October 26, 2009

Paper for ICRIER Conference

Global Financial Architecture

The events of 2007-08, when problems in a segment of the U.S. credit market – housing finance for sub-prime borrowers – quickly escalated into a global recession and turmoil in the currency and equity markets, emphasizes the need for a reform of the global financial architecture. The architecture includes not only the global monetary and exchange rate system, but also the system of banking regulation following from Basle II and, indeed, the International Financial Reporting Standards. Herewith a list of some of the important issues:

1. The International Monetary System

1.1 IMF quotas. The G20 has accepted the need for Asian countries' quotas to go up in parallel with their sharply increased share of global output, trade and reserves.

1.2 Global Imbalances: The Japanese surplus has come down and the U.S. deficit has nearly halved. The Chinese surplus too has come down if only marginally: a case for an appreciation of the yuan and some other Asian currencies in dollar terms?

1.3 Status of the dollar as the principal reserve currency.

Sooner or later, it will change. The key issue: can it happen in a sudden, chaotic fashion? One possible scenario

⇒ Oil exporters start pricing oil in, say, euros or in a basket of currencies like the SDR;

⇒ The dollar starts falling faster in relation to the other SDR currencies (it already has weakened significantly against the euro and the yen), prompting Asian central banks to shift existing reserves out of the dollar; and

⇒ Other commodity exporters give up dollar pricing.

The result: a sharp fall of the dollar against particularly the euro and the yen. The European authorities have already started voicing fears that the strength of the euro is making economic recovery more difficult. A further rise of the currency would mean an even deeper recession. The impact on Japan would be little different. In the U.S. market, bond yields would rise sharply, steepening the yield curve and dampening the reflationary impact of the cheaper dollar. And, with the big three economies in deeper recession, even dynamic Asian economies would suffer, particularly if trade protection gains ground. Overall, the costs to the global economy of a chaotic, unplanned shift out of the dollar as the principal reserve currency would be very high.

1.4 SDR: a possible alternative?

The U.N. Commission refers to an expanded role for the SDR. The Chinese authorities, the world's largest holders of dollars, have also discussed the issue. Can, for instance, dollar reserves be exchanged with IMF for SDRs? The big issue is exchange risk.

1.5 A possible solution

A Grand Bargain would require multinational co-operation and agreement on the Bretton Woods scale:

⇒ Upvaluation of the yuan; and

⇒ Agreed, multilaterally guaranteed bands for fluctuations in the G4 currencies: the dollar, the euro, the yen and the yuan, the last also to be included in the SDR basket in replacement of the pound.

To me, the present is a good time to consider this as G-3 rates seem reasonable. And, if everybody accepts the need to manage the domestic value of a currency (i.e. inflation), in a globalised world, the same logic holds for the external value. Wildly fluctuating currencies, unexplainable on economic fundamentals, are an impediment to cross border trade and investments: they only benefit the trader/speculator!

2. Banking Regulations

2.1 Capital for liquidity risk. All the recent, major bank failures (Northern Rock, Bear Stearns, Lehman Brothers, etc.) occurred because of over reliance on short term market borrowing – in other words the liquidity risk. Northern Rock had a healthy capital ratio, but this did not help. There is a clear case for imposing a capital charge on the liquidity risk a bank carries.

2.2 There is a need to eliminate capital arbitrage between trading and banking books.

2.3 Hikes in credit and market capital ratios being discussed. Basle II norms on Potential Future (Credit) Exposure on derivatives are less than logical and need significant reform.

2.4 Insured deposit taking banks should undertake only narrow banking. Intermediaries undertaking riskier activities should be debarred from collecting deposits. And, their dealings with narrow banks should be only through CCPs. Else, we would perpetuate the "private profits, public losses" model.

2.5 Derivatives

All plain vanilla should trade only on exchanges. Complex structures can be traded OTC – but only on collateralized basis with daily collection of MTM margin.

3. IFRS

3.1 MTM of liabilities: the weaker a bank, greater the gains on issued bonds!

3.2 Accounting of market value of loans and advances could lead to bank runs.

3.3 Hedge effectiveness criteria for cash flow hedges too onerous, acting as disincentive to hedging interest rate risk in banking book.

A.V.Rajwade
(Panelist)