WP-2009-004

Global Financial Architecture:
past and present arguments, advice, action

Ashima Goyal

Indira Gandhi Institute of Development Research, Mumbai
June 2009
http://www.igidr.ac.in/pdf/publication/WP-2009-004.pdf

Global Financial Architecture:
past and present arguments, advice, action

Ashima Goyal*

June 8, 2009

Professor
Indira Gandhi Institute of Development Research
Gen. Vaidya Marg, Santosh Nagar,
Goregaon (E), Mumbai-400 065
ashima @ igidr.ac.in
Tel.: +91-22-28416524 Fax: +91-22-28402752
http://www.igidr.ac.in/~ashima

Abstract

In the context of the formation of G-20, the paper points out the absence of reform in the global financial architecture (GFA) after the East Asian crisis, and assesses factors that can improve the chances of real reform this time. A factual assessment of various causes advanced for the global crisis, puts the main responsibility on lax regulation. Liquidity created by current account imbalances was tiny compared to endogenous amplification of liquidity in the financial sector. Emerging markets needed reserves as self-insurance in the face of volatile cross border flows. Even so global imbalances increase risk. The paper summarizes the Chimerica debate and the blocks that have stalled progress in resolving the issue. It argues that symmetric and balanced reform, at individual country and international level, is required to remove the blocks. Deeper governance reforms will make it feasible. Potential contributions of the G-20 are outlined. It is argued that India is a useful example of flexible but managed exchange rates that allowed market deepening and export growth.

JEL codes: F02, F32, F33
Key words: Global Financial architecture, Crisis, G-20, Imbalances, Over-saving

* This is a revised version of a paper presented at the June 1, 2009 NCAER-CEPR, conference on "India in the G-20: Macroeconomic Policy Coordination, Regulation and Global Governance", New Delhi. I thank Shashank Bhide for the invitation and for comments, the discussants of the paper Subir Gokarn and Stijn Claessens, and other participants for very useful comments and discussions, Shruti Tripathi for research and Reshma Aguiar for secretarial assistance.

Global Financial Architecture:
past and present arguments, advice, action

Ashima Goyal

Introduction

As our hopes for substantial reform now rest on the G-20 it is sobering to remember that a G-20 plus (G22, 1998) was set up after the East Asian crisis also. A large number of reform proposals were floated then for the Global Financial Architecture (GFA) but only one was implemented—a dilution of the collective action clause in international debt contracts so as to allow restructuring of debt even if a minority of creditors were unwilling.

In contrast, despite the damage they had suffered in the crisis, Asian countries were willing reformers. They wanted to do whatever was necessary to participate fully in globalization, which had given them real gains. But while willing to adopt the best standards in transparency and in legal and regulatory reform, they wanted more transparency for others also in the global financial system. In view of the role of lax developed country regulation in the current crisis, the paragraph below is interesting:

> Recipient countries, however, would like similar requirements imposed on hedge funds, and stricter surveillance not only for emerging markets, but also for developed countries and offshore financial centers. Large investors should make their movements public. Korean President Kim Dae-jung (2000) proposed that a hedge fund monitoring channel be established at an appropriate multilateral institution, since ready exchange of information on the investment activities of highly leveraged financial institutions (including investment banks) would contribute to the stability of international financial markets. Current scrutiny and surveillance are not adequate because regulatory structures have lagged behind the increasing sophistication of financial instruments. Regulators have to find innovative ways to make institutions and markets reveal more information (Goyal 2002, pp. 187)

Implementing Kim Dae-jung's and other such requests for improved regulation would have saved the world, and financial entities, much damage. Many of the latter would still be around[1]. Tirole (2002) remarked that if the many potential crises solutions, such as bail-in, standstill, that impose minimal costs, have never been applied it must be for deeper political reasons. These have to be countered for reform to be possible.

In the absence of meaningful reform in the GFA, and given dangers from volatile and poorly regulated capital flows, Asian countries were forced to go in for self-insurance through reserve accumulation, and for mutual aid through central bank swap arrangements and reserve pooling such as the Chang Mai initiative. These policies have helped them survive the current crisis without major damage to their currencies or financial sectors. So global imbalances are a direct result of the failure of reform.

The structure of the paper is as follows: Section II provides a factual assessment of different causes advanced for the global crisis. Section III summarizes the Chimerica debate on global imbalances, and Section IV assesses the blocks that have stalled progress in resolving the issue. Section V analyzes the reform required to remove the blocks and the deeper governance reforms that will make it feasible. Section VI presents potential contributions of the G-20 and more specifically of India before Section VII concludes.

Causes of the Current Crisis

But there is a view that blames the crisis on these global imbalances, despite clear evidence of the overwhelming role played by lax regulation and excessive leverage.

Global imbalances

Portes (2009) writes that huge cross-border financial flows due to major saving-investment imbalances put stresses on financial intermediation that even sophisticated markets could not cope with. Caballero and Krishnamurthy (2009) argue that the large demand for safe US securities—treasuries—to park reserves in, forced US financial institutions to leverage and increase their holdings of risky assets. In effect they held the toxic waste generated to satisfy world demand for riskless assets. The argument is

[1] According to Hedge Fund Research 1,471 hedge funds, nearly 15 percent of the industry, had to close in 2008.

incomplete however because there is no regulatory threshold on the leverage ratio. Without that it is not possible to discriminate between the hypothesis that an unregulated bubble developed, and that of financial stretch to absorb riskless assets. Moreover, the reason central banks buy dollar securities is that US financial markets are so deep and liquid that their purchases do not disturb markets. There were no signs of stretch in US government securities markets themselves[2]. They absorbed inflows many magnitudes higher than reserves as funds returned to the US, after the Lehman Brothers crash.

Numbers (some of them reported in Goyal 2009), help to put these arguments in perspective. Notional amounts outstanding in derivatives grew from $100 trillion in 2002 to $516 in April 2007 (BIS, 2008). Since 2000 the market for mortgage-backed securities exceeded that for US treasury notes and bonds. The 33 percent compound annual rate of growth in derivatives occurred just over the period regulations were relaxed for investment banks. In 2004 the US securities regulator (SEC), relaxed the net capital rule or ceiling of twelve times capital on borrowing for investment banks. They were allowed to use their own models to determine risk. As a result leverage shot up; when Lehman Brothers was allowed to fail its leverage was 30:1 compared to 15:1 for a commercial bank.

Compared to this growth in derivatives, both the net ownership of US assets by foreigners and reserves were trivial. The former grew by about $1.5 trillion in the period. Asian reserves were less than $3 trillion, while the US current account deficit grew from $200 to $700 billion. These numbers should not disturb a well-regulated, deep and liquid financial system. Internally generated liquidity dwarfed any external source.

Asian oversaving

Among other causes of the crisis, US monetary accommodation that kept short rates very low for extended periods is said to have encouraged excessive risk-taking[3]. But

[2] Imbalances were widely expected to create a currency crisis—but the crisis originated in US sub-prime loans. So the need to prove that the cause of the crisis was actually as predicted may be a motivator of this research.

[3] Monetary policy is a blunt instrument to act against an asset bubble, and the direct instrument of prudential regulation is available. Taylor (2009) argues that US policy rates were cut in 2003 more than

the US monetary establishment again seeks to deflect responsibility to Asia. Bernanke (2005) made a famous assertion that Asian over-saving kept long rates low, not US monetary policy. But Taylor (2009) points out that this cannot be correct. Global savings were actually at a historical low in this period, so high savings could not be responsible for low global interest rates. US dissaving overcompensated for Asian saving. The volatility of capital flows indicates they were investment not savings driven.

Table: Chinese Reserves and Savings of US Households

	US Personal		Chinese (in billion USD)	
	Savings Ratio	**Savings (in billion USD)**	**Reserves**	**Investment in US treasuries**
1984	11.2	1259.2	17.4	
1994	5.3	997.8	52.9	
1999	2.5	634.2	157.7	54.6*
2003	2.4	699.5	408.2	135.8
2005	0.5	129.8	821	243.1
2008	1.8	770.6	1946.7	767.9

Note: *gives the figure for M1(January) 2000, in the column other figures are for M1, except M6 for 2008
Source: USA department of Commerce, Bureau of economic analysis; IFS; US department of the Treasury

Indeed Krugman (2009) argues Reagan-era legislation in the early eighties removed New Deal restrictions on mortgage lending requiring families to put a significant down payment for a home. This started the decline in US savings. Tax incentives and wealth effects from the real estate bubble the regulatory regime encouraged accelerated the fall. The Table shows a steady fall in the US savings ratio from the peak level in 1984. The ratio and absolute level of savings had already fallen substantially before Chinese investment in US treasuries reached a critical mass. Until 2008, the Chinese investment was too low even to compensate for the large fall in US savings, let alone lower long-term interest rates. After peaking in July 2008, Chinese investment in US treasuries began to decline. US monetary policy certainly had no need to reduce US interest rates and savings to accommodate Chinese demand for US assets.

required by the prevailing inflation and output slack, in order to compensate for the bursting tech bubble. But this stoked a real estate bubble. Handling bubbles through monetary policy alone can be dangerous.

US broad money supply growth averaged about $15 trillion with an annual growth rate of about 6 percent, nowhere near the growth in derivatives. Modern financial markets have large powers to endogenously create liquidity, and a strong motive to do so in good times. Lax regulation magnifies this many times.

Private foreign inflows to emerging markets fell in the period following the East Asian crisis, but more than doubled to an annual average of about $ 200 billion over 2003-06. They peaked at 617.5 billion in 2007[4]. US policy interest rates had been held at 1 percent over June 2003 to June 2004, and were raised after that. So if low US interest rates were driving the flows they should have been highest in 2003-04 not in 2007, when the federal fund rate peaked at 5.25 percent. Leverage enhanced flows in response to profit opportunities.

Even if the reserve imbalances were the tail wagging the dog, they were required as self-insurance in response to the excess leverage and resulting capital inflow volatility. It follows the ultimate causal factor was the excess leverage. The tail is weak in real terms also. The 2009 World Development Report (World Bank) shows Asian relative per capita incomes. Compared to US GDP per capita of USD 46,850, Chinese was 2360 and Indian 950. Growth rates may be high but they are from a very low base. It is unseemly for an elephant to seek to pass responsibility to an ant.

Contrasting Positions: the Chimerica Debate

Since the US and China are the countries with the largest imbalances, there is a long running debate between them. Each emphasizes different factors as responsible for imbalances. The US points to the Chinese exchange rate peg to the dollar, while China points to large US fiscal deficits, and more recently to the dollar's position as the international reserve currency. The US downplays the cheap imports for its consumers, and China downplays the contribution of US deficits to Chinese export demand.

[4]Private Capital Flows include direct investment, portfolio investment, and other long- and short-term investment flows. The figures are calculated from data available at http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/tables.pdf

Exchange rates

The US is keen to force more flexibility in the Chinese exchange rate regime. Appreciation of the Chinese currency is seen as essential for correction of current account imbalances. And if imbalances are responsible for the collapse of the global financial system it follows they must be corrected. But many European countries did not run a capital account deficit (Mohan, 2009). Since the Chinese currency was fixed to the dollar, as the dollar depreciated against the Euro, so did the Renminbi. So if exchange rates drive the current account, imbalances with China should have been largest for Europe.

Extreme views would force an appreciation of Asian exchange rates relative to the dollar large enough to compensate for lower Asian wages (Woolfolk 2004). But there are limits to the appreciation of exchange rates in populous countries. Appreciation requires a rise in real wages, which cannot occur unless surplus labour is absorbed or average productivity rises. Without that wages and prices could be bid down to convert a nominal depreciation into a real depreciation. If wages tend to be downward rigid unemployment would rise. It follows exchange rates cannot bear the entire burden of adjustment. Part of the adjustment has to come from rising domestic absorption in Asia and reducing fiscal deficits and consumer demand in the US.

Even so, Asia’s keenness to modernize and develop deeper financial markets is pushing it towards more flexible exchange rate regimes. And the severe blow to export demand will push these countries to turn more to stimulating domestic demand. As the Indian case has shown, some flexibility of exchange rates develops markets, and is feasible even without full currency convertibility. But a full float has to await fully developed markets and reforms in the GFA to mitigate excessive volatility of capital flows. A full float was adopted in mature economies after crossing a threshold of development, not before. Even a full float, however, will not produce sufficient real appreciation to compensate for lower Asian wages.

Therefore adjustment has to be gradual. During this period an attack on the dollar is not certain but it is possible. A unique Nash equilibrium requires a collective action failure where all Asian countries sell their reserves. This is unlikely. Goyal (2005) shows there are multiple Nash equilibria with attack and hold both as possible

outcomes. A coordination failure could result in an attack on the dollar. Since the probability of an attack rises under faster dollar depreciation, the current strengthening of the dollar makes an attack less likely. The US rapid policy action and deep tax base are all strengthening the dollar compared to the Euro, once regarded as a possible rival, and there is no other immediate rival for the dollar. European countries are themselves in trouble. While the crisis requires an immediate fiscal-monetary stimulus, in which the US has led the way, focusing on imbalances would demand a long-term contraction in countries with large deficits.

The international reserve currency

The Iraq War has contributed to rising US fiscal deficits. Since the USD is the reserve currency, whenever the US has been subject to macroeconomic shocks, the world has been forced to share the costs of adjustment. Thus large US deficits during the Vietnam War led to dollars held abroad exceeding gold stocks. Fear of an attack on the dollar led to Nixon's unilateral abrogation of gold standard. The world's willingness to hold dollars has encouraged the US to live beyond its means, stoking future crises.

A solution would be to develop an international reserve currency. But China's raising of this issue is regarded as threatening. If investment in US securities indeed generates toxic wastes, why do they want to hold on to it? Revealed preference implies a net gain for the US from the dollar as the reserve currency[5].

The US needs capital now, but in the long run, encouraging genuine reform of the financial system and the development of an international reserve currency should be in its enlightened self-interest. The first would reduce the need for reserve accumulation for self-insurance; the second ensure reserves are not all held in dollar securities. The US can move to a current account surplus since it would no longer have to supply the world with dollars.

[5] One of Hillary Clinton's first acts as a newly appointed secretary of state was to visit to China in 2009. There was no mention of the Chinese exchange rate, but a request for the Chinese to continue to hold 'secure' US treasuries.

Such a change could only occur in the very long term after supporting market and payment institutions are developed. For example, for Central Banks to be willing to hold the SDR, markets with liquidity rivaling the dollar must be created in SDR denominated assets, and the IMF must be empowered to maintain liquidity in SDRs, without waiting for permission from 85 percent of its members, thus becoming a true International Lender of Last Resort (ILOLR). But given that markets are currently locked into the dollar, which has a first mover advantage, it will require sustained effort and be a long time before such rival depth is created. But a beginning can be made by facilitating the holding of some reserves in SDRs, which are safer since they are based on a weighted average of currencies.

China has begun moving from long-term to short-term US securities to safeguard the value of its holdings against future US inflation raising long rates. It has also begun bilateral deals with its trading partners to use the Renminbi rather than the dollar. The US should also initiate proactive adjustment to reduce its double deficit vulnerabilities and reassure its investors, while maintaining dialogue to ensure adjustment remains gradual.

Motivated Misperceptions

It is unclear whether these contrasting positions are due to *cognitive dissonance* or to a *bargaining* stance. *Blaming* the other can arise from either. It is easier to force the one whose guilt is established to take remedial action, helping a bargaining position. But since people tend to see their own losses and the gains others have made, they do not easily accept blame. These psychological traps have vitiated any progress on resolving global imbalances. China and the US have long indulged in a mutual blame game. The US debate focused on competition for its industry more than on benefits from cheap imports; China neglected the demand US deficits created for its exports (Goyal 2005).

Reasoned analysis can help mitigate cognitive dissonance; but it has a chance only if bargaining power is even. The absence of the latter created political blocks so serious reforms in the GFA were not undertaken after the Asian crisis. Since rational creditors would have gained from changes in the GFA that could have reduced the probability of a crisis they should have been willing to adopt them. But cognitive dissonance

made them more concerned about the loss itself than the reduction in its probability, so that they did not minimize the expected value of crises losses. Moreover, the higher bargaining clout of investing nations meant policy makers followed creditors' preferences and pushed to protect them in the event of a crisis rather than to reducing the probability of crisis (Goyal, 2002).

Dissolving the political blocks

Financial markets are subject to boom and bust cycles, but a pro-market stance enhanced this procyclicality. The system of bonuses, accounting, funding, securitization and risk management based on market prices all encouraged risk-taking. Why was there such extreme cognitive dissonance about potential risk? Partly it was an extreme swing away from government intervention and towards markets. Warning voices were shot down. Regulators were regarded as people who do not understand markets and tend to blindly forbid activities. Everyone bought into wrong, market based models for risk assessment and diversification. Partly it was that the US comparative advantage was largely in finance and US greater power, forced support for finance driven growth. US business profits coming from the financial sector rose from less than 16 percent over 1973-85 to reach 30 percent in the 90s and peaked at 41 percent in the 2000s (Johnson, 2009).

Therefore current US initiatives in energy, education, infrastructure promise well for a more sustainable growth path. The previous US administration had a reputation for not listening to disinterested domestic advisors or to foreign opinion. The current administration, in a promising start, wants to lead by listening. More balanced global power so that financial interests are not predominant will also insure listening. Balance of power prevents extreme views from dominating. More attention paid to a diversity of views would be good for the international financial system. It could even benefit creditors. For example, Indian financial regulation had many anti-cyclical features that the US would have done well to emulate.

Even so, a reaction against markets should be avoided now. Progress has to be spiral; circular swings are not progress. Regulation should remove the features that encourage pro-cyclicality of markets while preserving their energy and innovation.

There is no shortage of reform ideas, but a better power balance, with a broader representation of interests, will aid implementation.

Emerging market economies (EMEs) have also suffered from the export slowdown and capital outflows post crisis and are keen to see the global revival essential for mutual prosperity. Self-insurance has not been complete; it can be done more efficiently. Reforms of the GFA and deepening of domestic financial markets would reduce the costs of global integration for EMEs. These costs include sudden stops in inflows and widening of spreads on foreign currency loans. Lane (2009) makes the point that developing domestic markets for laying-off currency risk can encourage international loans in domestic currency, decreasing the impact of currency fluctuation on balance sheets of and credit availability for domestic firms.

While blame and pushing leads to *resistance*, real dialogue is possible to discover robust solutions. Communication and explicit coordination is necessary also to preempt the scenario where one country sells its dollar reserves because it fears the other might do so. Thus discussion can also mitigate *fear* or tendency to expect the worst, which can worsen biases and prevent a reasoned approach to an acceptable solution. Discussion becomes necessary to resolve issues, as bargaining power becomes more even. Moreover, reforms in standards and tax regimes have to be at a global level. An individual country tightening on its own would be subject to capital flight. Therefore discussion needs to be institutionalized in permanent expansion of the G-7.

Global Governance and Reform

But just forming the G-20 is not enough. More even power has to percolate through the system. There have to be real changes in the governance of the IMF and other international institutions, away from the current Western dominance in a structure frozen as it was set post-World War II. Political oversight is excessive. The membership of the Bank of International Settlement (BIS), and the Financial Stability Board (FSB), has been made more representative but pressure has to be kept up for more inclusive global governance more generally. The G-20 has come up with a comprehensive list of reforms. But most of these rely on the IMF-WB to oversee or implement. Therefore reform of those institutions must come first. Otherwise the list

will remain the wish list produced after the East Asian crisis, as financial interests regroup and persuade. Even now the US has not been able to restructure banks and penalize managements, which is essential for effective resolution of a financial crisis.

Suggestions made to reform the International Monetary Fund (IMF) after the Asian crisis are still pending. Creditor interests wanted it to focus narrowly on providing IIOLR services with strict pre-conditionality. This would require giving the IMF power to create resources much as a central bank can, but with backing from world governments. Debtor countries, however, suffering from incorrect advice and delayed funding, wanted an expanded scope to be accompanied by change in the governance structure to reflect current world economic strengths. Moreover, they wanted quicker response and more sensitivity to the needs of poor debtor countries, where financial interests may not have a large stake. They favoured ex-post conditionality: rewarding countries following better policy with better terms to create ownership of reform and incentives to implement them. Criticism of IMF functioning led to a demand for the creation of an Asian Monetary Fund, which was shot down on the grounds that it would lead to a dilution of conditionality.

But stonewalling of reform after the East Asian crisis resulted in many emerging market initiatives that have improved the bargaining power of this block, as has the post-crisis weakness of mature economies. It is beginning to be recognized that credible insurance mechanisms are required for countries to reduce reserve accumulation. Suggested reform of the IMF now favours a flexible and fast-disbursing facility with little or no conditionality for countries adversely affected by global shocks. Since March 2009 the IMF has made a new flexible credit line (FCL) available, without strings attached, to countries with a track record of sound macroeconomic policies and institutions. This has actually been used, unlike earlier facilities, since the stigma attached is low.

The IMF has been talking of moving to true multilateralism, rather than just giving a larger share in governance to emerging market powers. But to move from the G-7 to G-150 is a sure recipe for paralysis of an institution, or to allow continued domination of the small group currently in power. Moreover, expansion of resources to service its new facilities will require large contributions from the reserve holding countries—and

power must have some relationship to ability to bear responsibility, with balancing of bilateral positions from adequate representation of different regions, and of financial interests with broader tax payer and consumer interests. Governance design must be linked to function.

Large inflows from MNC banks have reversed so East Europe needs resources. Since it is Western European banks that are in trouble there, perhaps Europe can be made to realize that reducing its current overrepresentation will make more resources available with the IMF to lend to it. Tying the reform to removing the current US veto would make it even more acceptable to Europe.

India and the G-20

What is India's potential position and contribution in this debate? India has a flexible exchange rate, and while intervention has resulted in reserve accumulation, the latter has clearly been driven by volatile inflows since the country normally has a current account deficit, despite healthy export growth.

It has been only indirectly affected by the crisis through fall in trade, inflows to stock markets, and foreign financing for firms. Its cautious stand on inflows, with a preference for equity over debt inflows, has helped to limit the impact of the crisis. Its conservative regulatory stance has also paid off. It has benefited, however, from the liberalization process and market development and is committed to it.

Its stance is agreement with the emphasis on stronger regulation, eliminating tax havens, maintaining trade, transparency, global standards, and funds for emerging markets to fight a crisis not of their making, reached at the G-20 meets.

From the EME perspective, areas of special concern are making the globe safer for EMEs to engage with; GFA reforms to reduce inflow volatility; alternatives for self-insurance; for example, an emerging market fund to stabilize EM bond price or spread index;

funds for infrastructure spending in EMEs to help revive global demand, and contribute to development.

The G-20 (2009) report on regulation has come out with 25 recommendations concerning a national focus on financial stability, oversight of all systematically important institutions, countercyclical macro prudential norms, comprehensive international standards to be applied consistent with the national context, and micro-conduct regulation to improve incentives for financial stability. Since there are regulatory limitations, improving these incentives is most important. Also prompt corrective action can be mandated based on well-defined financial, prudential parameters[6].

While the relevant national authorities are to implement, the monitoring responsibility is largely on the IMF-WB, except for the last category. Therefore a possible concern is whether implementation and monitoring would be effective without governance changes. In the past surveillance and oversight of developed countries has been weak. A quick possible reform is to make IMF expert reports and warnings independent of board approvals. Another concern is the continuing Chimerica stalemate on global imbalances. Can the deadlocked dialogue be made effective?

Since India is not directly involved it could work towards resolutions that improve global stability such as more exchange rate flexibility for China and a long-term reduction in twin deficits for the US. The Indian example demonstrates some flexibility in exchange rates and gradual capital account convertibility is compatible with export growth and market development. In recent high-level Chimerica meetings the US had not talked of exchange rates and China has agreed that an expansion of US deficits is required at the current juncture. An external push may help ensure adjustment does take place.

Pressures for asymmetric adjustment have to be resisted, however. After the East Asian crisis EMEs reformed, but developed countries did not. Nor was the GFA modified. Today there are pressures for EMEs to allow currency appreciation to correct global imbalances, and to stimulate domestic demand, while developed countries are to be excused from reducing deficits since they have to fight the crisis. Unless their massive liquidity expansion is withdrawn along with revival it could

[6] India's banking regulator, the Reserve Bank, has instituted this since 2002.

flood EME markets where green shoots are appearing. There are also suggestions for the WTO to be asymmetrically used to force a revaluation for countries with a balance of payment surplus.

After the 70's collapse of the Bretton Woods agreement on fixed exchange rates, countries are free to follow what exchange rate regime they choose; there is no enforceable agreement with the IMF. There are suggestions that the WTO's enforcement mechanism could be used to force a revaluation. The argument is there are trade and distributional implications of undervalued exchange rates, which are equivalent to export subsidies and tariffs, making the issue relevant for the WTO. The IMF would continue to assess whether or not an exchange rate is undervalued. But bringing in the WTO seriously reduces flexibility. Change at the WTO tends to get mired in endless negotiations.

There is asymmetry again since there is no mention of WTO action against overvalued exchange rates, due to large temporary foreign inflows. If the WTO is to take action against undervaluation it must also be authorized to take action against overvaluation. But this would require regulatory action against volatile flows. The WTO has is work cut out in fighting against protectionism in a recession; that is the urgent issue for it to focus on.

EMEs need to manage their exchange rates. They cannot go for full floats since their narrow markets would otherwise be subject to excess volatility aggravated by capital movements. Moreover, the real exchange rate has to be relatively depreciated to the extent the average real wage is lower in an EME.

Participating in regional initiatives will be useful to maintain global power on an even keel; the many Asian groupings can help ensure that more reforms are actually implemented this time around.

The G-20 recognizes that while global standards are important they must be sensitive to context. Capacity building is especially important for EMEs. This and GFA are preconditions for full reform in EMEs. But market deepening is in India's own interest, and some opening can aid this. Markets for long-term finance, such as a

vibrant corporate bond market are required for its massive planned infrastructure expansion. Inducement to hedge from two-way movements in the exchange rate, and markets for hedging currency risks, can save firms the blows their balance sheets have received form the depreciation when an appreciation was widely expected.

But more opening has to be calibrated and is conditional on GFA, better macroeconomic variables and market institutions. So India must maintain reserves as self-insurance against volatile inflows, and place restrictions on debt compared to equity inflows and on full CAC until a satisfactory new GFA is in place and its institutions have matured.

Conclusion

The current crisis has had a major global impact and so may lead to genuine reform of the global financial architecture. But memory is short and inertia sets in once a crisis is past. The G-20 must maintain pressure for reform even if the crisis is resolved. It has a major role to institutionalize a more even global power balance, between countries, regions, finance and the average citizen even while improving the effectiveness of global institutions and coordination. Then there is a chance for real dialogue to resolve outstanding issues.

Global imbalances were not responsible for the current crisis. Despite being the only warning flags commented on prior to the crisis they did not cause it. Even so a resolution of imbalances will aid world financial stability, but to have a chance of working it must be gradual, symmetric, and fair.

References

Bernanke, Ben S, 2005, "The Global Saving Glut and the U.S. Current Account Deficit," speech delivered at the Sandridge Lecture, Virginia Association of Economics, Richmond, Va., March 10, Available at http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/default.htm (accessed in May 2009)

Caballero, Ricardo, J. and Arvind Krishnamurthy, 2009, “Global Imbalances and Financial Fragility” NBER working paper 14688, January, http://www.nber.org/papers/w14688

G22 (Group of Twenty-Two), 1998, Report of the Working Group on Transparency and Accountability (online), Available at http://www.imf.org/external/np/g22 (Viewed in May 2000)

Goyal, A, 2002, "Reform Proposals from Developing Asia: Finding a Win-win Strategy", chapter 7 in *Debating the Global Financial Architecture*, Leslie Elliott Armijo (ed.) SUNY Press Global Politics series, under the general editorship of James Rosenau, (New York: SUNY Press)

Goyal, A., 2005, "Asian Reserves and the Dollar: Is Gradual Adjustment Possible?" *Global Economy Journal*, 5(3): Article 3, http://www.bepress.com/gej/vol5/iss3/3

Goyal, A., 2009, "Financial Crises: Reducing Procyclicality", *Macroeconomics and Finance in Emerging Market Economies*, 2(1): 213-223. March 2009.

G-20, 2009, "Working Group on Enhancing Sound Regulation and Strengthening Transparency (Co-Chairs: Tiff Macklem and Rakesh Mohan), March 25, Available at http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=549 (Accessed in May 2009)

Johnson, Simon, 2009, "The Quiet Coup", *The Atlantic*, 19 May, Available at http://www.theatlantic.com/doc/200905/imf-advice. (Accessed in May 2009)

Krugman, Paul, 2009, "Reagan did it", *New York Times*. Published on May 31. Print version on June 1 2009. pp: A21. available at http://www.nytimes.com/2009/06/01/opinion/01krugman.html

Lane, Philip, 2009, "Global Imbalances and Global Governance", *Intereconomics*, March/April, Available at http://shop.ceps.eu/free/intereconomics/44-2/forum2.pdf (Accessed in May 2009)

Mohan, R., 2009, "Global Financial Crisis: Causes, Impact, Policy Responses and Lessons", based on speeches by the Deputy Governor, RBI, Available at http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=417 (accessed May 2009)

Portes, Richard, 2009, "Global Imbalances" in Mathias Dewatripont, Xavier Freixas and Richard Portes (Ed.), *"Macroeconomic Stability and Financial Regulation: Key Issues for the G20"*, Centre for Economic Policy Research, London, Available at http://www.voxeu.org/reports/G20_ebook.pdf (accessed in May 2009)

Taylor, John, 2009, "The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong", Working Paper 14631, January, *National Bureau of Economic Research*. http://www.nber.org/papers/w14631

Tirole, Jean, 2002, *Financial Crises, Liquidity and the International Monetary System*, New Jersey: Princeton University Press.

Woolfolk, M, 2004, “US Job Losses and Budget Deficit are Caused by the Exchange Rate Inflexibility of Asian Countries,” Leaders & Letters, *Financial Times* 25 October: 12