

ARBITERS AMISS: THE FAILINGS AND SHORTCOMINGS OF INSTITUTIONS GOVERNING THE GLOBAL FINANCIAL SYSTEM

PAUL BLUSTEIN

KEY POINTS

- The financial crisis that erupted in 2008 cast profound doubt over the effectiveness of the global financial system's governing institutions. Serious shortcomings are manifest from a detailed look at their inner workings during the run-up to and early months of the crisis.
- Evidence that includes thousands of pages of confidential documents points to dispiriting conclusions about the capacity of these institutions to address the challenges now facing the world economy. This material lays bare the institutions' chief weaknesses: they are unable to accurately discern where and how crises are likely to arise; and they lack the power, and often the will, to stop countries from pursuing policies that threaten financial stability.
- The Financial Stability Forum (FSF) was slow to detect the financial system's fragility and direct preventative and preparatory action; the International Monetary Fund (IMF)'s "multilateral consultations" and initiative to crack down on countries with currencies that are "fundamentally misaligned" demonstrated its fecklessness in inducing policy changes in its most powerful member countries.
- Advancements made since the global financial crisis have not fundamentally altered the institutions' ineffectiveness. Achieving sustainable, balanced recovery and well-honed global regulation requires institutions capable of issuing — and enforcing — credible, candid assessments of problems arising in individual countries that may adversely affect others.
- Establishing a dispute settlement system resembling that used by the World Trade Organization (WTO) is one solution that would endow the Fund with the enforcement power and sufficient credibility and neutrality to umpire effectively.



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INTRODUCTION

Myriad dangers beset the global economy. The US Federal Reserve is trying to curb its ultra-easy money policy, a delicate operation that could plunge the world into recession if done too abruptly. The euro zone might fall back into turmoil. Japan’s experiment with “Abenomics”¹ could go sour. China’s banking system looks shaky. Emerging economies are suffering large-scale withdrawals of foreign funds.

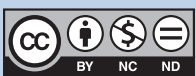
There is another problem, far from the headlines, that should not be left to fester — the weaknesses of international institutions responsible for governing the global financial system. They include the IMF, the Group of 20 (G20) major economies, the Financial Stability Board (FSB) (a body responsible for overseeing a wide range of international regulatory issues), and the Basel Committee on Banking Supervision (a group that issues guidelines and standards for international banks).

The global financial crisis that erupted in 2008 cast profound doubt over the effectiveness of these institutions; yet adroit action by them is required to overcome serious challenges that loom in the wake of the crisis.

The first challenge involves rebalancing the global economy to ensure a sustained recovery. Massive trade imbalances must be shrunk, preferably with a well-coordinated plan. After all, the countries that have run large trade deficits, notably the United States, are obliged to impose significant austerity measures sooner or later. Belt-tightening in deficit countries will endanger global growth unless countries with large

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¹ Abenomics refers to economic policies introduced by Japanese Prime Minister Shinzō Abe in an attempt to pump up the Japanese economy after assuming office in December 2012.

trade surpluses, such as Germany and the export powerhouses of Asia, take offsetting action by ramping up demand and importing more goods.

International cooperation is, likewise, critical for enhancing the regulation of the financial system so that it becomes less crisis-prone. The nations of the world must avoid creating a hodgepodge of new rules, lest banks move operations to the countries with the most lax regulatory regimes. Better international rules regarding banks and shadow banks — or at least well-harmonized broad principles — are vital, as are improved systems to manage crises that spill over from one country to others. In the absence of a clear understanding of how to handle thorny regulatory issues that may arise during crises, the narrow interests of individual countries may undermine globally optimal outcomes; for example, bank regulators in one country may seize the assets of a troubled international bank, destroying its viability in the process.

Serious shortcomings and failings are evident in the global institutions tasked with addressing these challenges, based on a detailed look at their inner workings (and that of their predecessors) during the run-up to and early months of the crisis. That is the upshot of my research, which included interviews with scores of policy makers and examination of thousands of pages of confidential documents — memos, emails, meeting notes and transcripts — to which I obtained exclusive access. This wealth of material is presented in my newly published book, *Off Balance: The Travails of Institutions That Govern the Global Financial System*. The book points to dispiriting conclusions about the ability of these institutions and the world's major countries to coordinate the policies necessary to generate a balanced, sustainable global recovery and prevent future crises.

The point is not that these institutions caused the crisis, or even played a major role; they did not. They have, however, proven lamentably deficient in two critical respects. First, despite their efforts to attain elevated, global perspectives on the workings of modern markets, they can't accurately discern, amid all the bewildering complexity, where and how crises are likely to arise; indeed, sometimes they unwittingly take measures that exacerbate vulnerabilities. Second, they don't have the power, and often lack the will, to stop countries from pursuing policies that threaten their neighbours' stability or even the entire financial system. Adding to these problems is a related one — the decline in US power. For decades prior to the crisis, the United States dominated international economic institutions. It has been obliged to accept a significant dilution of its influence, and the absence of a clear leader compounds the institutions' difficulties.

GLOBAL WATCHDOGS, MISSING A WORLD OF TROUBLE

An illuminating case study is an institution that's very little known — the FSF, which was created shortly after the Asian crises of the 1990s and is based in Basel, Switzerland. The FSF merits far more attention than it has received. Its primary aim was to coordinate efforts in preventing and mitigating future crises, and its members included top-ranking officials from the finance ministries, central banks and regulatory agencies of the world's richest countries. Moreover, the FSF's successor body, the FSB — whose name reflects the two bodies' many similarities — was established by world leaders in 2009 amid solemn promises that the leaders were putting in place the mechanisms necessary to ensure the global financial system's safety and soundness. Key FSF episodes recounted in *Off Balance* do not bode well

for the FSB; they illustrate the inability of regulators to keep pace with the globalization of the financial system and the transmission of risk across borders and oceans.

The FSF's meeting of March 2007 is a prime example. Although signs of serious trouble were emerging in the US mortgage market — precisely the type of threat that the FSF was supposed to size up — Randall Kroszner, a governor of the Federal Reserve Board, delivered a soothing message: it was “important to recognize that the market segment affected...only constitutes 7 to 8 percent of the overall US mortgage stock,” a confidential summary of the meeting quotes him as telling the group, “and there has been little evidence of spillover into other market segments.” Moreover, the confidential document includes no indication that anyone voiced a contrary opinion. “Nobody around that table said, ‘This is not believable,’” one former FSF member acknowledged to me — and that, he added, was fairly typical of FSF meetings, where “there was great defensiveness, and excessive politeness.”

FSF members were by no means blind to, or blasé about, the forces that would eventually menace global prosperity. Records of their meetings show that they spotted and discussed a number of these factors, but that they also spent a lot of time on issues that turned out not to matter much, and failed to respond with sufficient alacrity to ones that turned out to matter a great deal. Previously unavailable to the public — the FSF was highly secretive — these records lay bare, with far greater specificity and authority than has been possible to date, how slow the body was at discerning the financial system's fragility and at directing preventive and preparatory action.

In the fall of 2007, only six months after the March meeting, financial turmoil provided the first early warning of what was to come — and even then, the FSF

was way behind the curve, as the crisis deepened well beyond its expectations. In a confidential assessment of global vulnerabilities prepared for the FSF's September 2007 meeting, the “worst-case scenario” envisioned was “that a core financial institution encounters severe financial stress.” By the next meeting, in March 2008, that worst-case scenario had gotten much worse; the collapse of Bear Stearns a couple of weeks earlier had shocked the body into recognizing how dire the outcome might be. “Credit flows could decelerate rapidly and asset values fall sharply throughout the financial system, spurring a self-reinforcing flight to safety,” a confidential FSF document prepared for that meeting said. “Illiquidity, and the threat of insolvency, would spread to a widening circle of financial institutions.”

A FLOP AND A DEBACLE

Another revealing example of institutional frailty is the IMF's pre-crisis efforts to address global imbalances. The problem obviously required a multilateral solution, given the number of countries whose policies were responsible — the standouts being the United States, with its overconsumption financed by a heavy inflow of foreign capital, and China, with its undervalued currency fuelling its export juggernaut.

The IMF's lack of success on this issue is no secret. But its utter fecklessness at inducing policy changes in its most powerful member countries can only be appreciated through a detailed chronicling of what went on behind closed doors. Here again, extensive evidence from confidential documents helps provide an authoritative account of events.

In the “multilateral consultations,” a collaborative exercise that, in late 2006 and early 2007, brought

together high-ranking representatives of the United States, China, the euro zone, Japan and Saudi Arabia, IMF officials initially harboured high hopes for brokering a meaningful agreement. They shied away from the idea of playing the role of an umpire that would publicly identify which countries were cooperating and which ones weren't. Indeed, the IMF's number 2 ranking official, John Lipsky, who chaired meetings of officials from the five participating economies, made a conscious effort to avoid acting too obtrusively in the meetings. Confidential summaries of the meetings show how little progress was made; only in the final stage did Lipsky take a more interventionist stance, imploring the Chinese to publicly approve a modest change in currency policy, which they had indicated some willingness to undertake. Failure to accept the change "will represent a serious disappointment to the other participants," Lipsky wrote in a letter to China's deputy central bank governor. Beijing rejected the plea, underscoring the Fund's pitifully limited powers of persuasion. In the end, the exercise flopped, with the parties agreeing only to continue with policies they were already pursuing.

A related initiative, the IMF's attempt to crack down on countries whose currencies are "fundamentally misaligned," turned into a debacle that *Off Balance* recounts at length. Documents show that some high-ranking IMF officials fought hard to devise a system of rules that would apply even-handedly — "symmetrically," in Fund parlance — to countries with large surpluses as well as ones with large deficits, and countries that pegged their currencies as well as ones that floated them. These officials knew, of course, that pressure from the United States was a major impetus for the new rules; the US Treasury was eager to see the Fund apply a "fundamental misalignment" label to the Chinese renminbi. An intense struggle ensued

among IMF member countries and staff, culminating on June 15, 2007, when the executive board approved the "2007 Decision on Bilateral Surveillance Members' Policies," over strenuous objections from China.

The IMF proved muddled and downright impotent during the implementation stage. The Fund officials who were most enthusiastic about the decision wanted to label the currencies of several big countries, not just China, on the theory that such an even-handed approach would have the greatest impact. But in one case after another, their hopes were dashed. A confidential IMF memo describes a key July 2007 meeting in which top Fund management rejected a bid to label the US dollar, which appeared to be significantly overvalued in view of the vast US trade deficit. Among the arguments used in defence of the greenback was the appallingly wrong-headed assertion that its high exchange rate was attributable, in large part, to the marvellous efficiency of US financial markets.

The Japanese yen likewise escaped labelling. Next came an attempt to label one of the world's least-important currencies — the Maldives rufiyaa. That effort, too, went down to defeat in the executive board, whose members couldn't bring themselves to pick on such a tiny country, even though its economic policies were wildly out of kilter.

The crowning blow to the whole undertaking came during August and September 2008, just as the financial crisis was approaching full fury. The Fund staff prepared a report on the Chinese economy that — as quoted in *Off Balance* — included an accusation of fundamental misalignment. After Lehman Brothers went bankrupt on September 15, however, this report was withheld from public release and quietly secreted away. The United States lost interest in labelling the Chinese currency — for the obvious reason that

picking a fight with Beijing at that particular juncture would have been foolish in the extreme. Washington desperately needed Chinese cooperation in quelling the turmoil.

So in the end, the most perverse sort of symmetry and even-handedness prevailed — that is, all countries avoided labelling. Vindication belonged to those who reckoned all along that the 2007 decision was far too quixotic and vulnerable to the vagaries of international politics.

STILL WANTING

Whatever their past missteps and fiascos, the international institutions that govern the global financial system have undergone considerable fortification since the outbreak of the crisis. At the April 2009 G20 summit in London, world leaders undertook coordinated action that helped avert a depression. At that summit, the IMF was endowed with significant amounts of new resources, giving the Fund additional firepower to combat crises. Another achievement of that summit, as mentioned above, was the transformation of the FSF into the FSB, whose charter indicated its greater muscularity. Membership in the FSB would entail new obligations, including commitments to observe internationally agreed financial standards, and member countries would undergo periodic peer reviews of their financial systems as well as scrutiny by a special IMF financial sector program.

The very fact that the London summiters represented the G20 economies was another major step toward more effective global governance, by driving more nails into the coffin of the system that had been dominated by the elitist Group of Seven. Membership in most major regulatory bodies, notably the FSB

and Basel Committee, was also expanded to include representatives from G20 countries.

Although the London summit was a high-water mark of international cooperation that has gone unmatched ever since, the G20 and other major international institutions have hardly been idle since then. The G20 has launched its “Framework for Strong, Sustainable and Balanced Growth,” featuring a broad agreement for reduction in imbalances. The novel part of this undertaking is the Mutual Assessment Process (MAP), in which the G20 — instead of giving an external body like the IMF the primary role for overseeing the exercise — arrogated those responsibilities to itself, pledging that G20 countries will subject each other’s policies to a sort of peer review. The Basel Committee, whose “Basel II” standards for international banks had proven sadly inadequate during the crisis (and arguably made it worse), moved with dispatch to issue “Basel III” in September 2010, establishing tougher requirements for the quantity and quality of capital that banks will have to eventually maintain to cushion themselves against downturns. The FSB also took a series of actions to buttress the global regulatory infrastructure, including the intensification of supervision over the world’s biggest mega-banks, securities firms and insurance companies.

Are international institutions now sufficiently robust to manage the main challenges facing the world economy? Do the above measures, taken at the London G20 Summit and after, mean that institutional arrangements are in place to secure the economic rebalancing necessary for healthy global expansion, and the regulatory rules and apparatuses necessary for minimizing the risk of future crises?

The evidence presented in *Off Balance* provides ample grounds for answering in the negative, underscoring

the inconvenient truths cited above about international institutions — their inability to discern how and why crises are likely to arise, and their lack of both power and will to crack down on national economic and financial policies that threaten the global commonweal. Unfortunately, the enhancements that have been achieved since the crisis, laudable and helpful though they may be, do not fundamentally alter those truths.

Consider the G20's approach for tackling imbalances using "mutual assessment" rather than an external body. Understandably, given the IMF's woeful pre-crisis performance on the issue, the G20 chose to sideline the Fund, relegating it to a sort of secretariat function of providing technical analyses of countries' policies. This approach has been touted as giving the G20 countries "ownership" over the process, something they lacked during the multilateral consultations, when the IMF allegedly asserted control. But the reasoning involved is questionable. As previously noted, the problem with the multilateral consultations was not an over-assertive IMF; Fund officials were both disinclined and unable to play anything more than a facilitating role.

In other words, G20 "ownership" over the MAP isn't likely to make it any more successful than the IMF initiatives, which ultimately exposed the degree to which the Fund is captive to the whims of its most powerful members. Just as the Fund fell far short of the standards required to act as an unimpeachably objective arbiter, so too is the G20 poorly suited for such a task. The G20 is the very epitome of a political body, with all sorts of considerations — including diplomatic ones — likely to affect the judgments its individual members are prepared to issue about each other's economic policies. It strains credulity to conceive that the G20 could issue verdicts so stern, so credible and so

concerted as to alter the policy-making calculus in the capital of a major country.

On the regulatory front, similar conclusions apply in assessing recent reforms, as a comparison of the FSB and FSF shows. The new body employs a much more organized and systematic process than its predecessor did for detecting weaknesses in the global financial system, determining appropriate responses and inducing countries to improve their regulatory practices. Three committees are separately tasked with those responsibilities, which enables participants to focus on specific issues, including identifying vulnerabilities and conducting peer reviews. It is a well-conceived approach, but not transformative. The FSF also had a sensible process for assessing and prioritizing risks — a "High Level Vulnerabilities Working Group," consisting mainly of senior staffers from central banks and regulatory agencies, who met before each FSF meeting to help draft the agenda.

And although the FSB has a larger secretariat than the FSF (about 25 staffers, at last count), it is still modest, and more than two-thirds of the staffers are on secondment from member governments and other international institutions. Without a much more independent identity for the FSB, prospects do not appear bright that its peer reviews will be free from the aforementioned "great defensiveness and excessive politeness" that hampered the FSF. Members know that harsh treatment toward others will invite the same on themselves. For much the same reason that it is hard to conceive of the G20 joining together to shame a member country into changing macroeconomic or currency policy, it is hard to conceive of the FSB doing so on regulatory issues.

RECOMMENDATION: TAKE A LEAF FROM THE WTO

To achieve global economic rebalancing and effective financial regulation, the world needs institutions that are as free as possible from “great defensiveness and excessive politeness.” It needs institutions that can make and issue credible, candid assessments of problems arising in individual countries that may adversely affect others — and preferably these institutions will gain power to enforce judgments. With no illusions about political practicality, I propose the following:

- **Start with a list, akin to the Ten Commandments, of “thou shalt nots” — that is, actions that countries shouldn’t take:** Conveniently, the IMF recently produced a serviceable list, in a new decision on surveillance issued in mid-July 2012. Countries should “avoid manipulating exchange rates to gain unfair competitive advantage” (a long-standing Fund precept), and beyond that, they should “avoid domestic economic and financial policies that give rise to domestic instability,” as well as “exchange rate policies that result in balance of payments instability,” “large and prolonged current account deficits or surpluses,” “official or quasi-official borrowing that...is unsustainable,” and so on.²
- **Give that list some punch:** Sensible as those proscriptions may be, the Fund’s capacity to prevent countries from doing such things is as feeble as ever. The next step, therefore, is to devise a way of overcoming the potency deficiency that plagues the Fund and other international institutions. For that, the Fund needs two things it

currently lacks: enforcement power, and sufficient credibility and neutrality to umpire effectively, especially in the debate over global imbalances and currency policy.

- **Establish WTO-style tribunals:** The one solution that would endow the Fund with those capacities would entail a radical change in its modus operandi — adoption of a dispute settlement system resembling that used by the WTO, with independent tribunals rendering judgments on matters of major contention. The Fund could use such tribunals for the purpose of deciding when countries are violating the terms of its new surveillance decision — in other words, when their policies post a major risk of fomenting global instability. If governments could feel reasonably confident that their policies — and those of others — would be judged by neutral parties according to objective criteria, perhaps they would be more willing to submit to such judgments.
- **Give them power to impose well-tailored sanctions:** As with the WTO, in cases where a tribunal finds a country “guilty” of fomenting instability, enforcement of that decision could come in the form of sanctions against the offender, although these would vary depending on the nature of the offence. A country with a large current account surplus and heavily undervalued currency could face the prospect that its trading partners would raise tariffs on some of its products. Imposing similar punishment on a country with a large current account deficit would make little sense, since doing so would only aggravate the deficit. Rather, the country would have to accept some other penalty — and perhaps the most sensible one would be a surcharge on the capital

² See IMF (2013), “Factsheet: Integrated Surveillance Decision,” March 15, available at: www.imf.org/external/np/exr/facts/isd.htm.

requirements for its banks, since its policies would presumably be increasing the risk of a financial crisis.

Objections to these policy recommendations are easy to imagine, and in a world of sovereign nations, a sanctions-based system is probably not within the realm of serious possibility. Modestly enhancing the G20's current cooperative approach and bolstering the FSB's independence — for example, by beefing up its staff, and appointing a full-time chairman — may well be the only practical route to success.

The main purpose of offering these drastic solutions is to make the point that unless something of this nature is adopted, optimism is hard to justify. In a world where capital roams freely, the lack of strong international institutions leaves the global economy in grave peril.

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CIGI was founded in 2001 by Jim Balsillie, then co-CEO of Research In Motion (BlackBerry), and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario.

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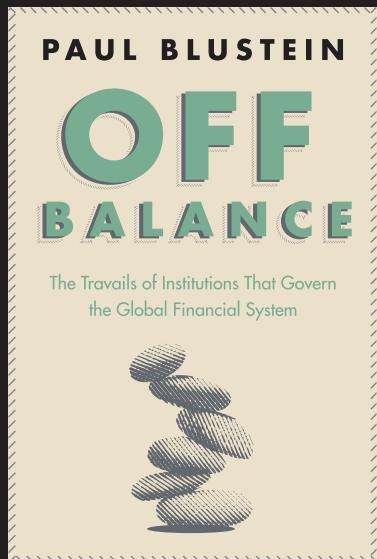
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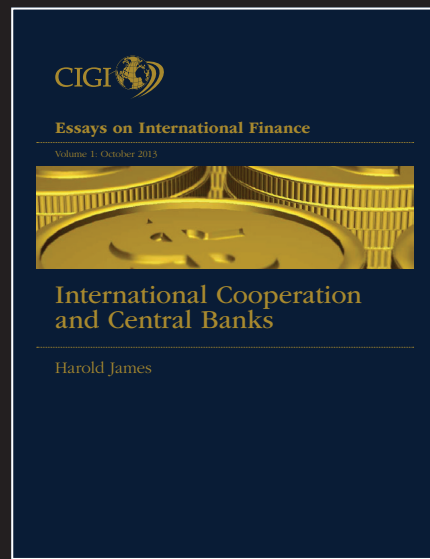
Off Balance: The Travails of Institutions That Govern the Global Financial System

Paul Blustein

October 2013

Paperback: \$28.00 eBook: \$14.00

The latest book from award-winning journalist and author, Paul Blustein, is a detailed account of the failings of international institutions in the global financial crisis. Based on interviews with scores of policy makers and on thousands of pages of confidential documents that have never been previously disclosed, the book focusses mainly on the International Monetary Fund and the Financial Stability Forum in the run-up to and early months of the crisis. Blustein exposes serious weaknesses in these and other institutions, which lead to sobering conclusions about the governability of the global economy.



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Harold James

October 2013

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Richard Gitlin and Brett House

August 2013

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