COUNCIL on FOREIGN RELATIONS

The Global Finance Regime

Last Updated: January 23, 2012

This page is part of the multimedia ***Global Governance Monitor*** *from the* ***International Institutions and Global Governance*** *program.*

Scope of the Challenge

For twenty-five years, globalization produced unprecedented levels of both economic growth and economic risk. Financial markets became more open, which allowed firms and governments to invest more freely. But as global finance grew bigger, it also grew more complex. Faster-flowing capital became more volatile, and economic risk became harder to track. Domestic regulators struggled to keep up with evolving financial practices, many of which they did not fully understand. To make matters worse, most national governments refused to cede regulatory authority to a global system, limiting the extent of international oversight over global markets. International cooperation was based on a patchwork of often ad hoc arrangements with limited scope and coercive power. One result was an explosion of systemic banking crises, with more than **120** (PDF) taking place between 1970 and 2007. By the spring of 2008, policymakers who were disheartened by the severe impact of these crises began expressing anxiety about the lack of effective regulation of the global financial system, which former U.S. Treasury Secretary **Lawrence Summers** said had generated "over one major crisis every three years."

The 2008 financial crisis shook the entire system, plunging the world into a devastating recession. Since then, stimulus packages and bailouts have staved off a 1930s-like depression, but the ongoing crisis illustrates the need for a more comprehensive global finance regulatory

Global Governance Monitor

regime. In 2010, the Group of Twenty (G20) and the International Monetary Fund (IMF) agreed on initial steps toward international regulatory reforms and liquidity support but the G20 has not lived up to expectations. Fundamentally, two underlying weaknesses in the international financial regime remain. First, there are too many institutions and mechanisms—often with overlapping mandates but limited power. Second, despite this machinery of cooperation, building critical agreement often proves impossible. When states perceive a conflict with their immediate national interest, they repeatedly disagree on fundamental issues, hindering the prospects for cooperative regulation to truly reform the international system. Further crises loom large on the horizon.

For reforms of the international financial system to be successful, they need to address the weaknesses exposed by the 2008 crisis, and also embrace the new global power structure. In early 2009, U.S. secretary of the treasury Timothy Geithner **called** for a "global framework, a global infrastructure which has appropriate global oversight, so we don't have a Balkanized system at the global level." Such a framework that sets out to reshape the financial system and tame volatility while preserving finance's creative growth, will require consensus among the G20 countries. This promises to be a daunting task considering the group's lack of agreement regarding the root causes of the financial crisis and appropriate responses.

International Financial Architecture: Strengths and Weaknesses

Overall assessment: *Improving, but with hiccups.*

After the global financial system collapsed in 2008, policymakers around the world scrambled to respond. The Group of Twenty (G20) designated itself the world's **premier forum** for economic cooperation, but has not lived up to the initially high expectations. The International Monetary Fund (IMF) was also **retooled** to better reflect shifts in the global economy. Similarly, regulators from twenty-seven countries forged **new rules**, known as Basel III, in an effort to prevent similar crises in the future. But despite these efforts, mitigating financial risk and coordinating global economic policy remains a challenge.

In 1944, world leaders gathered in Bretton Woods, New Hampshire, to craft a global financial regime based on fixed (but, in principle, adjustable) exchange rates. They hoped the regime would provide the financial stability needed to recover from the Great Depression and World War II. But by the 1970s, the postwar setup had become untenable. A key principle of international economics is that countries cannot simultaneously have national policy autonomy, free capital movement, and fixed exchange rates. But surplus countries refused to allow their currencies to appreciate and the United States decided it would rather unhinge the dollar from the gold standard than sacrifice its macroeconomic autonomy. In 1971, the United States allowed the fixed-exchange-rate system to collapse, ushering in a new era of floating exchange rates. This new regime produced tangible benefits, allowing the major economies to combine national policy autonomy with open capital markets. (Emerging economies that valued stability could still peg their currencies to a major currency, though doing so often required large foreign-exchange reserves).

Meanwhile, floating exchange rates stimulated the development of capital markets, opening new opportunities for countries—rich and poor alike—to run large external deficits. In the 1970s, major international banks financed deficits in less-developed countries by recycling petrodollars. In the 1980s, surpluses in Germany and Japan financed the U.S. trade deficit—which rose to the then-high level of three percent of U.S. gross domestic product (GDP).

Even during the last few decades of unprecedented economic growth and globalization, crises periodically interrupted the expansion of global finance, forcing the international community to develop mechanisms that could prevent or mitigate them. The IMF, and more recently the G20, provided a forum for world economic leaders to address global crises. Nevertheless, achieving consensus on effective collective responses has proven an enormous challenge. Essentially, policies to improve the health of the global system are often perceived to threaten some states' short-term interests. Additionally, crisis response is often ad hoc, and the will to make major changes often dissipates once a crisis passes.

For decades, the IMF supplied emergency financing to troubled economies with a primary focus on developing countries, acting as a lender of last resort. In addition to financial assistance in times of crisis, the fund often worked to promote structural adjustment policies designed to reduce the state's economic role and expand free markets. However, with the 2008 global economic recession and subsequent eurozone crisis, the IMF assumed a newly active role in developed economies. In the past three years, the IMF provided loans to Iceland (its first loan to a developed country since the 1970s), Greece, Hungary, Ukraine, Pakistan, Latvia, Romania, Ireland and Portugal.

Even as the IMF became a central figure in crisis response, countries resisted shifting too much power—especially regulatory power—to the fund and similar global institutions. Regulation remained fundamentally national, though occasionally states coordinated their national regulations to avoid a race to the bottom. One such initiative were new regulations proposed by the **Basel Committee on Banking Supervision** in September 2010. Known as Basel III, these regulations were created by the Group of Ten (G10) to stabilize national financial systems in response to the global economic contraction. More often than not, however, advanced economies have not agreed on the right response to crises. Some believe that international institutions need more firepower to help tame global markets. Others worry provisions for crisis insurance would reduce incentives for investors and countries to avoid crises themselves. Some emerging economies, for their part, often trust in national self-help, building up large reserves, and in some cases limiting capital flows, rather than relying on global institutions.

Aside from its inability to prevent financial crises, the global financial regime has also been slow to adjust to tectonic shifts in the international distribution of economic power, particularly with regard to the rise of China, India, and other emerging-market economies (EMEs). In the wake of the 2008 crisis, the G20 emerged as the most promising forum for policy coordination between developed and developing states. Its membership included stalwarts of the Bretton Woods system alongside burgeoning economic heavyweights like China and India. While the G20 produced an initially strong response to the crisis, it has struggled to bolster its initial success with strong implementation and further agreements. Policy disagreements emerged between developed and developing countries, as well as among the major developing economies, which have distinctive interests and outlooks. As a result of these fractures and deep divisions over macroeconomic policy, the G20's 2010 meeting in Seoul failed to produce any major achievements. The United States Federal Reserve's policy of quantitative easing as well as China's currency manipulation, in particular undermined the G20's cooperative agenda. More recently, the eurozone **crisis**, and in particular the financial and political turmoil in Greece and Italy, overshadowed the G20 Summit in Cannes, France.

The World Bank and IMF have also attempted to enhance the role of developing nations in policymaking processes. Both institutions have endorsed voice and quota reforms aimed at increasing the voting power and influence of developing economies, though they are at different stages in the process.

The World Bank, which released an **external review** in October 2009 with proposals for governance reforms, successfully increased voting shares for developing and transition countries across its various groups: The International Bank for Reconstruction and Development (IBRD) increased voting shares by just over three percent, and the International Finance Corporation (IFC) and the International Development Association (IDA) raised voting shares by approximately six percent. These measures were applauded by G20 leaders at the Toronto Summit of June 2010.

In October 2010, G20 finance ministers **agreed** to redistribute executive board seats and quota shares. Advanced European countries also consented to hold **two fewer seats** on the IMF Executive Board, and have until the 2012 annual meetings to implement the change. Yet, the European member nations remain resistant to relinquish their long-held overrepresentation, especially given the effective veto power of the United States over major fund decisions, which require approval by countries representing at least eighty-five percent of IMF shares. (The United States' quota is currently 17.7 percent.)

The quota reallocation shifted six percent of quota shares to developing economies in the International Monetary Fund (IMF). The changes placed China as the third largest shareholder, and pulled India, Russia and Brazil into the ranks of top ten shareholders. However, details of the shifts revealed that much of the quota shares were taken from other developing economies. In fact, the voting share of more traditional advanced economies will only **decrease** 2.6 percent. Thus, although the reform enjoys broad international support, truly proportional representation remains a distant goal.

Coordinating macroeconomic policies and exchange rates: *A weak system since 1973*

One major shortcoming of the global financial architecture is the lack of any robust mechanism to allow the world's economies to coordinate their macroeconomic policies. This gap has become acute in recent years, encouraging massive structural imbalances and leading some to question the future of the dollar as the main global reserve currency. While the global financial crisis encouraged provisional efforts, these have not been institutionalized in an international regime.

During the years of the Bretton Woods system, the dollar's value was linked to gold, and other currencies were pegged to the dollar—providing an international framework for monetary policy. But when Bretton Woods ended in 1973, no mechanism of multilateral coordination emerged to replace it. More recently, the unprecedented buildup of foreign-exchange reserves by emerging-market economies (EMEs) led some countries to declare the emergence of a new Bretton Woods system—or **Bretton Woods 2**—marked by unilateral pegs to the dollar. The currency gap has become particularly acute in recent years, promoting **massive structural imbalances** between surplus and deficit countries. As a result, the United States, as an importer, consistently runs up current account deficits of around $500 billion, while Asian commodity exporters rack up large surpluses. The current account surplus of China alone rose from $20.5 billion in 2000 to more than **$593 billion** in 2011.

The most recent financial crisis fostered unprecedented levels of macroeconomic cooperation among the world's major economies. In the immediate aftermath of the crisis, many countries passed fiscal stimulus packages to foster economic growth. Subsequently, the Group of Twenty (G20) demonstrated its potential as an international focal point for macroeconomic coordination in embracing the **Framework for Strong, Sustainable, and Balanced Growth** (PDF) at its September 2009 summit in Pittsburgh. In adopting the framework, G20 members agreed to undertake close macroeconomic coordination, including of their macroeconomic and fiscal policies; harmonize the national stimulus plans and "exit" strategies; and correct longstanding imbalances between surplus and deficit countries, which had contributed to the crisis. To encourage progress on the framework—and permit G20 members to evaluate one another's progress in achieving their espoused goals—the G20 established the **Mutual Assessment Process** (MAP), in close coordination with the IMF.

Thus far, the first three phases of MAP have been successfully **completed**. Before the June 2010 G20 Summit in Toronto, the IMF aggregated G20 nations economic policies, analyzed barriers to growth, and drafted "alternative policy scenarios" that would lead to further growth. In response, G20 nations launched a second stage of MAP to draft recommendations for international policy coordination, which were agreed upon during phase three in February 2011. The final stage, which began in April 2011, assessed member nations' progress and guided the action plan at the November 2011 Cannes G20 Summit. The resulting **Action Plan for Growth and Jobs** highlighted a growing international consensus toward the importance of tackling international unemployment. Specifically, the plan includes the creation of a G20 task force on employment with a focus on youth employment.

However, **infighting** among European leaders, still struggling to resolve eurozone debt crises, precluded the development of comprehensive solutions to major issues left unresolved at the 2010 Seoul Summit. The **Summit's Final Declaration** (PDF) primarily **rehashed** established consensuses on the problems and vulnerabilities of global markets without substantively addressing them.

Beyond the G20, other international organizations, like the Group of Eight (G8), the United Nations, and regional development banks, provide venues for economic policy coordination. Still other institutions, like the **Organization for Economic Cooperation and Development** (OECD), and the **Bank for International Settlements** (BIS), further cooperative action by providing governments with consultative forums, analytical support and financial guidelines. Through dialogues in the aforementioned organizations, as well as through direct diplomacy, major economic powers have pursued monetary policy coordination. The United States Federal Reserve, Bank of England, European Central Bank, and People's Bank of China implemented a round of coordinated **interest rate cuts** in late 2008, though analysts **doubt** their success in taming investor jitters. In late 2008, the Federal Reserve also **gave** European banks unprecedented access to U.S. dollars to buttress them in case of a bank run.

Yet monetary policy is not only a cooperative tool—it also serves competitive purposes. Facing difficult economic conditions at home, states have used monetary policy to pursue national advantage. Issues of currency valuation have caused **tension** between the United States and China, resulting in entrenched nationalist positions and lost opportunities for further macroeconomic alignment. The controversy has also caused bitterness among emerging economies like China and Brazil—Brazil **accuses** currency manipulators of unfairly redirecting global capital inflows away from its markets. In the G20 and elsewhere, these conflicting interests have become an impediment to meaningful action on financial regulatory reforms.

Discord arises not only from the repercussions of international competition, but also from fundamental disagreement on how to rebalance the system. The United States believes that policy changes in major creditor countries, such as the appreciation of the Chinese yuan, can address the world's imbalances without structural change. Competitors like China, however, advocate for broader changes in the system, including a shift away from dollar reserves. The prolonged debt ceiling debate in the U.S. Congress before the United States reached its ceiling on August 2, 2011, followed by Standard & Poor's downgrade of the U.S. credit rating three days later, heightened U.S.-China discord by putting Chinese holdings of American debt at risk.

Monitoring and regulating financial standards and financial activity: *Insufficient consensus to prevent further global crises*

Another major weakness of the global financial system is the lack of a coherent set of rules for monitoring, regulating, and standardizing financial activities, particularly at the cross-border activities of systematically significant actors. The current system entails an uneven patchwork of oversight efforts and entities, sometimes with overlapping mandates and jurisdictions. As a first step toward tackling this problem, the Basel Committee announced a new set of reforms for the banking sector. Known as Basel III, they aim to create a more coherent regulatory framework by increasing transparency in financial markets, preventing diversion of resources, and tracking excessive risks—with the intension of spotting rotten players (or practices) and quarantining them before they infect the entire system.

Prior to any such regime being installed, however, participants must agree that they want to limit excessive risk-taking in the first place—a difficult precondition to set. One school of thought holds that regulations give investors false comfort and thus leads them to pay too little attention to the risks of lending to a regulated institution. Others argue that regulation introduces distortions that lead to bad investment decisions.

Financial policymakers first realized the need for more transparency and accountability in the mid-1970s. The first international banking crisis of the postwar era prompted the creation of the Basel Committee on Banking Supervision, which was charged with coordinating national banking supervisory policy. In the 1980s, the debt crisis revealed that many large international banks did not have the capital to absorb an outright default on their loans, leading to almost a decade of rescheduling—or revising repayment timeframes—to give the banks time to build up their capital. In an effort to avoid such crises in the future, the Basel Committee adopted common standards for evaluating risk-weighted capital. After the Asian financial crisis, similar attention shifted to improving the quality of bank supervision in emerging economies. In 1997, the Basel Committee released its **Core Principles for Effective Banking Supervision (PDF)** and the IMF, in conjunction with the World Bank, began to systematically assess supervision in its macroeconomic health checks through the **Financial Sector Assessment Program**.

The Basel Committee announced its newest round of banking regulations, Basel III, in September 2010 as a response to the economic crisis. A month later, at the 2010 Seoul Summit, the G20 endorsed the new rules, emphasizing their function in stabilizing market fluctuations and lowering the financial risk and fallout emanating from the failure of large banks. The rules require banks to hold higher levels of tier-one capital and establish counter-cyclical buffers to offset potential fluctuation. Unfortunately, banking regulation moves slowly and Basel III will not go into effect fully until 2019—allowing known systemic risks to go unregulated until then. While important to the global regulatory regime, the sclerotic pace of implementation makes Basel regulations an unwieldy tool for much-needed reform.

Several similar arrangements emerged in the securities, insurance, corporate governance, accounting, and auditing sectors. In addition, the **Joint Forum of Financial Conglomerates** and the **Financial Stability Board** (FSB) promote overall coordination and cooperation by regularly bringing together overseers of the global financial system. Recently, at the Cannes Summit, the G20 **strengthened** the purview of the FSB, giving it legal standing and buttressing its financial institutions. The OECD and the World Bank have also pitched in, leading international discussions on corporate governance standards, insolvency, and bankruptcy.

Nonetheless, obvious flaws remain in the global regulatory structure. Regulation remains overwhelmingly national, and external verification and assessment mechanisms are weak. No organization has the power to enforce compliance with agreed standards, rules, and guidelines—or to sanction countries that fail to live up to global standards. Even recent systemic regulatory measures like the Basel III banking reforms will be subject to national implementation, the extent of which will determine the speed and strength of its entry into force on the international level. The acceptance of global standards will remain subordinate to the perceived competitive edge of national financial sectors.

Additionally, important new financial players have fallen through the cracks. Central banks, finance ministries, and bank regulators, for example, were surprised to discover the extent to which **new actors** in the shadow financial sector—which consists of unregulated special investment vehicles and broker-dealers—had taken on the risks associated with subprime mortgages. There are **increasing** efforts to place these actors under new regulatory mechanisms —including EU **restrictions** on short selling and derivatives as well as laws mandating greater transparency for hedge fund transactions.

Managing financial crises: *Progressing, but overarching concerns remain*

Under the current global financial regime, the world has found itself vulnerable to severe financial crises but unable to manage them successfully. The **International Monetary Fund (IMF)** is ostensibly the premier fire fighter in such circumstances—but despite success in reducing economic tensions during the recent financial crisis, it has often underperformed. And in the absence of a single authority, states have created their own dizzying array of bilateral and multilateral arrangements to help cushion against financial crises, as the eurozone crisis aptly demonstrates.

Excessive volatility in financial flows has become a hallmark of the global economy. In some cases, countries suddenly lose access to market financing and find that they can no longer finance substantial deficits. Likewise, short-term financing for financial institutions can dry up equally fast—be they special-investment vehicles that have to roll over short-term asset-backed commercial paper, U.S. broker-dealers that rely on the repo market to obtain financing from money market funds, or European banks that rely on the wholesale market. At the start of the global economic crisis, the reliance of Iceland's banks on short-term borrowing in foreign currencies sent the country's entire economy into a tailspin once instability began to appear in European markets. And financial contagion affects weak and strong investments alike. Losses in one portion of a portfolio may prompt a leveraged institution to sell other assets, pushing the price of healthy assets down. Once investors begin confusing sound investments with unsound ones, financial institutions can lose confidence in one another.

The IMF is the principle institution for managing financial crises. The IMF took on some of the functions of lender of last resort when currency crises swept the developing world in the 1990s. It created two emergency credit facilities, the **Supplemental Reserve Facility of 1997**, and the **Contingent Credit Lines of 1999** to facilitate faster financing for countries judged to already have relatively sound policies.

When developed nations required assistance during the most recent financial crisis, the IMF was able to draw upon past experience. As with the developing world's currency crises in the 1990s, the IMF created the **Short-Term Liquidity Facility of 2008** to more rapidly inject capital into relatively stable financial systems. Again, in 2010, the IMF and the European Central Bank **approved** a package of $930 billion to provide stability to eurozone countries. In December 2011, the eurozone again **sought** IMF assistance to craft a new massive bailout fund of $260 billion, but when Britain refused to contribute, the combined IMF-EU bailout fund only set aside $200 billion.

The IMF issues its loans with a variety of conditions, which often impose painful fiscal austerity on crisis-battered societies. While many in the developing world have long regarded the IMF as a tool for developed nations to control developing nations, the fund's eurozone bailouts have generated resentment in Europe, too. In fact, portions of European publics have begun to demonize the IMF for its strict austerity demands. Furthermore, IMF critics still question the discretionary nature of its interventions; the institution lacks clear standards for determining how much financing countries should receive. Some economists even argue that the existence of the IMF prompts governments and investors to pursue reckless policies because they know they can receive IMF loans if their investments fall through. Unlike domestic lenders of last resort, IMF lending capacity is limited by donor contributions contingent on internal voting processes and the feasibility of issuing new Special Drawing Rights (SDRs). As one expert **notes**, "Neither the IMF nor the Bank of International Settlements nor any other international organization has the authority to create and extinguish reserve money."

Past concerns with the IMF prompted a slew of new bilateral, regional, and multilateral institutions—including the Brady Bonds, the Chiang Mai Initiative, and the European Central Bank—all aiming to supply a troubled country with the foreign exchange currency it needs in a crisis. In the European case, a multinational currency—the euro—and its accompanying policy infrastructure enabled the EU to oversee regional crisis management. European bailouts, however, have repeatedly been bolstered by IMF contributions. Indeed, efforts to manage crises without the IMF never fully succeeded. For example, expectations that debt will be restructured or rescheduled can prompt investors to pull money out quickly at the first hint of trouble. Likewise, efforts to restructure sovereign bonds would still not stop domestic or cross-border bank runs. IMF loans thus remain an essential tool, as evidenced by its important role in the latest crisis: the IMF provided traditional conditional loans to Iceland (its first loan to a developed country since the 1970s), as well as to Greece, Hungary, Ukraine, Pakistan, Latvia, Romania, Ireland and Portugal.

To quell fears that the post-2008 wave of lending would exhaust the IMF's resources, the G20 and a few emerging market economies agreed to expand the **New Arrangements to Borrow**, providing the IMF with up to $500 billion in supplementary financing in March 2011. The IMF's members also authorized a Special Drawing Rights allocation, which expanded the IMF's global pool of reserves by giving each member additional reserves in proportion to their contribution to the IMF. While these capital infusions were supposed to increase IMF resources to $1 trillion, the IMF's spending on eurozone bailouts, as well as countries' failure to match rhetorical commitments with cash, have caused the IMF to **fall short** of that target.

Supporting Development: *Some progress, but still starving for aid*

A final shortcoming of the current global architecture is the disproportionate effect financial crises have on developing countries. Poor countries are notoriously vulnerable to negative spillover effects that culminate in rampant poverty, mass unemployment, and food shortages. Over the years, multilateral development agencies and the IMF have refashioned their policies to more effectively support financial sector stability and growth, and to encourage financial activity through incentive programs. However, the demand for aid in developing countries remains real.

Multilateral efforts to address the needs of the developing world extend back to 1945, when the architects of the Bretton Woods system created the World Bank to support postwar reconstruction. Many capital controls were dismantled, and private capital markets emerged as an alternative source of long-term financing. But countries with rudimentary financial and banking infrastructure or unstable governments still struggled to attract private investment on any but the most onerous terms. Concerns that development failure might spill into neighboring economies created a demand for multilateral development support. The World Bank increasingly focused on helping the world's poorest economies, and in 1960, it set up its **International Development Association**, or so-called soft loan window.

Today, the World Bank continues to make loans to middle-income countries with access (in good times) to private markets. These loans are priced commercially so they provide the World Bank with a profit, part of which is used to subsidize concessional assistance to poorer countries. In addition to being a financial intermediary, the World Bank has become a knowledge intermediary: it disseminates lessons learned from its experience of maintaining programs in dozens of countries. Regional development banks have sprung up with similar objectives.

Bilateral official development assistance (ODA) from donor countries has helped support development goals in poor countries. However, too often bilateral ODA **suffers** from a lack of harmonization and host country-ownership. Despite boosting funding levels in recent years, the increased number of actors involved—from donor states to nongovernmental organizations and philanthropic foundations—has muddled the arena of development operations. Additionally, weak capacity and corruption in recipient states leads to ineffective implementation and squandered resources. With all those involved and less than transparent circumstances on the ground, accounting for actual progress made also remains a challenge.

In recent years, the developing world gained yet another source of financing: government-backed firms from Europe, the Middle East, and Asia. Such investment, together with renewed private investment in mines and oil fields driven by high commodity prices, pushed investments and loans to Africa from **$9 billion in 2000 to $62 billion in 2008**. Such investors often offered governments an opportunity to sidestep the transparency requirements, performance monitoring, and governance rules attached to loans from development banks or Western ministries.

The financial crisis of 2008 left poor countries in particularly desperate need of funds to counter a slump in foreign direct investment, remittances, and rising commodity prices. Despite fiscal concerns at home, industrialized countries provided **$129 billion** dollars worth of official development assistance in 2010—the highest level to date—according to the Organization of Economic Cooperation and Development. The G20 also formally introduced development as a key issue to its agenda in November 2011 (which only the Group of Eight had formally included on its agenda previously). Consequently, the final communiqué agreed not to tax or restrict food destined for the United Nations World Food Program, established a task force to address youth unemployment, and enumerated steps to increase agricultural output.

Still, the efforts fall short of fulfilling commitments outlined at the **2005 World Summit**. In many cases, domestic policies in low- and middle-income countries need to become more **countercyclical and targeted** to address systemic vulnerabilities in financial markets. Development banks and the IMF will inevitably play a critical role to keep these economies from sinking as the global financial crisis continues.

U.S. Financial Policy Issues

The United States has been a champion of free markets, the architect of the Bretton Woods system, and home to one of the world's leading financial capitals. Despite evolving from the world's leading lender to the world's largest borrower, the United States has been the major promoter of a liberalized global financial system. Many therefore saw the United States as the major culprit of the 2008 financial crisis (though others blamed the crisis on global sources).

The collapse of previously reputable financial institutions tarnished the reputation of the United States. Chinese Premier Wen Jiabao blamed Wall Street's "**blind pursuit of profit**" for undermining the global economy, and French President Nicolas Sarkozy called on the United States to **overhaul** its financial system. Russian Prime Minister Vladimir Putin even called for an end to overreliance on the "**dangerous**" dollar.

In response, the Obama administration urged more rigorous global financial regulation, and pushed for a global fiscal stimulus to prevent the United States from being the sole engine of global demand. It also called for a dramatic expansion of the International Monetary Fund (IMF), and encouraged China to allow its currency to appreciate. Meanwhile, the U.S. Federal Reserve has pursued a policy of quantitative easing, wherein the bank pumped **$900 billion** into the U.S. economy during the first three quarters of 2011. The most recent round of quantitative easing, known as "QE2", followed the Fed's initial injection of **$1 trillion** into the economy in 2009. Though intended as stimulus, quantitative easing has drawn sharp **criticism** internationally from developing states like China, South Africa, and Brazil, as well as G8 countries Germany and Russia. Skeptics contend that U.S. quantitative easing could destabilize the global economy. Some foreign critics have even called it a currency war tactic. Quantitative easing also troubles holders of U.S. securities; releasing new money into the economy may lead to inflation, which could erode the value of American debt. U.S. Federal Reserve Chairman Ben Bernanke dismissed these criticisms as "**overstated**," defending quantitative easing as a domestically driven policy without inflationary risks.

Does global finance need sweeping regulation?

Yes: Crises arise, in part, due to a lack of regulatory oversight in markets. To prevent their occurrence, the world needs to devise and implement a set of monitoring and enforcement guidelines. After the financial crisis hit in 2008, the Financial Stability Forum—now the Financial Stability Board (FSB)—produced a **blueprint** (PDF) for global reform. In June 2010, leaders from the Group of Twenty (G20) **pledged** to pursue a "better regulated" financial system based on four pillars: (1) a strong regulatory framework; (2) effective supervision; (3) addressing the systemic problems involving important ally institutions; and (4) transparent international assessment and peer review. The FSB is monitoring implementation of G20 recommendations for increasing financial stability and **assesses** (PDF) that efforts are progressing. In September 2010, financial authorities from twenty-seven countries also **forged** new rules known as Basel III to require larger holdings of low-risk capital reserves, thereby reducing systemic risk. However, individual nations are responsible for implementation, and spotty compliance points to the inadequacy of currency regulations. Most recently, at the November 2011 Cannes G20 Summit, little progress was made to boost compliance with Basel III regulations.

No: Few **question** the need for reform, but some caution against going too far. Excessive restrictions and government interference might slow economic recovery by suffocating creative market dynamism. If the government's hand reaches too deep, politicians and policymakers may be tempted to use regulations to pursue their own agendas, creating dangerous distortions in resource allocation. In sum, these critics argue that the painful recession should not make us forget the remarkable results of the past twenty-five years. Stifling financial innovation would be even **more costly** than the financial crisis. **Others argue** that instead of regulating too-big-to-fail institutions, the system needs to be made safe for failure—allowing markets rather than regulators to discipline financial institutions. Still others worry that reforms may concentrate too much power in the hands of a few regulators, such as the Federal Reserve, without eliminating the risk of regulatory capture. Moreover, adding new mandates to existing institutions could draw energy and attention away from traditional duties. These voices consequently favor limiting the Fed's regulatory responsibilities.

Should regulation come through a new global architecture?

Yes: Despite calls from **some analysts**, who argued as early as 1984 that global financial markets could not self-sustain in the long term, proponents have only now begun to rally support for a truly global financial governance regime. European leaders have been particularly vocal, with then European central bank president Jean-Claude Trichet, urging increased vigilance and a three-pronged approach based on "macroeconomic discipline, monetary discipline, [and] market discipline." The deep impact of the 2008 financial crisis has persuaded some economists and policymakers to favor a comprehensive financial architecture that looks not only at banks and coordinating macroeconomic policies, but also at the shadow financial market, including enhanced regulation and transparency of investment banks and derivatives. **Other analysts** have added to the plea by pointing out that the current financial system is too big to be rescued by one national government, and needs a more robust governance body to offer viable rescue packages.

No: Critics of a new Bretton Woods approach believe that the ills of global finance can in large part be cured at home. National policies, they argue, will do more to address the key problem of excessive bank leverage than new global rules. "It's worth remembering that after the last global crisis in 1997-98, there was lots of grand talk about a new international financial architecture," Sebastian Mallaby **writes**, but in the end, "the only important reforms were national ones." Looking at the aftermath of the Asian financial crisis, the *Economist* **argues** that huge foreign reserves, flexible exchange rates, and stronger banking systems proved more powerful than international initiatives in spurring economic recovery. Others, such as former U.S. treasury secretary Henry Paulson, **believe** that new, intrusive international rules will not only be useless, but also damaging, because they will inevitably rely on a one-size-fits-all approach. Moreover, a final group argues that, regardless of whether a theoretical global system would work, it will never see the light of day because countries will simply refuse to turn over real power to international regulators.

Should there be more support for global rebalancing?

Yes: Many analysts agree that a root cause of the latest financial crisis has been the global imbalances that have been accruing since the 1990s. As current account discrepancies between exporting and importing countries grow larger, the need for rebalancing solutions becomes more imperative. Supporters of global rebalancing efforts feel that larger structural changes need to occur to correct these imbalances. Surplus countries, particularly China and Germany, need to save less and stimulate domestic demand, and the United States must save more and increase the role of exports in its economy. The trend of global trade balance corrections since 2008 relied on unsustainable large fiscal stimuli and has already reversed.

No: Critics contend that a global correction is already under way. The 2008 financial crisis has driven global demand lower, **contributing** to a decline in the U.S. trade deficit, a higher savings rate among U.S. households, and a correction in the U.S. exchange rate. Moreover, if countries were to pursue coordinated policies to tackle global imbalances, the question of who would be tasked with spearheading these efforts remains unanswered. The Group of Twenty (G20) has not adequately **addressed concerns**, and the recent summit in Cannes, France represents a continued **failure** in these efforts. Some also believe that the informal institution may also be too big to prescribe consensus-based global rebalancing policies. A smaller grouping—such as a G4, representing the European Union, United States, China, and Japan—might be most practical, although agreements would still have to be reached on measures and how to implement them.

Does the world need a new global reserve currency?

Yes: Many countries—particularly creditors like China that hold vast dollar reserves—believe that there is too much reliance on the dollar. Proponents argue that the existing dollar reserve system is slowly eroding as countries with large dollar reserves witness diminishing real values in their U.S. bond holdings without any control over the dollar's volatility. Overreliance on a few currencies makes the financial systems less stable and increases the likelihood of inflation. An **international reserve currency** with a stable value would promote economic stability. Russia and China have both proposed using the IMF's special drawing rights (SDRs) as the new global currency. World Bank President Robert Zoellick suggested in 2010 that economies should take on a **modified gold standard** to protect against currency inflation.

No: According to the United States, national reserve currencies and the absence of a global reserve currency are not the problem. The problem is that some countries want to maintain undervalued exchange rates to support their export sectors. This leads to a buildup of foreign exchange reserves and contributes to global imbalances. The problem thus lies not with the reserve currency, but with policy choices.

Recent Developments

Troubled euro recovery negotiations

Eurozone leaders continue to **debate** how to jumpstart recovery throughout the eurozone. Angela Merkel and Nicholas Sarkozy, leaders of the eurozone's biggest economies, have pledged to defend the union, and in December 2011, **spearheaded** a historic new fiscal union. The plan aimed to inspire investor confidence, spur growth, and reassure populaces of wealthier nations that they would not be required to bankroll fiscal instability of the eurozone's weaker members. The agreement would introduce a European Stability Mechanism in June 2012 to function as a permanent rescue mechanism, and would impose a limit on government deficits and penalize governments that exceed maximum deficit levels. However, Britain rejected the plan, forcing the other twenty-six EU states to create a separate accord without it. The lack of unanimity complicates prospects for institutional reforms and **stokes** fears that the eurozone will splinter.

Previously, the eurozone nations have struck a series of compromises that their leaders hoped would stem the crisis. During the summer of 2011, European leaders consented that the European Financial Stability Facility (EFSF) could purchase states' debt and recapitalize insolvent banks to rescue failing economies. Then, in early October, the governments of all seventeen eurozone member states **approved** the expansion of the EFSF. Weeks later, eurozone leaders agreed that private banks would write off 50 percent of their returns on Greek debt, and passed requirements for European banks to raise €100 billion to cushion against government defaults. At the same time, they created a special mechanism to expand the EFSF, through collecting funds from emerging economies like China and Brazil. Nonetheless, in January 2012, the ratings agency Standard and Poor's **downgraded** the EFSF, cut the French and Austrian rating to AA+ from the coveted AAA, and slashed Italy, Spain, and Portugal's debt rating by two notches.

G20 Cannes Summit

The November 2011 Summit of the Group of Twenty (G20) in Cannes, France disappointed those hoping that leaders would strike major agreements to balance international trade and tame risks of global finance. Domestic political turmoil in eurozone nations undercut the twenty nations' efforts to address major items on the agenda. Greece's former prime minister, George Papandreou, suddenly announced a referendum on the long-awaited eurozone deal of October 27, 2011, and subsequently retracted the planned referendum following intense international backlash. Additionally, doubts over Italy's financial stability further complicated G20 negotiations.

Nevertheless, leaders **did** **retool** the Financial Stability Board (FSB) as well as pledge support for strengthening the World Trade Organization (WTO) to improve transparency and enhance its dispute settlement mechanism, officially add development to the G20 agenda and **reaffirm** support for implementation of the Basel III finance regulations.

Annual World Bank & IMF meetings

Much of the conversation at the annual meetings of the World Bank and International Monetary Fund in September 2011 centered around the sovereign debt crisis in the eurozone, which threatens the future of the common currency and the stability of the global financial system. European Union officials **discussed** expanding the rescue fund of the European Union, potentially to five times its current size. Greek finance minister Evangelos Venizelos also met with the managing director of the International Monetary Fund (IMF), Christine Lagarde, to steady the downward spiral of the Greek economy as the IMF provides emergency funds. Russia also tried to spearhead an agreement among the BRICS (Brazil, Russia, India, China and South Africa) to pledge support for Europe, but the group was unable to achieve consensus.

Additionally, the World Bank **launched** its most extensive analysis to date of gender issues and their role in global poverty alleviation. The report, entitled *World Development Report 2012: Gender and Development*, called attention to the issue, but the implementation plan is still in its "**infancy**."

United States credit rating downgrade

The United States reached its $14.3 trillion debt ceiling in May 2011. After months of partisan haggling, in August 2011, the United States Congress **approved** a bill to raise the U.S. debt ceiling to allow the United States to continue borrowing through 2013, and to reduce future deficits by as much as $241 trillion. Ratings agency Standard and Poor's expressed concern that the bill would not reduce the nation's debt by $4 trillion over the next ten years, and cut the U.S. credit rating from AAA to AA+, marking the first U.S. downgrade in history. Markets plummeted in the following days, and reached their lowest point since the onset of the financial crisis in 2008, though they recovered in late 2011.

S&P continues to have a **"negative"** outlook on the financial situation in the United States. A bipartisan Congressional commission was tasked with drafting budget cuts by November 23, 2011, but concluded two days before its deadline that it would "not be possible to make any bipartisan agreement." Their failure set in motion a **timetable** for cuts that would begin in January 2013, which includes $500 billion in cuts to the U.S. defense budget, though budget negotiations are likely to decrease the required cuts.

G8 meets in Deauville

After the G8 seemed to be **replaced** by the G20 in the wake of the 2008 financial crisis, heads of state from the group of eight nations (G8) decided to meet again in May 2011, demonstrating the continued utility of a meeting restricted (with the anomaly of Russia) to "like-minded" Western democracies. The final communiqué by the leaders of Canada, France, Germany, Italy, Japan, Russia, the United States, and the United Kingdom included a forceful declaration on the Arab Spring, and pledges of **twenty billion** to support two nations in transition, Tunisia and Egypt. In September 2011, G8 finance ministers promised an additional **$38 billion** to Tunisia, Egypt, Morocco and Jordan.

Options for Strengthening the Regime

The 2007-2009 economic crisis, followed by the sovereign debt traumas in Europe, has triggered a variety of operational and normative challenges in both finance and economics. The United States and other major economies are being pressured to find effective strategies that remedy financial instability, through both measures at home and international cooperation. Strengthening multilateral mechanisms remains the foundation for responding to financial crises, but importance must also be placed on coordination of domestic policies, particularly among the top twenty industrialized nations. These recommendations reflect the views of **Stewart M. Patrick**, director of the program on international institutions and global governance.

In the near term, the United States and its partners should pursue the following initiatives to ensure the global recovery is a success:

Revitalize G20 action on global economic imbalances

During the April 14-15, 2011 Group of Twenty (G20) meeting of finance ministers and bank governors in Washington, DC, the group **agreed** (PDF) on a two step process to reduce persistently large imbalances between countries with current-account surpluses (notably China) and those with deficits (notably the United States). The plan also charged the International Monetary Fund with identifying factors that drive countries to accumulate massive surpluses or deficits. However, building unanimous consensus on the outcome of these independent assessments is notoriously **difficult**. The risk is that national politicians will despair of a multilateral solution and will resort to unilateral sanctions, as suggested by a bill in the U.S. Congress that would punish China for alleged currency manipulation. Because unilateral measures could result in retaliation and escalation, the United States and its partners must display leadership by affirmatively supporting the G20 process. Both China and the United States recognize that it is in their own interest to address imbalances, so an international understanding about benchmarks of progress should not be impossible.

Unfortunately, at the G20 Cannes Summit, leaders made hardly any progress on these issues due to heightened tension over the eurozone.

Stemming liquidity crises

The United States should support France's **proposal** to bolster the IMF's role in helping countries respond to liquidity crises. Stronger IMF responses to liquidity crises would decrease the motivation for vulnerable countries to stockpile excessive reserves as a precaution in case of a sudden capital outflow. An increasing number of emerging economies are practicing precautionary reserve accumulation—which **contributes** to macroeconomic imbalances and mispricing of financial risks. As the U.S. dollar is the currency of stockpiled reserves, widespread reserve accumulation drives up the value of the dollar, widening the U.S. current-account deficit. A larger IMF, and one that stood ready to lend rapidly and without excessive conditions, would reduce the incentive to unilateral reserve accumulation: collective insurance would displace individual insurance.

Implement IMF governance reform

Leaders at the 2010 G20 Seoul summit agreed to increase the voting shares of emerging economies at the International Monetary Fund (IMF) by six percent, and give more seats to developing countries on the IMF Executive Board. The IMF board of governors **agreed** to these reforms in December 2010, but the timeframe for actual implementation is slated for October 2012. By this date, countries should ratify the changes in their domestic processes, to ensure a smooth and quick adoption of the proposed reforms for the 2012 deadline.

An additional challenge will be negotiations within Europe to decide which European nations will give up seats on the executive board to allow for emerging economies. Ever since the proposal of sweeping governance reforms, progress toward adoption has been slow—and it follows that, despite these promises, that will continue to be the norm. The United States needs to continue to pressure its partners in the G20—especially those European countries hesitant to acquiesce—toward implementing these and future reforms. A timely increase in the voting shares of emerging economies will reinforce the sense of ownership that these countries feel toward the IMF. That, in turn, should encourage them to have faith in the IMF's ability to provide liquidity in a crisis, and should dampen the temptation to unilateral reserve accumulation.

Resolving the European debt crisis

Resolving the European debt crisis will be important for curbing fears of **contagion** across the eurozone and reinvigorating a sustainable global economic recovery. Although France and Germany have demonstrated greater leadership in late 2011, it remains to be seen whether the political **collaboration** of Merkel and Sarkozy will be enough to pull the region out of the crisis.

Since early 2010, when Greece received its first bailout package, the lack of coordination within the eurozone has resulted in a series of policy shifts that have damaged market confidence. While Europe's leaders created a new regional bailout fund, the European Financial Stability Facility (EFSF), they acknowledged that it was too small to do its job. The upshot will be that Europe acquires new regional institutions, including centralized financial regulation for the eurozone and some version of an enhanced EFSF. The question is whether these reforms will be put in place in time to calm skeptical markets. At an October 2011 meeting, leaders agreed to leverage new funds for the EFSF of up to 1 trillion euros, but could not agree on how to cobble together such a large sum. Indeed, leaders' statements implied a hope that the Brazil, Russia, India, China (BRIC) bloc of rising powers would provide a significant portion of the budget, but of the BRICs, only Russia later **suggested** that it might contribute twenty billion dollars to the eurozone through the IMF.

At another round of negotiations in December 2011 that sought to provide the IMF with funds to bail out troubled European economies, European nations pledged €150 billion, but fell short of their €200 billion ($260 billion) goal as Britain refused to donate.

Improve regulatory standards to mitigate financial risks

Experts and policymakers have placed much of the blame for the financial crisis on weak regulatory standards and inadequate supervision of sophisticated financial activities. Although progress has been made, particularly through the creation of the Financial Stability Oversight Council in the United States and the European Systemic Risk Board in Europe, the complexity and integrated nature of modern finance continues to pose unprecedented challenges. Responding to the crisis, the Financial Stability Board (FSB), formerly the Financial Stability Forum, has **provided** (PDF) a set of proposals to "restore confidence in the soundness of markets and institutions." Though the 2011 G20 Cannes Summit endowed the FSB with a "legal personality," its recommendations remain advisory, and have no legally binding enforcement mechanism.

Beyond the aforementioned near-term steps, the United States should consider another set of important proposals:

Implement Basel III regulations

The recently released Basel III regulations require banks to hold higher levels of tier-one capital and develop countercyclical buffers to cushion against future financial turbulence. Implementation of the reforms requires national supervision and the willingness of individual financial institutions to adhere to the new standards. The established time frame for banks to meet requirements, on some measures lasting until 2019, means that there will be plenty of opportunities for global progress on Basel III to slow or falter. The IMF has recently **criticized** the European Commission's efforts to implement Basel III regulations as "too weak" and "a disappointment." In addition, the approaches to national enforcement may be altered by local political and economic concerns, leading to an **inconsistent** application between countries over that period. To some extent, differences in implementation may be justified: It is reasonable for Switzerland or Britain, whose banks are extremely large relative to gross domestic product, to demand especially thick precautionary capital buffers, whereas Germany or the United States, where banks are relatively smaller, may reasonably be less demanding. But it is vital that legitimate differences in implementation of capital and regulatory standards do not open the way for a regulatory race to the bottom.

Finance the developing world

The economic recession that followed the global financial crisis had a serious effect on developing countries. Export demand collapsed, commodity prices fell, and the flow of both remittances and private capital shrank. The World Bank estimates that in the first year of the crisis alone, 130 to 155 million people fell into extreme poverty. The period 2009-2011 saw a sharp rebound for emerging economies, especially commodity exporters that took advantage of resurgent prices and red-hot demand in China. But the extremes of the recent cycle demonstrate the value of public-sector development banks that can lend in a countercyclical fashion. Thus, in addition to commitments to the IMF, the United States and its industrialized partners should commit to multilateral financing for development banks and reject protectionist measures in international trade.