

# What Have We Learned in the Past 50 Years about the International Financial Architecture?

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It is a great honour to be invited to give the luncheon address at this Symposium to mark the 50<sup>th</sup> Anniversary of the Reserve Bank of Australia. The Reserve Bank has played a major, and very positive, role in the economic life of Australia in the past half century. Over the years, it has been fortunate in attracting to its staff a highly competent and dedicated group of public servants. It has been my privilege to have known many of them, and even to have met the legendary 'Nugget' Coombs, the first Governor. Hence, it is a pleasure, as well as an honour, to join Glenn Stevens, his colleagues and predecessors in marking the Reserve Bank's first 50 years.

My topic today is the international financial architecture – how it has operated and evolved over the 50 years of the Reserve Bank's existence, and what we have learned. In reviewing this half century of experience, I hope to draw some of the lessons about the strengths and weaknesses of different arrangements. These lessons will be important as we approach the task of reforming international finance in the wake of the current crisis.

To begin with, however, I should start by defining terms. To my knowledge, there is no comprehensive and generally accepted definition of the 'international financial architecture', despite the frequency with which the term has been used over the past 10 years or so. I will take it to encompass three interrelated elements: first, the basic economic model that governs cross-border monetary and financial relations; second, the institutional structure that exists to manage and, where necessary, adapt these relations; and third, the distribution of decision-making authority in international institutions (their 'governance'). All three of these elements have evolved enormously over the past 50 years, and are changing further as the lessons of the current crisis are absorbed.

The Reserve Bank of Australia came into existence in the heyday of the Bretton Woods system. The Bretton Woods arrangements were noteworthy in several respects. Most strikingly, they represented the first attempt to create a planned international monetary order, subject to agreed and enforceable rules of behaviour by all participating countries. They were a key part of the post-World War II international settlement, which was consciously designed to avoid the political and economic failures that had followed the 1919 Treaty of Versailles.

In the economic sphere, these failures had included the lack of any plan for post war reconstruction; the spread of protectionism during the Great Depression; and the beggar-thy-neighbour payment and exchange rate policies of the 1930s. The political consequence of these economic failures was the rise of totalitarianism and eventually another disastrous war.

To prevent a repetition of such consequences following 1945, the Bretton Woods architecture envisaged a new model of international economic cooperation, and created new institutions to oversee its functioning.

The World Bank was to provide a source of financing for reconstruction and development. The General Agreement on Tariffs and Trade created a framework for liberalising trade. And the International Monetary Fund (IMF) established rules for a managed international monetary system. Given the focus of this Symposium, I will direct my remarks today principally towards the monetary and financial architecture, and how it has evolved and changed over time.

The Articles of Agreement of the IMF were a remarkably comprehensive blueprint for the operation of the international monetary system. They covered all the key elements of financial relations among countries: the exchange rate regime; payments arrangements; the adjustment process; and the management of international liquidity.

The exchange rate regime was based on fixed but adjustable rates. This was thought to provide the right balance between the excessive rigidity of the gold standard, and the quasi-anarchy of the floating rates of the 1930s. Payments restrictions on current account transactions were to be gradually eliminated over time. International liquidity would be based on gold, supplemented by US dollar balances and conditional liquidity in the form of drawing rights at the IMF. Balance of payments adjustment would be managed through domestic fiscal and monetary policies.

To oversee this system, the IMF was given powers to grant or withhold approval of exchange rate changes, to review payments restrictions, to lend to countries experiencing payments problems, and to assess the operation of the international adjustment process. This was, in the words of Padoa-Schioppa and Saccomanni (1994), a 'government-led' system. The basic design of the system was established by an intergovernmental treaty, the key decisions in its operation were made by governments, and its management was overseen by an international organisation.

In 1960, as the Reserve Bank came into existence, there was reason for satisfaction with the way in which this government-led system was operating. High levels of employment had been sustained; trade and output had grown rapidly; exchange rates had been stable, with occasional adjustments; exchange restrictions had been dramatically reduced; and neither deflation nor inflation had proved to be a serious problem.

From an institutional standpoint, the IMF was the acknowledged focus of international financial cooperation. The distribution of decision-making authority within the Fund was broadly accepted. Two aspects of the governance of the IMF were important in its success. First, voting power was distributed broadly in relation to economic weight, albeit through a complex formula. Second, decisions by the IMF Board were invariably reached by consensus, which encouraged a collegial and inclusive approach to decision-making. Another element making for success was the tradition of a highly competent and non-political staff. All these factors should be accounted important lessons learned in the early days of the Bretton Woods system, whose relevance, I believe, endures to the present day.

The success of the Bretton Woods system at the time the Reserve Bank was founded was not to last, however. As the 1960s wore on, a number of weaknesses in the Bretton Woods system became apparent. Paradoxically, these weaknesses were revealed by the very success of the

system in facilitating the cross-border liberalisation of financial markets and in promoting the rapid growth of trade and output. In fact, the system made remarkably little provision for the integration of global capital markets.

The growing mobility of capital exposed a central flaw in the fixed-but-adjustable exchange rate model. If a country's exchange rate became a candidate for devaluation, it created incentives for speculators to bet against it. The prescribed remedy in the Bretton Woods system was to use monetary and fiscal measures to redirect resources to the current account of the balance of payments, while protecting the exchange rate through market intervention and the judicious use of capital controls. This prescription became increasingly difficult to use, however. It took time for monetary and fiscal measures to work, during which unemployment had to be endured. The financial resources available to bridge the period while adjustment was taking effect were strictly limited. And exchange controls proved leaky in a liberalised financial system.

Moreover, the adjustment process, in practice, operated asymmetrically. Keynes had already foreseen this when the Bretton Woods treaty came into force. Deficit countries were obliged to adjust by a loss of reserves. But surplus countries could run surpluses and accumulate reserves more or less indefinitely. The mechanism in the IMF Articles of Agreement that was designed to put pressure on surplus countries, the Scarce Currency clause, was never invoked.

Liquidity arrangements, too, came under pressure. The quantity of gold was more or less fixed, so that primary international liquidity became smaller and smaller relative to world trade and output. For a time, liquidity could be enhanced by the accumulation of US dollar balances, but this was only a temporary solution. President de Gaulle objected to the 'exorbitant privilege' this arrangement conferred on the United States, while Robert Triffin pointed out that the growing share of US dollars in reserves cast doubt on their convertibility into gold. Borrowing rights at the IMF were not seen as a satisfactory substitute for owned liquidity, since they could not be counted on under all circumstances.

As is well known, the internal contradictions in the Bretton Woods system led to its demise in the early 1970s. I would draw three central lessons from this experience. First, a system designed by intergovernmental decision-making is unlikely to envisage the ways in which markets will evolve in practice. The development of new financial market instruments and the liberalisation of capital flows combined to make a government-led system untenable. A resilient system needs to have the flexibility to adapt to market developments.

A second key lesson is that powerful countries will not abide by rules that they do not perceive to be in their national interest. In the late 1960s, the rules of the game were telling the United States that it should restrain domestic demand. But the escalation of the Vietnam War and the implementation of the Great Society were pushing in the opposite direction. Similarly, the Bretton Woods rules suggested that Germany should allow demand to expand, but public opinion was demanding vigilance against inflation. To be successful, an international financial architecture has to harness, not run counter to, perceived national interests.

A third lesson, particularly relevant in present circumstances, is that asymmetrical obligations on countries will eventually lead to unsustainable outcomes. Simple economics tells us that exchange rates are multi-sided, and that global balance of payments positions have to sum to zero. If pressures to devalue and revalue are not broadly symmetric, unsustainable financial

imbalances will arise. The need for symmetry goes to the heart, not only of the design of the monetary system, but also to the institutional structure by which it is managed and to the powers exercised by the various players in the system. I will return to this theme later in my remarks.

First, however, I turn to the architecture that emerged in the post-Bretton Woods era, which for convenience I will take to run from the mid 1970s up to the early years of the present century. This was a time during which there was a growing belief that market forces were the best basis for the allocation of resources. In particular, open, international financial markets were viewed as beneficial for the efficient mobilisation of saving and distribution of investment. Free capital mobility could complement free trade in maximising the growth of output and trade. A corollary to this belief was that governments should not attempt to control market outcomes. They should rather focus on facilitating the operation of market forces and, where necessary, dealing with sources of market failure.

Consider how this set of underlying beliefs about markets maps into the key features of the international monetary system that I described earlier. First, exchange rates should not be arbitrarily determined by governments but should be allowed to find their own equilibrium. Second, currency convertibility should be assured by the access of the private sector to a free foreign exchange market. Third, the adjustment process should work through the incentives created by the price mechanism, without attempts to target particular components of the balance of payments, such as the current account. And fourth, liquidity can emerge as a result of the working of open capital markets.

But there is more. In contrast to Bretton Woods, which had implicitly assumed financial markets that were national and relatively closed to international influences, the system of the latter years of the 20<sup>th</sup> century celebrated the openness and global orientation of both markets and institutions.

Of course, such a pure 'market-led' system did not emerge immediately, nor did it ever apply in its full sense, or in all countries. Many governments, especially in the emerging world, maintained fixed, or at least managed, exchange rates. Among industrial countries, members of the European Community sought to protect themselves against the disruptive effects of uncontrolled exchange rate movements within the European single market. But to a remarkable extent, a market-driven international monetary system, at least among the major countries and economic blocs, became accepted as both inevitable and desirable. Even among those countries that maintained managed exchange rates, the 'Washington Consensus' emphasised movement towards freer financial markets. This was interpreted by many to embrace the liberalisation of international, as well as domestic, capital markets.

The market orientation of the basic model of national and international economic management had important implications for the institutional arrangements for international economic cooperation. In relative terms, the role of the IMF became less central, since it no longer had the function of coordinating exchange rate and adjustment decisions taken by governments. The Fund became an institution whose major tasks were to lend to developing countries in financial difficulties, to develop standards of financial transparency and to provide periodic assessments of member countries' economic policies.

By contrast, an increasing role in economic management was played by those agencies that regulated markets, such as central banks and supervisory authorities. To provide a basis for the international coordination of these bodies, various existing groupings were strengthened and new mechanisms were established. Noteworthy in this regard was the enhanced role of the Bank for International Settlements (BIS) and the various semi-autonomous committees established under its auspices, such as the Basel Committee on Banking Supervision, the Committee on the Global Financial System, and the Committee on Payment and Settlement Systems. Also of growing significance were other bodies of regulators and standard setters, such as the International Organization of Securities Commissions (IOSCO) and International Accounting Standards Board.

There were also important implications for the distribution of power in the post-Bretton Woods era. The end of fixed rates deprived the system of an important fulcrum for the assessment of countries' policies. Yet it was clear that economic policy interactions continued to be important. To fill the vacuum, the major countries began having regular informal meetings to discuss these interactions.

The process began in the mid 1970s, with meetings of the Finance Ministers of the United States, France, Germany and the United Kingdom. The group soon expanded to include Japan, and was quickly broadened to include central bank Governors as well. However, ministries of finance generally remained in control of the group's agenda. Subsequently, Italy and Canada were invited to participate, and the resulting body endured for some 20 years as the G7.

The G5/G7 began life with a focus on issues among its members, such as their exchange rate relationships. Landmark agreements on exchange rate relationships were reached at the Plaza and Louvre meetings. Over time, however, the G7 expanded its area of interest to become an informal and self-appointed 'directorate' for the management of the international monetary system more broadly.

As a result of all this, without much planning or forethought, the institutional architecture of the global monetary system was transformed. Key aspects of macroeconomic management passed largely into the hands of the G7, while the increasingly important area of market oversight became subject to many different sources of authority, most of them loosely under the umbrella of the G10 Governors in Basel. With the benefit of hindsight, these unplanned arrangements had both strengths and weaknesses, which provide lessons for how the system of the future might be managed.

On the positive side, four aspects are worthy of note. First, the emergence of the G7 process engaged the major countries directly in the management of the system, something that might not have happened if the IMF alone had been the focus of cooperation. Second, the network of market committees at the BIS had greater flexibility to adapt to changing circumstances. They generally accepted the evolution of financial markets without attempting to place them within a specific 'model' of international cooperation. Third, the new bodies stressed regular meetings of principals, that is, those responsible for decision-making in their respective countries. Fourth, the predominant form of cooperation was information exchange, with limited attempts at coordinated decision-making. This facilitated confidence-building and avoided some of the

problems that would have come with attempts to force countries to follow policies dictated by formal rules.

But the proliferation of international groupings and the concentration of power in the hands of smaller groups also had major drawbacks. There was a lack of overall vision as to how the system should be managed, and where threats to stability might arise. Coordination among the various groupings was lacking and the one organisation that could have supplied coordination, the IMF, was frozen out of a number of key aspects of decision-making. Lastly, the new arrangements lacked representativeness. The G7 was particularly exclusive. But the Basel-based committees were hardly less so, dependent as they were on the G10 membership that formed the core of the BIS Board. Given the speed with which emerging markets were growing, especially after about 1990, the exclusion of major national players outside the industrial world was increasingly anomalous.

Some efforts were made to deal with these shortcomings, though evidently not enough to avoid the financial meltdown that began in 2007. Beginning in the mid 1990s, the BIS took steps to broaden its membership to include the major emerging markets. Periodic meetings were arranged between central bank Governors and other regulators to try and improve coordination. After the Asian financial crisis, the G7 set up the Financial Stability Forum (FSF) as a body to bring together central banks, regulators and finance ministries to monitor the health of national and international financial systems. At the same time, the G-20 was established to provide a forum in which Finance Ministers and central bank Governors from all systemically important countries could regularly review economic and financial issues.

In the end, despite these modifications, the market-based international financial architecture was found wanting. Most obviously, it failed spectacularly to prevent the current financial crisis.

Several lessons flow from this failure. First, an international system that is based on market forces managed only through 'light touch' regulation is inadequate to prevent the emergence of unsustainable financial imbalances. Second, an institutional architecture in which responsibility for systemic oversight is shared among multiple authorities needs more effective coordination than happened in practice. And third, the exclusion of key countries or bodies from the process of decision-making undermines its effectiveness and legitimacy.

These lessons need to be borne in mind as we contemplate the task of reforming the international financial architecture, the topic to which I now turn. I will cover, in turn, the basic model of international finance, the institutional structure for the global financial system and the distribution of decision-making power.

Concerning the basic model for cross-border financial activity, it is hard to deny that the way in which the market-based system operated 'failed' in some important ways. In particular, a lightly regulated global financial market resulted in excessive and unrecognised risks that ultimately exacted a heavy price in unemployment and lost output.

But this does not mean that we would do better to substitute governmental decision-making for market forces. The history of government failure is just as long as that of market failure. What has been demonstrated by recent events is not that the market should be abandoned as an organising principle for economic relations, but that the scope for market failure is wider than

previously supposed. Reforms therefore need to deal with these sources of market failure, not to attempt to suppress market forces.

At the macro level, the model of cross-border financial relations should continue to be based on open trade and capital markets, which will almost certainly entail flexible exchange rates. But there needs to be a more effective way of ensuring that exchange rates reflect fundamental forces, and that neither deficit nor surplus countries can prevent the adjustment process from working. For certain countries, particularly emerging markets, there may be a case for managing capital mobility and exchange rates, so as to avoid procyclical market tendencies. But this needs to be done sparingly and transparently. Above all, there needs to be an accepted international process for assessing the suitability of the exchange rates that emerge from the combination of market forces and government management.

At the micro level, it has been amply demonstrated that inadequate risk management has the capacity to generate systemic crises. Reforms are needed to both reduce the likelihood of failures of key institutions and markets, and to limit the costs if institutional failures nevertheless occur. The focus should be to protect the basis on which financial markets function, not to preserve specific market players. In my view, it could be a distraction from this goal to attempt to prescribe business models on the basis of supervisory convenience. This would be an interference with the market's role in judging the business models that best meet customers' needs. Even more importantly, it would risk unintended consequences as markets responded to new incentives and business shifted to less-regulated channels. Equally, it would be undesirable to try to roll back the forces of globalisation. Financial firms have global reach for many of the same reasons that non-financial corporations do. There would be significant costs in trying to restrict them to national boundaries just because it was convenient from a supervisory standpoint.

A better approach, in my view, is to work on mechanisms to internalise risk, such as minimum capital and liquidity requirements, and to allow failing firms to go out of business with appropriate losses to shareholders, management and unsecured creditors. Doing so would do much to limit moral hazard concerns, while still leaving in place suitable incentives for innovation and business efficiency. Innovation and globalisation have brought benefits across the board, both in the financial and non-financial realm. It is better to address any negative consequences of these head-on, rather than to try to turn back the tide of history.

What of the institutional infrastructure needed to manage a system in which market forces remain predominant, but are subject to more effective regulation and supervision than in the past? For reasons I gave earlier, I think the model in which a substantial management role is played by bodies in which top-level national officials meet regularly carries considerable advantages. But steps need to be taken to make the coordination of these various bodies more effective.

The recent enhancement of the G-20 process, and the transformation of the FSF into the Financial Stability Board (FSB) should be regarded as positive in this connection. The G-20 itself is much more representative of the world financial community than its predecessor, the G7. The same can be said for the FSB by comparison with the FSF. Both the FSB and its member groupings, such as the Basel Committee, IOSCO and the International Association of Insurance Supervisors have been enlarged to have broadly the same membership as the G-20.

With its enhanced legitimacy, the FSB thus has the capacity to develop into a genuine overseer of global financial stability and an effective coordinator of the activities of other bodies. Indeed, US Treasury Secretary Geithner has labeled the FSB the 'fourth pillar' of the international system, alongside the IMF, World Bank and World Trade Organization.

A strength of the FSB and its member groupings is that it brings together the principal decision-makers in member countries. Much of the work of developing recommendations is undertaken by member authorities, with the permanent FSB staff playing a facilitating and drafting role. In my experience, international cooperation works better if member countries are directly involved in key policy decisions, rather than being invited to approve proposals generated by an international staff, however competent.

Even so, there are aspects of the emerging arrangements that warrant careful consideration. Let me end by touching on some concerns and open issues.

First, although the G-20 process is much more representative and legitimate than the previous G7, it is still not universal. Second, although the FSB has been given numerous important tasks, and has a formal 'Charter', it does not embody an institutional 'vision' of what the international financial architecture should comprise. Nor does it yet have effective mechanisms to ensure that member countries do not bypass it in favour of national initiatives. Third, there remains a disturbing lack of clarity in the relationship between the FSB and the G-20, on the one hand, and the IMF, on the other. And fourth, the international adjustment process is still characterised by significant asymmetry. How could these shortcomings be addressed?

The G-20 and the FSB could enhance their legitimacy by involving non-member countries more formally in their discussions. As envisaged in the FSB Charter, but not really implemented, there could be regular 'outreach' activities, in which non-member countries could express views before decisions are made by the more limited group of large countries.

To clarify its role, the FSB could develop the 'medium- and long-term strategic plans, principles, standards and guidance', referred to in its Charter, so as to provide a more comprehensive description of the desired international financial architecture. To put it another way, we know what the FSB exists to *prevent*, that is, financial instability, but we do not fully understand what it exists to *promote*, which is presumably a competitive and efficient, as well as a stable, system. More work needs to be done to ensure the FSB continues to be an effective forum after the current crisis is past. This will inevitably raise the question of its legal standing and decision-making authority.

Developing an overall vision for the FSB should help in the third potential problem, that of clarifying its relationship with the IMF. In this connection, a useful distinction can be drawn between the international *monetary* system, which is the responsibility of the IMF, and the international *financial* system, which could become the area of focus of the FSB. The international monetary system includes aspects such as the exchange rate regime, international liquidity and the adjustment process – all macroeconomic issues. The international financial system covers features such as capital mobility, the oversight of financial markets and financial market institutions, and arrangements for the coordination of regulatory and supervisory policies. Little has been done over the years to develop a 'Bretton Woods' for the financial system. Perhaps, with the creation of the FSB, it is time to try and fill this gap.



Finally, one of the thorniest issues of international economic cooperation is how to restore more symmetry to the international adjustment process and to prevent the dangerous prolongation of unsustainable financial imbalances. This task is clearly that of the IMF, and to the extent that the G-20 is involved, it should be to encourage the IMF to play its natural role. Under the auspices of the IMF, special consultations among key players have taken place, with some useful results in clarifying issues. But clearly more is needed. Bearing in mind the lesson from Bretton Woods that countries cannot be forced to adopt policies when they do not want to, an enhanced effort is needed to demonstrate the ultimate negative consequences of unsustainable policies, and to seek mutually acceptable solutions. For example, if payments imbalances have emerged because countries want to hold higher owned reserves, then SDR allocations need to be considered.

Major countries have all expressed the intention to allow the IMF to act as an impartial assessor of members' policies. Where these policies are found to be contrary to national and international stability, the IMF should be empowered to use its moral authority to publicise such lapses. This could then form a basis for domestic pressure within the countries concerned and peer pressure from without. Nobody should be under the illusion that peer pressure alone would do the trick, but at least it would be a start.

In conclusion, let me emphasise that a new comprehensive international financial order, similar in breadth and ambition to the Bretton Woods system, is not a realistic possibility in our pluralistic world. But this does not mean that we cannot make meaningful improvements to our international architecture to reflect the lessons we have learned over the years. What is needed is neither a reversion to the 'business as usual' of before the crisis, nor an atavistic yearning for a world uncomplicated by financial globalisation. It requires thoughtful assessment of what made the financial system so brittle and solutions that preserve its contribution to global welfare, while improving its resilience to market shocks. Admittedly this will not be easy, but to shirk the task would be to give up on our ability to learn from a half century of experience.

## Reference

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