PRAGMATIC CHOICES FOR INTERNATIONAL FINANCIAL GOVERNANCE

PART ONE

Crisis Prevention and Prosperity Management for the World Economy

Introduction

My recent book, *Turbulent Waters: Cross-Border Finance and International Governance*, advocates faster progress in strengthening the international financial system (sometimes referred to as architectural reform). Most important, that book urges national governments and international organizations to upgrade the supranational surveillance of cross-border traffic regulations and of nations' macroeconomic, exchange rate, and balance-of-payments policies. Concurrently, they should streamline and strengthen intergovernmental lending intermediation for the liability financing of payments deficits.

In addition to surveillance and lending intermediation, *Turbulent Waters* identifies two other groups of reforms for enhancing the utilities infrastructure of the world financial system and strengthening the world economy. First, governments and international organizations should foster further major improvements in the prudential oversight of financial activity and in the associated design and monitoring of financial standards. Second, they should improve their cooperative management of financial crises. The enhancements needed include improvements in the contingent provision of emergency lending, in the handling of moral hazard difficulties, and in the involvement of private financial institutions in concerted lending.

All three types of reform—supranational surveillance and lending intermediation, prudential financial oversight, and cooperative crisis management—are needed. Each will reinforce the others. Each will help to strengthen the growth and resilience of the world economy and financial system.

The cooperative management of financial crises can be likened to the activities of a local fire department. A fire department is charged with extinguishing unexpected blazes, and international financial institutions may be charged with coordinating responses to unexpected financial crises. Surveillance at a supranational level of the economic and financial policies of national governments is akin to the activities at the local level of police departments, traffic regulators, and municipal agencies charged with licensing, inspection, public health, and safety standards. Supranational surveillance seeks to encourage compliance with international norms and intergovernmental agreements. It monitors cross-border traffic regulations. Surveillance is exercised in noncrisis and crisis conditions alike.

Traffic regulators discourage traffic violations. A major purpose of supranational surveillance is to inhibit individual nations from deliberately or inadvertently pursuing policies likely to cause economic disruption for other nations. Put the other way round, collective surveillance aspires to encourage preventive policies that are sound and neighborly.

Policymakers' concern with cross-border finance has been driven in recent years by the disruptions stemming from financial crises. Skillful crisis management is essential. Sound economic management in noncrisis conditions, however, is even more critical. Because choosing sound policies in normal times can substantially reduce the probability that crises will occur, enhancing the collective surveillance of national policies should have high priority. Intergovernmental lending intermediation to facilitate the adjustment of macroeconomic imbalances in national economies, most notably lending by the International Monetary Fund (IMF), can reinforce such surveillance, to the benefit of all.

More than anything else, in other words, architectural reform should emphasize the *prevention* of economic and financial crises. The primary preoccupation should be with encouraging healthy growth and financial stability—*prosperity management* rather than crisis management.

The reforms needed for crisis management and for supranational surveillance and lending intermediation presume central roles for the IMF and the national governments that are the predominant shareholders in the IMF. Reforms in prudential financial oversight, in contrast, involve numerous international organizations and consultative groups. One reason for differentiating prudential financial oversight from the macroeconomic dimensions of supranational surveillance and lending intermediation is its greater variety of institutions involved and the specialized complexity of their activities.

This essay augments and provides supporting detail for the analysis of collective surveillance and intergovernmental lending intermediation in *Turbulent Waters*. Supporting analyses for the other two areas of reform are contained in companion essays, *Prudential Oversight and Standards for the World Financial System* and *Crisis Management for the World Financial System*.

Collective Surveillance: Rationale and Basic Questions

The rationale for intergovernmental cooperation is straightforward and analytically sound. Decentralized national decisions that fail to take into account the cross-border spillovers from policy actions can produce welfare outcomes that are inferior to those that can be attained through informed collective action.

Inferior outcomes from decentralized decisionmaking are examples of situations in which negative externalities lead to market failures. If governments consult and bargain with one another cooperatively, they may be able to identify mutually beneficial adjustments of policy instruments that can offset market failures. Such adjustments may thereby permit nations to reach higher levels of welfare. Because cross-border economic integration has generated a growing variety and intensity of collective-action problems with cross-border dimensions, the rationale for intergovernmental cooperation is even more compelling in the first decade of the twenty-first century than it was half a century earlier.[1]

Efforts to cooperate are not invariably successful. Government intervention intended to remedy market failures can be counterproductive. In some circumstances, cooperative intergovernmental decisions can lead to government failures, thereby undermining rather than enhancing welfare. If intelligently pursued and not overly ambitious, however, cooperation

1. Bryant (2003), hereafter cited as *Turbulent Waters*, exposits the rationale for intergovernmental cooperation and the greater need for it when international economic interdependence increases (see especially chapters 3, 4, 7, and 8).

among national governments can often foster the common interests of their citizens.

When governments agree to make decisions cooperatively, they also need to ensure compliance with those decisions. The more ambitious the efforts to cooperate, the stronger the emphasis on compliance. The rationale for intergovernmental cooperation therefore comes with a corresponding rationale for *surveillance* of the policies of national governments. Establishing processes and institutions for surveillance facilitates compliance with international norms and intergovernmental agreements. Surveillance combines elements not only of *monitoring* but also of *enforcement*.[2]

The presumption in favor of supranational surveillance of national policies raises many difficult issues:

—Through which institutional venues—consultative groups, international organizations, or both—should surveillance be conducted? If several different venues are involved, how should surveillance activities be allocated among them?

—Should the surveillance of current account transactions (trade in goods and services) and the surveillance of capital account and financial transactions be conducted through separate processes and institutions?

—Should supranational surveillance focus on cross-border transactions and other external sector variables (for example, exchange rates) that pertain explicitly to several nations together rather than just a single nation? Alternatively, must surveillance pertain to all national policies—domestic as well as external—that can have significant influences on foreign nations?

—Can supranational surveillance of economic policies be underpinned by operational guidelines that are clearly and precisely specified?

—Is analytical knowledge about macroeconomic interactions among national economies sufficiently advanced to support effective surveillance?

—Do international organizations and intergovernmental consultative groups disclose sufficient information about their activities? Could disclosure during surveillance dialogues be so extensive as to compromise confidentiality when confidentiality is desirable?

—How should the policymakers of an individual nation choose an exchange-rate regime? Must the choice inevitably be restricted to the polar extremes of a "pure flex" (untrammeled floating) or a "hard fix" (a currency board arrangement or participation in a currency union)? Is there an opti-

2. *Turbulent Waters*, chapter 7.

mum or ideal exchange regime? Can the choice of regime be separated from decisions about other aspects of economic policy?

—Should the surveillance of macroeconomic policies and exchange rates be integrated with the surveillance of financial standards and prudential oversight?

—What general guidelines should prevail for capital account convertibility (freedom for money and capital to flow across national borders)? How should the IMF use these guidelines in its surveillance of national policies?

—Could individual nations and the world economy benefit not only from cautious supranational surveillance but also from a more ambitious, explicit *coordination* of national economic policies? If so, how might processes and institutions to nurture such coordination evolve?

—Does intergovernmental lending intermediation promote the smooth evolution of the world economy or should all lending—including any lending to national governments—be carried out by private financial institutions and financial markets? In particular, is it helpful for the IMF to have the authority to act as an intergovernmental lending intermediary to support its surveillance activities?

—Would it be preferable to narrow the IMF's mandate so that the focus of its surveillance shifts toward vulnerability to crises? Correspondingly, should the IMF lend only in times of financial crisis, or might it be helpful to lend in noncrisis circumstances?

—Should the IMF's surveillance efforts be restricted to a core area comprising macroeconomic policies, payments imbalances, and exchange rates? Should the IMF continue its recent trend toward focusing also on the surveillance of financial standards and prudential oversight of financial systems? The promotion of development and poverty reduction in member nations has gradually become a prominent IMF operating goal. Is that broadening of the IMF's original mandate a welcome evolution, perhaps one to be carried even further? Should the mandate be broader still, including, for example, the surveillance of labor standards and environmental standards?

—What is the appropriate size of aggregate IMF lending facilities? How much differentiation should there be among the different facilities? What interest rates and fees should be charged? What performance conditions ("conditionality") should be imposed on borrowing nations, in what manner?

—Which nations should be the main "clients" of the IMF? Should the IMF itself focus primarily on developing nations?

—What procedures and structures should underpin governance of the IMF? In particular, how should decisionmaking powers be allocated among the IMF's member nations?

Most of the questions in this list are contentious. It is not now possible to offer definitive consensus answers. Instead, this essay clarifies the questions, identifies the range of alternative views, and summarizes my own answers.

The adjectives *supranational* and *international* appear throughout *Turbulent Waters* and in this essay. To avoid confusion, the terms need to be carefully differentiated.

My approach to international financial governance seeks a middle ground between polar extremes. Hence even the adjectives I use to modify *collective governance* reflect a preference for taking the middle of the road. The governance optimists who favor sweeping institutional reform for the world in effect advocate genuine supranational collective governance, in the sense of governance over nations and authority over national governments. But with very few exceptions, genuine supranational governance is not politically feasible. It is not, at least not yet, even desirable. I have therefore been consistent in making recommendations for international rather than supranational collective governance.

In contrast, however, I often speak of supranational surveillance rather than international surveillance. *Collective surveillance* is a subset of the potential functions of international collective governance. The collective surveillance activities that exist or can realistically be envisaged today are weak precursors of more extensive and more muscular dimensions of collective governance. Yet even today's surveillance conducted by the IMF and other international financial institutions merits the adjective *supranational*. That use of language is appropriate because the nature and content of the surveillance inevitably require a perspective above the level of national governments.

But supranational in the context of surveillance definitely does *not* presume that those who exercise surveillance have significant independent authority to influence national governments. Quite the contrary. Surveillance in practice so far has been—and even when strengthened with incremental reforms in the near future will be—only tentative and shaped by "soft" rather than "hard" guidelines. The real exercisers of supranational surveillance are the national governments themselves. They choose to act collectively not because they agree to bend to the will of an independent authority above them, but because achieving their mutual interests requires cooperation.