Secondly the expansionary policy course has to be given up timely and in an appropriate manner as soon as the crisis is over. If that would be the case the crisis could be overcome without initiating future instabilities.

Despite the actual very critical circumstances, economic policy still has the option to avoid many dangers. But action has to take place as soon as possible .and Germany as the leading economy has to take a leading role in that. In addition to that monetary policy has to ease its course further to provide an opportunity for the financial market sector to recover.

Risk of Deflation or Stagflation?

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Jörg Krämer

Risk of deflation is not zero, but it is low

I. When do we speak of deflation?

The term deflation is used when the general price level falls over several years. The situation is characterised by excess supply on the goods and factor markets. Experience shows that deflation is accompanied by a reduction in money supply.

II. Deflation periods in the past

1. Global Deflation 1929-1932

The global deflation can be characterized by the following points:

- Huge slump of the economy. In the US, GDP fell by 27% from 1929 to 1932
- Sharp rise in unemployment. With the slump of the economy, the number of unemployed soared. In the USA, the unemployment rate rose from 3% to 25%
- Drastic fall in consumer prices. The sharp rise in unemployment led to a fall in wages and therefore also the prices of goods and services. In the US, the consumer price index slumped by 25% between 1929 and 1932
- Strong decline in the money supply

The trigger

The bubble burst on Wall Street. The Dow Jones Index shed 48% within two months starting from its peak in September 1929. Up to the trough in July 1932, the index lost 88%. From today's perspective, it was the wrong reaction of monetary and financial policy that made a global crisis out of the crash on the stock market. Governments bound to the gold standard enforced an extremely restrictive fiscal policy. Many studies suggest that bank failures and the refusal of the Fed to raise central bank money caused money supply in the US to dramatically decline. This lack of money is often regarded as the main reason for the Great depression in the US.

2. Japan in the 1990's

The Japanese deflation of the 1990s can be characterized by the following points:

- Weak economic growth
- Rise in unemployment
- Moderate decline in consumer prices

The trigger

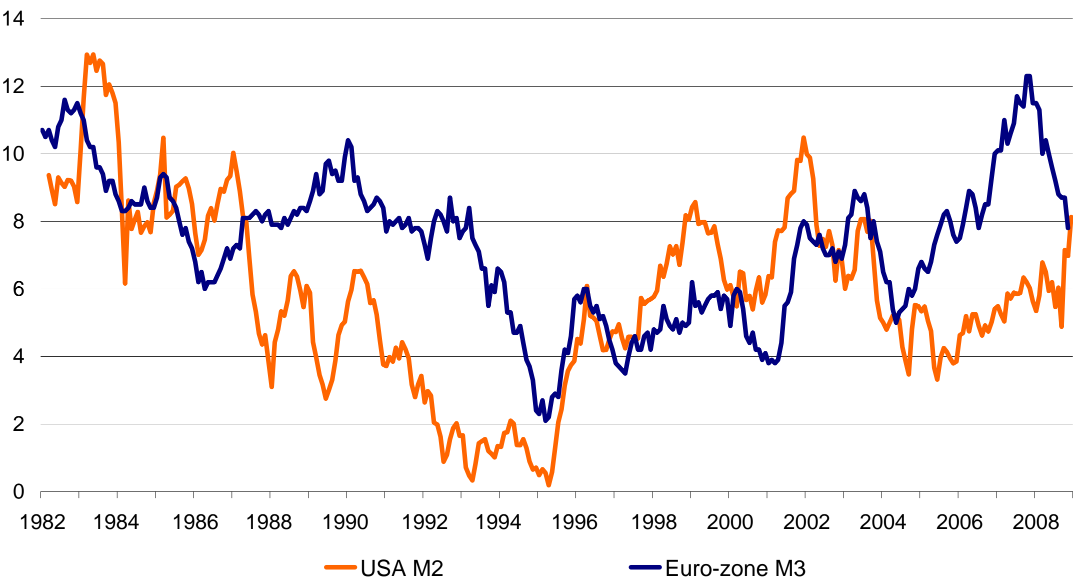
The burst of the bubbles on the equity and housing markets caused private households to raise their savings. Consumer restraint led to an under-utilisation of production capacities, rising unemployment and falling prices.

In the 1990's, the Japanese state reacted late with an expansive monetary and financial policy. They started to solve the crisis only The crisis was only overcome, though, when the government started to buy up bad loans from the banks in 1998 and to restructure the banking sector in 1999.

III. How is the current situation different?

There are a lot of differences between the current situation and the deflations of the past.

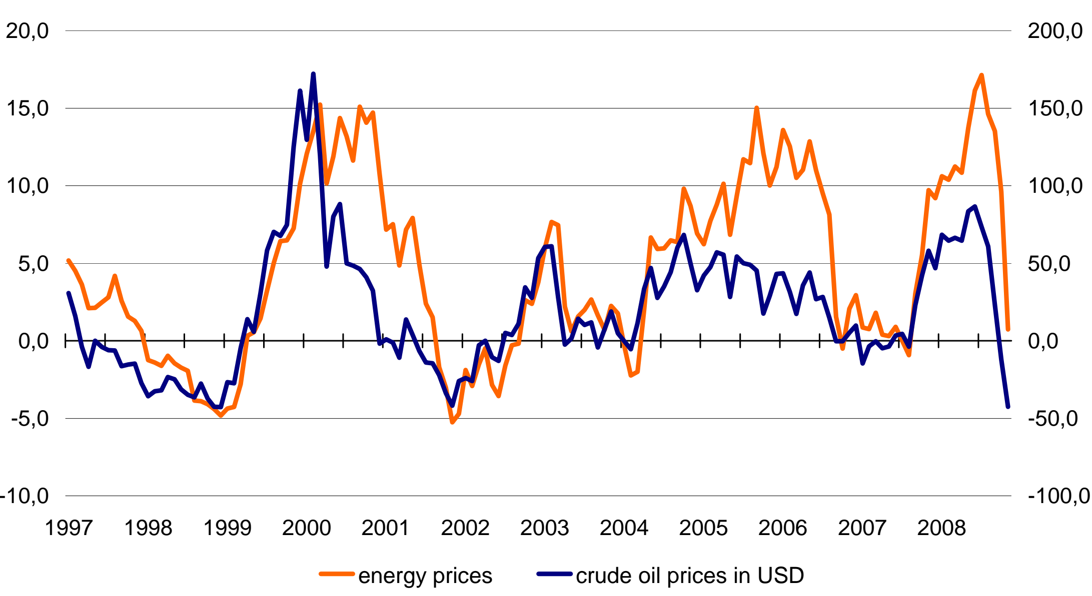
1. Since the outbreak of the current crisis in the middle of 2007, central banks and governments have intervened quickly and firmly. While it was not possible to prevent banks from restricting their lending to some extent, there can be no talk of a broad-based credit rationing in the euro-zone. The money supply on both sides of the Atlantic is still rising (Chart 1). This is in sharp contrast to the deflation periods of the past.



- Chart 1 -

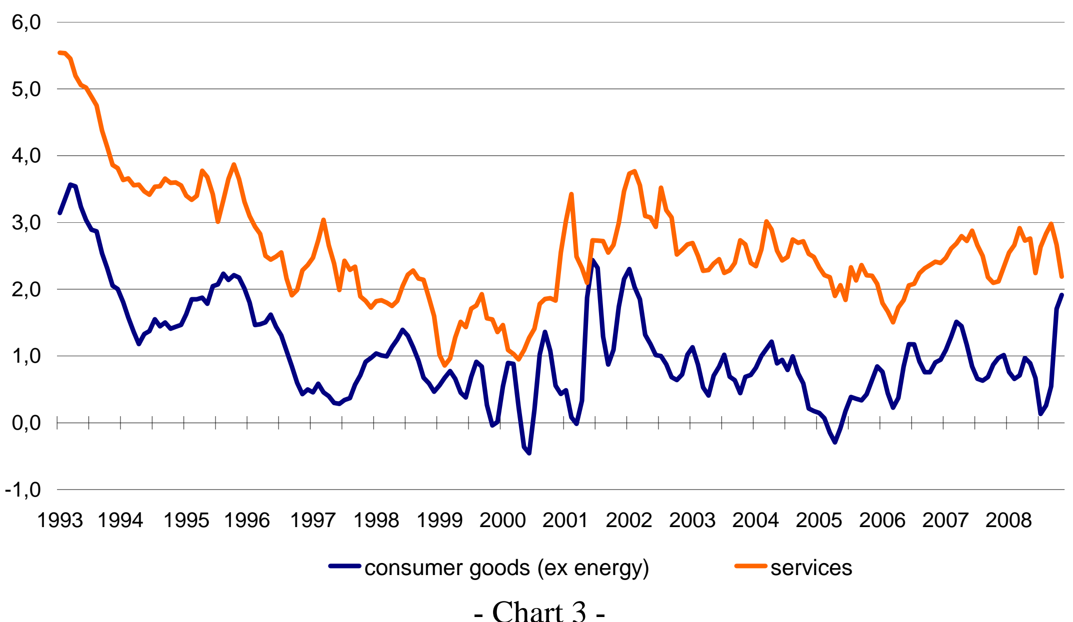
2. Unlike the global economic crisis when governments pursued a strongly restrictive fiscal policy, governments have reacted to weaker demand very quickly this time with huge economic stimulus programmes.

3. The current significant fall in inflation is solely attributable to the bubble bursting on the crude oil market. At the start of 2009, crude oil prices at around 45 dollars for a barrel of Brent are about 100 dollars lower than the peak of mid July. This has allowed the rise in energy prices in the euro-zone to fall by 15 percentage points since the peak in mid 2008 (Chart 2).



- Chart 2 -

Excluding energy, consumer prices for goods and services are rising at about the same rate as in past years (Chart 3).

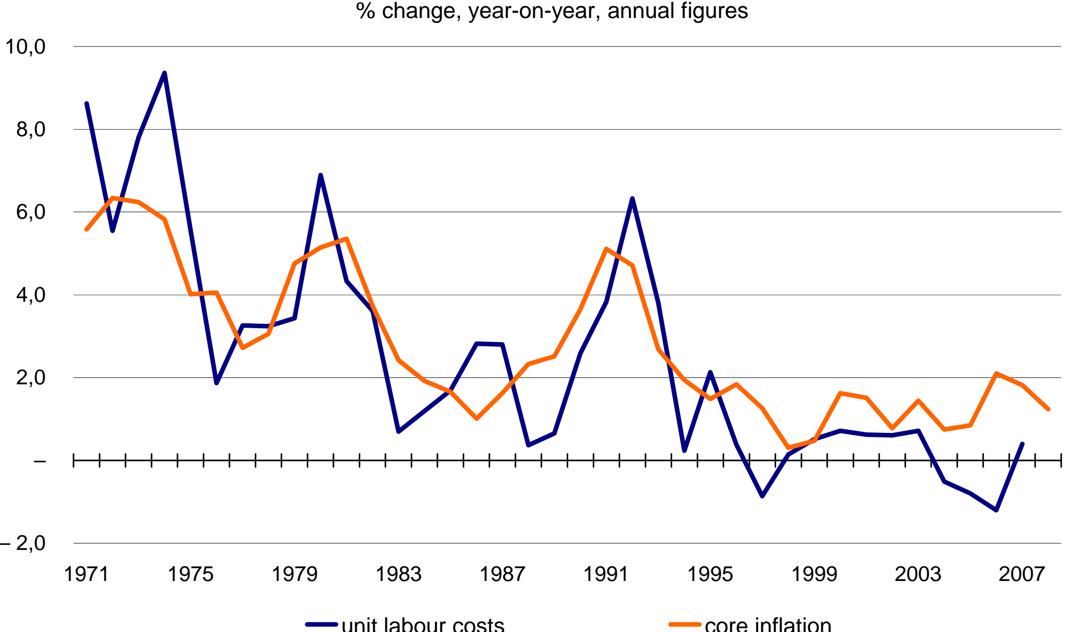


- Chart 3 -

4. Lasting retreat of consumer prices in eurozone is unlikely. A negative inflation rate in the eurozone cannot be ruled out in the course of 2009. Should oil prices stay at the current level in the first half of the year, the inflation rate will have a minus sign in front of it in the summer. But the period when prices are below last year's level will

not last long. The correction on the crude oil market is already well advanced. Based on the fundamental factors, the price of crude oil is even likely to have already plunged too far. With the stabilisation of crude oil prices, energy prices will not drop any further either.

Another slump in the price level means therefore that prices for goods and services have to drop. This is not very likely, however, as pay growth has tended to increase recently, and this is the main determining factor for core inflation (Chart 4).



- Chart 4 -

The recession and the resulting rise in unemployment will not be anywhere near as serious as in the global economic crisis of 1929-32. Central banks and governments have reacted to the crisis very swiftly and in a coordinated manner. Central banks have made huge rate cuts. And even with a key interest rate close to zero, a central bank still has instruments (open-market policies) to increase the demand for money.

A further positive factor is that States have supported demand through job creation and infrastructure programmes. This is a further means of overcoming the situation where the demand for money no longer rises, described by Keynes as a liquidity trap.

It is therefore unlikely that we will see a downwards spiral of falling employment, falling wages, falling demand, further falling employment etc. wages and therefore the underlying price momentum will generally point upwards in the euro-zone also in 2009.

IV. Inflation risks are more likely in the long term

1. ECB on stability course so far

Ever since the monetary union was founded, the ECB has steered a stability-driven course in its monetary policy. With our estimated Taylor Rule it is possible to show that the ECB has set interest rates in line with forecasts for growth and inflation. Only in the 2004 phase was the refi rate significantly lower than the Taylor interest rate.

In this phase, the ECB considered its own growth predictions as too optimistic, which proved right in retrospect.

2. Fundamentally favourable inflation climate

The contraction of the euro-zone economy is resulting in significant under-utilisation of the economy. This means, firstly, that companies have less pricing scope and, secondly, that rising unemployment is curbing pay growth.

In the longer term, though, inflation risks appear to have increased

- Demographic distribution conflicts: Germany and many other Western countries face demographic distribution conflicts as less employees have to feed a rising number of old age pensioner. Governments could defuse such conflicts in the short term by increasing their debt. This in turn increases the temptation to reduce the debt burden though inflation. An extreme example of this is the periods after the First and the Second World War. The debt that had risen because of the war was discharged in inflation – not only by Germany as the loser of the war but also in the USA as the victor. Distribution conflicts also fuelled inflation in the 1970s: in 1973, the dramatic rise in oil prices diminished distributed income
- The ECB's independence is not set in stone: In principle, an independent central bank can prevent conflicts ending in inflation. But the ECB has always had to defend itself against attacks on its independence. In 2005, for example, it only just managed to prevent a passus in the EU draft constitution that would have made it easy for state and government leaders to change the regulations of the ECB and encroach upon its independence
- High liquidity: Since 2001, the ECB has allowed the money supply to rise more sharply than intended. Under former chief Greenspan, the Fed quickly slashed the fed funding rates in times of crisis and was hesitant to raise them again in times of upswing. The excess liquidity has not inflationised the prices of goods but rather of assets – first equities and then, in the last few years, housing and corporate bonds. The marauding liquidity has barely left out a single asset class, and the risk that the prices of goods will rise more sharply in the next ten years has therefore increased.

V. Conclusions for ECB monetary policy

In order to tackle the economic crisis, a very expansive course in monetary policy is justified. The primary objective must be to prevent a liquidity squeeze and ensure that the economy receives the necessary credit. Even after a rate cut close to zero, the ECB can expand the money supply via open-market transactions. It could, for example, buy up loans from banks.

However, there will be a point in the future where the ECB will have solved the risk of deflation. Then, the medium to long-term inflation outlook will depend on whether the ECB is able to reduce high liquidity before this inflationises the prices of goods and/or assets. This could prove difficult. Given the delayed effect of monetary policy, central banks must raise interest rates before the economy reaches normal levels of utilisation again, meaning before unemployment falls again to the starting point before the crisis. Experience in the past has shown that such a change in course in monetary policy will encounter substantial political resistance.

Topic 2

How to restructure the international financial architecture?

How to restructure the international financial architecture?

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Jean-Paul Fitoussi

Executive Summary

Financial stability is a means to an end. The financial system is one of the key elements that ensure the smooth functioning of the real economy and contribute to macroeconomic stability, which in many ways can be considered as a global public good. With globalization, and the exponential increase of cross border transactions it became clear that macroeconomic stability cannot be ensured by individual governments, but needs to be the responsibility of the international community. Global governance of the financial sector today is organized around a number of institutions with overlapping when not conflicting goals, that often are uncoordinated among them and with national authorities, and above all that lack legitimacy and hence credibility. Central banks have for the past quarter of century successfully targeted inflation; this proved neither a sufficient nor a necessary condition for macroeconomic stability, as the current turmoil shows. A global institution in charge of monitoring and coordinating national regulatory activities, while directly designing and implementing regulation in cross border flows is needed today. A reformed IMF, whose governance should reflect today's world, seems the appropriate institution for such a role, and would have both the expertise and the credibility to act as an effective regulator of world's finance.

One of the main tasks of governments is to ensure macroeconomic stability, which in many ways can be considered as a global public good.

The financial architecture, by which broadly speaking we mean the set of rules and institutions that govern credit and financial markets, is a crucial element in ensuring the global public good "macroeconomic stability". The financial sector enhances the real economy performance by mobilizing savings and by allocating capital to investors. It further allows risk management by transferring it to the actors more able to bear it.

A properly functioning financial sector is thus crucial for guaranteeing a smooth functioning of the real economy through investment and innovation, and hence for contributing to global macroeconomic stability.

With globalization, and the exponential increase of cross border transactions it became more and more clear that the global public good "macroeconomic stability" cannot be provided by individual governments, but needs to be the responsibility of the international community. The recent dramatic events gave further proof of the need for globally coordinated responses, both to contrast the current crisis and to minimize the probability and extent of a new one. In fact, financial markets failed on all accounts: They encouraged unsustainable spending patterns in some countries (notably the US), thus reducing savings and liquidity; they misallocated capital to uses that were often too risky and unproductive. And finally, they were not able to manage risk, dumping it on the shoulders of uninformed and unprotected households worldwide. In particular, the parcelling out of risk, that was supposed to protect savers, turned out to be ineffective, because of the high degree of risk correlation.

Principles of a sound regulation

Among the principles around which a new regulatory framework should be built are the following:

1) *Improved transparency and disclosure*, that would be reached for example by greater reliance on standardized rather than tailor made products. In addition to reducing the informational burden for investors, this would also enhance *efficiency*, as in fact the differentiation of financial products reduces competition. But it has to be emphasized that the lack of transparency is itself the consequence of the malfunctioning of markets and if we don't remedy to the latter, the enforcement of transparency would be just a veil.

2) *Careful consideration of incentives*. In general, this means that the abnormal gap between rewards and performance that financial markets have allowed should be filled. Rewards for managers and middlemen should not be allowed to rely on short term performance and volumes traded alone. Thus, for example, stock options and bonuses should be linked to the performance over the medium run, and *should* be symmetric: bonuses for good results should be mirrored by penalties for disappointing performance. Furthermore, no financial institution should be allowed to get rid of the financial products it creates. In other words, the incentive for financial institutions to monitor the quality of their loans should be reinstated. Last, but not least, the whole sector of rating agencies should be reorganized to avoid conflicts of interest and bad monitoring.

3) *Reduction of risky practices and non competitive behaviour*. In particular *exploitive* practices of the banking sector (excessive variability of monthly payments, excessive effective interest rates, etc.) should be prevented.

4) *Comprehensiveness*, to avoid funds to flow through the least regulated part of the financial system. Some institution that oversees to the global functioning of the system, and closes loopholes would be crucial to avoid unfair competition and contradictions in the regulatory system

The failure of the current system

There are a number of reasons why the current state of affairs in what concerns financial regulation is not satisfying.

a) The first is that it exists a whole set of institutions that are at various titles concerned with the functioning of financial markets at the global level, like the IMF, the Bank for International Settlements, the Financial Stability Forum, the Economic and Social Council (ECOSOC) within the United Nations. The roles of these institutions are of course different, but sometimes overlap; methods, and sometimes goals differ, and membership is very different. For all of these reasons, there is great need for a rationalization.

b) These institutions are by no means coordinated. There is no official or informal forum where representatives from these institutions can interact. More importantly, with the exception of ECOSOC, that has a complex rotating membership scheme, these institutions lack the legitimacy to set and enforce the rules for financial markets, because by no means they represent today's world. This lack of legitimacy is all the more evident in informal clubs like the G8, or even the newly instituted G20. As Joe Stiglitz recently said, what we really need is a G192. In fact one G192 institution exists, the United Nations; but it lacks until now the expertise to effectively build and manage the global financial architecture.

c) Furthermore, these institutions rarely interact in an organized way with national regulatory authorities, which are in charge of implementation of regulation. The Financial Stability Forum is a partial exception, but its membership is way too limited for it to have a real impact. In addition the FSF is mainly a discussion forum, with no operational role.

d) Finally, as the current crisis proved in its early developments, there is no disincentive for the free riding of countries, and for what we could label corporatism at the global level.

Price Stability and Macroeconomic Performance

If we think at financial stability as a means to an end, in particular as one of the mechanisms that allow the development of markets and ultimately growth, while preserving macroeconomic stability, then we are confronted with a difficult issue. In fact, if financial stability is only an intermediate objective, the question raised by the role of central banks in assuring the surveillance of the financial system is not easy to answer: with a few notable exceptions, central banks are in charge of only one facet of macroeconomic stability, namely price stability.

The experience in fact shows that the attainment of this goal is neither sufficient nor necessary for macroeconomic stability. If we look back, since the mid 1980s the performance of central banks around the world in fighting high inflation looks bright. But this remarkable performance, and low inflation, did not prevent the world economy from plunging into a disaster that we are even unable to fully understand. Almost all economists have praised inflation targeting as the non plus ultra of monetary policy. Should we not have now some afterthoughts?

Beyond the short-term, central banks have to rethink their policy objectives in the aftermath of the process in which the explosion of global imbalances was sustained by the creation of excessive global liquidity which was in turn a symptom of the exclusive focus on consumer price stability which made growth dependent on increasing indebtedness They achieved the consumer price stability objective and, contrary to the doctrine, contributed to the build-up of financial risk. Central banks, due to their focus on consumer price stability including the Fed, were heavily dependent on reckless private credit expansion to sustain economic activity in an inequality and imbalances-dependent growth process.

An Effective and Legitimate Institution for Global Financial Regulation

In what precedes I argued that current international institutions do not reflect nor the needs of today’s economic systems nor the composition of the global economy. Furthermore, the almost exclusive focus of central banks on the intermediate objective of price stability spectacularly failed in attaining the final objective of macroeconomic stability. In fact, what we need is an institution:

a) That has broader goals than the central banks, notably to ensure the broad financial stability (not limited to price moderation), that serves the final objective of ensuring the macroeconomic stability that today is dramatically lacking.

b) That possesses the legitimacy that current institutions lack, notably by giving a much broader representation to developing and emerging countries.

c) And finally that has the expertise required for difficult regulatory task dealing with national and cross border factors.

The institutions that today have the goal of macroeconomic stability, while at the same time being legitimate because democratically elected, are the governments. But the most evident lesson of the current crisis is that the problem of financial stability is global, and individual governments are unable to deal effectively with it. Further, they risk engaging in dangerous competitive policies and free riding that are likely to worsen the problem (like the experience of the bank guarantees by the Irish government showed).

Thus, we need a global institution. Realistically, creating a new one from scratch would risk adding to the multiplicity and to the lack of coordination, thus leading to failure. It is more advisable to look for the solution within one of the existing institutions that deal with financial markets.

The obvious candidate is of course the IMF, that has the capabilities and the technical skills suited for the task. A reformed IMF, extended to give representation to all the countries in order to make sure that it has the legitimacy it needs to perform efficiently the task, could be the main body in charge of ensuring financial stability, in accordance with the broader objective of macroeconomic stability.

It is of course unforeseeable, for the immediate future, that the IMF directly regulates world financial markets. Nevertheless, financial regulation by national authorities could be subject to the control of the IMF that would have to be given the tools to assess the suitability of each country's system of rules, and its compatibility with global macroeconomic stability (across countries and markets). At the same time the IMF could progressively build a series of standards and rules that would apply to cross border operations (global finance), whose implementation it could oversee directly. An effective system of early warnings would also need to be part of this redesigned institution.

The new regulatory role would be blended with the current role of liquidity provision, which should be strengthened in order to allow developing countries that lack the resources to effectively intervene (for example with fiscal stimulus packages) to contrast the crisis.

In effecting its role, the IMF should look for a broad coordination with others international institutions: the BIS, the World Bank, but also the WTO, the ILO etc.

As a side note, I'd like to stress that while a system of improved safety nets for developing countries should be institutionalized in the future financial architecture that we are discussing here, it is of utmost urgency that the problem of developing countries is tackled in the short run as well. The Commission of Experts instituted by the UN General Assembly President, on the Reform of the International Monetary and Financial System, calls for the allocation of new SDRs to finance the short term measures to be taken by developing and indebted countries. According to the commission, this allocation of SDR should be seen as a key response to the current credit crunch.

For the new IMF not to remain ineffective, an adequate and realistic system of sanctions would have to be designed, to punish behaviours susceptible to hamper global stability. This is a particularly tricky question to be addressed, because the credibility of sanctions reposes on the legitimacy of the institution imposing them. Thus, it is worth stressing again that its task and its governance should have the same attention in the design of the "New IMF".

The IMF, in its new role, should also work in close coordination with the Bank of International Settlements and with the central banks that issue the reserve currencies of the world, namely the Fed, the ECB, the Bank of Japan, and probably in the future the Bank of China.

There has been some debate, in the past months, over the need of a "Bretton Woods II" conference, aimed at building a new system of rules for the world financial system. I believe that the changes foreseen in the current debate are of such amplitude that such a conference would be extremely welcome, provided it is as inclusive as possible, in order to reflect a world that is more and more globalized in prosperity as well as in depression.

How to restructure the international financial architecture?

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Jean-Pierre Patat

Executive Summary

Even if the present political, economic and financial context is very different from the situation prevailing in 1945, when the Bretton Woods agreement came into force, there is no need in our sense for trying to built a new “architecture”, with a new Bretton Woods which could deeply disappoint economic agents as a general consensus would perhaps be reached on a smaller common denominator.

But profound reforms are needed and must be decided and implemented in very concrete issues.

The first issue concerns the role of the IMF which should have a leading action in a lot of subjects, and above all must be reformed on two points: first, a better repartition of the quotas without ignoring the poorest countries' rights and in making sure that Europe, and especially the euro area, will not be the victim of this operation. Secondly, it is necessary to clarify the role of the IMF in the financial stability, which should perhaps not consist in giving to the IMF the function of a worldwide supervisor, which would probably create a lot of concrete problems, but in strengthening its role in the important existing procedures of monitoring standards and codes, with the ROSCs (Reports in the Observance of Standards and Codes) and the FSAP (Financial Sector Assessment Program). The IMF should be entrusted with the exclusive role in monitoring these procedures, while the Financial Stability Forum (FSF) could be integrated as a committee of the Fund. All countries would be obliged to accept ROSCs and FSAP the results of which would be systematically published.

The second issue concerns concrete reforms which must be implemented in very sensitive areas (the last G20 has listed some of them): rating agencies, deficits of regulation and supervision, accounting rules, off-shore centres, specific rules for securitisation, risk management process of financial institutions which must avoid procyclicality and underestimation of risks, salaries and bonuses of financial institutions managers.

Thirdly, it should be essential to have new standards and codes monitored by the IMF on the demand of strong involvement of central banks in banking supervision and in monitoring real estate and stock prices evolutions.

The fourth issue concerns the role of the major global central banks in the financial reform process. The ECB must be entrusted with the mission of designing and coordinating a macro prudential supervision in Europe. ECB and FED would be convinced, under the leadership of the IMF, to conclude an agreement for limitation of exchange rates fluctuations (like the Louvre agreement of 1985). The IMF would also take the initiative to take on Chinese monetary authorities for associating them to a global exchange rates fluctuations monitoring process.

Finally, it would be necessary to be aware of the links between monetary policy and financial stability, as the first can, in favouring wide imbalances and excessive indebtedness, create the “compost “of financial instability and crisis.

1) If we compare the political, economic, financial context in 1945, when the Bretton Woods agreement came into force, and the present situation, there seem to exist strong arguments for building a radically new “architecture”.

The so-called Bretton Woods system was a club of industrialised and relatively homogeneous countries, even if some of them were seriously affected by the war. Considering the disastrous consequences of the “competitive” depreciations of some currencies before the war, there was a consensus for implementing a fixed exchange rates system with the dollar being, de facto, the single reference currency. Even if a situation of free trade exchanges, of free capital movements and financial activities was firmly considered as the ultimate and necessary objective of the treaty, in 1945, such a result was not expected to be reached before a rather long term deadline. In fact, during the three following decades, the economies remained weakly opened, most of them maintaining more or less strict exchange controls. This specific context is often ignored by those who regret the relatively strong economic growth (what we call the “trente glorieuses” in France) of European countries during this period.

Today, financial globalisation seems irreversible, and explosive financial innovations and the new information and communication technologies, have deeply reinforced this evolution; floating exchange rates have become standard, and limits to trade exchanges have been strongly reduced. The dollar remains the first international currency but is far from having the same predominance as in 1945. Emerging countries play an increasing role in the world wide industrial output.

Does such a context need a radical change in the financial world-wide architecture, a new Bretton Woods that some economists and politicians are calling for?

In fact, one must observe that most of the present characteristics are in line with the objectives of the Breton Woods agreement we previously mentioned concerning capital flows and trade exchanges.

Who can seriously question that inversing these movements, if technically possible (which is uncertain for financial flows according to the existence of electronic money) would be disastrous for the world wide economy?

Nobody can call for coming back to fixed exchange rates between the big currencies, which would be impossible to respect, even if one can suggest bilateral agreements between the two major currencies responsible for trying to smooth fluctuations.

So, there is no objective reason for organising a huge “mass” with the purpose of a revolution in the world wide financial governance. A mass which, in addition, would have enormous trouble in reaching a general agreement, according to the strong divergences of political, financial, economic interests. So, one could fear that an agreement, if it came about, would be on a smaller common denominator. The risks of the mountain giving birth to a mouse would create a very dangerous climate for the world wide financial stability in deeply disappointing economic agents who had been excessively and wrongly confident in the need and the possibility of a solemn revolution in the international architecture.

On the other hand, it is clear that profound reforms are needed for a lot of reasons.

First, it is essential to take into account the wide enlargement of the international community, and the relative decrease of the role of the countries which signed the Bretton Woods treaty.

Secondly it is obvious that one of the ultimate objectives of Bretton Woods, the liberalisation of the financial and banking activities, has been reached but with considerable drifts in the practices, the institutions' rules of conduct, and even the regulation efficiency.

Thirdly, one of the main purposes of the Bretton Woods treaty and of the IMF creation has been to reduce imbalances, and react to risks of such situations. One has to consider that if this goal has been, if not reached totally, at least seriously treated for many emerging countries, especially in reaction to the “Asian” and “Russian” crises, the Bretton Woods institutions remain powerless to contribute to reduce imbalances in industrialised countries, and especially the huge deficit of saving and the excessive indebtedness of the US and, to a lesser extent, of the UK.

According to these issues I shall successively deal with the following:

- The necessity and the way for reforming the IMF functioning. This question will give the opportunity to debate about an eventual extension of the role of this Institution in the world wide financial stability,
- The concrete reforms which must and can be implemented in order to correct or to put an end to the drifts in the worldwide financial and banking system functioning,
- What role for central banks in financial stability and supervision?
- What could be the specific role and actions, individual or/and coordinated, of the major global central banks, namely, the FED and the ECB, and perhaps the Chinese monetary authorities, for enhancing financial stability?

2) It would be surely essential to associate the IMF to a lot of reforms and working groups for reforming financial practices. In the following paragraphs (cf infra), we will develop specific issues (new standards and codes on supervision, exchange rates fluctuations…) in which the IMF should have a leading role.

Concerning first of all the crucial question of the IMF reform, two main questions must be treated: a new repartition of the quotas and the opportunity of an extension of the role of the Institution in the world wide financial stability.

The crucial issue of a better repartition of the quotas must be resolved while considering three main constraints: firstly, not only emerging countries' but also poor countries' quotas must be significantly increased; secondly, Europe must not be the "dindon de la farce" of this reform; thirdly, a single country must not be in a situation to stop a decision or a reform.

In 2008, a "new" formula for the quotas determination has been introduced, .which is in fact not very different from the previous system as it consists in simple technical adaptations of the four traditional criteria: GDP, foreign opening, variability, exchange reserves.

But this formula, while advantageous for most of the emerging countries, which is a result wanted, will have catastrophic results in the medium term for the poorest countries whose weight will decrease and for the euro area whose share would be significantly reduced, and could even be almost divided by two if the quotas of the member states are merged, as some propose for a supposed strengthening of the area's positions. At the same time, the share of the USA could almost be doubled.

In order to avoid such an abnormal and unfair situation, it is necessary to introduce new criteria, such as financial flows and above all the demography, which could replace the variability criteria (this criterion gives a bonus to the most unstable economy): taking demography into account is the only way for giving more power to the poor countries and to have broadly similar USA and euro area weights which is in accordance with the economic realities.

The impossibility for a single country to stop a decision is blatantly obvious in the multi-polar world in which we are now living. The solution of this problem is easy. One can decide that there is no more balance of power level, or one can set this level at a definitely higher level than the most important individual quota.

3) The question of a unified structure which would be in charge of the world wide financial stability was already asked in 1998, after the so-called Asian and Russian crises; the former Bundesbank President, Hans Tietmeyer, in charge of a reflexion about this subject, concluded that every institution which had to deal with this question, at an international level (IMF, World Bank, Bank for International Settlements...) or at national levels (market authorities, banking regulators and supervisors) did a good job and had a correct and manageable action field, but needed better reciprocal information and coordination. In line with these conclusions, the Financial Stability Forum (FSF) was created. This institution brings together G7 representatives of market and banking authorities, and representative of all international financial institutions.

The FSF did a correct job in its field of competence, with essentially a role of reflexion and information facilitator but one is obliged to note that it has not been able to detect or to prevent the risks of the colossal financial and banking crisis of 2007/2008.

So, the question is once again asked with a particular emphasis on a possible role of the IMF in this issue, which seems logical as the FSF remains a rich countries' club with only occasional opening to the rest of the world.

If we consider the core problem of the financial stability issue, which is prevention, it is obvious that the IMF could play a greater role in more directly managing and improving the important existing procedures that are the ROSCs and the FSAP.

Twelve areas of fundamental “standards” and “codes” for financial stability have already been set up, concerning macroeconomic policy, institutional and markets infrastructures, financial regulation and supervision. Reports on these standards (ROSCs) are already done by the IMF and the World Bank. The Financial Sector Assessment Programs FSAP are crucial complements to the ROSCs as they recommend concrete orientations and measures for an efficient and well supervised financial and banking system.

So the IMF (and the World Bank) could be entrusted with the exclusive role in these procedures (respective roles of the IMF and of the FSF are presently not clear). All countries would be obliged to accept ROSCs and FSAP while, with the present voluntary service principle, emerging countries and to a lesser extent advanced countries (in which wide malfunctioning in market and banks supervision can yet be observed) are somewhat reluctant. Publications of the results of these procedures would also be systematic.

So it seems that instruments and procedures exist, even if they must be permanently improved, for having the ability of preventing banking and financial collapses (cf infra). The problem is to give to the ad hoc institution, the IMF, the power and the authority to change a presently rather consultative concept into systematic and compulsory procedures.

The authority of the IMF on these questions could be reinforced with the integration of the FSF as a committee of the Fund, in order to continue to benefit from the expertise of this institution but also to clarify the hierarchy of competences.

Is it necessary to go further and give to the IMF the role of a worldwide supervisor? If it is essential for the Fund to be in position to detect weakness in local supervisions and impose extensions, improvements, modification, it is doubtful that it would be the best solution to give to the institution the responsibility of the supervision process, in stacking a new administrative structure on the existing local bodies which, of course, would refuse to disappear, and in fact would continue to exert the main functions, unless one implements a gigantesque and very costly transfer of competences.

4) In some specific areas, concrete reforms must be implemented which would significantly improve the functioning of the worldwide financial system and remove major sources of trouble.

The press release of the recent G20 meeting clearly identified some core issues for decisive reforms: rating agencies, deficit of regulation and supervision, accounting rules, off shore centres. If concrete actions are implemented on these subjects a very important step will have been made.

Concerning the rating agencies, the G20 propose to register these institutions and subject them to monitoring. One would also forbid agencies to cumulate rating activity and securitisation advisory activity. But one must go further in order to abolish the present situation of quasi monopoly, harmonise practices and have public appreciations about the pertinence of the diagnosis of different agencies. It is essential to give this mission to an independent and neutral body which would have a world wide action field and could be linked to an international institution, IMF or BIS.

The deficits of regulation and supervision are existing at national level. One can assume the movie would have been different if Lehman Brother had been supervised by the FED and if the subprime loans distributors had not been exempted of any regulation and supervision. But in emerging countries there are also large “holes”. The deficits are also existing for specific institutions, among which the most important and potentially most harmful are of course the hedge funds. One must be sure that designing a scheme of regulation and supervision for these institutions will be extremely difficult according to the strong resistance that such an issue will provoke. It will certainly be claimed that hedge funds were not responsible for the subprime crisis. Of course, but they have spread the crisis as they hold almost 50% of the CDO market, thanks to their enormous indebtedness resulting in an excessive leverage. The CDO market became totally illiquid when hedge funds were forced to adjust their positions in order to face the margin calls of their counterparts. We can add that, as they desperately needed liquidity after the banks had reduced or cut their credit, they contributed, by massive selling, to destabilising world wide stock markets. So, one must consider that the nature of their activity is by itself a potential factor of crisis and of propagation or intensification of crisis.

An ad hoc regulation for hedge funds with specific limits for leverage and risks concentration, with some transparency requirements, at least towards regulatory authorities would be in the interest of financial stability, of course but also in the interest of hedge funds which give a bad image of themselves when the financial community knows the enormous losses they can sometimes suffer.

Finally, special “standards”, monitored by the IMF should prescribe the constraint of regulation and supervision concerning all financial institutions.

The accounting rules are a complex subject, as the fair value principle can have disastrous effects, while historical value is not suitable for all operations. A solution could be not to calculate daily market value, but to refer to a six or nine months average period. However suitable the solution could be, it is obvious that these rules have not only accounting results, but also political and economic repercussions. So, the International Accounting Standards Board must be supervised by an international authority like the IMF or the World Bank.

Off shore centres are generally called “fiscal paradises”. But they are less harmful in this area (every country can suffer from a “fiscal heaven”, that is to say a country in which the tax burden is less heavy than its own), when compared to the harm they can cause by their opacity and non-respect of financial and banking regulations. One must not have excessive illusions as to the possibility that the international community would agree on a general condemnation and ban to have relationships with these centres. An evolution on this question needs less general statements than concrete actions. A first and very important step would be that big countries, which have specific relationships with such centres act in clarifying these relationships: UK with Jersey…and with London, France with Andorra and Monaco, Germany with Lichtenstein, USA with Barbados, Bermuda, Caymans…

Many other questions must be treated: rules specific to securitisation, with a limitation of this technique to well evaluated risk assets and the obligation of credit institutions to keep in their balance sheet a part of the securitised credits; salaries and bonuses of financial institutions bosses; risks management by financial institutions with procyclicality of accounting rules and practices; underestimation of risks (inaccurate stress tests or value at risk method…). Perhaps a re-examination some directives of Basel II would be needed, but most of these problems must be treated in technical committees hosted by international agencies (IMF or BIS) and don’t need solemn revolution.

All reforms and new directives on these questions should of course be the matter of specific standards and codes under the supervision of the IMF.

5) Should central banks be given more powers and responsibility in the field of financial stability and supervision?

Asking such a question is already giving the response, which of course is yes. But implementation of this assumption raises some political and concrete problems.

As already mentioned in previous papers, the crisis has shown that the most serious failures (Lehman Brothers, Fortis, Northern Rock...) have concerned institutions which were not directly supervised by a central bank. That is a contrary demonstration of the superiority and the sui generis skill of central banks for banking supervision. But in a lot of countries, the central bank has no, or at best indirect or partial involvement in this job. Doctrinal and political reasons explain these situations.

The Jurassic “Chinese wall” argument ,according to which the same body cannot have the responsibility for monetary policy (which can affect banks' situations) and of the banking individual supervision, was invoked by some governments when they gave independence to central banks, for letting it outside the supervision mission or even for depriving central banks traditionally in charge of banking supervision of this job and giving it to specific and new entities such as the Financial Services Authorities.

There is no point in affirming that the Chinese Wall principle has come into total contradiction with the needs of financial stability and the strong involvement of central banks in this issue. In some circumstances, which seem to become more and more frequent, central banks must very rapidly consider the opportunity of injecting liquidity, assess the quality of the interbank market participants and identify liquidity or solvability problems. To obtain such a complete diagnostic requires to cross market information and banking information provided by the supervision.

But there is also political reticence to give too much power to an independent institution, not only in the strict area of the supervision, but in the ability to impose penalties which can go as far as eradication. Even if in independent central bank statutes, it is specified that this independence is limited to monetary policy, governments can fear to be totally excluded of some important decisions concerning the banking sector.

We think that this reticence can be overcome with important supervision decisions taken, not by the central bank boss but by a committee chaired by the central bank Governor and co-chaired by the Treasury head.

Finally, it would be absolutely relevant to have new standards and codes, monitored by the IMF, concerning a strong and concrete involvement of the central bank in the banking supervision.

Another aspect of the involvement of central banks in financial stability is the monitoring of asset prices, especially, real estate and stocks prices.

Watching housing prices is already one of the concerns of the ECB and the evolution of these prices was perhaps the major reason for the rise in its interest rates in 2006, as the institution was trying to obtain a soft landing in a particularly buoyant sector. In fact, central banks should expressly show that they consider this monitoring as one of their main missions, with the construction of a specific global price index that they would regularly publish.

Concerning the monitoring of stock prices, central banks have had until now what we can call a schizophrenic attitude as they are regularly (at least some of them) warning against the risk of bubbles but repeating also that it is difficult if not impossible to determine at what level stock prices are normal or excessive. That is a fable and we all know that in any latitude, trees don't rise to the sky. Moreover some technical instruments (like PER) exist to assess the price level of markets instruments. But saying that the central banks must be more in the offensive on this problem doesn't resolve the question of the action tools: is raising interest rates, with no concern about inflation because stock market prices surges seem excessive, the correct response? In fact it is surely a problem on which to have a systematic action scheme (like the one which more or less exists for fighting inflation) would be totally counterproductive.

So, we propose that central banks monitoring of asset prices (housing and stocks) be added in the international standards and codes. Publicly and solemnly in charge of this responsibility, central banks would be free to implement actions (verbal interventions, moves in interest rates...) they consider appropriate.

6) What specific role should the ECB play in the financial system reform process?

A first question concerns the role of the ECB in an optimal European supervision structure. The opportunity to give the ECB direct responsibility in European banking supervision has already been discussed in previous papers. Obviously, the fact that the euro area does not correspond, by far, to the European area, the difficulty to modify the statute of a multinational institution, which would be seriously reinforced by the fear to give excessive powers to an independent body, the quality of the national supervision in most European countries, the concrete difficulties for organising a competences transfer which could be very costly in term of efficiency, all these considerations inspire distrust in such a reform.

But there is a field, which is clearly included in the ECB statutes – which expressly refers to the financial stability mission that should be given to the ECB: to design and to coordinate a macro prudential supervision. The principle of a macro prudential supervision is simple: as the financial institutions are submitted to cyclical movements, it is necessary to integrate in supervision not only stability objectives for individual institutions but also for the whole financial system. But the implementation is very complex. The ECB, with the European Committee of Banking Supervisors, should lead reflexions and work on this subject.

To ask about the role of the ECB in a new financial international architecture leads to the question of coordinating actions of the major global central banks in financial stability.

Exchange rate fluctuations are a first important subject to be dealt with. Since 1999, the dollar/euro exchange rate has been affected by wide movements, often disconnected from the economic fundamentals. It would be of course impossible and counterproductive to implement a fixed exchange rates regime between this two big currencies, but the example of the Louvre Agreement in 1986 shows that it is possible and benefits to cooperate in order to limit fluctuations. We think that the IMF should take initiative to bring together US treasury and central bank, ECB and euro group leaders for managing a new similar agreement. The international institution would also take the initiative to take on Chinese monetary authorities for associating them to a global exchange rates monitoring process.

Lastly it would be essential to admit that there is a link between monetary policy and financial stability. Excessive interest rate decreases and rises have destabilising effects on the behaviour of the economic agents, financial institutions, markets, favour wide imbalances by excessive indebtedness, and create the “compost” for financial instability and crisis. The two major central banks, FED and ECB must be conscious of this constraint in managing their monetary policy. This question is all the more important in that the present context of deep slow down of economic activity encourages political leaders to take measures encouraging a strong new increase of indebtedness.

Some reflections on the reform of the international financial architecture

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Leon Podkaminer

Summary

This note dwells on the reform principles as contained in the G-20 Summit Declaration. Some of the Declaration's directions seem very important and long overdue. Development of global financial accounting standards, elimination of pro-cyclicality in regulation, isolation of 'heavens' of broadly defined illicit financial activities are worth of being pursued. And all of these goals seem capable of being actually reached – provided there is strong enough political will. However, the Chapter on Reinforcing International Cooperation appears to be rather empty of actions that can be expected to contribute positively to the new global financial architecture. The Chapter on Strengthening International Financial Institutions, although correctly stressing the need for stocking up the IMF and making it more responsive to the needs of the emerging and developing countries, on the whole appears to be rather enigmatic (in some parts also problematic).

The Declaration is mute on supranational regulatory/supervisory authorities to police the global financial system. Virtually nothing can be expected to change as far as the formal regulation/supervision (and also eventual bailout) of major financial institutions active globally (i.e. in different jurisdictions) is concerned. The failure to propose the setting up of such authorities is neither surprising, nor to be deplored. The idea seems impracticable even at the EU level.

Even if the restructuring of international financial architecture does not result in revolutionary changes, the global financial system may become much more resilient – at least for a couple of years. This forecast assumes that at the national level there will a radical overhaul of regulation and supervision in all major countries. The re-regulation could be expected to restrict all these corrupt practices that the policy allowed in the recent past. One could expect the scope of regulation to be much increased, standards (such as relating to leverages) properly modified, improvements in accounting for the systemic risks, etc. At the same one may hope for the return of the narrow banking based on the traditional principles.

Some more fundamental issues may need to be given some consideration. For example, should the authorities continue to applaud the progressing conglomeration of various types of financial activities? Or, should one be happy about the frenzy of mergers and acquisitions in the banking sector?

Finally, one should perhaps reflect on some deeper, structural developments behind the current financial crisis. One of these is the ballooning of the financial wealth which, finding investment in the productive activities unattractive, propels all sorts of hardly productive activities – as well as speculative booms and busts.

Introduction

The financial turmoil that started in the USA more than a year ago has produced reverberating effects throughout the globe. But it is only recently (following the collapse of Lehman Brothers) that the severity of the crisis – and its global scope – have been seriously acknowledged. The reform of the international financial architecture is again[19] becoming a topic for discussion (if not exactly for real action). As on the past occasions, there is currently no shortage of reform proposals – both general and quite specific. In this note I shall dwell on the reform principles contained in the Declaration of the Summit on Financial Markets and the World Economy, which was issued following the G-20 Summit held on 15 November. Because of the weight of that Declaration - and of the Body behind it - the principles are, presumably, more likely to be eventually followed in practice than other reform proposals circulating around.

The Summit participants pledged to implementing policies consistent with five common reform directions: (1) Strengthening Transparency and Accountability; (2) Enhancing Sound Regulation; (3) Promoting Integrity in Financial Markets; (4) Reinforcing International Cooperation; (5) Reforming International Financial Institutions.

Transparency, Regulation, Integrity

The first three directions address the issues to be tackled primarily at the national level - which does not rule out some involvement of international bodies (e.g. playing consultative, advisory or standard-setting roles), or some international (or regional) cooperation. As signalled by the very names of these directions, the goal here is to achieve the very same things - better regulation at the national levels, better disclosure, transparency, risk management, enhanced morality etc - which all proved elusive despite heavy efforts (e.g. by the Basle Committee) of the last 20 years. Of course, one should hope that this time over significant improvements in national regulation, transparency etc will be achieved. But it must be noticed that some of the specific actions projected in these directions, and some recommendations formulated therein, sound rather hollow. One senses a good measure of wishful thinking here, that is unlikely to produce specific improvements.

[19] Interest in reforming (or "strengthening") the international financial system fluctuates itself. Intense interest in the subject follows major international crises – only to abate later on. The previous major international crisis (in Asia, with its contagious repercussions in Russia and Latin America) of the late 1990s gave rise to many proposals and to some real initiatives. These were described by Professor Barry Eichengreen as follows: "*Official efforts to strengthen the international financial architecture are organized around four pillars: international standards for financial management and regulation, Chilean-style taxes on short-term foreign borrowing as a form of prudential regulation to be imposed until countries have brought other forms of banking-sector supervision up to a world-class levels, greater exchange-rate flexibility…, and collective-action clauses to create an alternative to ever-bigger IMF bailouts. All four elements would have to be adopted to make the world a safer financial place…While constructive steps have already been taken…, the new table on which the system will rest remains rickety. It has at best three legs, not four. And without all four legs, stability will be lacking*". In: 'Strengthening the International Financial Architecture: Where Do We Stand?', ASEAN Economic Bulletin, August 2000. One wonders *now*, which First-World country's banking supervision should then have been named as representing a world-class level. (US? Swiss? UK?).

To get the flavour of many of these empty or banal actions/recommendations proposed, let me quote just two such *immediate*[20] actions, described as follows: *“Banks should exercise effective risk management and due diligence over structured products and securitization”, or “Regulators should develop and implement procedures to ensure that financial firms implement policies to better manage liquidity risk, including by creating strong liquidity cushions”).*

Apart from preoccupation with the national issues, the directions 1-3 also touch upon some international issues.

As far *Transparency and Accountability* direction is concerned, the medium-term action stipulates, among other actions, that the key global accounting standards bodies work on creation of single high-quality *global* (i.e. presumably to be obeyed universally) accounting standards (e.g. for valuation of e.g. securities).

The *Enhancing Regulation* direction stipulates rather intensive involvement of the IMF, Financial Stability Forum (FSF) and other regulators and bodies which should develop, by 31 March 2009, ‘*recommendations to mitigate pro-cyclicality, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends*’. In plain language, the primary aim here seems to be to urgently correct the revealed fatal deficiency of the currently prevailing regulatory models (including the ones following the Basle-II rules). ‘*Mitigating against pro-cyclicality in regulatory policy*’ is also the first specific priority of rapid actions to be taken by the Finance Ministers. Other actions within that direction follow quite closely the common (by now) opinions (e.g. on the necessity ‘to do something’ about the private rating agencies which did contribute significantly to the current mess).

The *Integrity* direction hints at implementation of ‘*international measures that protect the global financial system from uncooperative and non-transparent jurisdictions that pose risks of illicit financial activity*’. Moreover, the direction envisages efforts to promote tax information exchange: ‘*lack of transparency and a failure to exchange tax information should be vigorously addressed*’.

Overall, some of the (international in scope) concerns expressed in the directions 1-3 seem to me both very important and long overdue. The specific goals enumerated above (i.e. development of global financial accounting standards, elimination of pro-cyclicality in regulation, isolation of ‘heavens’ of broadly defined illicit financial activities) are all worth of being vigorously pursued. And all of these goals seem capable of being actually reached – provided there is strong enough political will to succeed.

Reinforcing International Cooperation

The direction 3 stipulates two immediate and two medium-term actions.

The first immediate action requires national supervisors to collaborate in establishing supervisory colleges for all major cross-border financial institutions. Then, ‘*major global banks should meet regularly with their supervisory college for comprehensive discussion of the firm’s activities and the assessment of the risks it faces*’. In my opinion this is a vision unlikely to ever materialize.

[20] Actions to be taken by the relevant bodies in individual (presumably G-20) countries , and by various international bodies are either *immediate actions* (which are to produce results by 1 April 2009), or *medium-term actions* (with undefined deadlines).

Or, if it materializes, it is unlikely to produce any good. (At best, the red tape involved could perhaps encourage some cross-border financial institutions to withdraw from some activities abroad. And that could constitute a positive contribution to the international financial stability).

The second immediate action stipulates that regulators take '*all steps necessary to strengthen cross-boarder crisis management arrangements, including on cooperation and communication with each other and with appropriate authorities, and develop comprehensive contact lists …*" etc, etc. Of course this 'action' is sufficiently ambiguous to be of any practical significance.

The first medium-term action stipulates that authorities should collect information on areas where convergence in regulatory practices '*is in need of accelerated progress, or where there may be potential for progress…*' I am not sure this 'action' properly belongs to the realm of the direction on Reinforcing International Cooperation. Moreover, I am not sure whether any national authority in charge of financial sector regulation has to be reminded – by the leaders of the G-20 – of the usefulness of collecting information in question.

The second medium-term action specifies that '*authorities should ensure that temporary measures to restore stability and confidence have minimal distortions and are unwound in a timely, well-sequenced and coordinated manner*'. I have two remarks to this. First, the implied goal of having well coordinated unwinding of the temporary measures is certainly very important. But it would be much more important to have efficient international *coordination* of such measures while they are being introduced in response to a crisis. During the current crisis the actions taken by the authorities of individual countries have shown very little, if any coordination. (The concerted cut in the major central banks' interest rates executed on 8 October appears to be an exception). Rather, one observes a kind of 'non-cooperative games' being played, with actions of some national authorities possibly worsening the situation elsewhere. In the end, the lack of proper coordination of the individual countries' emergency moves is likely to harm all. Second, given the importance of avoiding unsound international competition likely to emerge during financial crises, it would be important to work out some effective international mechanism (a binding Convention?) guaranteeing at least some minimal degree of cooperation on the matters considered. The present postulate that the authorities '*should ensure coordination*' does not seem sufficient.

Reforming International Financial Institutions

There are six immediate actions to be taken to reform the international financial institutions, followed by three medium-term ones.

The first three of the immediate actions are about (i) the Financial Stability Forum (which should expand its membership of emerging economies); (ii) the sharing of tasks/responsibilities between the IMF and the FSF.

Of course it may be useful to make the FSF somewhat *more* representative (without making it another general assembly of all nations). But the proposed division of tasks between the FSF and the IMF is rather sketchy and quite (perhaps purposefully) ambiguous. This would not seem to be of vital importance as the two institutions are expected to strengthen their collaboration '*in drawing lessons from the current crisis*' - while also '*enhancing efforts to better integrate regulatory and supervisory responses into macro-prudential policy framework*' (whatever that may mean). More importantly, I am not sure that the two parties have been consulted over their marriage arranged at the Summit. In any case I do not see the advantages of chaining the FSF to the IMF.

Each should mind its own business – even if there seems to be some overlap of duties. Some competition between the two (e.g. on the provision of specific recommendations on, and assessments of, the financial system) should only be welcome.

The remaining three immediate actions are essentially about (1) increasing the IMF (as well as the World Bank and other multilateral development banks') resources and the revision of their lending roles in the light of the current crisis; (2) exploring ways to restore emerging countries' access to credit; (3) ensuring the provision of necessary financing from the multilateral development banks in cases where severe market disruptions have limited access to the necessary financing.

These actions go into the right direction. However, one could perhaps be more specific in recognizing the scale of the inadequacy of the IMF resources – and, importantly, about the ways of making up for that deficiency[21]. Besides, one would expect more direct and open commitment on the part of the major G-20 countries to instructing the IMF and other international financial organizations to make funds available quickly and generously[22] (in the first place to the emerging and developing countries should these suffer heavily from the collateral damage to the crisis engineered in the USA and propagated by the European banks). A mere commitment of that sort could stop, or weaken, the contagion suffered by weaker countries. One should perhaps consider rendering the IMF a sort of international lender of last resort[23]. It may be added that the actual material help to the emerging economies (should they actually need it) would eventually help to contain crisis also in the advanced countries.

The three medium-term actions are, essentially, about a comprehensive reform of the Bretton Woods institutions. Nothing new under the sun. The necessity to reform these institutions has been acknowledged for good 20 or more years. But the actual changes, though substantial in some areas, are still considered insufficient. Therefore one could remain a bit sceptical. Of course the intention to give the emerging and developing countries greater voice and representation in these institutions is to be applauded, as this may enhance these institutions' legitimacy and credibility. Similarly, one cannot object to the proposed upgrading of the IMF's competencies in e.g. providing macro-financial policy advice, supporting the implementation of new regulations etc. However, the Declaration's outline of the reform of the IFI lacks any meaningfully specific details. It is all full of buzzwords. That's a pity. The leading experts in the field have formulated many thoughtful, and reasonably specific, proposals for the reform of the IMF[24]. These proposals agree on quite many concrete issues. Virtually nothing of that has found its way into the Declaration. Thus, whether or not the medium-term actions reforming the international institutions will bring genuine and meaningful improvements remains an open question[25].

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[21] Professor Eichengreen has recently suggested an agreement to top up the IMF resources by tapping reserve-rich countries on an exceptional basis as the best solution currently.

[22] And without imposing any of their infamous conditionalities.

[23] As discussed a decade ago (see e.g. S. Fischer: '*On the Need for an International Lender of Last Resort*', The Journal of Economic Perspectives, No. 4, 1999).

[24] See e.g. the booklet edited by B. Eichengreen and R. Baldwin : 'What G20 leaders must do to stabilise our economy and fix the financial system', www.voxeu.org, 10 Nov.2008.

[25] Reforming of the IMF may collide with the entrenched interests of countries which at present dominate it. The fact that the individual EU member states guard their separate voting rights at the IMF (and that they are not replaced by a single EU representation) illustrates the difficulties inherent in reforming international institutions.

No supranational regulatory/supervisory authority in sight

The Declaration may have been a major disappointment to those who dreamt of creation of supranational regulatory/supervisory authorities effectively policing the global financial system. This is not on the agenda. Moreover, virtually not much can be expected to change as far as the formal regulation/supervision (and also eventual bailout) of major financial institutions active globally (i.e. in different jurisdictions) is concerned. The failure to propose the setting up of such authorities is neither surprising, nor to be deplored. The idea is impracticable – as shown by the fact that so far even the European Union has failed to develop such authorities for policing the integrating national financial systems of the member states[26].

Concluding observations

Even if the restructuring of international financial architecture does not result in revolutionary changes, the global financial system may none the less become much more resilient – at least for a couple of years. This pretty optimistic forecast assumes that at the *national* level there will a radical overhaul of regulation and supervision in all major – and most minor – countries. The international architecture will be strengthened because its constituent country 'bricks' will be more solid. The trend towards deregulation which set in the 1970s most likely will be reversed. The re-regulation could be expected to restrict all these corrupt practices that the policy allowed (if not encouraged) in the recent past. One expects the scope of regulation to be much increased, standards (such as relating to leverages) properly modified, improvements in accounting for the systemic risks, etc. At the same one may hope for the return of the narrow banking based on the traditional principles. Some 'innovative' practices may need to be forbidden, application of some 'drastic' measures[27] may be (conditionally) accepted.

Some more fundamental issues may need to be given some consideration. For example, should one continue to applaud the progressing conglomeration of various types of financial activities? Or, should one be happy about the frenzy of mergers and acquisitions in the banking sector? (I don't think so, if only because the emerging financial sector mammoths are prone to blackmailing the authorities – on the 'too big to fail' principle).

Finally, one should perhaps reflect on some deeper, structural developments behind the current financial crisis. One of these is the ballooning of the financial wealth which, finding investment in the productive activities unattractive, propels all sorts of hardly productive activities – as well as speculative booms and busts. The second (and related) development is the pretty universal tendency for the reduction of the labour share in the national income. This tendency is directly related to the ballooning size of directly unproductive wealth. Indirectly, the secular stagnation of the labour income contributed to the present crisis. The overall growth of the GDP (and profits) has been led (at least in the USA) not by the consumer demand out of rising personal incomes – but has depended on rising, unsustainable, debt of the working-class households.

[26] It is not clear at all what role the ECB should play in the restructured international architecture. But, it is also not quite clear what role the ECB should be playing as far as the strengthening of *European* financial system(s) is concerned. Currently the ECB does not have powers and responsibilities in the field of the European (of even euro area) financial sector supervision and crisis prevention.

[27] Such as temporary obstruction of cross-country flows of some sorts of capital.

How to restructure the international financial architecture?

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Anne Sibert

Executive Summary

- To lower the likelihood of financial crises:
  - Securitisation should be regulated to restore proper incentives for banks.
  - The euro area should adopt a regulatory system based on objectives.
  - The short-comings of the Basel II accord should be addressed.
  - While difficult, ways must be found to incentivise financial firms to change the way they compensate employees.
  - The euro area should have a single supervisor and regulator charged with ensuring financial stability.
- To prevent liquidity crises:
  - There should be good systems of deposit insurance.
  - Countries without important reserve currencies should not have large internationally exposed banking systems.
- To decrease the likelihood of exchange rate crises, the powers in Brussels and Frankfurt
  - should allow potential future members of the euro area to unilaterally adopt the euro without jeopardising their chances of future membership in the euro area.
  - should not enforce the exchange rate criterion of the Maastricht Treaty.
- Early warning of a financial crisis
  - is unlikely to be best provided by the IMF
  - might be provided by an independent committee of experts and individual market participants
- International cooperation in developing crisis management measures and disseminating this knowledge is desirable; funding these measures must be left to the national governments.
- Managing a crisis
  - Requires writing off bad assets: Central banks should learn how use auctions to value non-traded securities.
  - Requires short-term liquidity provision to and recapitalisation of viable financial firms: Countries should not have banking sectors that are to big to rescue.
  - International coordination to avoid beggar-thy-neighbour regulatory policies and exchange rate policies.

Restructuring the international financial architecture to safeguard the world against the ill effects of financial crises requires efforts in three areas. The first area is crisis prevention: appropriate supervision and regulation must be developed and implemented to lessen the risk of solvency crises. Strategies to protect market participants from liquidity crises should be in place. The second area is surveillance: it is desirable to have early warning of potential crises and an assessment of risks, weaknesses and vulnerabilities. The third area is crisis management: there should be policies to ensure that crises are mitigated and contained. The purpose of this note is to address each of these three aspects. I discuss which policies and reforms are feasible and which would make a significant contribution to global financial stability; I consider the appropriate roles for national and international institutions.

1. Crisis Prevention

Financial crises can occur when financial firms become insolvent or when solvent financial firms become illiquid. In the current crisis, both phenomena have occurred. In this section I discuss reforms that would lower the risk of solvency problems and reforms that would reduce the threat of liquidity problems. I also discuss measures to prevent speculative attacks on fixed exchange rates.

1.1 *The prevention of solvency crises*

Promoting a stable financial system requires both macroeconomic and microeconomic supervision and regulation. Typically, the central bank is charged with the macroeconomic tasks: acting as lender of last resort to illiquid but solvent financial institutions and ensuring the orderly functioning of financial markets. Traditional microeconomic tasks – imposing the minimum amounts of capital required, the minimum risk-based capital ratios, limits on portfolio investments and restrictions on off-balance sheet activities and then ensuring that these restrictions are complied with – have been allocated to various agencies, including the central bank, in ways that differ markedly across countries. Improving supervision and regulation to reduce the likelihood of future crises requires a two-pronged approach: first, the scale and scope of microeconomic prudential supervision and regulation must be expanded and secondly, microeconomic tasks should be reallocated, both within countries and internationally.

1.1.1 *Reforms to supervision and regulation*

I describe four obvious areas in which microeconomic supervision of the financial system must be reformed. In the first two, it is relatively clear what regulators ought to do; in the latter two, finding solutions is problematic.

The first area of necessary reform is securitisation. While allowing the diversification of idiosyncratic risk, securitisation perverts the incentives of commercial banks. Commercial banks exist as intermediaries between borrowers and lenders because they can mitigate asymmetric information problems in credit markets by collecting information about potential borrowers (thus reducing adverse selection problems) and by monitoring their behaviour (thus reducing moral hazard problems). A commercial bank that intends to securitise its loan portfolio has little incentive to either gather information about potential borrowers or to oversee the behaviour of borrowers once the loan is made. Regulatory reform need not eliminate securitisation, but it must restore the proper central bank incentives. One way that this could be done is to insist that a commercial bank or other financial institution that securitises its loans retain some fraction of the subordinate, or riskiest, tranche.

The second area is the nature of the regulatory system. Many countries – such as the United States – have an *institutional* system of regulation. That is, supervision is organised according to types of financial institutions. In a world where the difference between types of financial institutions is diminishing this makes little sense and it has allowed some financial institutions to be lightly regulated, or in the case of hedge funds, to be not regulated at all. The solution to this is to have a regulatory system that is based instead upon objectives, such as financial stability, consumer protection and adequate competition.[28]

The third area is capital requirements. The Basel II accord sets out international standards for banking regulators seeking to reduce excessive risk taking by banks by imposing the amount of capital that banks are required to hold. It is widely believed that these capital requirements are pro-cyclical. During an economic downturn, banks' estimates of the likely losses on their loans rise and, under the Basel II rules this increases their required capital. As a result, their ability to make further loans is impaired and this worsens the downturn further.[29] In addition, it is argued that the Basel II accord places an insufficient emphasis on liquidity management and too much reliance on internal risk management models and on ratings agencies.[30] Satisfactory solutions to the inadequacies of Basel II are not obvious, but resources should be devoted to developing them.

The fourth area is employee compensation. Employee compensation in the financial services industry encourages excess risk taking by providing exorbitant reward for good short-term results without severe punishment for bad long-term results. A solution to this problem is urgently needed, but given the high degree of labour mobility in the industry, this is possibly the most conceptually difficult regulatory problem faced by policy makers responsible for financial stability.

1.1.2 *Changing who does what*

As mentioned in the previous section, the allocation of regulatory responsibility is best done by objective rather than by type of institution. The objective of financial stability has both macro-prudential and micro-prudential aspects. There is no consensus in the academic and policy debate on whether these tasks should both be done by the same agency and there is no uniformity in practice: in the United States the Federal Reserve is one of the regulators of commercial banks; in the United Kingdom regulation of the financial services industry is the responsibility of the Financial Services Authority rather than the Bank of England. In the Euro area, it may or may not be desirable for the ECB to supervise and regulate financial institutions, but there should be a single euro area supervisory and regulatory agency charged with promoting the stability of the euro area financial system. I present two reasons.

First, for the ECB to fulfil its lender of last resort function it must be able to distinguish solvent but illiquid institutions from insolvent institutions. The central bank and the regulatory authority need to be able to share information quickly. Thus, it appears that the area of jurisdiction of the monetary policy maker and that of a single supervisory and regulatory authority concerned with financial stability ought to coincide. The second reason is the prevalence of cross-border mergers of financial institutions within the euro area. The risks faced by a multinational financial group as a whole may differ substantially from the risks of the part of the group located within a particular country. This suggests that it is important for cross-border financial concerns to be regulated by a single authority.

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[28] See Di Giorgio and Di Noia (2001) for a theoretical discussion of different types of regulatory frameworks.
[29] See Repullo and Suarez (2008) for a discussion of this.
[30] See Rubini (2008).

The second argument applies to the entire global financial system, as well as to the euro area, and some have suggested that the Financial Stability Forum (FSF) should have the power to supervise large transnational financial institutions. Unfortunately, global financial supervision is less politically feasible than euro area financial supervision and may not be possible. There is a potentially important role for the FSF, however. A monolithic euro area financial regulator, unless well structured, is likely to be cumbersome and bureaucratic and, thus, not conductive to innovative thinking. It may also be more subject to "regulatory capture" as relations with a single regulator may be more direct.[31] Thus, having an independent body to provide ideas and to assess the overseer is likely to be important.

1.2 *The prevention of liquidity crises*

While a good system of supervision and regulation may help prevent solvency crises based on poor fundamentals, it may not be sufficient to prevent liquidity crises. In this section I consider how the likelihood of bad outcomes associated with good fundamentals can be reduced.

2.1.1 *Preventing old-style and new-style bank runs*

Even when the fundamentals are good, financial markets can exhibit unfortunate outcomes due to coordination failures and participants' inability to aggregate information properly. To see how coordination failures can arise, imagine a bank with uninsured or underinsured depositors. If each such depositor believes that all other such depositors will keep their funds in the bank and that will be sufficient to prevent the bank from failing, then each such depositor finds it optimal to keep his money in the bank and the bank does not fail. However, if each such depositor believes that all other such depositors will withdraw their funds and that this will be sufficient to cause the bank to fail, then each such depositor withdraws his funds and the bank fails. In each case, depositors' expectations are self-fulfilling and rational. Both scenarios can be consistent with the same set of fundamentals. Thus, either outcome is possible: the bank fails or it does not.

Poor information aggregation can also cause banks to fail. Imagine that a few depositors hear a rumour that a bank might be in trouble and withdraw their funds. Other depositors, seeing this, withdraw their deposits, not because they have heard anything negative about the bank, but because of what they infer the other depositors must have known to have withdrawn their deposits. A cascade of withdrawals may result, based solely upon a small amount of noisy information embodied in the rumours heard by the few initial withdrawers.

In addition to causing old-style bank runs, the coordination failures and information cascades can cause new-style runs: wholesale creditors of a bank may fail to roll over their loans or to extend new loans because they believe that other creditors are going to fail to roll over their loans and that as a consequence the bank will fail and be unable to repay. A small amount of poor information about a bank may also lead to a cascade of wholesale funding being withdrawn.

A good international financial architecture should be able to minimise bank runs. Most old-style bank runs, where uninsured depositors flee, can be prevented by a system of deposit insurance where depositors have immediate access to their funds in the event of a bank failure. Runs on banks by wholesale creditors can be prevented if there is a lender of last resort with deep enough pockets and it is credible that this lender will make the needed loans.

[31] See Di Giorgio and Di Noia (2001).

As long as its banks' deposits and short-term liabilities *are denominated in domestic currency*, a government can always issue enough currency to avert a bank run. If the government is credible that it will do this, the run is likely to be averted. If a run occurs and the bank is fundamentally sound, it repays its loan and there is no consequent inflation. However, if banks' deposits and liabilities are denominated in foreign currency, the country must be able to come up with enough foreign exchange to avert a run. As the recent experience of Iceland illustrates, if a country's banking system is sizable enough, this may not be feasible.

The problems of funding provision and credibility suggest two lessons. First, it is highly undesirable for a small country with its own currency to have a large, internationally exposed banking sector. The fate of Iceland provides a stark warning and Switzerland, Denmark, Sweden and even, to some extent, the UK should pay attention to this. From the point of view of a healthy international financial architecture, all of these countries would be better off in the euro area.

1.2.2 *Preventing speculative attacks on currency pegs*

As with bank ranks, speculative attacks on fixed exchange rates may occur even when the fundamentals are good. Investors may attack a fixed exchange rate regime because they believe that other investors are going to attack and that this will cause the peg to fail. Their expectations are self-fulfilling. A small amount of negative information may lead to an information cascade that results in a successful attack. Unfortunately, it is generally more difficult to avert a speculative attack on a fixed exchange rate than it is to ward off a bank run. In addition, a forced devaluation may lead to a bank solvency crisis if it causes domestic banks to be unable to repay their foreign-currency loans.

It is always *feasible* for a central bank to fend off a speculative attack on a pegged exchange rate. All it has to do is set overnight interest rates high enough to achieve the necessary contraction of domestic credit. An attack will not occur if it is credible that a country is prepared to mount a successful defence. Unfortunately, in practice, defending a pegged exchange rate is quite costly.[32] A confidently expected 20 percent devaluation of the currency requires a 20 percent overnight interest rate (at a daily rate) to discourage speculators. During the ERM crisis of 1992-3, the central banks of Sweden and Ireland only temporarily staved off devaluation by setting their overnight interest rates at 500 percent and 300 percent (at an annual rate), respectively.[33] Thus, while averting an attack on a pegged exchange rate is *possible*, the damaging effect of high interest rates ensures that it is unlikely to be credible that a country will choose to do so.

This credibility problem suggests that a feature of a sound international architecture is that large economies should avoid fixed exchange rates.[34] Unfortunately for small open economies, a floating exchange rate may be better than a fixed exchange rate but is still an unattractive option. Such an economy is highly vulnerable to external shocks that cause wide swings in its exchange rate that make it difficult to use monetary policy to attain price stability, that can cause real damage to the domestic economy and that can threaten the banking sector if an unexpected devaluation makes it difficult to repay foreign-currency loans. As a consequence of this, small open economies should not have their own currency.

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[32] See Rogoff and Obstfeld (1995).

[33] See Buiter et al (1998).

[34] A country might try to gain credibility by having a currency board. If the rules of this pegged exchange rate arrangement are strictly adhered to, the central bank has enough foreign reserves to defend its peg by buying back its monetary base. Unfortunately, as the Argentinian disaster of 2001 demonstrates, domestic concerns make adherence to the rules difficult.

The arguments suggest that the criteria for entrance into the euro area contribute to financial instability and have no place in a sound financial architecture. Most candidate and potential candidate countries for membership into the euro area are too small to have their own currency and would be better off unilaterally adopting the euro. Although nothing in the Maastricht Treaty specifically excludes this, these countries are likely deterred from doing it because they fear it might preclude eventual membership in the euro area and, thus, access to the ECB as lender of last resort. The ECB, Brussels and the Council should decide and make it clear that unilaterally adopting the euro will not jeopardise membership chances. If countries must or wish to keep their own currencies prior to adopting the euro, the ECB, Brussels and the Council should decide and should make it clear that the exchange rate criterion will not be applied rigidly. Italy and Germany did not meet the fiscal criteria when they joined; Greece met the criteria by fudging its data; Italy, Finland and Greece did not meet the exchange rate criterion. Current candidates should not have to subject themselves to the possibility of a damaging exchange rate crisis to become euro area members.

1.2.3 *An international lender of last resort*

An international lender of last resort may seem like an appealing reform measure, but it has never proved feasible in practice. The reason is that distinguishing solvent but liquid borrowers from insolvent borrowers is difficult, particularly if the lender of last resort is not also (or does not also have a close relationship with) the supervisor and regulator of a financial institution in need of a loan. If a loan is made to a financial institution that turns out to be insolvent and cannot repay, then the tax payers of the countries who fund the international lender of last resort must pay. To fund an international lender of last resort requires deep pockets and a willingness to transfer money from tax payers in one country to the creditors of a defaulting financial institution in another country when an *ex post* incorrect decision is made.

The IMF has not been especially successful at playing the role of lender of last resort. Traditional IMF loans, with conditionality and funds disbursed in tranches, are not suited to a liquidity crisis. Recently, however, the IMF has expanded its limited role as international lender of last resort (to countries, rather than to specific financial institutions) by introducing a short-term lending facility (SLF). The purpose of this facility is to provide large amounts of short-term financing to fundamentally sound countries that have temporary liquidity problems in their financial markets. Countries will be allowed to borrow up to 500 percent of their quota for three months, and can renew the loan twice in 12 months. Unfortunately, while welcome, this is not adequate to save many countries with full-blown crises. If such a facility had existed last September, it would have provided Iceland with roughly $900 million, a small fraction of the $10 billion Iceland may have needed to stave off collapse of its banking system.[35] It would currently provide Mexico with about $24 billion; in 1994 Mexico spent $25 billion in reserves and borrowed $25 billion more in an unsuccessful attempt to defend the peso.[36] Moreover, with loanable funds of about $200 billion (at the end of August 2008) the IMF's resources are severely limited.

[35] See Buiter and Sibert (2008).
[36] Rogoff and Obstfeld (1995)

2. Crisis Warning

The second aspect of restructuring the international financial architecture is improved crisis warning. Financial crises usually take markets by surprise. There were few high-profile observers issuing loud warnings of either the apparent liquidity crisis that erupted in August 2007 or the solvency crisis that surfaced in 2008. Similarly, markets were startled by the emergence of the international debt crisis in August 1982, the Mexican crisis of 1994 and the Asian crisis of 1997.

Some crises, especially financial account crises, can be extraordinarily difficult to predict. Empirical researchers have had little success in isolating useful sets of leading indicators to predict speculative attacks.[37] One reason for this is that speculative attacks – as described in the previous section -- can be one outcome in a scenario where multiple outcomes are possible; thus, the same set of fundamentals can be consistent with a speculative attack occurring or not occurring. Other crises, however, seem rooted in the fundamentals and are not merely coordination failures or a result of improper information aggregation; the recent financial crisis appears to be an example. With the benefit of hindsight, it seems that it ought to have been possible to have foreseen that the combination of a sharp decline in US house prices, rampant securitisation, high leverage and inadequate accounting standards might lead to a solvency crisis of the magnitude we are seeing. But, few if any, seemed to see it.

2.1 *The IMF as provider of early warnings*

While reliably foreseeing all crises in time to forestall them may be an impossible goal, better prediction seems possible. An early warning system is a reform measure which would contribute to an improved financial architecture and which may be feasible, as well as relatively inexpensive. Some have suggested that the IMF is the natural institution to provide such a service.

The IMF itself sees surveillance as one of its primary roles. In their joint letter to finance ministers and central bank governors, the IMF and the Financial Stability Forum state that, "Surveillance of the global financial system is the responsibility of the IMF." However, while the IMF has considerable expertise in evaluating macroeconomic policy, its institutional structure – as wall as its past performance -- suggests that is not the right institution to provide early warning of impending financial crises.

The IMF is intensely bureaucratic. Its culture may result in staff who are socialised to think in a particular way. To see a looming crisis before others typically requires thinking in a highly independent and unconventional way. In addition, the IMF is an exceedingly political organisation; to argue one's unusual and possibly sensitive view may not be a career-enhancing move for a staff member. Finally, while the IMF has the expertise to analyse financial account crises, its emphasis on macroeconomics may mean that it does not have the expertise to predict financial sector crises based on microeconomic failures. The objections raised to the IMF as provider of early warnings apply to a great extent to other international organisations and central banks.

2.2 *An alternative proposal*

Research economists outside of large bureaucratic and political organisations do not face the same negative incentives that the IMF staff do; indeed, they may be rewarded for advocating unusual views. But, they too cannot be relied upon to provide a warning. There are two reasons for this. First, most researchers have little incentive to worry about international financial crises, preferring to do publishable research or to think about some other topic.

[37] See Chamon et al (2007) for a recent attempt and a discussion of the literature.

The second is that, until the recent crisis hit, the percentage of research economists who knew what a collateralized debt obligation was, was minute: most research economists lacked the institutional knowledge to understand what was taking place.

I propose that as an alternative, an early warning system should be provided by an independent body of experts who are required to provide reports of weaknesses in the financial system. This body should consist of eminent research economists – both macroeconomists and microeconomists, as well as finance theorists, research accountants and practitioners in the financial sector. The last group would provide the relevant practical expertise. Terms on this committee should be short, to maintain independence of thought and to discourage group think. Pay and prestige should be sufficient to recruit the most talented thinkers and reports should be widely published so that members are accountable and have an incentive to care about their reputations.

3. Crisis Management

There is widespread agreement that managing a local solvency crisis requires three things: first, bad assets should be removed from financial institutions' balance sheets; second, viable financial institutions should be recapitalised; third, short-run liquidity needs should be addressed.[38] Managing a global financial crisis requires an additional component: nations must coordinate to ensure that the crisis does not propagate.

The removal of bad assets from balance sheets requires first a mechanism for valuing assets. Economists are good at devising auctions. Central banks should begin hiring people with the appropriate expertise and start experimenting. A difficulty is that there is a trade-off: firesale prices worsen the problem; too generous prices are a transfer from tax payers to possibly delinquent financial institutions.

International organisations can help provide technical expertise, but because of the political aspect and because the government may have to purchase some or all of the assets, national central banks in the main financial centres should probably implement the auction with national treasuries buying the assets if necessary.

The IMF can provide loans for recapitalisation and short-term liquidity needs to some small countries with large banking sectors. An IMF Stand-By Arrangement is currently providing Hungary with over $15 billion. However, the IMF does not have deep enough pockets to do anything but render technical assistance to large countries. National treasuries, financed by their tax payers must borrow to finance this refunding. Countries should be discouraged from having banking systems that they are too small to recapitalise. Along with recapitalisation, there should be schemes in place to temporarily protect financial institutions from their creditors and to reorganise them. There should be rules about who should bear the cost and risk of recapitalisation.

The Great Depression of the 1930s was made worse by competitive devaluations and tariffs. The current crisis saw a round of enhancements of deposit insurance; it is likely that some of the motivation was to compete for funds. In a global financial crisis international coordination is necessary to ensure that begger-thy-neighbour policies do not worsen matters. The IMF can play a role in this by promoting cooperation.

[38] See, for example, Strauss-Kahn, D., Speech at the Banco de España, Madrid, Spain, 15 Dec. 2008.

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How to restructure the international financial architecture?

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Norbert Walter

Almost inevitably, the current financial crisis has again triggered a debate about the appropriateness of the international financial architecture. When this subject was last addressed – viz. in the wake of the Asian crisis – the emphasis was on strengthening financial systems in emerging markets and on devising instruments and mechanisms for a more orderly resolution of sovereign debt crises. Institutionally, the IMF was at the core of the debate then, even though it is worth recalling that the Financial Stability Forum (FSF) was created as a result of the deliberations at the time. This time, emphasis is on strengthening the resilience of the global financial system as a whole (with a special emphasis on mature markets), while institutionally a plethora of different institutions are being reviewed. All of this is, of course, a reflection of the further globalisation and differentiation of the international financial system that has taken place in the intervening years.

The term "architecture" may suggest that changes in the institutional structure of financial regulation and supervision should be at the core of policy efforts. While there is no denying that institutional structures are of major relevance, there can also be no doubt that the key to a more stable financial system does not primarily lie in institutional changes per se, but in creating structures, processes and incentives that reduce the financial systems susceptibility to recurring shocks and bolster the system's ability to withstand such shocks. In what follows, we will therefore, after first establishing some principles for the reform of the international financial architecture, discuss such structures, processes and incentives, before turning to institutional aspects. This is followed by sections on the specific role of the ECB and on the role of central banks in macroprudential supervision respectively.

1) Principles

Efforts aimed at reforming the international financial architecture should be based on the following principles:

Openness: Over recent years, financial market regulation has been built on the premise that open, liberal financial markets are conducive to a more efficient allocation of resources, higher growth and closer integration of nations and economies. This premise still holds as true after the crisis. Any reform efforts should therefore be guided by the principles of an open, liberal market environment, based on the free flow of capital and freedom of establishment, as well as the contestability of national markets on equal terms for foreign-owned and domestic firms. All efforts should be made to prevent a relapse into fragmented national markets. At the same time, global, integrated financial markets require a regulatory framework that is commensurate with the level of market integration.

International consistency: Given political interests and accountabilities as well the legislative dimension of financial regulation, reform of the financial regulatory framework will, inevitably, take place within national jurisdictions (including the EU legislative process).

As seen in the past, this creates the danger of divergent approaches and, as a result, an inconsistent global framework for financial regulation, which endangers global financial stability (due to regulatory arbitrage) and the effectiveness of financial supervision; it also – although this is a lesser concern – causes unnecessary compliance costs for cross-border groups. The dangers of such a divergence could clearly be seen with the delayed implementation of Basel II in the US and in recent proposals by the EU (e.g. on CRAs and on securitisations) which would in effect create distinct European regulatory standards that would not only be incompatible with a globally integrated financial market, but would be to the detriment of EU-based financial intermediaries.

Consensus on objectives: Governments, regulators and the financial industry should strengthen and maintain the emerging consensus on the objectives of financial regulation. This should include the following key principles: (1) Regulation and supervision should improve safety and soundness, mitigate system risks, prevent periodic crises, improve efficiency in the intermediation of savings; improve transparency of price discovery and the integrity of financial markets, and provide equitable and effective business conduct regulation; (2) Financial regulation should create a system where financial intermediation is efficient and innovation is encouraged to the extent that it is consistent with the other key principles; (3) appropriate protection against fraud is essential, with the level of protection tailored to the degree of sophistication of the customer or investor; and (4) competition among intermediaries and markets should be promoted.

Inclusiveness: So far, the regulatory framework for global financial markets has largely been set by the G7 countries. This reflects, of course, the fact that the financial markets of the established industrial countries represent by far the largest share in total global market volume and the fact that, as of now, the largest, globally active financial institutions are domiciled in these countries. However, the relative weight of emerging markets and of financial institutions based there is obviously on the rise. Against this background, it is highly desirable that the future regulatory debate should be conducted in a broader setting that includes key players from EMs in an appropriate form, which may vary depending on the issue at hand.

Principles-based regulation: Before the crisis, there was a clear tendency to balance prescriptive rules with a principles-based regulation. This yielded considerable benefits in the shape of more targeted, efficient regulation which worked with the market and was aligned to market practices. Notwithstanding the need for regulatory adjustments, these benefits should be maintained in the future. Indeed, greater coherence and convergence of the regulatory framework will only be possible by using principles-based regulation. This holds equally true for the creation of supranational structures for financial supervision in the EU, and for reform efforts on the global level.

Political accountability: Until now, financial market regulation – especially as regards international rule-setting – has largely been a technocratic process, driven, as far as standard-setting is concerned, by supervisory cooperation (esp. within the BIS / FSF frameworks) or by independent standard-setters, such as the IASB and FASB. With the recent crisis, which required the large-scale use of taxpayers' money, financial regulation has left the technocratic sphere. It is therefore necessary to clarify who is responsible for what within and among jurisdictions. In doing so, it will be advisable to strike the right balance between the benefits of efficient, targeted and apolitical processes on the one hand and the need for political acceptability of both the process and the results on the other, so as to maintain a broad political acceptance of the regulatory framework. In this context, an appropriate inclusion of parliaments into the policy process should be striven for.

2) Structures, processes and incentives to strengthen the financial system

It is instructive to note that national financial systems worldwide as well as the global financial system have all been subject to recurrent periods of instability despite the fact that these systems display very different institutional set-ups for financial regulation and supervision. This seems to suggest that, in order to enhance the stability and the resilience of any given financial system, looking at institutional structures alone will not provide satisfying answers. Preserving financial stability is not only a regulatory and supervisory task, but must include the appropriate setting of monetary and fiscal policies as well as a consistent exchange-rate framework.

a) Reducing procyclicality

The financial system has always displayed a strong tendency for procyclicality. During an economic upswing, actors in the financial system grow more optimistic; an expansion of lending volumes and better prospects for economic growth combine to increase asset prices, which, in turn, support a further growth in lending volumes. Arguably, this procyclical tendency has become even more pronounced by regulatory changes over recent years, such as the greater importance of mark-to-market accounting rules, the introduction of more risk-sensitive capital requirements, and more generally, by the transition towards a more market-based financial system.

Procyclicality is an inevitable element of a market-based, modern financial system. Hence, the key question is not how to eliminate cyclicality from the system, but how to reduce its amplitude. This will require changes in the following fields:

- Monetary policy: Monetary policy must be more pro-active in responding to the build-up of financial bubbles and excessive movements in asset prices. The built-up and unwinding of financial imbalances have a bearing on financial stability as well as price stability. In particular, a rapid unwinding of imbalances (i.e. the bursting of an asset price bubble) can cause substantial economic dislocation which can have a heavy impact on the normal conduct of monetary policy. Therefore, in setting monetary policy, central banks should, within their mandates, take a holistic view of monetary stability and include the evolution of asset prices in the set of indicators that are used to guide monetary policy decisions as well as by central banks' communication with the financial markets. By addressing asset price developments, central banks can influence market dynamics and thereby make a contribution to reducing cyclical tendencies of the financial system.
- Accounting systems: Here, the delineation between assets held to maturity and tradable assets must be more clearly defined and the issue of cyclicality should be considered in rules for, inter alia, reclassification from the trading to the banking book.
- Capital requirements: on the basis of full implementation of Basel II in all relevant jurisdictions flexible use should be made of Basel II pillar 2 in:
    - assessing and responding to weaknesses of business models,
    - complementing pillar 1 risk-sensitive (and therefore potentially cyclical) capital requirements by alternative or complementary mechanisms to pillar 1 and pillar 2 regulatory requirements such as dynamic provisioning,
- Compensation arrangements: banks, in collaboration with supervisors, should devise internal mechanisms to ensure that their business strategies and compensation policies look through the cycle.

Most of the instruments mentioned above do not work automatically (nor should they necessarily), but have a strongly discretionary nature, in other words, authorities must decide to act depending on their assessment of the building up of imbalances. Hence, measures aimed at reducing the cyclicality of the financial system will only be successful if financial stability is effectively monitored. This is essentially the role of macro-prudential supervision, which, in turn, needs to be effectively aggregated and coordinated at the European as well as the global level. There is no need to set up new institutions or fora for this;[39] rather, what is needed is bringing together key central banks, treasuries and financial supervisors on a regular basis, based on a systematic analysis of all aspects that pertain to financial stability. A systematic, structured dialogue with market participants could be helpful for authorities to gather information on ongoing market developments. Likewise, a close dialogue should be maintained with accounting standards setters, rating agencies, and auditors.

Incidentally, it should be noted that efforts to reduce the procyclical tendencies of the financial system need strong political support. This may sound trivial, but is far from being so: All interest groups and stakeholders share an interest in avoiding the excessive downturn of financial markets and the real economy in a crisis – and would hence, be able to agree on regulatory measures that prevent such a downward spiral, such as the temporary suspension of mark-to-market accounting rules; however, similarly all interest groups share an interest in maintaining a period of rising asset prices and lending volumes: Investors are interested in rising asset prices, borrowers in continued access to funds, consumers are interested in spending, even if debt-fuelled (all three of course constitute the electoral base!); banks are interested in profits, politicians in continued growth, and central banks and supervisors are not interested in triggering political pressure by choking off (allegedly prematurely) a boom phase. Consequently, there is no natural constituency for curtailing a boom. Given their independence, central banks might be seen as the most likely candidate to bear this responsibility, but, as the build-up of the severe imbalances in the run-up to the current crisis has shown, even central banks can fail in this role. It would therefore be inappropriate to conclude that central banks are the natural choice when looking for a financial stability supervisor.

b) Risk-based supervision and focus on systemically important institutions

Much has been made of the passage in the G20 declaration, according to which the G20 commit to ensure that, henceforth, "all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances." The political commitment made with this declaration is neither economically sensible nor credible. It is not credible, because the qualification ("as appropriate") leaves sufficient scope for political discussion between governments and for loopholes in the application of this principle; in addition, "oversight" is a lose term that can simply mean monitoring.[40] More importantly, the declaration is not economically sensible because by, in principle, aiming at comprehensive control, authorities are in danger of spreading scarce regulatory and supervisory resources too thinly, which will not be conducive to financial stability.

[39] In particular, we see no need for the creation of a "European Financial Stability Forum". Creating such an institution would only further complicate to the already existing Kafkaesque structure of financial supervision in the EU adding another voice to the chorus which will make sound analysis, let alone targeted action, even less likely.

[40] Unsurprisingly, no material progress seems to have been made on the practical implementation of this part of the G20 declaration.

Instead, efforts should be focused on identifying and on supervising systemically important market participants. The traditional definition of a systemically important financial institution is a large bank whose failure would result in losses on deposits by the public, impairment of other institutions and/or a collapse of the clearing and settlement system for cash transactions. As the intermediation of financial savings has become more "marketized," and financial institutions have come to rely increasingly on transactions in financial markets to manage their financial risks, certain non-bank financial institutions, markets and clearing and settlement infrastructures have become much more central to the maintenance of financial system soundness. For example, these include financial institutions that act as counterparties in the over-the-counter derivative transactions that are used by insured banks to hedge their financial risks or systems that provide clearing and post-trade settlement of such transactions. These developments provide a rationale for extending the definition of "systemically important" to a broader array of institutions, markets and infrastructures that may need to be regulated and supervised by the authorities in order to ensure the overall stability of the financial system. Indeed, the blanket guarantees, government capital injections, asset purchases and officially encouraged mergers that the authorities in key financial jurisdictions have undertaken over the past eight months reflect an implicit recognition that certain non-bank financial institutions, markets and infrastructures are sufficiently important to the stability of the financial system that they cannot be allowed to fail.

In the context of a comprehensive reform of financial regulation, policymakers will therefore need to consider which institutions, markets and systems should be designated as "systemically important" and subject to regulation and supervisory oversight. In a reformed financial regulatory system, the agency that bears responsibility for overseeing and maintaining the overall stability of the financial system should have the authority, subject to governmental review, to designate an institution, market or system as "systemically important" and subject it to appropriate oversight.

This approach would also tend to reduce the incentives for regulatory arbitrage that have undermined the stability of the current financial system up to now, since it limits the scope to transfer the ownership of assets from regulated institutions to unregulated ones that can hold the same risks with lower amounts of capital. The authorities' designation of "systemically important" entities would need to evolve and change over time, reflecting the impact of financial innovations that change the elements of the system that most strongly affect its financial safety and soundness. The extent of regulation and the degree of supervisory oversight should also be risk-sensitive: that is, the authorities should engage in closer oversight of an element of the system the greater is their assessment of the systemic risk resulting from the collapse of an institution, the seizure of a market, or the failure of a key component of the financial infrastructure.

c) Harmonisation of policy tools

In addition to efforts aimed at reducing the cyclicality of the financial system, better tools are needed for a more effective crisis management. This requires action on several fronts, which would include the following:

- *Central bank liquidity support:* A greater harmonization of central banks' policies for liquidity operations (e.g. range of eligible collateral, haircuts applied) would not only help to make banks' liquidity management more efficient, but would also avoid distortions in times of emergency liquidity provisioning.

- *Insolvency rules:* The failure of Lehman Brothers has confirmed that failures of complex, large cross-border groups are difficult to manage, because of differences in winding-up procedures and insolvency laws. This does not only make such processes more complicated than they are by their nature anyway; it also creates incentives for ailing banks (and authorities) to shift assets across jurisdictions.
- *Effective exchange of information between supervisors:* Authorities can only make informed decisions that help reduce the damage done by financial crises if and when they have access to all the necessary information. In the era of large, cross-border financial groups, effective crisis management therefore requires the possibility to effectively exchange the necessary data between the supervisory authorities concerned and, in an aggregated, anonymous form, with central banks.

3) Institutional issues

There is a need to distinguish between institutional arrangements for prudential supervision, arrangements for financial regulation and arrangements for policy coordination.

a) On the organisation of prudential supervision

Arrangements in the EU: Institutional arrangements for prudential supervision in the EU require a fundamental overhaul. While this has long been ignored by many policy-makers, some momentum seems to have been created by the crisis. The recommendations of the High-Level Group chaired by Jacques de Larosière will presumably point to institutional options. For our own recommendations, we refer to our previous contributions, especially our August 2007 paper. We use the opportunity, though, to reiterate the important point that the EU will only be able to have a meaningful influence on the debate on the international financial architecture if it can credibly demonstrate that arrangements established within the EU are effective, powerful and contributing to financial stability.

Arrangements on the global level: In the absence of appropriate legal, political and institutional preconditions, the task will, for better, for worse, remain embedded in international supervisory colleges. This being said, a lot can be done to enhance the effectiveness of these international colleges, which, so far, are little more than informed discussions on major strategic aspects of the financial institution concerned. Also, while the G20 have decided that such colleges be established for all large cross-border groups, they have not set institutional parameters for these colleges in order to ensure that these work according to the same principles and standards. This, however, is not only a pre-condition for their effectiveness, but also a precondition for ensuring competitive neutrality.

For the sake of completeness, it is pointed out that grand plans for global supervision should be shelved, as there is no political support for such an idea[41] and none of the legal and organisational pre-requisites for such an arrangement are in place. Besides, none of the existing institutions is even remotely qualified to assume this task. Thus, the IMF is unsuited to assume such a role, as it lacks the necessary expertise and, at present, the necessary resources for this role. In addition, the IMF is too much of a political institution. Likewise, the FSF does not have the institutional underpinning for such a task. The BIS, in turn, could draw on its existing expertise and infrastructure as well as the competences of its member institutions; however, it lacks satisfactory arrangements for political accountability which are a necessary pre-condition for any financial supervisor.

[41] Indeed, the G20 declaration explicitly notes that regulation is “first and foremost the responsibility of national regulators who constitute the first line of defence against market instability”.

b) On the organisation of financial regulation

As far as regulation is concerned, the achievements of technical committees such as the Basel Committee and the FSF are noticeable. Both fora, the FSF in a leading political role and the Basel Committee as the key drafter of new regulation, have been exceedingly effective since end-2007 in steering the regulatory debate and in transposing the political commitments of governments into practical regulatory rules and policies. The FSF, in particular, while it is unsuited as a global supervisor for large cross-border financial groups, is the perfect forum for the effective coordination of global regulatory activities. By virtue of representing the major financial centres and largest financial markets, both fora dispose of the necessary gravitas to make such rules effective even beyond their own jurisdictions, especially if their proposals are seen as conducive to fostering financial stability.

This is not to deny that the relative weight of emerging markets and of financial institutions based there is obviously on the rise. Against this background, it is highly desirable that the future regulatory debate should be conducted in a broader setting that includes key players from EMs in an appropriate form, which may vary depending on the issue at hand. With the internationalisation of financial markets and against the background of the growing economic and political weight of many emerging market economies, these countries need to be involved more intensively in the restructuring of the global regulatory process. Negotiations on new global financial market regulation need to become increasingly inclusive, bringing in key emerging market players, so as to progressively increase their "buy-in" into the global regulatory framework. The existing outreach exercised by the Basel Committee, the G7 and the FSF provide good platforms for this process to go forward.

In turn, emerging markets that purport to play a greater role in international fora must be expected to apply and implement existing international standards first. As their financial markets mature, emerging market economies should progressively adopt the full set of existing global financial regulatory rules. The key will be for the emerging markets countries to see the adoption of internationally consistent standards and norms as being in their own interest as important stabilising elements in their financial systems.

Nonetheless, we would warn against premature efforts to expand the membership of the FSF beyond the current membership, as this would probably reduce the effectiveness of the FSF's work. This corresponds to our cautious assessment of whether the G20 really is the best forum to deal with the global regulatory agenda. Notwithstanding the powerful political symbolism of the G20 summit of Nov 15, 2008, it remains a fact that almost all of the G20's reform programme had already been incorporated in the FSF's agenda finalised in April 2008. Also, the EM members of the G20 have failed to demonstrate convincingly that they can make a meaningful contribution to most of the regulatory issues. Thus, instead of expanding membership of the fora, a more encompassing observer status for emerging markets may be the more appropriate approach (as already practised in the Basel Committees).[42]

[42] Incidentally, the warning against an overhasty expansion of membership and a politicisation of regulatory bodies also applies to standard-setting bodies such as the IASB.

As regards the cooperation between FSF and IMF, there should be a clear separation of roles based on the core competences of the two institutions. Given the membership of the IMF in the FSF, proper coordination of their respective work should not be a problem. As discussed, the core competence of the FSF is the development of international regulation. In turn, the IMF's core competence is in macro-prudential analysis, based on its traditional surveillance work enriched by the FSAP (Financial Sector Assessment Programmes) programmes. Building on the framework established over recent years, emphasis should be on multilateral surveillance and a closer integration of financial sector stability analysis with traditional macroeconomic analysis. FSAPs need to be expanded and need to become a regular, mandatory exercise for all IMF members. The IMF must review each member country's financial system of financial supervision and regulation to ensure that its policies and practices are consistent with international standards.

An important value-added which the IMF could create with its work clearly lies in the aggregation of risks identified in the individual assessments, by identifying the interlinkages between national financial markets and by assessing whether risks identified in individual national markets and market segments reinforce each other or cancel out.

A possible area for joint work by the IMF and the FSF is the advancement of early warning systems (EWS). We would caution against expecting too much from this, though, as there are limits to what EWS can achieve. Uncertainty is a defining characteristic of the financial system due to human nature, finance being a bet on uncertain future and feedback loops. EWS can, however, be important tools to underpin an informed international dialogue on potential threats to global financial stability.

c) Arrangements for policy coordination

As said in the beginning, the preservation of global financial stability is not just a function of regulatory and supervisory activities, but, given the impact of macroeconomic policies on the emergence of financial imbalances, is also dependent on macroeconomic policy interaction. As discussed above, the IMF is the appropriate institution to bring this about. Multilateral surveillance is, in principle, the right tool for this. It is true, that the results of multilateral surveillance have been disappointing so far. This, however, can neither be blamed on the instrument, nor on the institution. Rather, it directly reflects the unwillingness of IMF members – particularly its rich member states – to have their macroeconomic policies be scrutinised, let alone be influenced by the IMF. It remains to be seen whether the fact that global imbalances, based on non-sustainable, uncoordinated macroeconomic policy action, contributed materially to the present crisis will be sufficient to bring about a change in thinking.

4) What role should the ECB play in a restructured financial architecture?

Over the past 18 months, the ECB has demonstrated its importance and its eminent position in the concert of the most important financial institutions. It is obvious that the ECB, as the ultimate provider of liquidity denominated in EUR, carries an enormous role for maintaining financial stability in times of stress. Consequently, there can be no doubt that the ECB does and must play a crucial role in all efforts and in all institutional arrangement aimed at making crisis management more effective at both the European and the global level.

Similarly, there can be no doubt that the ECB will play a crucial role in the context of macro-prudential supervision. Not only is monetary policy, as demonstrated, a crucial instrument to achieve greater financial stability, but central banks also have a major interest in macro-prudential supervision, as they are directly affected (in their role as the ultimate providers of liquidity) if financial stability is compromised (which, in turn, may threaten central banks' ability to achieve their primary objective, i.e. price stability).

Recognising the important role of the ECB in international crisis management, is not tantamount to saying that the ECB should assume a direct role in going-concern, day-to-day prudential supervision. There is no unanimity in the academic literature on the optimal arrangement between central bank and financial supervisors. In recent years there had been a dominant trait of thought arguing for separate supervisory agencies. Under the impression of recent events, however, more voices could be heard recently arguing for a greater involvement of central banks in financial supervision, especially in banking supervision.

In part this may reflect a genuine conviction that banking supervision is more effective, especially in times of crisis, when executed by the central bank. In part, however, it may simply reflect political opportunity: As the ECB is the only existing supra-national institution in the EU in the area of financial stability and since the EU Treaty (art 105,6 TEU) offers a comparatively easy option to establish banking supervision at the EU level, many supporters of a EU-level financial supervision simply seize on this option.

On balance, however, there are still weighty arguments against entrusting financial supervision to the central bank (and to the ECB, specifically), in our view:

- The traditional argument is that a conflict of interest can arise between the tasks and aims of a central bank and those of a financial supervisor. Central banks responsible for financial sector (especially: banking) supervision might be tempted to maintain a loose monetary policy in order to support financial institutions. It is occasionally claimed that this is no longer an issue in the Eurosystem, as in this system monetary policy is no longer determined by individual national central banks acting on their own. This argument is not entirely convincing: First, national central banks have an active part in determining the role of monetary policy in the euro area. So, while the potential for a conflict of interest may have diminished because a national central bank only has one vote, it is clearly still there. In fact, it will be even greater, once a greater number of financial institutions emerge, which operate on a European scale and which will therefore be of interest to a number of ECB Council members. Second, if the supervisory function were given to the ECB, the argument of a potential conflict of interest would hold all the more, given the weight of the ECB Directorate in the ECB Council and the pivotal role of the ECB in analysing monetary conditions in the euro area.
- Second (and related to the first), assuming the supervisory role would, given the nature of financial supervision as the exercise of sovereign authority, inevitably bring the ECB under greater political scrutiny and, most likely, greater political pressure.
- In addition, central banks that are also banking supervisors have a reputational risk: if they fail in their role as supervisor, this will undermine their credibility for monetary policy, too.

- It is a fundamental rule that institutions should have clearly defined mandates in order that parliaments and the public can hold them accountable for their actions. This is all the more important for institutions which – for good reasons and rightly so – enjoy as much independence as central banks. Giving the ECB two mandates – one for fighting inflation and one for financial supervision – would make it more difficult to define clear accountability structures. This argument carries particular importance in the EU, where accountability of EU-level institutions is often questioned anyway. Moreover, the more diverse and the more political the task of a central bank is, the greater the risk of political interference.
- It would be incompatible with basic democratic principles to entrust too much power to a single institution. This holds particularly true in the case of institutions that enjoy a great level of autonomy and independence, as the ECB – rightly – does.[43]
- In addition, a strong case can be made for an integrated form of supervision comprising banking, insurance and securities markets supervision under one roof. Again this would speak against entrusting supervision to a central bank not only on the basis of the arguments against a concentration of powers, but also because it is not evident why central banks should have a comparative advantage in supervising conduct of business in securities markets (or insurance markets, for that matter).

Notwithstanding the arguments above, there is a strong case to be made for a very close cooperation between the central bank and the financial supervisor, in order to have micro- and macro-prudential supervision interlink optimally. Central banks should have full insight into the aggregate micro-prudential data of the banking system. In the euro-area, the ECB needs to have full access to the aggregate data for the 50 or so systemically relevant financial institutions.

5) Should central banks in general be given more powers and responsibilities in the field of financial stability and supervision?

As argued above, central banks should not be accorded the task of micro-prudential supervision. However, central banks should play a major role in macro-prudential supervision.

The micro-prudential perspective prevailing in the current firm-specific approach to supervision has resulted in insufficient supervisory attention being given to macroeconomic developments and risk trends. Too little has been done by supervisors to properly analyse such developments and how they may affect financial institutions given, in particular, their respective business models. Arguably, the micro-prudential approach has become more pronounced by the Basel regulatory framework aimed at drawing as much as possible on the internal risk management methodologies (such as supervisory recognition of internal models for regulatory capital) and their micro-economic focus.

The analysis and supervisory response to such macro-economic trends must play a more prominent role in day-to-day supervision. The macro-prudential analysis must inform the micro-prudential supervisory activities.

- Micro- and macro-prudential perspectives and functions must be aligned (cf. discussion on the need for appropriate fora to monitor financial stability in section 2a above).

[43] Though it needs pointing out that central banks that have a supervisory function enjoy autonomy and independence only as regards monetary policy, not as regards their role as banking supervisors.

- Supervisors, together with central banks, should develop a macro-prudential strategy for each supervisory cycle, addressing specific macroeconomic developments and resulting risk trends as they affect financial institutions. The IMF financial stability assessments programme has produced useful findings on this subject for many Fund member countries. These insights would then flow into the development of institution-specific supervisory action, specifically supervisory measures taken in the context of Pillar 2.
- The decision-making on the macro-prudential strategy should be informed by a formalised public-private dialogue between authorities and the industry.
- Suitable tools including in particular horizontal, thematic supervisory work for peer groups should be developed. The use of similar stress-test scenarios for institutions with comparable risk profiles is a good example for such tools; such stress-test scenarios would be based on the comprehensive assessment of risks to financial stability as conducted in the macro-prudential analysis. Such tools would also ensure that financial institutions with similar risk profiles and, hence, similar exposures to potential macro-prudential shocks are supervised on a comparable basis.

Specifically, central banks should be tasked with identifying the build-up of unsustainable leverage in the financial system and to deploy the necessary tools to contain it. This will also require that central banks act against the built-up of financial imbalances even in the absence of traditional (goods market) inflation.

The international financial architecture
and the ECB

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Charles Wyplosz

Executive Summary

The crisis has reminded us of many well-known weakness of the international financial architecture. A window of opportunity for reform has opened, and should be fully exploited before the pressure dissolves, as has been the case following previous crises.

Unfairly perhaps, the IMF is first on the list of international financial institutions that need to be reformed. Most of the plans under discussions are unlikely to result into action. Redistributing voting rights is a zero-sum game which can only be played on the margin. Reducing the number of European Executive Directors – one third of the total, currently – is a better and more effective alternative. In particular, a single seat for all euro area countries would give them collectively a power equivalent to that of the US. An even more effective and possibly less contentious way to strengthen the Fund's independence and therefore improve its performance, would be to change the role of the Executive Board, making it an *ex post* supervisory body.

Deeply integrated financial markets logically call for world regulation and supervision. This is an idea that is logical but clearly not feasible for many years to come. A significant first step would be to transfer bank regulation and supervision within the euro area to a single body. The ECB has the technical ability and independence to carry out this task.

International macroeconomic policy coordination is desirable in theory but unlikely to occur in practice, if only because its usefulness is not established in normal times. In crisis times, policy coordination is indeed highly desirable. Most likely, the solution is not to set up a permanent body entrusted with effective authority but informal contacts of the kind that central banks have long nurtured under the auspices of the BIS. The G7 was set up precisely to that effect. Its successes are rare and far apart, and the group has become obsolete. The G20 is a step in the right direction but the group is too big to work effectively.

The debate on the international financial architecture last flourished in the aftermath of the Asian crisis of 1997-8. It is now returning to the forefront, again because of the current crisis. The pattern always the same: a crisis reminds us of untreated flaws, the abundance of proposals reveal deep disagreements – most of which represent diverging interests – which deter policymakers from quick action and when the crisis is ended nothing much is done. The G20 meeting next April is meant to avoid a repeat of this pattern, but there is little reason to believe that serious changes will be decided. Anyway, the ECB is ill-placed to take any initiative. At best, it may be given regulatory and supervision authority that it currently lacks.

Current shortcomings

The previous crises (Latin America in the 1980s, 1990s and 2001; Asia in 1997-8) mostly affected developing countries and involved the IMF and the World Bank as primary relief providers. As a result, the limelight was on the international financial organizations. So far, the current crisis has mostly hit the developed countries, which did not need any support. This is why most of the attention has focused on regulatory and supervisory failures. Yet, it is a matter of time before more developing and emerging market countries are hit and call upon the international organizations.

The international financial institutions

As the international lender of first resort,[44] the IMF became very powerful during the 1980s and 1990s when many developing countries, which had followed the Washington Consensus principles of financial liberalization, faced acute external pressure. Quite naturally, its power was resented by borrowing countries subject to conditions that they considered harsh. When the IMF mis-stepped in Asia, latent resentment surfaced and led to strong criticism. Eventually, the IMF acknowledged some shortcomings. The question is what remains to be done and what can be agreed upon.

Many issues concern the way the IMF staff analyzes the situation. This involves judgment on the quality of the staff work and possible bias in their recommendations. To that effect, the Independent Evaluation Office was created in 2001. It issues several reports a year on various aspects of the Fund's work and on specific interventions. The IEO thus exerts *ex post* peer pressure. Professional economists provide some peer pressure with a shorter lag, an activity that has been facilitated by greater transparency from a previously highly secretive institution.

In recent years, however, attention has focused on the Fund's governance, in particular the voting rights that are perceived to be tilted in favour of the developed countries. Years of negotiation have yielded little more than a symbolic outcome whereby just 2% of voting rights have been redistributed. This is unsurprising for two main reasons. First, it is not clear what criteria should be used. The underlying logic is one of shareholding where power is associated to the amounts deposited, which are related to ability-to-pay, measured by GDP. On this basis, current voting rights are, if anything, tilted in favour of poorer countries as shown Table 1, which includes the 30 countries with the largest voting rights. Alternative criteria (exports, population, size of financial sector) have long been proposed and found their way in a formula that is complicated and therefore controversial and open to endless disagreements. Second, any reallocation of voting rights is a zero-sum game exercise, with winners and losers. Obviously, this makes negotiations highly contentious.

This is why the pressure has shifted towards management issues. The Executive Board, which makes all operational decisions, is composed of 24 Executive Directors and the Managing Director. Eight Executive Directors – one third of the Board – are European, as has been the Managing Director since the creation of the Fund. This has prompted calls for reallocating seats at the Board, another zero-sum game on which no progress has been made so far. The only potential change is a statement that the next Managing Directors will not have to be European.

[44] This expression, aptly coined by Michael Mussa, refers to the fact that, during crisis times, developing countries are unable to borrow from anyone except the IMF.

Table 1. GDPs and voting rights (% of total)

	Voting rights	GDP		Voting rights	GDP		Voting rights	GDP
United States	16.77	27.16	Netherlands	2.34	1.37	Sweden	1.09	0.79
Japan	6.02	9.01	Belgium	2.09	0.81	Argentina	0.97	0.44
Germany	5.88	5.98	India	1.89	1.88	Indonesia	0.95	0.75
France	4.86	4.64	Switzerland	1.57	0.78	Austria	0.86	0.66
United Kingdom	4.86	4.90	Australia	1.47	1.61	South Africa	0.85	0.53
China	3.66	5.46	Mexico	1.43	1.73	Nigeria	0.80	0.24
Italy	3.19	3.82	Spain	1.39	2.53	Norway	0.77	0.69
Saudi Arabia	3.16	0.72	Brazil	1.38	2.20	Denmark	0.75	0.57
Canada	2.89	2.62	Korea	1.33	1.83	Iran	0.69	0.45
Russia	2.69	2.04	Venezuela, RB	1.21	0.38	Malaysia	0.68	0.31

The World Bank has been subject to much less criticism. One reason is that the Bank finances long term projects while the IMF lends during periods of acute distress and under very specific conditions that unavoidably interfere with national sovereignty. Most of the criticism of the Bank has been directed at the ecological impacts of the projects that it finances, at the poverty alleviation record of its activities and at suspected cases of corruption. These are rather specific issues, which mobilize a large number of NGOs but rarely make headlines in the media. The Bank has responded by establishing a dialogue with the NGOs and developing a highly professional communication strategy, largely quieting down outside criticism.

The relative calm that surrounds the World Bank may be surprising, but is easily understandable. The Bank makes loans at rock-bottom rates, because its own borrowing is guaranteed by all member governments, which results in the world's lowest costs. It follows that governments that borrow from the Bank are structurally pleased. In addition, a Bank subsidiary, the International Development Association (IDA) makes zero interest rate loans and even grants to the poorest countries.

Yet, hard questions have to be asked, even if they are unpopular. The Bank was created to provide loans to developing countries that could not borrow from the private sector because they are poor. Fortunately, over the years, a significant number of developing countries have gained access to international financial markets. Still, they continue borrowing from the World Bank, at concessional rates. This means that, in effect, the Bank is competing with private financial institutions, but the competition is unfair since no other institution can raise resources as cheaply as the Bank. The hard question is whether this public activity has indeed helped development. Repeatedly, outside economists have answered this question with scepticism, sometimes negatively. The Bank's own studies predictably reach the opposite conclusion. Since there is no cost of having the Bank – it pays for its own operations by lending at the slightly interest rate than the one at which it borrows – and since it officially helps the developing world, criticism of its *raison d'être* seems outlandish. The same applies to the regional development banks.

Finally, even less attention is devoted the UN system, even though a number of agencies operate under ECOSOC (the Economic and Social Council). Historically, they have often defined themselves as a counterpart to the IMF and the World Bank seen as pro-Western and especially as pro-US.

International regulation and supervision

Financial globalization has reinforced the inter-connectedness of financial markets around the world, especially among the financially-advanced countries. As a consequence, as the crisis spectacularly illustrates, serious failures in one market may lead to contagion to other markets. In practice, this means that the proper functioning of every integrated market matters for all others, a characteristic called an externality. An immediate implication is the need for coordination in the area of regulation and supervision.

This need has been recognized long ago, at least since 1974 when the G10 countries created the Basel Committee on Banking Supervision (BCBS), an independent organization based at BIS headquarters. The Committee has worked as a negotiation forum and produced the Basel Accord I in 1998, now superseded by Basel II. The accords define a set of minimum standards for banks that all countries of the world are encouraged – but not obligated since the BCBS is not a formal organization – to apply. Professional groupings like IOSCO (International Organization of Securities Commission) or IFAC (International Federation of Accountants) have also agreed on common standards. More recently, the G7 supported the creation of the Financial Stability Forum (FSF), which brings together officials from central banks and treasuries from twelve countries with significant financial markets as well as various international institutions. The Forum is mostly used for information exchange and in-depth discussions.

The common feature of these arrangements is that they do not challenge the principle that each country is sovereign in the area of financial market regulation and supervision. As a result, negotiators typically face two opposing objectives: sufficiently international tight regulation and supervision to limit the risks to one's own markets from contagion, on one hand, and light domestic regulation and supervision to enhance the attractiveness and competitiveness of national financial institutions. More importantly, perhaps, the application of agreed-upon standards is left to national authorities that are often keen to not undermine their national champions.

International economic governance

There is no international agreement to coordinate macroeconomic policies.[45] The IMF imposes a number of guidelines on exchange rate and capital movement policies and conduct regular surveillance of all its member countries, but it does not normally attempt to encourage cooperation in the area of fiscal and monetary policies. The absence of any arrangement suggests that the benefits are limited. This is the case in normal times, but the current crisis provides an instance – admittedly exceptional – when it would be desirable that countries adopt compatible policies and not attempt to free ride on each other.

The need for some cooperation was recognized in 1974 when the G7 was started.[46] The G7 served as *de facto* coordinator and had some influence but its effectiveness, always dependent on personal alchemy, gradually waned. Bringing in Russia did not help. On the other hand, G7-Deputies (top civil servants in Finance Ministries) regularly meet and reach agreements. During the period 2000-7, when the main international challenge was the "global imbalances", it became clear that the absence of emerging market countries was undermining the G7 effectiveness.

[45] The situation is different for international trade policies, which are coordinated through WTO (World Trade Organization).

[46] It started first as a G5, but was soon extended when Canada and Italy joined in.

Coordination among central bankers is less visible but more successful. These meetings take place quarterly at the BIS and bring together central bankers from BIS member countries – the list has expanded over the last decade – as well as from other countries. The meetings are informal and their frequency allows for in-depth discussions that lead to common understanding. The effectiveness of this grouping has been revealed during the crisis.

Major reform objectives

The crisis has confirmed that, as is often the case, policies lag behind reality. Quite simply, an economically and financially integrated world requires common rules and guaranteed enforcement of these rules. Meanwhile, governments are unwilling to give up their prerogatives and public agencies defend their turfs. The crisis has opened a window to make progress, but it is unlikely that much will be achieved.

The creation of the G20 is a response to the increasing anachronism of the G7/8. But the size of the group is too large for effective negotiations to take place. In financial matters, the G20 includes far too many countries with no systematically important financial institutions while countries like Hong Kong, Singapore or Switzerland are absent. Attention is now focused on the London meeting of the G20 in April 2009.

The international financial institutions

There is no plan to streamline the World Bank or the UN agencies, nor is there any willingness to reopen the IMF voting rights issue. Most of the attention goes to the operations of the IMF. The British government has asked that the IMF provide an early crisis warning system but the Fund did devote considerable resources to this goal in the wake of the Asian crisis only to realize that it is a futile effort. The current state of knowledge is simply insufficient to develop an effective tool.

On the other hand, simple reasoning can go a long way if backed by political will. For instance, in the mid 2000s it had become plainly clear that housing prices were excessive in the US and that mortgage lending was developing along dangerous lines. The IMF could have issued strong warnings and pressed the US to deal with the situation in good time. Its management, however, did not feel that it had the weight to engage the Fund's main shareholder. More generally, strengthening independence and accountability of the Fund is highly desirable. This would call for reducing the Executive Board's *ex ante* influence while strengthening its *ex post* oversight.

Another issue is that Fund is likely to be underfunded in the event of a new wave of currency crisis. The easiest way of increasing resources is to issue new SDRs. Such issues have been blocked since 1981, with a proposal pending since 1997.

International regulation and supervision

As it should be, the reform focus is strongly on the regulatory failures that lie at the root of the crisis. Unfortunately, regulation and supervision are subtle undertakings. Public perception is that financial markets and institutions are under-regulated. On the other hand, it is very easy to over-regulate – no public cost, a perception of willpower, the possibility of targeting sacrificial lambs, etc. The problem is not with the quantity of regulation but with its quality and the quality of supervision. Obviously Basel II needs to be overhauled, with two main aims: 1) reduce complexity which is opens the door to opacity and 2) remove the private credit rating agencies from public regulation.

The second challenge is to move beyond national regulation and supervision. It is unlikely that governments will accept to transfer formal powers to a supranational organization but there is an opportunity of strengthening supranational oversight. The areas to be covered are: setting international norms (i.e. re-thinking Basel II), supervising the activities of national supervisors and organizing cooperation for emergency interventions in times of crisis. Norm-setting for banks has been carried out by the BCBS and by IOSCO for stock markets. These are non-official fora, so the question arises whether the time has come for making these arrangements official. The main benefit would be make the adoption of norms compulsory, but there are serious, possibly lethal drawbacks: any compulsory system would require all countries to be part of it; accountability would be difficult; enforcement would call for international treaties. There have been suggestion to raise the profile of the Financial Stability Forum (FSF) but this would require massive investment in staff. The IMF has been seen as a better alternative because it has a large and competent staff but this could create a conflict of interest. Indeed, the Fund would then be responsible for the quality of international regulation, which is more art than science, while it has the duty to provide conditional support in the event when the regulation fails. Additionally, this could require changing its Articles of Agreements, a risky endeavour. A possible arrangement would be to merge the FSF and the BCBS while asking the IMF to supervise national supervisors.

International economic governance

There is much excitement about the creation of the G20. It is indeed a positive step if it replaces the G7/8 that has become obsolete and ineffectual. Yet, its very size is a bad omen and the experience with the G7 is sobering. Informal groupings of powerful nations can occasionally make a difference, and the G7 can boast a few rare such instances.

On the other hand, global economic governance is an idea whose idea has not come. Anyone that doubts this conclusion should only look at the European Union. A (relatively) small of countries with considerable commonality, deeply integrated and supported by supranational institutions (the Commission, the Parliament, the Court of Justice) has made very little progress in macroeconomic policy coordination beyond the partial adoption of a common currency.

The role of the ECB

Most of the issues on the table do not directly concern the ECB. The ECB is only an observer at the IMF, it has no authority in matters of bank regulation and supervision nor does it supervise the asset markets. At best it can express an opinion, which is unlikely to carry much weight and could actually backfire if the ECB is perceived to try to extend its role beyond the powers given by the Treaties. Yet, a reformed international financial architecture would optimally extend the role of the ECB in a number of areas.

IMF representation

Sooner or later – probably later than sooner – the European representation on the IMF Executive Board will have to be reduced. The natural way to do so would be to have a single seat for all euro area members. This would provide the euro area with a weight at least equal to that of the US, including the 15% veto right. In that situation, it would also be natural that the seat be occupied by a representative of the ECB, which is the only relevant euro area institution. The alternative would be to attribute the seat to a representative of the Eurogroup.

Regulation and Supervision

Much the same applies to bank regulation and supervision. Ideally, we would have a world regulator and a world supervisor, but even the EU has been unwilling to move in this direction. The recently created College of Supervisor is clearly a successful effort by national supervisors to thwart any attempt at creating a euro area-wide supervisory body.

Yet the crisis has provided many examples of the need for a euro area-wide supervision.[47] Assuming that this step will be taken, the question is whether we need a single regulator-supervisor like the British FSA and whether supervision should be attributed to the ECB or to an independent agency. The crisis has provided fairly convincing evidence that central banks need to have real-time information that only the supervisor can have and that they have both the technical capacities and the independence to carry out the task. It follows that, even if that is not theoretically the absolute best solution, in practice the only possible solution is to devolve bank regulation and supervision to the ECB.

[47] Examples: the Société Générale affair, the rescue of Fortis, the Irish decision to guarantee all bank deposits.