Policymaking in an Integrated World: Discussion

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The organizers of this conference invited discussants to present their own views as well as to comment on the papers themselves. I am dissatisfied with how most commentators about "reform" of the "international financial architecture" perceive the subject as a whole. I therefore begin by sketching, in very broad strokes, what I believe to be the fundamentals.

I should observe at the outset that Barry Eichengreen's views and mine about this subject are consonant in most ways. His paper for this conference is largely persuasive, as was his thoughtful book earlier this year (Eichengreen 1999). My initial remarks about fundamentals are directed not at Eichengreen but at those who get the foreground debate out of perspective by failing to perceive it appropriately against a larger background canvas.

Political Constraints, Economic Imperatives, and Pragmatic Incrementalism

The political structure of the world is multilayered, heterogeneous, and inherently conflictual. The second half of the twentieth century has been characterized by increasing political pluralism—a marked expansion in the number of governmental decisionmaking units and a greater diffusion of power among them. Increasing political pluralism in turn has been accompanied by rising nationalism.

Growth in economic interdependence among nations has been a second pervasive trend in the past half century. Cross-border lending and

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borrowing, with assets and liabilities denominated in several different national currencies as well as the domestic currency, have become progressively "internationalized," and at a pace even faster than that for cross-border trade in goods and services.

Despite the fact that economic and financial interdependence has greatly increased, national borders continue to have immense significance in economic terms. Nations are substantially different—in their social and cultural norms, historical experiences, types of private institutions, types and jurisdictions of government institutions. Many nations still maintain partial "separation fences" at their borders (though much less so than at mid-century). It is a basic characteristic of free-enterprise capitalism that market extremes can cause market failures. It is a basic characteristic of pluralist politics that government extremes and rigidities can cause government failures. Virtually every nation therefore has a "mixed economy," some combination of decentralized markets and governance infrastructures. But the particular combination—the specifics of the "mixed economy"—differs widely across nations. All these cross-nation differences are fundamental explanations for why national borders still have great economic significance, despite the intensification of cross-border integration and the "globalization" of culture brought about by modern communications technology.

The world polity and economy at the end of the twentieth century are thus at messy, "intermediate" stages of evolution. The political structure is so heterogeneous and multilayered as to seem bewildering. Economic structures are changing and complex. Any sensible approach to international financial architecture must grapple with this hybrid, intermediate messiness.[1]

In this intermediate world, collective-action problems with cross-border dimensions will continue to grow in importance relative to domestic governance. National governments will inevitably be forced to cooperate more among themselves and to ask international institutions to carry out a wider range of functional responsibilities. Reform of the international financial architecture, at its deepest level, is thus about the evolution of *international collective governance* for the world financial system.[2]

Financial activity, when it functions smoothly, is enormously bene-

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[1] Journalism and popular discussion in the last few years now assert sweeping but superficial generalizations about "globalization." Some, for example, Thomas Friedman (1999), view the trends approvingly. Others, such as Greider (1997) and Gray (1999), perceive them as alarming and try to incite antipathy. Much of this popular commentary about globalization is unhelpful in understanding the intermediate messiness of today's actual world. For a cogent overview of how much national borders still matter, see Helliwell (1998).

[2] As Robert Keohane emphasizes in his contribution to this volume, institutions matter—and collective governance matters.

ficial in promoting growth and efficient resource allocation. It permits the diversification and sharing of risk. It allows ultimate savers and ultimate investors to make independent localized decisions, yet render the decisions consistent in the aggregate. Completely unconstrained financial activity, however, may not be able to deliver these benefits. Informational asymmetries, adverse selection and moral hazard, herding behavior and contagion, and excessive volatility in asset prices cause financial activity to be inherently vulnerable to instability.[3]

The appropriate societal response to this dilemma is to establish and maintain a collective-governance infrastructure for the financial system. Within an individual nation, the critical features of this infrastructure include high standards for accounting, auditing, and information disclosure; well-designed and competently administered legal procedures for enforcing contracts and adjudicating disputes; skillful prudential supervision and regulation of private financial institutions; an effective but limited potential for crisis management and crisis lending; and, not least, sound and predictable macroeconomic policies that shape the general environment within which the financial system and the wider economy operate.

If a well-functioning collective-governance infrastructure is a precondition for a domestic financial system to operate smoothly, why is an analogous infrastructure not needed *on a world scale* for the smooth operation of the conglomeration of all national financial systems? Economic logic tells us that a global collective-governance infrastructure *is* needed. But because the political preconditions do not exist in our messy intermediate world, the economic logic cannot fully apply. The global polity does not yet contain collective-governance institutions that can effectively carry out the functions of a supranational infrastructure.

The international community has only recently begun to develop recommendations for minimum global standards in the areas of accounting, auditing, and information disclosure. No institutional mechanisms for implementation and monitoring of such standards have yet been agreed upon, even if consensus on the recommendations could be achieved. There exists no world legal system, no infrastructure of international courts or legal bodies for the resolution of cross-border disputes. Even for private entities, cross-border contract defaults and insolvencies, and hence cross-border procedures for arbitration or bankruptcy, pose serious difficulties. When sovereign governments or entire nations are involved, the difficulties are an order of magnitude more

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[3] Analytical references on these subjects include Diamond and Dybvig (1983); Bikhchandani, Hirshleifer, and Welch (1992); Banerjee (1992); and Avery and Zemsky (1998). Masson (1998, 1999) focuses on the cross-border aspects.

difficult. Individual national governments and entire nations do not become insolvent or undergo bankruptcy proceedings.

The world has only nascent supranational institutions, with very limited responsibilities, for the prudential oversight of financial activity or even for oversight of the national prudential supervisors themselves. Significant progress in the right direction has been made in recent years, for example under the aegis of the Bank for International Settlements-sponsored Committee of Banking Supervisors and the IOSCO cooperative group of national securities commissioners. The new Financial Stability Forum is a very recent step. But we are still very far from having international analogues of the prudential-oversight institutions that operate within national financial systems.

The issues of crisis management and crisis lending on a global scale are several times more complicated than the issues faced within a national economy by a national central bank. The world does not have global or regional monetary policies, as distinct from the separate monetary policies of individual nations. Similarly, the notion of global or regional fiscal policies is an oxymoron. Yet the general global stance of macroeconomic policies is a critical feature influencing the global economic and financial environment. Procedures for intergovernmental cooperation among the fiscal authorities and the monetary authorities of the largest nations are in their infancy.

Given the need for further evolution of international collective governance—but recognizing the hybrid, intermediate status of the world polity—one has to be practical about how to make progress. In key areas, we should be encouraging a stretching of intergovernmental cooperation and a further strengthening of international institutions. This approach, call it *pragmatic incrementalism*, does not retreat from the need gradually to strengthen international collective governance. But neither does it unrealistically demand too much, too soon.

Pragmatic incrementalism is positioned in the middle of the road. It is distanced from the ditch on the right-hand side that is the extreme *untrammeled markets view*, and it is removed from the extreme in the other direction, the left-hand ditch of the *sweeping institutional reform view*. The untrammeled markets view sees governance failures as pervasive, at both the national level and the nascent international level. In that view, efforts to mount governmental action are more likely to be "the problem" than "a solution." That view retreats from collective governance and hopes that markets themselves will be resilient and cope well with any difficulties that materialize. In sharp contrast, the sweeping institutional reform view sees market failures as pervasive, domestically as well as internationally. It believes that financial markets periodically go out of control, especially with cross-border transactions. It wants either to rebuild the separation fences at national borders or to delegate greatly enhanced authority to international institutions. Neither the untram-

meled markets view nor the sweeping institutional reform view is based on compelling analysis. Both views, furthermore, are politically unrealistic.

SINS OF OMISSION IN THE EICHENGREEN PAPER

Eichengreen and I are both pragmatic incrementalists in our views about how to improve the international financial architecture. In this paper as well as in his book, Eichengreen speaks of his approach as resting on his "four pillars." I agree with most of what he says about his four pillars. The main problems I have with the paper concern not sins of commission, but rather sins of omission.

The first omission is a failure to speak enough about the advanced industrial nations and their contributions to the architectural problems that need fixing. Eichengreen succumbs too much to the currently fashionable (but probably transitory) view that the problems in the international monetary system are predominantly located in emerging-market and developing nations. A not unfair characterization is that this view sees the advanced industrial nations as a splendid first team—the "varsity," spruced up and washed clean. The emerging-market nations are at best a weak "junior varsity." And the "unwashed" of the developing nations are merely amateur sandlot teams. Seen from this unfortunate perspective, the enemy is weak private institutions and weak governance in the emerging-market nations and the developing nations. In contrast, I am much more in the frame of mind of Pogo: We have met the enemy, and the enemy is us, too!

It is true that accounting and audit standards in emerging-market and developing nations tend to be less well developed and often are less strongly enforced than in North America, Europe, and Japan. The laws governing defaults and insolvencies are less complete. Bankruptcy and arbitration procedures are less fully worked out. Standards and procedures for prudential oversight of financial institutions in many developing nations are less stringent and often less assertively monitored. The economies of many developing nations are smaller, and more open. Herding behavior and contagion can be more virulent and, therefore, the risk of national financial instability is somewhat greater. Portfolio investors and creditors from the advanced industrial nations—the dominant actors in the world capital markets—can be very unforgiving about problems within the developing nations. Many such creditors are potential members of a herd, prepared to exercise a disciplining "exit option" on slight provocation, especially if through informational cascades they observe other creditors heading for the exit. For many years these problems in emerging-market and developing nations were relatively neglected. Eichengreen and others are correct to spend much effort focusing on them now.

But it is surely wrong to imply that all is well on the varsity team. It is salutary to remember the protracted savings and loan crisis in the United States in the 1980s. Recall the exchange-rate turbulence in Europe in 1992 and again in 1993, and the associated severe banking crises in Scandinavia. Throughout the second half of the 1990s, the Japanese financial system has been struggling with huge amounts of bad debts and many weakened financial institutions.

Borrowing a leaf from Eichengreen's own work, it is also instructive to bring in a historical perspective. Until well into the twentieth century, the United States, Canada, and Australia were "emerging-market" nations. London and several other European capitals were the advanced center of the financial world and had considerably more sophisticated financial institutions and practices than those in the United States. The United States had, to put the point politely, an altogether undistinguished record of financial stability. The phrase "wildcat banking" stems from flagrant abuses in nineteenth-century American banking. Severe financial panics occurred in the United States in 1873, 1893, and again in 1907. The United States in the nineteenth century certainly failed to have adequate mechanisms in place for the prudential oversight of private financial institutions and for the collective provision of emergency liquidity assistance in times of financial crisis.

Accounting and audit standards in the United States and in so-called newly settled nations such as Canada, Australia, and Argentina were less well developed and less strongly enforced than in Britain. Bankruptcy and arbitration procedures were less fully worked out. Standards and procedures for prudential oversight of financial institutions were less well developed, less stringent, and less assertively monitored. Most of the generalizations so readily applied to developing nations today were applicable with at least equal merit to then-emerging nations at the beginning of the twentieth century.[4] If the international community is to encourage an appropriate evolution of collective governance for the world financial system, the supposed varsity team should be more careful about pointing the finger of blame exclusively at the junior varsity and the sandlot players and telling them that *they* must pull up *their* socks.

Eichengreen's paper has a second sin of omission, related to the first. He presents too restricted a concept of "surveillance" and its evolution. I have just emphasized that collective surveillance should be applied to all nations, not merely—and not even especially—to emerging-market and

[4] The historical experience of the United States and the other emerging-market nations of the nineteenth century also teaches the lesson that the transfer of stringent standards from advanced to periphery nations is a slow-moving, learning process. The gradual historical strengthening of U.S. accounting procedures and prudential oversight, for example, was due in large part to pressure from British investors and imitation of British standards. See, for example, Bordo, Eichengreen, and Irwin (1999).

developing nations. Equally important, collective surveillance and intergovernmental cooperation should be applied to all types of policies, and most notably to general macroeconomic policies.[5] Eichengreen's discussion of surveillance focuses on financial standards and the prudential supervision and regulation of financial institutions. The two of us agree that enhancement of collective governance in those areas is needed. I am supportive of most of the suggestions that he recommends. But the net of surveillance and monitoring should be cast wider than that.

In my own vision for the evolution of collective surveillance and intergovernmental cooperation, I place the greatest emphasis on *prosperity management*, in contrast to crisis management. Nor is prosperity management in any simple sense merely crisis prevention.

Encouraging national governments to pursue stable, predictable, and mutually consistent macroeconomic policies should be the central feature of collective surveillance. Hence, reform of the architecture should include, for example, a further strengthening of the International Monetary Fund's processes of Article IV consultations and exchange-rate surveillance—strengthened most of all vis-à-vis the largest varsity nations, including explicitly the United States, not merely vis-à-vis the supposed JVs and the sandlot. Analytical exercises such as the IMF's *World Economic Outlook* and the OECD's *Economic Outlook* should be given more prominence. I can envisage a progressive strengthening of intergovernmental coordination of the largest nations' monetary and fiscal policies gradually, over time (Bryant 1995).

An improved analytical understanding of macroeconomic interactions among national economies is an essential prerequisite for the development of this enhanced collective surveillance. This point has not come up in any of the official discussions of reforming the architecture. But it should have. The governments of the major countries have taken little direct interest in promoting an improvement in this analytical understanding. Nor have they put pressure on international institutions to make this objective a high priority for staff work. Such efforts as have been made have been sponsored by individual central banks, or individual groups within international institutions, or research or academic institutions.

Over the medium and long runs, national governments should actively support the establishment of one or more staff groups at international institutions charged with the collective task of improving analytical knowledge about cross-border macroeconomic interactions and diffusing that knowledge more widely. Staff support of that type, backed by an international epistemic community eager to expand our

[5] Since Eichengreen in some of his other recent articles has shown an awareness of the importance of a broad concept of macroeconomic surveillance, the omission of the broader dimension in his paper for this conference may be inadvertent.

knowledge in this sphere, is a precondition for progress in cooperation among policymakers themselves. Analytical foundations are not a sexy subject. That, no doubt, is one of the reasons why they have not surfaced in official discussions of reforming the international financial architecture. But building more solid analytical foundations is the only reliable way to improve future policy debates and render future policy decisions more robust to error.

Is the IMF Too Political?

Eichengreen includes in his paper, under the heading of surveillance, a proposal for making the IMF more "independent and accountable."[6] The motive for the proposal is the contention that "the Fund's decisions are distorted by the parochial concerns of national governments" and that therefore "greater independence from those governments is the logical solution." I do not have space to discuss this proposal carefully, but I cannot refrain from observing that the political assumptions underlying it seem puzzling. It is far from obvious that, in the current intermediate state of the world polity, we should want international institutions to be less, rather than more, accountable to national governments. For the IMF at the current stage of its evolution, the analogy of a politically independent central bank within a nation is *not* persuasive. And even if one were to take the view that the IMF should have more political independence, why propose the Interim Committee as the locus of political power to hold the "newly independent" IMF Executive Board more accountable? The Interim Committee is itself directly accountable to national governments and scarcely immune from "parochial concerns." If the Interim Committee is eventually transformed into the Council (already provided for in the IMF Articles of Agreement), the Council will be directly accountable to national governments. So the shorter-run logic of this recommendation eludes me. To be sure, over a longer run the political aspects of IMF accountability and its degree of independence from national governments will gradually become more salient. But for the short or medium runs, Eichengreen and his Geneva colleagues seem with this proposal to have uncharacteristically abandoned the approach of pragmatic incrementalism.

IMF Lending, Moral Hazard, and Crisis Management

Most of the recent architecture discussion has unfortunately lost sight of the point that lending by the IMF to nations experiencing

[6] The proposal is presented at more length in de Gregorio et al. (1999).

balance-of-payments difficulties is not solely a question of *crisis* lending and *crisis* management. The original Bretton Woods concept of the IMF was that it would act as a lending intermediary, lending to mitigate payments imbalances in a variety of situations—not merely in times when the payments imbalances blew up into a crisis.

Journalists have now discovered moral hazard, and generalizations are thrown about much too cavalierly about the moral hazard associated with IMF lending. Virtually any IMF stabilization package, under any circumstances, is prone to superficial criticism as a "bailout." Much attention is being paid to how to facilitate orderly workouts for nations that cannot maintain existing contracts to service their debt, and this in turn leads to discussion of "bailing in the private sector."

I wish Eichengreen had better integrated his discussion of crisis lending and crisis management into a larger analysis of IMF lending as a whole. But his positions on the moral hazard associated with crisis lending and on orderly workouts are largely persuasive. And he makes useful suggestions for trying to involve the private sector more, such as by making incremental changes in bond contracts and in case-by-case procedures for concerted lending.

On the particular point about introducing collective-action clauses more widely into bond contracts, I strongly support Eichengreen's admonition that the "official community" (read especially the G-7 varsity team, and most especially the U.S. Treasury) "needs to do more than examine, consider, and encourage." I have not yet heard a convincing argument why the United States and the other G-7 nations cannot show leadership in this area by introducing administrative or legislative changes that would permit the incorporation of such clauses into their own borrowing instruments.

The details in each major creditor nation's situation are different. The United States government borrows in its own currency. It may not be administratively straightforward in the United States to introduce such changes. No doubt voices will argue that the borrowing rate even for the U.S. government might rise by a basis point or two if such changes were made, and no risk whatsoever of this sort should be allowed. And so on. Yet Eichengreen is surely correct that adverse-selection difficulties will inhibit Venezuela or South Africa or India (for example) from introducing such clauses into their bond contracts unless the G-7 nations set a good example and do so themselves. Such changes might yield significant, albeit modest, gains for financial stability in the world as a whole. As the quarterback of the varsity first team, the U.S. Treasury should either put its money where its mouth is on this point or else provide a clear explanation of why it believes that such changes to debt instruments would be adverse if adopted by the United States but would be beneficial if adopted by the JVs and the sandlot teams.

Exchange Regimes and Exchange Rates

Exchange regimes are discussed interminably as part of the architecture debate. This conference is no exception. Here, too, I am dissatisfied with how the conventional wisdom is evolving. So I conclude my discussion with a few telegraphic observations about exchange regimes.

Unfortunately, in my view, the subject of exchange regimes and exchange-rate policies receives disproportionate emphasis. Any type of exchange regime can be hell, if an individual country adopts poor macroeconomic policies and poor prudential-oversight policies. No exchange regime can insulate a nation from large external shocks. When domestic policies are unsound or external shocks are large, a nation can easily get into major trouble, the world capital markets can lose confidence, and the nation can suffer large disruptions to its economy and financial system—no matter what the exchange regime.

To be sure, an especially good way for a nation to get into trouble is to peg its exchange rate when the rate will probably have to be changed. But floating will not prevent trouble if domestic policies are badly out of whack. Despite the yearning for an "optimal" exchange regime, no regime can prove best in all circumstances at all times for all nations. Good exchange rate policy is highly context-dependent. Even for an individual nation, it is probable that no single regime is best in all times and circumstances.

Conventional wisdom in the last several years has gravitated toward the view that the only viable options for a nation are the two extremes—either free floating, or irrevocably fixed pegs via a currency board or actual currency union. This "corner-solution" view, the contention that all intermediate regimes are bound to vanish as unsustainable, is partly due to Eichengreen himself, in his book for the Brookings Integrating National Economies Series (Eichengreen 1994). When I was editing that 1994 book, I tried—unsuccessfully—to get him to back away from the strong line that all intermediate regimes were unsustainable. He has since mellowed. Pragmatic Eichengreen, vintage 1999, seems to me more persuasive than Corner-Solution Eichengreen, vintage 1994.[7]

The sad thing is that, as Eichengreen has rediscovered the middle ground, many others have bought the corner-solution contention. The most recent example I can cite is Jacob Frenkel, in a luncheon talk at a May 1999 IMF conference. Yet the hypothesis that the intermediate middle ground is bound to disappear in the short or medium runs does not rest on sound theoretical foundations.[8] And, again, no exchange rate

[7] Eichengreen's views about exchange regimes are discussed more extensively in his book earlier this year than in the paper for this conference.

[8] See Frankel (1999) for a thoughtful criticism of the corner-solution view.

regime—none—can insulate a country from balance-of-payments crisis and economic disruption if its domestic policies are unsound.

The awkward truth is that the yearning for an ideal set of exchange rate arrangements is misguided. The manner and degree of exchange rate variability are important. But they are not, in themselves, the policy issues of overriding importance for an individual nation, or for the world financial system as a whole.

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