ECONOMIC RESEARCH FORUM

منتدى البحوث الاقتصادية

2010

working paper series

THE UNENDING SEARCH FOR A NEW GLOBAL MONETARY AND FINANCIAL ARCHITECTURE

Gerardo della Paolera

Working Paper No. 553

THE UNENDING SEARCH FOR A NEW GLOBAL MONETARY AND FINANCIAL ARCHITECTURE

Gerardo della Paolera [1]

Working Paper 553

October 2010

Send correspondence to:
Gerardo della Paolera
Global Development Network GDN
Email: gdellapaolera@gdnet.org

[1] The views expressed in this note are exclusively mine and do necessarily reflect those of the above mentioned institutions. I thank the very efficient research assistance and comments provided by Shelly Dahiya, Aarti Khanna and Vichitra Sharma from GDN.

First published in 2010 by
The Economic Research Forum (ERF)
7 Boulos Hanna Street
Dokki, Cairo
Egypt
www.erf.org.eg

Copyright © The Economic Research Forum, 2010

All rights reserved. No part of this publication may be reproduced in any form or by any electronic or mechanical means, including information storage and retrieval systems, without permission in writing from the publisher.

The findings, interpretations and conclusions expressed in this publication are entirely those of the author(s) and should not be attributed to the Economic Research Forum, members of its Board of Trustees, or its donors.

Abstract

This paper analyzes some key features of the global monetary and financial crisis and the limitations faced by Central Banks. It also includes a brief description for the collectively previous efforts to anchor a Global Monetary and Financial regime. The main difficulties to "globalize" banking and financial reforms are illustrated in this paper. It is concluded with some open questions concerning the threats and opportunities that this crisis presents for emerging, developing and poorer countries.

ملخص

تحلل هذه الورقة البحثية بعض الملامح الرئيسية للأزمة النقدية والمالية العالمية والقيود التي تواجهها البنوك المركزية. وتتضمن الورقة أيضا شرحا موجزا للجهود السابقة التي تم بذلها بشكل جماعي لمساندة ودعم النظام المالي والنقدي العالمي. كما تتضمن الورقة شرح الصعوبات الرئيسية التي توجه "عولمة" الإصلاحات المصرفية والمالية. وتختتم الورقة ببعض الأسئلة المفتوحة بشأن التهديدات والفرص التي تقدمها هذه الأزمة للدول الناشئة والدول النامية وكذلك البلدان الأكثر فقرا.

1. Introduction

There were numerous cracks in the façade of the Washington consensus during the optimistic last decade of the twentieth century. One notable feature then was that most of the potential disturbances to a gloomy global state of affairs in the world economy occasionally came from an emerging country, mainly as a result of overheating the domestic economy. Indeed, when some currency or financial crisis, or both, destabilized or rocked countries such as Mexico, Thailand, Russia or Brazil, not to mention Argentina, the therapy diagnosed to adjust the excesses back "to business as usual" was predicated on the basis of the accepted world perception built around the Washington consensus.

We can safely say that the end of the Washington consensus as we knew it came with the transition from the Clinton to the Bush administration, which brought about an abrupt change in the management of the U.S. domestic economy in the aftermath of September 11th, 2001 and also in the implicit and explicit new Treasury and International Monetary Fund (IMF) doctrines regarding assistance to emerging countries under stress.

A notable inflection point for the perception of emerging markets is that a stand ready multilateral insurance scheme to weather events such as the sudden halt of international capital flows ceased under the O'Neill-Krueger doctrine. The fall of Turkey and then of Argentina in December 2001 was notable for the unprecedented speedy freefall of an emerging economy and signaled the end of a regime (or at least the perception of it) which provided an ex-post "financial insurance" to avoid a major financial and monetary collapse. Since then, emerging countries have understood that they would most likely have to rely on the global private markets to tackle the financial insurance matter.

Three major political economy trends developed during the 2002–2007 core economies pre-crash period:

(1) The U.S. shifted to a situation of unprecedented twin deficits with the level of domestic absorption rising to historical high levels, to become an indebted hegemon.

(2) Unnoticed by the traditional western world, China, India, Brazil and other smaller emerging powers speedily started to apply pressure through their enlarged aggregate demand on the world economy, producing intense realignments in the relative prices of raw materials, energy and food products.

(3) As previously noted, the emerging countries were suspicious about the extent to which private global capital markets would smoothly ensure their inter-temporal needs, and started to mobilize internal resources to buy out international reserves in order to cushion themselves from possible violent swings in the availability of global credit.[2]

Many economists warned about the tensions brought about by these factors, in particular, a heated debate focused on the sustainability, or the lack of it, from global imbalances and who had to bear the burden of the adjustment (or who was going to throw in the towel first).

It was the end of December 2001 that marked the approximate date for the end of the full confidence of emerging markets on development policies drawn solely in Washington. Martin Wolf (2008) identified the first quarter of 2008 as the beginning of the Great Financial Meltdown when he said "Remember Friday March 14 2008; it was the day the dream of global free-market capitalism died".

[2] A fact notably anticipated by Calvo (1998) already after the Asia/Russia crisis though the IMF signal with Argentina exacerbated the policy of international reserves accumulation as an insulation mechanism to sudden stops. See also, Obstfeld, Shambaugh and Taylor (2009) for a rationale to keep high liquid foreign international reserves as a protection to twin crises in which exchange rate and banking problems interact in emerging markets.

Certainly nobody had imagined that such a hard landing was to come from a big corner of the developed western world; the extent and speed of the financial crash was more akin to a developing country crisis than recently admired sophisticated global financial system. The fact that the towel was thrown in by the developed western world accelerated the demands from emerging countries to make sizeable changes on the global political economy front, making things more complicated for the core economies during the wild 2008–2009 debacle.

Most of us know by now and have experienced the devastating global effects in these last 18 months in spite of the recent, and more than welcome, respite. We suggest here that to analyze the therapy for the future we need to diagnose, as best we can, the unresolved economic issues to avoid additional pitfalls, with legitimate economic tools.

In section 2, we analyze some key features of the global monetary and financial crisis and the limitations faced by central banks. In section 3, we describe some useful episodes from previous concerted or implicit collective efforts to anchor a global monetary and financial regime. In section 4, we succinctly present the main difficulties in "globalizing" banking and financial reforms due to the very peculiar morphology of financial markets. This article ends with some open questions concerning the threats and opportunities that this crisis presents for emerging, developing and poorer countries. It is fair to say this short article puts more emphasis on asking ourselves about the serious efforts required towards the international political/economic realignments that the world economy needs to tolerate if we are to see the reinvention of a "new Bretton Woods" sooner rather than later, but the incentives to tackle this matter are always inversely related to the international business cycle.

2. Characterizations of the Disease: Global Connections and Modern Central Banking Hesitations

Though the characteristics and manifestations of the most important financial crises witnessed since the Great Depression are well documented, the proximate determinants at the origin of this anomalous phenomenon are still under heated academic discussion.

In a very stimulating column, Caballero (2009) puts the global imbalance situation for the period 2001–2007 at the center of the genesis of the excessive financial expansion and innovation in the U.S. This is a very appealing approach to draw inferences about the chances for developing, in the immediate future, such a thing as global governance in monetary and financial matters. The analysis establishes a clear nexus between the global monetary macroeconomic disequilibrium features with the nature of financial intermediation.

In his view, the pre-crisis phase is characterized by a global excess demand for safe assets, because of the shortage of financial assets to store value and the emerging market and demographic pressures in the old world, resulting in a protracted decline in real interest rates. The reasoning does not stop there; the U.S. was considered as the center of world capital markets, as excess demand built up creativity in the financial market built up too and the creation of subprime mortgage assets plus all subsequent derivatives filled the void. How innovation and high-leveraging turned into eventual disaster is something to be blamed on fiscal and monetary authorities' ambiguous and contradictory actions at the beginning of the tightening situation. [3]

John B. Taylor (2008) concurs with the presence of an unpredictable framework for intervention by the monetary and fiscal authorities but disputes the importance of global imbalances or—as he calls it— the savings glut situation, as the main cause that gave birth to the mega-growth in the financial intermediation process and the creation of multiple new

[3] See Caballero (2009) « A global perspective on the great financial insurance run: causes, consequences, and solutions" , Vox Column (www.voxeu.org) , 23 January 2009.

financial instruments and vehicles. Rather, he places emphasis on domestic causes such as the systematic insistence on running a monetary policy of very low interest rates which finally exacerbated the level of domestic absorption and generated a bubble in the non-traded sector.

However, he also recognizes a fundamental global connection for the existence of a scenario of very high international uncertainty: economic actors were not sure by 2007 whether key central banks were "cooperating" to stabilize the situation or were focused on strict domestic considerations. These domestic goals were the overriding variables in the objective functions of the mega-central banks.[4]

The Federal Reserve (FED) and European Central Bank's (ECB) radically different behavior during 2007 in relation to the setting of interest rates brought back memories of the divergent goals of the Bank of England, the FED and Banque de France during the 1929–1931 period which transformed a fierce recession into a great depression. However, a very positive feature—and probably an initiation of a departure from insular policies—was provided by the FED's cooperative role to extend dollar swap lines to industrial and emerging countries central banks during the 2007–2008 period.

The pre-existing monetary theory to tackle the issue of a global financial architecture is based on the effective power of modern central banking to aim for many goals at the same time while banks, including the FED, in fact possess very few instruments at hand. Also, there is an unsettled issue about the relevant and robust macro-model which central bank policymakers should bear in mind to influence prices and interest rates.

The leading indicators facing sophisticated central bankers during the 2007–2008 period is a revealing case, showcasing the limitations of the instruments at hand for central bankers. During the first half of 2008, worries focused on the sustained increase in the relative price of commodities but at the same time, particularly in the U.S. the disinflation of asset prices was already substantial. Monetary authorities were walking a tightrope: what leading business cycle indicators should they look at? The possibility of an inflationary upsurge and tightening monetary policy to seek price stability or, on the contrary, loosening monetary conditions because of the real deflationary danger in the asset markets that would produce deleterious effects on financial markets.

The incompatibility of seeking both responsibilities in such a state of affairs made it clear that sophisticated economic agents knew for a long time that independent central banks have neither the size nor the instruments to accomplish both tasks at the same time under very rare but probable states of nature. This is an important aspect to keep in mind for the discussion on what type of global financial markets and structures we can envision that will be less prone to such devastating deleveraging episodes.

In short, core central banks did not have a predictable framework of intervention neither before the manifestation nor during the initial phase of the crisis. They acted as firefighters in an ex-post fashion relying on the classical prescription: quantitative easing. The FED doubled the monetary base only for the last nine months while the ECB followed a more prudent policy of liquidity injections.

Now the questions we have at hand before discussing the prospect of reinventing Bretton Woods are:

[4] See Taylor (2008) The Financial Crisis and the Policy Responses: An Empirical Analysis of What went wrong, page 5.

1) Economic agents and analysts are wondering about the fate of the U.S. dollar as the key international reserve currency. Basically, given the new global chess game, do we need a supranational coordinator of international reserves of last resort?

2) In what direction should we proceed to seek global financial stability? If a supranational regulator of financial markets is under discussion, do we agree on the type of financial intermediaries we are talking about and do we fully understand how they operate and their relationship with the real economy? We turn next to the first question.

3. From the Gold Standard Architecture to the Contemporaneous Global Fiat Regime: Is Collective Action in International Money Needed?

The considerable concentration of dollar assets in the major central banks portfolios has created a situation in which the U.S. faces a situation of an oligopsonistic "piling up of reserves" by China and other upcoming emerging countries, for some time now. Until the recent financial meltdown, the usual argument of the U.S. as a safe financial haven was undisputed, but now some U.S. creditors are worried about the future course of U.S. domestic monetary and financial policies. They have become focused as FED watchers but they are also becoming extremely nervous about the contagion effects propagated by a reckless hegemon.

In this context, a short economic history of how we travelled from the sterling international reserve "king" situation to the dollar supremacy should be useful to assess the demise of the sterling as the key international currency, and also describe some of the vagaries and gymnastics for the U.S. dollar to maintain its preeminence as the global currency during the twentieth century with the aim of shedding light on the long-run context of what might happen next.

Figure 1 and Table 1, from Obstfeld and Taylor (2002) are extremely useful to tackle the Global Monetary and Financial Architecture schemes attempted in the recent past. The Sterling was king during the gold standard regime from 1860 to 1914: a regime of fixed exchange rates parities among most of the core countries characterized by very few controls in capital mobility, a reluctance to enact activist domestic policies that would derail the "automatic" mechanism of the international monetary regime and a clear leadership of London as the banker of the world.

Also, it is important to highlight an important aspect which went hand in hand with the Sterling supremacy: between 1860 and 1914, 60 percent of international trade was settled in Sterling and core and peripheral countries maintained an important stock of gold convertible Sterling which could be invested in short-term Sterling-denominated securities. Hence, as the banker of the world, Great Britain did what the U.S. was to do in the next century: it had the capacity to borrow short and lend long. By 1899, the Sterling represented 64 percent of the official international reserves holdings, the French Franc came a distant second with 16 percent. Then in 1913 on the eve of World War I, the Sterling's share dropped to 48 percent while the Franc represented a sizeable 31 percent. Hence, the Sterling was king but even during the heyday of the international Gold Standard, countries diversified their international reserves.[5] The Bank of England was perceived as the leading central bank, the orchestra conductor, in a period when Great Britain was a net creditor vis-à-vis the rest of the world — a World Banker with positive capital.[6]

[5] See Eichengreen (2007), pp. 127–131.

[6] There was no such thing as a supranational monetary regime; however the Foreign Office had appointed a vast number of economic analysts in crucial Commonwealth and other newly settled economies to run very detailed country or region risk analysis to gather early signals of political, fiscal or financial distress. Also the role of the Corporation of Foreign

Putting aside humanitarian considerations, whether World War I meant more wealth destruction for Great Britain in relative terms than the present meltdown means for the U.S., would be something interesting to assess. What is certain is that the fall in the preeminence of the Sterling as a key international currency by suspending the gold standard and the outcome of the war meant a huge realignment in the global political economy. The international regime could not be maintained, capital mobility ebbed and central banks went from international cooperation to more inward-looking objective functions, with a vast array of sterilization mechanisms to overcome the disruption in the international financial markets. There was an attempt with the establishment of the League of Nations to agree to re-adopt the gold standard regime, to pursue the benefits of free trade and to restore private international capital flows. The end of the story is well known.

In the meantime, the American economy expanded and the preeminence of the U.S. dollar as an international reserve was a non- monotonic episode at least until the end of World War II. During the interwar period, the Sterling, Dollar and French Franc were among the chosen currencies to cushion reserves and, as said before, the FED and Banque de France had a more mercantilist attitude to expand their gold stocks, giving U.S. a slight déjà-vu flavor as per the contemporaneous global imbalance problem. A chaotic international fiduciary regime preceded the outbreak of World War II, with the sole attempt by the U.S. to maintain an official parity of the dollar with gold at a devalued rate.

Bretton Woods was to be a gold-dollar system and gold reserves were to be the anchor of the international system but only the U.S. committed to fix the parity at 35 U.S. dollars an ounce and the other currencies would be pegged to the U.S. dollar. The FED stood ready to convert dollars to gold and vice versa only for official creditors but not in the private spot market. In short, it was an adjustable fixed exchange rate regime, to avoid the nightmares caused by the interwar period's beggar-thy neighbor devaluation actions. The newly created International Monetary Fund (IMF) would regulate, ensuring that activist policies not in line with the system would be avoided by the countries and would allow adjustments only in the event of fundamental disequilibria in their balance of payments.

An important aspect to remember is that the Bretton Woods world was not one of international free capital mobility. On the contrary, it was a world of capital movement with explicit or implicit controls. With one subtle exception, the U.S. unsuccessfully championed the lifting of capital controls of its official counterparts. The sole gold convertible currency available at hand for central banks was the U.S. dollar. Once the U.S. economy and the phenomenal recovery in international trade were much in need of U.S. liquid dollars, the pressure by some official central banks to swap dollars held as reserves into gold, notably France, became acute on the presumption that the official gold-dollar pegging was unsustainable.[7] But as in today's situation, the collective dumping of the greenback to swap it for gold would have produced a massive loss for the core central banks.

An important collective exercise to save the gold-dollar exchange standard as an anchor to the international regime in place was the enactment of the Gold Pool in 1961. The idea was to create a stabilization fund to intervene in the London spot market to avert major discrepancies between the official gold dollar price of an ounce and the spot market price.[8]

Bondholders was a precursor of a supranational type of entity to monitor, survey and rate the sovereign bonds and debentures.

[7] In a pure gold-dollar exchange standard, with a relatively fixed supply of the gold stock, deflation was to become the prescribed policy or a revaluation of the U.S. dollar in terms of gold. Obviously this scenario was unthinkable after the experience during the interwar period but also it was contrary to the intentions of the newly incepted Kennedy administration.

[8] See Eichengreen (2007), « The Anatomy of the Gold Pool ». The countries which created the syndicate were Belgium, France, Germany, Italy, the Netherlands, Switzerland, the United Kingdom and the United States.

The experiment was in place between 1961 and March 1968. The agreement was informal and the participation to supply gold was led by the U.S. with half of the stock and then by ad-hoc established shares of the other countries. Stabilization and net purchases of gold by the Pool worked until 1965 and then the trend reversed dramatically until its abandonment in 1968 with France being the first country to leave the syndicate in 1967. This is a standard example of a collective effort that could bring collective benefits but that at an individual level produces incentives to deviate from the common goal to maximize short-run capital gain benefits. The U.S. maintained the official window opened until 1971; for three years it could not maintain the official "speculative" attacks against its convertible dollar and then decided to declare inconvertibility. In 20 years the U.S. lost almost 60 percent of its gold reserves.

This was the end of Bretton Woods and the beginning of a world of fiduciary currencies within a floating exchange rate regime, the reestablishment of private capital mobility and the prioritization of policies by central banks that were to enhance strictly domestic welfare considerations.

In spite of this, as shown in Table 2, the dollar maintained its preeminent international reserve situation: in 1973, U.S. dollars represented 85 percent of the foreign exchange reserve composition; it lost ground against the Deutsche Mark by 1987 and today represents almost two thirds of the global composition of reserves. Next to it is the newly engineered Euro with 27 percent.

The question now is whether there will be a next round in the arena of international monetary affairs in which the U.S. dollar will lose this preeminence, and, if this is the case, against which competing currencies or regimes? Till the present day, the free fall of the Sterling after 1929 does not yet resemble the asymptotic decay of the U.S. dollar. Will the resolution of the present meltdown and the quantity of money expansion needed by the U.S. to persist, or even increase, induce at some point, a sudden discontinuity in this trend? In other words, as the U.S. was the big "global monetary solver" in 1944, are China and some other big creditor countries needed, to stabilize or to cooperate in a preemptive architecture, to avoid a sudden collapse of the reckless hegemon?

This is obviously not easy to answer. On one side of the profession there are those who would argue that the hard landing of the U.S. is already part of the adjustment process. Yes the finance needs fixing but the recession or the decline in the growth rate of the U.S. economy will do the job of reducing the tension of global imbalances. On the other side, another set of scholars would argue for the need of a new kind of Gold Pool, within an institutionalized organization such as the IMF to avoid a sudden total collapse in the international exchanges due to massive erosion in the long-term credibility of the dollar's value. Why does such a course of action seem imperative today?

The way the international exchange rate market currently operates, with a build-up of substantial international reserves by new economic and institutional actors–for example the FE, ECB, China and the pan-Asian and EM, the Sovereign Wealth Funds (SWF)–which are not suited by themselves to build a clear institutional commitment to stabilize exchange rates, means that we have new actors. However, the incentives they have look very like the older reserve system regime that brought the sterling down in 1931.

Some fears of the U.S. dollar re-living the past with the U.S. dollar at present have a kernel of truth. First, before the mega-financial meltdown, the U.S. was, in Stiglitz's terms, a consumer and a debtor of last resort contributing to a paradoxical but highly unstable situation of U.S. dollar debt accumulation and confidence erosion. Second, the recycling by which emerging markets lend the U.S. at lower rates but borrow at higher ones to reinvest in the real sector of

the economy became a perceived inequitable seigniorage privilege. Third, the Euro has been a monetary union success but — as will be analyzed in the next section— the inner European fiscal and banking harmony is still an unfinished task. The lack of an alternative for the moment to the U.S. dollar as a king currency helps to maintain this increasingly uncertain status quo but the discussion to think of a global reserve currency type of mechanism was brought very fast to the international agenda after the American financial debacle.

Bordo and James (2008) and Gros, Kluh and Weder di Mauro (2009) have argued in favor of a more independent IMF, which by reforming its governance structural power could take the job of being the global manager of international currency reserves to replace the implicit role of the U.S. as a "manager" of the global monetary reserve system. We can spare here the big political economy and geopolitical implications that come together with this eventual revolutionary step.

The proposal by the above mentioned authors does not go as far as the unsuccessful proposal made by Keynes in 1939 to establish the Bancor, a global world currency, but if implemented it goes far enough to challenge the present situation of recycling resources through a few concentrated financial core countries.

The proposal brings some analogy to the Gold Pool, a scheme to intervene massively in the Gold Market aimed to counteract destabilizing private speculation and speculators. We are not going to fully describe the main details of their proposals, but the idea is that of a transparent new governance principle in which many new reserve-rich countries would, by injecting or placing a share of these massive reserves in a global pool, co-matched with the G-7, be able to seize a fairer weight in the voting rules at the IMF. The idea is to design a legitimate world asset manager who would not deviate from the objective collective function of seeking stability in international exchange rates and overcoming any individual strategic action on the part of individual central banks. The size of the pool would allow the IMF to effect counter-cyclical exchange rate policies in the event of sudden panics.

Bordo and James suggest the establishment of a Reserve College by which, for example, 50 percent of the votes in the new pool would stay as is and the remaining 50 percent would be allocated as a function of deposits in convertible currency made by the reserve-rich countries to give a more powerful voice to the emerging countries and in particular to China. [9]

Whether this has been discussed in the G-20, besides the agreement to inject more capital to the IMF to enhance its financial lending facilities, I do not know, but the very preeminent situation of China and its very fast pace of learning-by-doing in multilateral organizations predicts more serious talks about restructuring the way the international money market works. Because, in spite of the welcome attempts of the two giants, the U.S. and China, to redress their macro situation and to live a present "Indian Summer," we do not know whether we'll see light at the end of the tunnel, or tunnel at the end of the light.

Let us turn now to the related and systemic aspect of the financial system. What are the prospects for a supranational regulatory body for the multiplicity of domestic financial systems?

4. Global Banking and Finance Architecture: Some Caveats

While the proposal to revamp the role of the IMF as a global asset or international reserves manager seems politically difficult–if feasible and operational, from an economics standpoint–the need for a supra-national independent institution, the establishment of an international lender of last resort for a global financial regime is an even more difficult political and analytical question. Global financial integration means that simple interest rate

[9] See Bordo and James (2008) pages 31-34.

arbitrage mechanisms work well in the upside of the business cycle, and the existence of an international body looking after the transparence and property rights of the trillions of dollars that are traded across borders always seems an oddity, a redundant nuisance. However, on the downside and deleveraging global process, finances tend to travel at the speed of light to seek domestic and autarkic solutions. Forget about global product promises, power points showing solidity and profitability and advertisements convincing locals that to do business at this local branch have the legal guarantee of the headquarters.

The recurrent delusion with banks resides in one simple reason: the traditional nexus between money and credit is essentially flawed as it stands. The nature of most banking systems is one of fractional reserves in which a fraction of demandable deposits is used to finance long-term projects.

The system is intrinsically fragile. If all depositors, because of a general lack of confidence, demand the conversion of their deposits into currency at the same time, then there is a run which forces the system to seek more liquidity, to realize more illiquid assets producing a fire sale spiral which is transmitted to the real economy provoking a "real" crisis. And when the confidence crisis is acute, like in the subprime crisis, even the usual policy mechanisms such as the FED discount window and the interbank lending market are ineffective to stop the drain. Central banks as lenders of last resort, in some tail-events lately, are sterile to the vagaries of liquidity creation and destruction of a fractional financial reserve system.

More than this, in a situation of FED policy uncertainty on how to cope with the crisis, the sophisticated financial markets started behaving like emerging financial markets overnight. Interbank lending ceased, individuals preferred to hoard currency in cash, corporations lost confidence and trust in reputed institutions' credit lines and liquid reserves. Hence every economic actor jumped to a certain form of self-insurance only to worsen the slump.

And as long as we insist on a banking structure in which money and credit are blurred, financial crises will always recur.

Table 3 from Bordo and Eichengreen (2002) which includes the duration and depth of financial crises during different regimes, show that there is not an unequivocal relationship between the presence of financial crises and type of monetary arrangements with one sole exception: the Bretton Woods period in which the degree of private international capital flows were of a very small magnitude. In periods like we see in Figure 1 of massive capital mobility financial crises had devastating effects on the level of real output: during the gold standard twin crises produced cumulative losses of GDP relative to its trend of 16 percent; during the more recent period the loss was as high as 18.6 percent. We still have to wait to see the numbers for the present crisis.

The reality of the matter is that Bretton Woods was the system in which we had what Krugman calls "boring banking" or banks close to the concept of narrow banking, introduced in 1933 by Henry Simons, and recently refreshed by some economists such as L. Kotlikoff and E. Lazear. In this regime, the separation between a 100 percent reserve bank and the investment bank activities is to be revived because at the center of the recurrence of financial crises is that a fractional reserve banking system is inherently unstable.

If one would insist on a global therapy for the financial system, at least the discussion of the intrinsic fragility of the ongoing financial intermediation mechanism becomes valuable before attempting supra-national gymnastics to try to regulate or supervise an intrinsically flawed system. As James (2009) emphasizes, even in the design of the common European currency, the Euro, the countries could not envision a supra-national mechanism for dealing with the European financial system. Once the crisis hits, bank bailouts and fiscal and monetary injections are left to the domestic authorities. The protracted crisis which recently

initiated in Greece shows that bailouts are ex-post instruments which do not solve the intrinsic original sin of the Euro.

So, in spite of the historical heroic efforts of the IMF and the Bank for International Settlements (BIS), I believe that aiming for a global financial architecture was, and still is, a herculean job. First because there is a need for a thorough discussion on the nature of banking and financial intermediaries in need of regulation and supervision, and second because an objective appraisal of what needs to be fixed in the nexus of money-banking has to precede the fixing of global finance. In other words, if it keeps breaking, it needs fixing. Let us turn now to the preemptive reaction in emerging and developing countries.

5. What's in It for Emerging and Developing Countries?

The political/economic behavior of emerging markets considerably shifted gear after September 11th, 2001. The following are some salient features of how emerging and developing countries faced the 2007–2009 global crises and how governments and strong leadership in some cases prevented a full transmission or pass-through to their economies. We will concentrate here on the Latin American experience, which has learned many important lessons from the decade of the Washington consensus.

The world economy also dramatically changed after 9/11. In particular, the direction of international trade for African and Latin American Countries (LAC) has shifted massively towards Asia. It is evident that here too, emerging and developing countries saw a "controlled" deterioration in their terms of trade. In addition, they could not maintain trade credit lines denominated in currencies other than the dollar. For example, for the first time, China offered swap lines for several emerging and developing markets in its domestic currency to some important trade partners.

Izquierdo and Talvi (2009) analyze the key fundamentals for LACs used to confront the global crisis. Some of the fundamentals reversed the previous macrostructures of the countries. Governments were crucial here to overcome the impact of the global economy's market failures but they learned, in cases such as Chile, Brazil and Uruguay, to effect "good" interventions both in macroeconomic markets and in the design of social policies.

To begin with, the countries entered the period with controlled levels of inflation. On average, the region had a 4 percent annualized inflation rate versus the extremely volatile average rate of about 18 percent in the nineties. With the exception of one or two countries in the region, most countries consent that price stability is good and that the exacerbation of inflation rates is extremely regressive and should be avoided.

In harmony with other emerging markets, the most successful countries pursue policies of prudent fiscal balances and of building up international reserves due to the previous traumatic experience of sudden stops. International reserves have gone from $175 billion during the Russian crisis of 1998 to a present regional stock of $460 billion. After a decade of average consolidated public deficits of 2 percent of GDP, the region was running surpluses of about 1.5 percent before the global mega-crash. Chile built up a substantial sinking fund during the boom phase of world copper prices and was ready to apply counter-cyclical policy with genuine resources to smooth out the downturn of the business cycle.

In terms of banking and debt fragility, non-performing loans at banks went down from 9.5 percent to 2.5 percent and loan loss provisions increased substantially in the context of maintaining a predominantly private banking system. The central bank's international liquidity indicator, defined as the ratio of international reserves to outstanding one year debt amortizations and central bank short-term foreign liabilities, went from one to two in the course of 10 years.

An additional very important feature was the de-dollarization of public debt and of internal or domestic credit. Foreign currency debt as a percentage of total debt reached an all-time high of 70 percent and it was termed by Eichengreen and Haussman this citation needs to be completed and also added to the reference section as the "original sin" problem. Today, the ratio has dropped to 37 percent. Of course, here we are not discriminating between countries that have well developed internal debt markets and those who do not, in the sense that this fall means much more for the latter group since they are trapped by not having access to the international capital markets. However, the main governmental philosophy in LACs is that an extreme "original sin" feature is to be avoided.

What about growth? The region entered the crisis phase with an average growth rate of almost 6 percent and with a sizeable inflow of foreign capital, which obviously helped to sustain this important performance.

So what happened during the crises? The empirical evidence shows that the pass-through could not be avoided, sovereign bond prices went down by 30 percent after the Lehman Brothers collapse but three months later they were only 15 percent below their pre-collapse levels. For countries such as Chile, Brazil, Uruguay or Peru, the international markets were not close to issuing sovereign bonds but of course they could opt for this strategy at a higher spread. The governments preferred to enact expansionary monetary and fiscal policies taking advantage of exchange rate flexibility and a more independent course in setting the domestic interest rate. Depreciation of currencies amounted to 30 percent and an increase of social expenditure plans was announced by Brazil, Chile and Argentina among others. The result was an "impact effect" to the real sector activity through the usual trade, investment and capital flows channels but a sudden financial and economic collapse was prevented. [10]

In short, one can say that the emerging market economies are witnessing with extremely cautious macroeconomic and social policies the resolution of the global imbalance conundrum. They have a voice now to be heard through the Group of Twenties. However, it is doubtful that this group is going to deliver a new framework in the arena of global monetary and financial affairs.

Perhaps this is only the reflection of a biased economic historian who cannot ignore the very rich and telling contemporaneous historical episodes. To change drastically, the crisis has to be a terminal one. Hopefully, at the moment, it looks like we have just escaped one.

[10] See Izquierdo, Alejandro and Talvi, Ernesto, (2009) Policy Trade-Offs for Unprecedented Times : Confrontting the Global Crisis in Latin America and the Caribbean, IDB,

References

Bordo, M. and E. Barry. 2002. "Crises Now and then: What lessons from the Last Era of Financial Globalization." *NBER Working Paper No. 8716*, January.

Calvo, Guillermo. 1998. "Capital flows and Capital- Market Crises: The Simple Economics of Sudden Stops." *Journal of Applied Economics*. Vol. 1. November.

Calvo, Guillermo. 2009. "Looking at the Financial Crises in The Eye: A simple Finance/Macro Framework." *Unpublished manuscript*. September 2009.

Diamond, Douglas and Philip Dybvig. 1983. "Bank Runs, Deposit Insurance and Liquidity." *Journal of Political Economy*. Vol. 91, N. 3, pp 401-419.

Eichengreen, Barry. 2007. "*Global Imbalances and the Lessons of Bretton Woods*." Cambridge: MIT Press.

Eichengreen, Barry and Ricardo Haussman. 1999."Exchange Rates and Financial Fragility." Paper presented at the symposium New Challenges for Monetary Policy, 26-29 August, Jackson Hole, WY.

Gross, Daniel, Ulrich Kluh and Weder di Mauro, Beatrice. March 30, 2009. "Reforming Global Governance: How to make the IMF more Independent." *Preliminary Draft*. Prepared for the Conference "*The Financial Crisis: Restoring the Health of the International Economy: Reinventing Bretton Woods,*" March 30, 2009. Paris.

Izquierdo, Alejandro and Talvi, Ernesto. 2009. "*Policy Trade-Offs for Unprecedented Times: Confronting the Global Crisis in Latin America and the Caribbean*." Inter-American Development Bank.

Obstfeld, Maurice and Taylor, M. Alan. 2002. "Globalization and Capital Markets." *NBER Working Paper No. 8846*, March.

Obstfeld, Maurice, Shambaugh, Jay and A.M. Taylor. 2008. "Financial Stability, the Trilemma, and International Reserves." *NBER Working Paper No.14217*, August.

Internet Sources

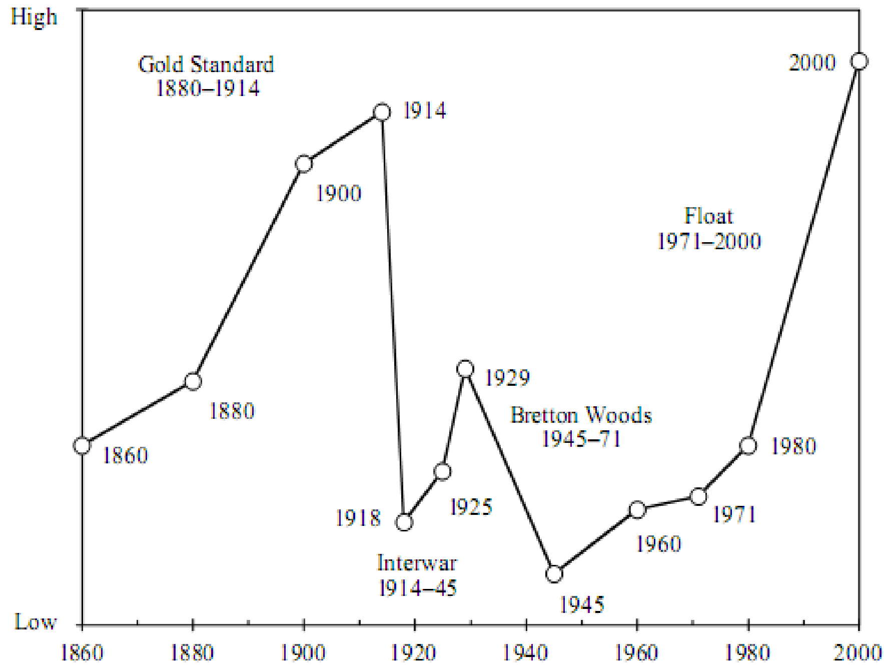
Bordo, Michael. and James, Harold. 2008. "*The Past and Future of the IMF Reform: A Proposal*." URL: *michael.bordo.googlepages.com/ThePastandFutureofIMFReform.pdf*

Caballero, Ricardo. 2009. "*A global perspective on the great financial insurance run: causes, consequences, and solutions*." Vox Column (*www.voxeu.org*). 23 January, 2009.

James, Harold. 2009. "*Fixing Global Finance: Who Broke Global Finance, and Who Should Pay for It*?" Council on Foreign Relations. URL: http://www.foreignaffairs.com/articles/63590/harold-james/fixing-global-finance

Taylor, John. B. 2008. "*The Financial Crisis and the Policy Responses: An Empirical Analysis of what went wrong*." URL: *www.stanford.edu/~johntayl/FCPR.pdf*

Figure 1: Conjecture? A Stylized View of Capital Mobility in Modern History



Source: Obstfeld and Taylor (2002)

Table 1: The Trilemma and Major Phases of Capital Mobility

Era	Resolution of trilemma Countries choose to sacrifice			Notes
	Activist policies	Capital mobility	Fixed exchange rate	
Gold standard	Most	Few	Few	Board consensus
Interwar (when off gold)	Few	Several	Most	Capital controls especially in Central Europe, Latin America
Bretton Woods	Few	Most	Few	Board consensus
Float	Few	Few	Many	Some consensus; except currency boards, dollarization, etc.

Source: Obstfeld and Taylor (2002)

Table 2: Currency composition of foreign exchange reserves (percentage)

Regime	1973	1987	1995	2004	2006	2008
U.S. dollar	84.5	66.0	56.4	65.9	65.5	64.0
Euro	-	-	-	24.9	25.1	26.5
Sterling	5.9	2.2	2.1	3.3	4.4	4.1
German mark	6.7	13.4	15.8	-	-	-
French franc	1.2	0.8	2.4	-	-	-
Swiss franc	1.4	1.5	0.3	0.2	0.2	0.1
Yen	-	7.0	6.8	3.9	3.1	3.3
ECU	-	5.7	8.5	-	-	-
Other	-	3.4	4.8	1.8	1.8	2.0

Source: Eichengreen (2006) and IMF

Table 3: Crisis in Different Eras

Duration and depth of crises (from Table 1 of Bordo et al. 2002)					
All countries	**1880-1913**	**1919-1939**	**1945-1971**	**1973-1997 21 nations**	**1973-1997 56 nations**
			Average duration of crises in years		
Currency crises	2.6	1.9	1.8	1.9	2.1
Banking crises	2.3	2.4	a	3.1	2.6
Twin crises	2.2	2.7	1.0	3.7	3.8
All crises	2.4	2.4	1.8	2.6	2.5
			Average crisis depth (cumulative GDP loss in %)		
Currency crises	8.3	14.2	5.2	3.8	5.9
Banking crises	8.4	10.5	a	7.0	6.2
Twin crises	14.5	15.8	1.7	15.7	18.6
All crises	9.8	13.4	5.2	7.8	8.3

Source: Bordo et al (2002)