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Editorial

The emerging global financial architecture: What's new and what's old?☆

The global financial crisis that began in 2007 is the first serious test of the modern era of financial globalization. Financial globalization among industrial countries took off in the 1970s after the end of the Bretton Woods system and in most emerging markets and developing countries by the 1990s. While the 1980s and 1990s were not without some turmoil, the remarkable decline in volatility and the price of risk over this period – termed the "great moderation" – propagated optimism about the enduring gains of globalization. During this period, countries experimented with various policy arrangements, involving the pace of financial integration, the degree of exchange-rate flexibility, and the independence of monetary policy. Greater exchange-rate flexibility and inflation targeting (both formal and informal), combined with greater financial integration, emerged as a regime of choice among a growing number of countries. While the International Monetary Fund (IMF) played a role in responding to crises during the 1980s and 1990s, the "great moderation" and the rapid increase in private capital flows led to renewed questions about the mission of the IMF and the need to reform the architecture of the international financial system.

The global liquidity crisis has raised questions regarding the sustainability of these trends. In order to gain a better understanding of the issues involved, a conference under the aegis of the JIMF took place on May 1–2, 2009, at the University of California at Santa Cruz. The conference dealt with the nature and the durability of the emerging new global financial architecture. This volume provides the refereed proceedings of that conference, including six papers and a keynote address.

In his keynote address, "The Immoderate World Economy," Obstfeld argues that the global current account imbalances of the past decade were a primary symptom of forces that led directly to the financial crash. Through 2007 many economists believed that efficient capital markets would smoothly finance and absorb large global imbalances; that in the event of a fall in home prices, real estate losses would be limited and contained through central bank interest-rate cuts; that central banks were securely independent and firmly in control of inflation; and that the IMF might be redundant in a new era of stability in emerging markets. These assertions do not look so convincing in 2009. Global imbalances, in Obstfeld's view, have been symptomatic of policy missteps and financial-market distortions that also were central causes of the financial meltdown. Home-price losses served as the fulcrum for the financial crisis. Concerns about liquidity and deflationary pressures have elicited

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unprecedented expansionary responses from central banks, including in some cases quasi-fiscal actions. These spillovers between monetary and fiscal policy have led many observers to question the ultimate independence of those central banks. IMF resources also have been sharply augmented with the result that the Fund is now lending to, or backstopping, many countries.

Obstfeld also articulates several lessons of the crisis. While from the standpoint of an *individual* emerging market, reserves provide liquidity insurance, he suggests that there may be a macro-stability cost of this type of micro-prudence. More specifically, there is the potential fallacy of composition in thinking that measures to enhance an individual institution's (or country's) stability must necessarily enhance the stability of the system. Consequently, regulators must get better at spotting and war-gaming potential crises, especially those with significant systemic implications. In particular, Obstfeld argues, they need to pay more attention to systemically sensitive assets, i.e., those subject to the most severe economic disaster risk. Another major lesson, he says, is the need to take a systemic view of global financial stability, with greater agreement on international standards of financial regulation – as well as with regard to which countries and/or institutions should serve as the ultimate lender(s) of last resort.

In the years preceding the crisis, emerging markets opted for greater exchange-rate flexibility, supported by large hoarding of international reserves. While it is premature to evaluate the extent to which these choices helped emerging markets to deal with the crisis, recent experience provides useful information regarding the tradeoffs faced by developing countries in determining their macro policies, tradeoffs that will shape the choices facing these countries in the aftermath of the 2008–9 crisis. In "The Emerging Global Financial Architecture: Tracing and Evaluating New Patterns of the Trilemma Configuration" Aizenman, Chinn, and Ito investigate how the trilemma policy mix affects economic performance. To recall, the trilemma indicates the scarcity of policy instruments – a country can only achieve at best two, but not all three, of the goals of monetary independence, exchange-rate stability, and financial integration. The authors confirm the tradeoffs predicted by the trilemma, and find that emerging markets (EMs) have converged to a middle ground with greater exchange-rate flexibility, greater financial integration, and lower monetary independence, while simultaneously holding much higher levels of international reserves as a buffer. In contrast, developing non-EMs as a group has not exhibited such a policy configuration. The authors also find that greater monetary independence can dampen output volatility, while greater exchange-rate stability is associated with greater output volatility, which can be mitigated by sizable reserve accumulation. Greater monetary autonomy is associated with higher inflation, while greater exchange-rate stability and greater financial openness are linked with lower inflation. In addition, pursuit of exchange-rate stability can increase output volatility when financial development is at an intermediate stage, while greater financial openness, when accompanied by a high level of financial development, reduces output volatility. These results potentially explain why many countries have been accumulating foreign exchange reserves – the desire to relax the trilemma constraint. Greater international reserves holding allows countries to pursue *both* a higher level of exchange-rate stability *and* a higher weighted average of the other two trilemma policies through active foreign exchange intervention.

The accumulation of foreign-currency liabilities is often perceived as creating a financial vulnerability for emerging markets in a world of volatile capital flows. Unhedged exposure to debts denominated in foreign currency has been credited with exacerbating the severity of financial crises in the 1990s. In "Foreign Currency Debt, Financial Crises and Economic Growth: A Long Run View," Bordo, Meissner and Stuckler provide an historical perspective on the role of foreign debt. They study the short-term growth and long-run output effects of exposure to foreign-currency debt using data from two periods of international financial integration (1880–1913 and 1973–2003) for over 45 countries. They find that greater hard currency debt increased the risks of currency and debt crises in both periods, especially when a country's macroeconomic financial fundamentals are weak. They also find that the risk of financial crisis associated with hard currency debts translated into significant output losses. In addition, they provide evidence that strong financial development and policy credibility attenuate the crisis risks associated with high exposure to hard currency debt. Moreover, foreign-currency liabilities and capital inflows are associated with crises that lower growth temporarily and leave output permanently lower compared to trend. The lessons from the crises of the 1990s have been to reduce currency mismatches by fostering development of domestic debt markets, accumulating

reserves, and avoiding soft-currency pegs. Globally, net foreign-currency exposure has not been totally eliminated since 1997, but it has diminished substantially. Some LDCs now issue local-currency denominated debt on international markets while lenders have increasingly participated in domestic bond markets. Improved liquidity and depth have expanded the development of local financial markets, and the accumulation of reserves, especially in East Asia, has offered significant insurance against instability. However, the authors caution that while countries have now started to minimize currency mismatches, uneven development, unregulated credit booms, sudden stops, and contagion still lurk in the shadows. The inadequacies of the current international financial architecture in dealing with these problems is increasingly likely to become more evident since global capital flows show little sign of decreasing in the near term.

The global financial crisis of 2008–9 has been traumatic and costly. Although it is too early to know precisely how the international financial system will evolve in response to the crisis, it would not be surprising if in the years to come we see greater restrictions on cross-boarder capital movements. In order to understand the way in which possible reforms of the international financial architecture will affect different countries and outcomes, it is essential to understand the effectiveness and the impact of restrictions of capital mobility on developing countries. In "Controlling Capital? Legal Restrictions and the Asset Composition of International Financial Flows," Binici, Hutchison, and Schindler investigate the effectiveness of capital account restrictions over time. They provide new answers based on a novel panel data set of capital controls, disaggregated by asset class and by flow direction, covering 74 countries during the period 1995–2005. They find that the estimated effects of capital controls vary markedly across the types of capital controls, both by asset categories and the direction of flows, as well as across countries' income levels. In particular, both debt and equity controls can substantially reduce outflows, with little effect on capital inflows, but only high-income countries appear able to effectively impose controls on debt outflows. These results imply that capital controls can affect both the volume and the composition of capital flows and that controls can be useful in stemming or warding off flight of some forms of capital. Their study also demonstrates the value of using disaggregated data on asset restrictions across international capital outflows and inflows. Aggregate measures may provide misleading and biased estimates of the effectiveness of capital controls on international financial movements and therefore may offer a poor guide for policymakers attempting to insulate their economies from foreign shocks and pursue some independence in monetary policy.

Another dimension of financial integration deals with the transmission of interest-rate changes in financial centers to countries with varying degrees of financial integration. Identifying the impact of financial regulations on this transmission can help evaluate the costs and benefits of financial controls. The paper by Edwards, "The Transmission of Global Financial Turmoil to Emerging Markets," investigates to what extent, and how rapidly, changes in U.S. policy interest rates are transmitted to emerging countries. Edwards uses weekly data for eight emerging countries – four from East Asia and four from Latin America over the period 2000–September 2008. The study focuses on the differentials between domestic and international interest rates (properly adjusted for currency and country risk). With dynamic panel estimation, Edwards finds that there is a negative relationship between the Federal Reserve's policy interest rate and interest-rate differentials in these countries. In the long run, the pass-through coefficient is -0.5, i.e. a one percentage point increase in the federal funds rate reduces the domestic interest-rate differential by one-half percentage point, for both the Latin American and the Asian countries. In the short run in Latin America, there is an immediate reaction to changes in the U.S. Fed policy rate, while in the Asian countries the adjustment is gradual and smooth. He also finds that changes in the U.S. yield curve have a positive effect on interest-rate differentials. On the other hand, he finds no evidence that changes in the international price of oil affect interest-rate differentials or that the extent of capital mobility has affected the transmission of interest-rate shocks to Latin American countries. The case of the Asian countries is different, however: here the results suggest that the extent of transmission to Asian countries with "high capital mobility" is stronger and faster than to countries with low capital mobility.

During the first phase of the global financial crisis, some observers expected that there would be some degree of decoupling between the business cycles of the U.S. and other countries. Flood and Rose in "Inflation Targeting and Business Cycle Synchronization" evaluate the degree to which the proliferation of inflation targeting regimes has affected the correlation of cross-country business cycles.

Since New Zealand began to target inflation in early 1990, twenty-six other countries have adopted formal inflation targeting regimes. At first blush, one might imagine that inflation targeting (IT) should be associated with lower business cycle synchronization, since the monetary authority might seem to acquire the ability to insulate itself from foreign shocks with a strategy of focusing on purely domestic phenomena such as inflation. However, Flood and Rose use a simple theoretical model to show that, depending on the objective of the central bank IT could in principle associated with greater business cycle synchronization. If the objective of the central bank is to stabilize output, the domestic output response to a foreign output shock is dampened. An inflation target objective, on the other hand, allows output to move while stabilizing prices so that business cycle synchronization can end up higher. The authors evaluate the experience during recent decades of 64 countries. Their sample includes observations for countries that have maintained fixed exchange rates or relinquished monetary sovereignty in a currency union, as well as for inflation targeting countries. Intriguingly, the authors find that inflation targeting seems to have a small but *positive* effect on the synchronization of business cycles; countries that target inflation seem to have cycles that move slightly more closely with foreign cycles. Indeed, decoupling does not seem to be present at all in their data.

The global financial crisis revitalized the role of the IMF, as a key player in fighting global financial crises. Yet in the past the IMF has often been criticized as having hindered rather than helped the recovery of many countries by demanding inappropriate policy changes. In "Does the Global Fireman Inadvertently Add Fuel to the Fire? New Evidence from Institutional Investors' Response to IMF Program Announcements," Wei and Zhang apply a case study methodology to re-assesses the role of the IMF in past crises. They utilize a database that tracks the asset allocations by 168 international mutual funds in 94 emerging country markets over the period January 1996–February 2005. With this information, they measure the actions by mutual fund managers before and after IMF program announcements. To test if investors modified their views significantly when IMF programs were announced, Wei and Zhang also examine the stock market indexes and EMBI bond spreads before and after the date when these announcements were made. They find that international investors tend to revise upward an economy's outlook after an IMF program is announced, and increase their investment in the country. Patterns of concurrent asset price movement suggest that it is unlikely due to a bailout/moral hazard effect. This means that IMF programs tended to be regarded as helpful to countries in crisis, and hence tended to increase investors' confidence in these economies. Wei and Zhang also find that the effect varies by countries' characteristics. In particular, the increase in investments tends to be bigger in program countries with strong governance, a higher level of reserves, and a larger IMF loan size.

The studies in this volume raise pertinent questions regarding the impact of the global crisis on the emerging global financial architecture. Our hope is that they will motivate continuing research on this topic.

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