Post – crisis Reforms of the International Financial System: the Role of Europe

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Robust financial globalization of the late 20th / early 21st century

1. **leading factors:**

- increasing independence of financial sector from the real economy
- financial innovations
- new financial institutions
- fast cross – border expansion of financial activities

2. **evidence of financial globalization:**

- flows: fast increase; uphill instead of downhill
- stocks: ratio of gross external assets and liabilities to GDP today as compared to mid 1970's: world – 3; high income countries – 5; low and middle income countries – 2; East Asia – 6; Eastern and Central Europe – 3.

Macroeconomic effects of financial globalization – theory

1. **positive effects:**

- more efficient capital allocation across the globe
- better diversification of risk
- international transfer of financial technology and management
- strengthened discipline in macroeconomic policies

2. **risks:**

- failures immanent to financial markets: asymmetry of information; fast-profit seeking behavior, including speculation; “principal-agent” between managers and owners; herd behavior (not related to macroeconomic fundamentals); irrational exuberance and self fulfilling expectations

- these failures result in an unusual volatility of financial flows

Macroeconomic effects of financial globalization – empirical evidence

1. cross – country studies: more ambiguous than in case of trade globalization
2. late 20th / early 21st episodes of financial instability:
   - wave of currency crises in emerging economies from Mexico 1994/1995 to Argentina 2001
   - burst of asset bubble in ICT sector in the US in 2000/2001
   - global imbalances:

current account imbalance as percent of GDP:

	2001	2003	2005	2007
US	-3,9	-4,8	-6,1	-5,9
developing Asia	1,7	2,7	4,0	6,7
China	1,5	2,8	7,2	11,1
Middle East	5,9	8,3	19,7	19,8

Financial crisis 2007 - ?

- from a relatively small financial shock to a systemic crisis, i.e. to a global financial breakdown, with adverse consequences for the real economy and international confidence

- debt – financed economic boom of previous years, with international spillovers

- unlike previous episodes of financial instability, today we have an across-the-board crisis affecting all: agents, risky assets, regions – crisis absorption options reduced

Main failures explaining the origins of the current financial crisis

Policy failures	Regulatory failures	Market failures
• overly accommodative monetary policy • exchange rate pegging in some emerging economies	• exemption of commercial banks' off – balance sheet and investment banks from regulatory oversight • lack of coverage by regulators of systematically important sectors of the financial system • lack of transparency of the originate-to-distribute model	• asymmetry of information • herd behaviour and irrationality • agency problems

Response to the financial crisis

1. **Regime of the governance of the international financial system:** the set of rules that govern the international financial relations and the network of institutions that support and enforce these relations

2. **Market-based** rules and governance as the dominating approach in the international financial system

3. Within market-based rules there is a space for **government institutions** at different levels: national; international; supranational

4. **National considerations** matter most so far in the governance of international financial system

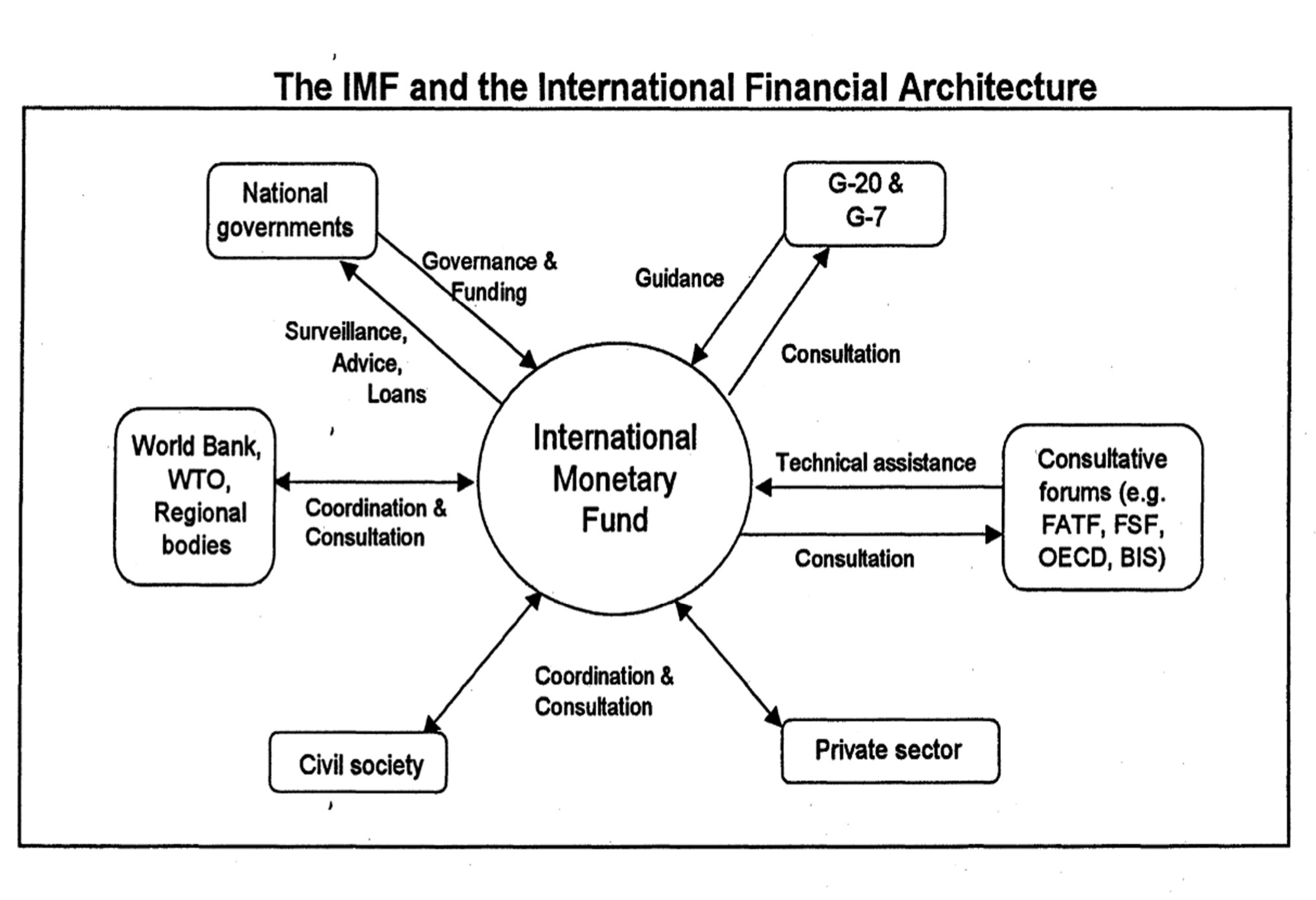
Conclusion: globalization of financial markets went ahead of the institutional governance of the international financial system

Global financial governance

1. **The case for global governance**
   – stability of international financial system is a kind of public good
   – financial globalization involves externalities between countries

2. **Reasons for a moderate progress in global financial governance**
   – existing national or regional spirit and bias in some countries
   – increasing number and diversity of economies which are significant from a global perspective
   – distributional considerations: winners and loosers, both between and inside the countries
   – insufficient “glue” cementing all market economies

The network of international financial institutions as a critical component of global financial governance



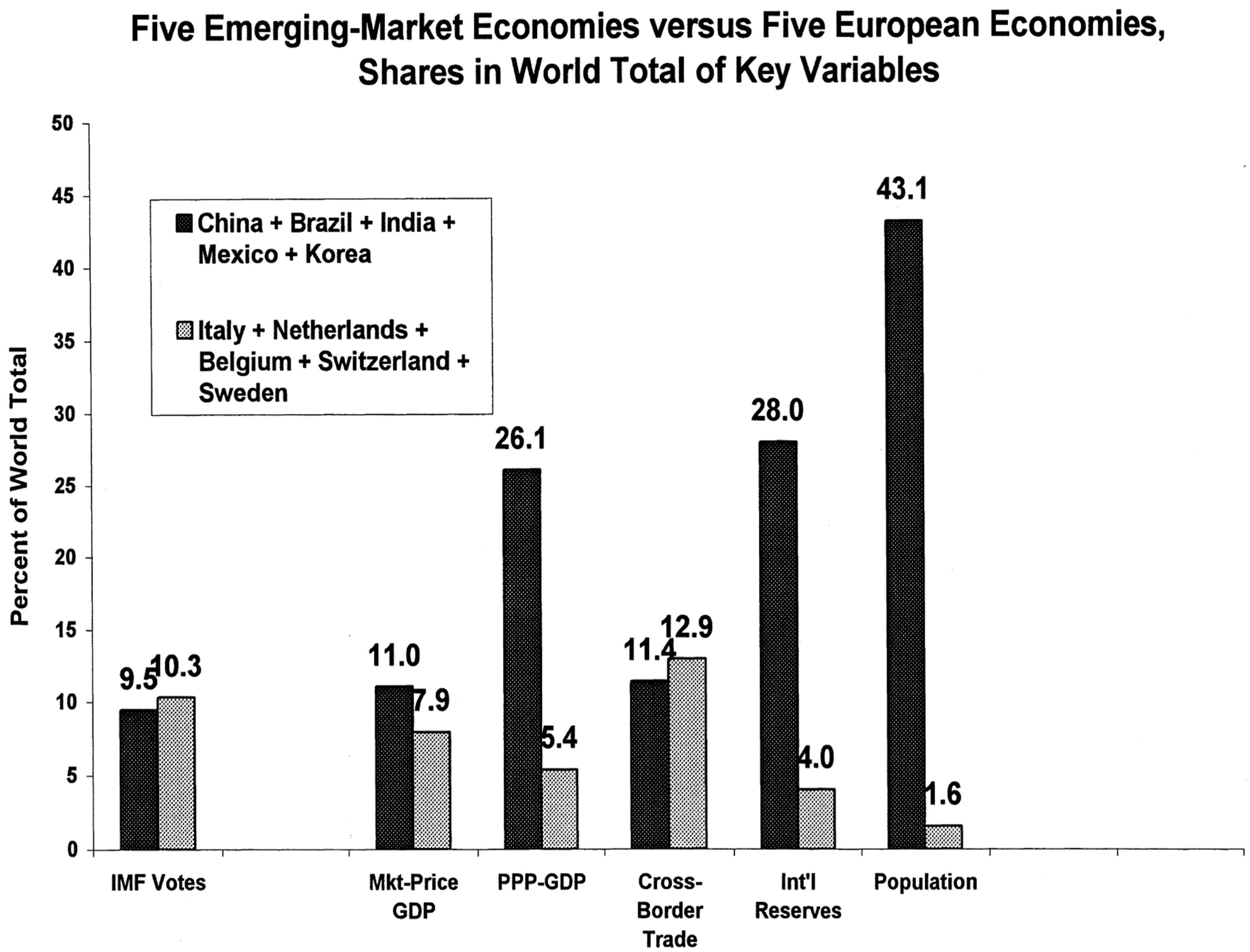
Four important dimensions:

- resources should be sufficient to respond to financial crisis
- mandates and responsibilities of IFI's: to timely and adequately identify systemic/global risks – in 2007 - ? crisis risks originated from financial sectors and advanced economies
- programs and instruments
- legitimacy and accountability

20 largest economies in different scenarios

in IMF	% of total vote	G-20	by GDP-PPP*	rank	by GDP-PPP	rank
US	16,7	US	China	15,4	China	15,4
Japan	6,2	Japan	EU	14,7	US	12,8
Germany	5,8	Germany	US	12,8	India	10,8
France	4,3	France	India	10,8	Japan	4,3
UK	4,3	UK	Japan	4,3	Brazil	2,8
China	3,8	Italy	Brazil	2,8	Germany	2,8
Italy	3,2	Canada	Russia	2,6	Russia	2,6
S. Arabia	2,8	Brazil	Indonesia	2,4	Indonesia	2,4
Canada	2,5	China	Mexico	1,9	UK	2,1
Russia	2,4	India	Pakistan	1,6	France	2,1
India	2,3	Russia	Bangladesh	1,3	Mexico	1,9
Netherlands	2,1	Mexico	S. Korea	1,3	Italy	1,8
Belgium	1,8	S. Africa	Nigeria	1,2	Pakistan	1,6
Brazil	1,7	Argentina	Canada	1,2	Spain	1,3
Spain	1,6	Australia	Iran	1,1	Bangladesh	1,3
Mexico	1,5	Indonesia	Turkey	1,0	S. Korea	1,3
Switzerland	1,4	S. Korea	Egypt	0,9	Nigeria	1,2
Australia	1,3	S. Arabia	Philippines	0,9	Canada	1,2
S. Korea	1,3	Turkey	Thailand	0,9	Iran	1,1
Venezuela	1,1	EU	Vietnam	0,8	Turkey	1,0

* EU as one area



Five Emerging-Market Economies versus Five European Economies,
Shares in World Total of Key Variables
Percent of World Total
50
45
40
35
30
25
20
15
10
5
0
China + Brazil + India + Mexico + Korea
Italy + Netherlands + Belgium + Switzerland + Sweden
9.5
10.3
11.0
7.9
26.1
5.4
11.4
12.9
28.0
4.0
43.1
1.6
IMF Votes
Mkt-Price GDP
PPP-GDP
Cross-Border Trade
Int'l Reserves
Population

EU in the global financial governance

1. **EU 10 especially hardly hit by the crisis**
   - projection for 2009 for EU 10 - all EU 10 in or very close to recession; the Baltics 7% - 14% decline in GDP; Hungary – ca. 5%; (Eurozone 2%; UK 2,8%)
   - deteriorating investors' sentiment towards CEE; capital flowing out, currencies weakening:

currency depreciation vis a vis the euro (beginning March; Sept. 2008=100)

Poland	**70**
Czech Rep.	85
Hungary	75
Ukraine	60

external vulnerability in CEE (ratio of FX reserves to short term debt plus current account balance; prudential ratio=100)

Latvia	33
Lithuania	34
Estonia	36
Romania	41
Slovakia	44
Bulgaria	68
Poland	79
Czech Rep.	98
Hungary	133

volatile financial sectors in EU, particularly in EU 10

EU has developed and advanced the regional system of financial governance:

- in monetary integration – supranational regional coordination
- financial integration – not yet completed
- EU system of structural and cohesion funds
- EU macroeconomic financial assistance; EIB

Critical issue: whether EU responds to the crisis in the spirit of common responsibility as well as solidarity or divisions between the countries or groups of countries prevail

EU should also be a strong supporter of the global financial coordination: EU particularly active and taking a leading role in some areas (climate change and energy issues; development assistance);

EU representation in international financial institutions: single or dispersed?