The Role of International Financial Institutions in Addressing the Financial Crises of the 21st Century: Confrontation or Cooperation?

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The role of international financial institutions is to promote cooperation. They have limited scope to confront their members because their authority derives from those same members, which have ceded a small measure of sovereignty to them. The question I address is whether nations have ceded too much sovereignty to international financial institutions. My answer is negative. Whether the international financial institution is formal, like the International Monetary Fund (IMF), informal, like the Financial Stability Board (FSB), or institutionalized, like the euro area, an excessive attachment to national sovereignty is holding back cooperation.

There are alternative views. Two months ago Mark Mazower wrote a piece in the Financial Times suggesting that Europe raised the specter of an ungovernable world. He noted that the concept of “international” was coined by Jeremy Bentham in 1789.1 In Mazower’s words, the prevailing view in the post-Napoleonic era was that nationalism and internationalism were “soul mates.” He argued that this philosophy underpinned the creation of the European Union, starting with the Schuman Declaration in 1950 which proposed the establishment of the European Coal and Steel Community. The idea was that “international cooperation is the best guarantee of national wellbeing.” The same might be said about international cooperation in the economic and financial arena, in general, and about participation in international organizations designed to promote such cooperation, in particular.

Mazower’s thesis was that this philosophical approach may have produced net benefits during the first four decades after World War II, but starting in the mid-1980s, the notion that sovereignty and international cooperation are complementary was called into question. The economic gains were reversed by the association of cooperation with the liberalization of capital movements. He identifies the architects of that view as Paul A. Volcker, former Chairman of the Federal Reserve Board, and Michel Camdessus, former managing director of the International Monetary Fund. I am confident that Paul Volcker would be surprised by that identification. In the case of Camdessus, in the late 1990s, he advocated updating the IMF’s Articles of Agreement to provide the Fund with an updated and clearer jurisdiction over capital movements, but I can assure you that he is not an advocate of unrestrained capital movements for all countries at all times.

Mazower is right that membership in international organizations requires members to give up some sovereignty in exchange for the benefits of joining. It is debatable whether he is right that this process has now gone too far and democratic, national political institutions have given up too much power to unelected central bankers and technocrats.

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What is not debatable is that the genie of international economic and financial integration is long since out of the bottle. A few facts illustrate this point.

In 2011, world GDP in US dollars was six and a half times its level in 1980. The multiple is seven if the metric is GDP in purchasing power parity (PPP) terms—adjusted for differences in price levels. (It is of note that on a PPP basis, in 2013, the combined GDP of the emerging market and developing countries will surpass that of the advanced countries.2) The growth of international trade has outpaced the growth of economic activity in general. In 2011, world trade was nine times world trade in 1980. But the growth of trade relative to GDP pales in comparison with the growth of cross-border investment activity. Since 1980, US foreign investment plus foreign investment in the United States has increased 25 times by 2011. Excluding direct investment, the multiple is 30 times.

To reverse these trends would require a total reconstruction of the global economy and financial system. That reconstruction would inevitably be preceded by a collapse of the global economic and financial system. It would return us the 1930s and the immediate post-World War II period when governments effectively controlled all international economic and financial transactions. This would be highly undesirable. Instead, what is needed is renewed attention to international cooperation motivated not by a view that cooperation is complementary to national sovereignty, or that it requires a loss of national sovereignty, but by an understanding that an increase in shared sovereignty is essential if the inevitable financial crises of the 21st century are to be effectively addressed. I say “if the financial crises of the 21st century are to be effectively addressed.” Based on experience with the global financial crisis of 2007–09 and its echo in the European sovereign debt crises of 2010 to date, it is far from certain that public opinion in the leading nations of the world will support the necessary sharing of sovereignty. Our political and public opinion leaders have their work cut out for them to convince their publics that stability and prosperity lies in sharing sovereignty not in preserving the illusion of sovereignty in an increasingly interdependent world.

In the remainder of my remarks, I first offer some observations on the principal institutions of international economic and financial cooperation. My central point is that the evolution of our institutions has lagged behind changes in the global economy.

I then discuss three urgent, interrelated topics: (1) reform of the International Monetary Fund, as the central institution of global economic and financial cooperation; (2) supervision and regulation of the global financial system, which is in its infancy; and (3) the European sovereign debt crises, which will bring us back to the issue of shared sovereignty.

I conclude that if the world as we know it is to survive into the 21st century, international cooperation must be deepened. It is a tall order, but I am a pragmatic optimist.

The Institutions of International Financial Cooperation

The principal institutions of international economic and financial cooperation are: the International Monetary Fund; the World Bank group and the various regional development banks; the World Trade Organization, which evolved out of the General Agreement on Tariffs and Trade; and the Bank for International Settlements (BIS) and the cluster of groups that generally meet at the BIS in Basel, Switzerland, in particular the Financial Stability Board (FSB), formerly the Financial Stability Forum.

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2 Excluding the newly industrialized economies of Asia (Hong Kong, Korea, Singapore, and Taiwan) from the advanced countries, this already happened in 2010.
All of these institutions trace their origins to the end of World War II or before. The BIS was founded in 1930, but it was revived and gained global significance starting in the mid-1990s, when its membership of central banks began to expand. This is one reason why, in 1999, the Financial Stability Board was linked to the BIS.

Until about a decade ago, these institutions were largely dominated by the North Atlantic powers, Europe, the United States, Canada, and that honorary western economy, Japan. The finance ministries and central banks of these nations cooperated informally to guide the IMF, in particular, and the operation of the economic and financial system, in general, via the Group of Ten (G-10) countries (eight West European nations plus Canada, Japan, and the United States) or the Group of Seven (G-7) countries, which excluded the four smaller European nations. In the wake of the Asian financial crises of the late 1990s, the Group of Twenty (G-20) was created at the level of finance ministers and central bank governors, including the G-7 countries, Australia, and 11 large emerging market and developing countries.

However, the G-7 nations conspired to ensure that the G-20 was not centrally involved in pressing global economic and financial issues. All this changed in the fall of 2008 when the global financial crisis entered its virulent phase. The G-20 met at the leaders’ level for the first time. One of their first institutional acts was to force the transformation of the G-7-centric Financial Stability Forum into a body, the Financial Stability Board, that parallels the G-20 in its representation.

The G-20 has advanced international cooperation, but progress to date has been limited by three factors: a reluctance of the Europeans to give up their disproportionate representation in the major institutions, uneven pressure for change coming from the United States, and the fact that, as more countries have emerged on the global stage as important players demanding a say, cooperation has become more difficult.

One aspect of the third factor is that the new players did not share in shaping the written and unwritten rules and conventions of the global economic and financial system. Consequently, they have not internalized a responsibility for sustaining the system. In other words, the desirability of sharing sovereignty is even less well developed among the emerging and developing economics than it is within the traditional North-Atlantic consortium.

Three Interrelated Topics

Reform of the International Monetary Fund

The International Monetary Fund is the central institution of the international macroeconomic and financial system because of its broad mandate and essentially universal membership. It was established during World War II to oversee the international monetary system—the Bretton Woods system. But the IMF has evolved to play a major, if not the central role, in the international economic and financial system.

The IMF’s jurisdiction initially stopped at the water’s edge. Although the principal means of achieving external adjustment during the Bretton Woods era was via domestic contraction, even when it lent to countries, the Fund did not become deeply involved in countries’ economic policies. Following the collapse of the Bretton Woods system of not-so-adjustable exchange rate pegs, which interestingly Canada flouted for much of the post-World War II period, some thought that the IMF would be pushed to the sidelines.
Nevertheless, in the post-Bretton Woods era, the IMF was pulled into the international lending game in a big way, in part, in the context of the oil price shocks of the 1970s but also during the debt sovereign crises of the 1980s. The former involved substantial lending programs to several European countries, in particular Italy and the United Kingdom. The latter involved the IMF deeply in countries’ macroeconomic and structural policies, and that involvement became controversial both for the countries involved and the other countries in the system.

However, the stigma attached to having an IMF program began much earlier. In particular, once the European countries established an internal mechanism to provide support for partner countries facing external financial difficulties, European countries turned to Brussels rather than Washington because the scale of the financing was much more generous and the conditions placed on economic policies much less onerous. In many respects this laid the seeds of the current European sovereign debt crises; European bureaucrats and leaders were disinclined to be tough on their friends and close neighbors. At the same time, the myth arose that advanced countries did not need IMF programs to support reforms of their economic policies. For example, the IMF was sidelined during the crises of the European Exchange Rate Mechanism in 1992 and 1993. Once the euro area became operational in 1999, the European nations pulled back even deeper into their own mechanisms, actively discouraging advice from the IMF and other countries.

Moving on, the IMF became involved in the economic transformation of the countries of the former Soviet Bloc as well as those that were part of the Soviet Union itself. In the process, it became the near-universal institution it is today. The IMF played a major role in the Mexican and tequila crises of the mid-1990s and a controversial role in the Asian financial crises and the subsequent crises in Russia, Brazil, Turkey, and Argentina.

As the IMF was developing its role as a firefighter in the crises of emerging market and developing countries, it also undertook a role in the surveillance of the economic policies of all its members—their macroeconomic policies, structural policies, and financial policies. This authority derived from a revision in the IMF Articles of Agreement. However, the IMF was unable to establish much traction over members’ policies. For example, the IMF management and staff, as well as the members themselves, performed woefully in anticipating the global financial crisis. And, prior to the crisis, IMF lending diminished substantially.

As the global financial crisis entered its virulent phase, the IMF’s lending operations had declined to the lowest level in decades. At the end of March 2008, only $10 billion in credit was outstanding to countries other than to the low-income borrowers, which borrow from a separate pool of financial resources. As of early September that year, a grand total of only six countries, other than low-income borrowers, had active IMF lending programs for total commitments of less than $2 billion. At the time, it was common for finance ministers and central bankers from advanced countries to speculate about phasing out the IMF’s lending role, so that the IMF would focus solely on surveillance and policy advice. Moreover, in September 2008, the IMF’s total permanent lending capacity, other than to low-income countries was only about $250 billion. As of the end of May 2012, total IMF credit was $140 billion. As of June 21, 2012 IMF commitments programs with 22 members totaled almost $250 billion with almost $185 billion undrawn.

The IMF’s permanent lending capacity was expanded from about $250 billion to about $750 billion as the result of the implementation of the G-20’s commitment in April 2009 to augment the New Arrangements to Borrow through which the IMF accesses additional funding. Unfortunately, the G-20 declined to endorse a further enlargement of the IMF’s financial resources at its summit in Seoul in November 2010. Consequently, IMF managing director Christine Lagarde recently has been forced to line up additional bilateral lending commitments of $456 billion in the context of the European debt crisis.

The IMF's role in the crises of emerging market and developing countries, as well as its inability to anticipate the global financial crisis, led to a decline in its lending operations to the lowest level in decades. The IMF was able to expand its permanent lending capacity from $250 billion to $750 billion through the G-20's commitment in 2009. However, the IMF was unable to further expand its financial resources after the Seoul summit in 2010. As a result, IMF managing director Christine Lagarde is forced to line up additional bilateral lending commitments to address the European debt crisis.
crisis, potentially increasing the IMF’s potential lending capacity to almost $1.25 trillion—five times what it was only four years ago. The additional funding is intended for programs for the general membership of the IMF, but it is relevant that 43 percent of the additional commitments are from the euro area, 53 percent are from European Union members including the United Kingdom and Sweden, and 57 percent are from Europe as a whole including Switzerland and Norway. If one were to include Russia and Turkey in Europe the total would be 63 percent. In effect, Europe is lending to the IMF to help itself, which is controversial.

IMF funding for Europe is controversial for three basic reasons. First, well before the turn of the century, many observers had convinced themselves that the so-called advanced countries would never again need to borrow from the IMF. This supposition was called into question when the IMF lent to Korea in Asian financial crisis in the late 1990s. It was further called into question as the global financial crisis broke and the IMF lent to Hungary and Latvia, two EU member countries, as well as to Iceland, then one of the wealthiest countries in the world, in the fourth quarter of 2008. This lending was followed by a flexible credit line commitment to Poland in May of 2009, and ultimately lending to three euro area countries—Greece in May 2010, Ireland in December 2011, and Portugal in May 2011—and now potentially Cyprus, Spain, and Italy may be knocking on the IMF’s door. The view of some, even now, is that the European countries are wealthy enough to take care of their own problems. This is one reason why Canada has chosen not to participate in the latest round of bilateral lending to the IMF. The Canadian view is that IMF should only offer technical advice on the European economic reform programs.

The United States also is not participating, but the principal reason is that the United States normally is not a party to temporary lending to the IMF. Moreover, it would be very difficult to get the necessary extraordinary legislation through the US Congress in an election year. It is noteworthy that at the height of the global financial crisis the US Federal Reserve had almost $600 billion in credit outstanding to foreign central banks, much of which was to the European Central Bank (ECB). Again, earlier this year the Federal Reserve had almost $110 billion outstanding, of which $90 billion was to the ECB. As of July 18, $31 billion was outstanding.

The second reason why IMF lending to Europe is controversial is that the lending is not directly aimed at supporting the external financial positions of the borrowing countries. After all, the euro area countries borrow in their own currency. One might expect that the institutions of the euro area would provide its members with sufficient financial resources to meet their, largely internal, financial obligations. In addition, IMF lending has not only been used to finance the payment deficits of Greece, Ireland, and Portugal with other euro area countries, but also has been used to cover those countries’ fiscal deficits and help to recapitalize their banking systems. The truth is that IMF lending for these latter purposes is not unique to the European cases. In today’s global economy and financial system, it is essentially impossible to draw the line in a crisis at the border of a country and say that any internal financial needs should be met by the country itself out of its own domestic resources. Everything is connected to everything else even when a country issues its own currency, but in particular when it does not do so, as is the case within the euro area. However, just because there are ample precedents for the type of lending that the IMF is doing with Europe does not mean that all members are comfortable with the expanded interpretation of the IMF’s lending authority.

The third reason why IMF lending to Europe is controversial relates to the governance of the IMF. This is partially true to the extent that the bilateral lending to the IMF will be recycled back into IMF programs for the euro area; these operations are essentially a political subterfuge. Aside from the Europeans lending to themselves through the IMF, a more serious issue is the historical dominance of the Fund by Europe. The managing director has always been a European, even as the President of the
World Bank has always been a US citizen. Not to be critical of Christine Lagarde on her merits, but the truth is that she faced a highly qualified alternative candidate in the election last year in the person of Agustin Carstens. She was elected, in large part, because she started out with more than 30 percent of the votes from the other countries in the European Union who declared for her before any other candidates had been nominated. By comparison, the US voting share is 16.7 percent.

The universal view, outside of Europe, is that Europe is over-represented in the IMF. The voting share of the European Union in the IMF is currently 30.9 percent, 33.1 percent if Norway and Switzerland are included. Once the hard-fought agreement in the G-20 in Seoul in November 2010 is implemented, the EU’s voting share would decline a minuscule 1.5 percentage points, 1.8 percentage points with an expanded definition of Europe. Moreover, under the existing formula, which is used as a basis for revising IMF quota and voting shares, Europe’s indicated share would rise by about 2 percentage points.

Europe is also over-represented on the IMF executive board. Out of 24 seats, the European Union holds seven, and Switzerland occupies an eighth. The European Union also occupies the seats of seven alternate executive directors, including one in a constituency anomalously led by Canada.

The Europeans committed themselves at the G-20 meeting in Seoul to reduce representation on the IMF executive board by the advanced European countries by two seats in the election of executive directors following the implementation of IMF governance agreements reached in Seoul in 2010, which was expected to be by November of this year. However, full implementation of that timetable is in doubt because the Seoul package requires approval of all of the elements of the package, and the key element, without which nothing else goes into effect, requires approval by 60 percent of the members with 85 percent of the votes, and so far only 87 of the necessary 113 members have approved with 58 percent of the needed votes.

One reason that the original timetable probably will not be met in full is that the US administration, unfortunately, has not submitted the necessary legislation to the US Congress. However, as of June 20, 2012 the United States had a lot of company from within the G-20 group, including Canada, Argentina, Indonesia, Russia, Saudi Arabia, and South Africa. At least the Europeans cannot be principally blamed for the delay, but they can be blamed for recalcitrance in agreeing on a further reform of the quota formula, which was to be agreed by January 2013 to lay the groundwork for agreement on a further adjustment of IMF quotas by January 2014 when it is used to guide the 15th general review of IMF quotas.

On the positive side, because of the delay in approving the Seoul agreements, there is a better chance that a revised quota formula will point to a well-deserved reduction in the voting power of the Europeans and that, when used in 15th quota review, the new formula will produce a significant realignment of votes and quotas along with a substantial addition to IMF financial resources. My view is that they should be boosted to $1 trillion in quota resources and $500 billion in permanent potential borrowed resources. In addition, the Europeans should further commit to a reduction in their representation on the IMF executive board to three seats: one for the euro area countries, one for the non-euro area members of the European Union, and one for the non-EU Europeans. This would represent a substantial step forward in cooperation, shared sovereignty, and an end to confrontation over IMF governance.

The dominant lesson from the financial crises of the past five years is that the world is more financially integrated than anyone two decades ago could have imagined. What is needed is an effective international-lender-of-last-resort structure. The steps taken so far on IMF governance and resources
will not convert the IMF into a true international lender of last resort because the IMF cannot create unlimited amounts of liquidity on short notice.

I also favor an enhanced IMF capacity to supply credit to member countries in the form of temporary Special Drawing Rights (SDR) allocations in emergency situations, but this too is unlikely to be enough. What also is needed is an institutionalized global swap network among central banks centered, for the moment, on the central banks that issue the currencies most often used to denominate international economic and financial transactions: the dollar, the euro, sterling, yen, and the Swiss franc.

In summary, reform of the IMF illustrates both the necessity and opportunities of international cooperation and, at the same time, the depth of some of the historical and institutional confrontations involved. However, reform is underway.

**Supervision and Regulation of the Global Financial System**

Institutional rivalry between national central banks and the IMF has inhibited building an effective set of arrangements for an international-lender-of-last-resort function and a global financial safety net. Unfortunately, this rivalry also extends to institutional cooperation on supervision and regulation of the global financial system. Over the past twenty years, central banks have become increasingly independent of their governments. At the same time the central banks’ own institution, the Bank for International Settlements, located in Basel, Switzerland, has become more universal in its membership. BIS facilities are used by organizations that include authorities other than central banks; it hosts meetings of the Basel Committee on Banking Supervision and hosts the secretariats of the International Association of Insurance Supervisors, of the International Association of Deposit Insurance, and most important of the Financial Stability Board.

The Financial Stability Board was established first in 1999 as the Financial Stability Forum and expanded include representatives of all the G-20 countries in 2009 under pressure from the G-20 leaders. Its mission is to coordinate the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory, and other financial sector policies. Its members include national authorities, representatives of various standard setting bodies, such as the Basel Committee on Banking Supervision and regulation and representatives of other international organizations, such as the IMF. However, the IMF is only a partner. The FSB and the IMF can and do cooperate, but there are two basic sources of tension. The FSB, although it includes representatives of finance ministries and non-central bank regulatory authorities, is dominated by the central banks—each of the four chairmen of the FSB/FSF has been a central banker. In addition, membership in the FSB is far from universal while IMF membership is essentially universal.

The FSB is a quintessential cooperative organization in that it has no enforcement powers other than naming and shaming countries in their policies and practices. Moreover, its agreements are implemented by national authorities, as are agreements among the groups setting financial standards, such as the Basel Committee on Banking Supervision and Regulation. One of the principal difficulties of the FSB approach is that the history, regulatory culture, structure, and stage of development of national financial systems differ substantially. Thus, it is difficult to agree upon, and gain consistent implementation of, standards that apply uniformly to all countries.

The inherent challenges are aptly illustrated by the current attempts within Europe to establish a banking union. Even though member countries operate under a common set of EU directives in most areas, substantial cultural and structural differences remain. For example, some members of the euro area have banks that fully qualify as “too big for their countries,” such as Cyprus, which has applied for a
euro area program of financial support estimated at 50 percent of its GDP because of bank failures associated with losses on Greek government debt that was written down in the fall of 2011; and Iceland and Ireland, which in 2007 had bank assets close to 900 percent of GDP and a financial sector of more than 1000 percent of GDP, both figures were larger than better known financial centers like Switzerland, Hong Kong, and Singapore.3 The combined assets in 2009 of the top five banks in the five largest banking markets in the euro area ranged from 138 percent of GDP in Italy and 151 percent in Germany to 220 percent in Spain, 344 percent in France, and a whopping 464 percent in the Netherlands.4 Given these differences, it is not surprising that euro area countries are hesitant to share sovereignty with respect to deposit insurance and recapitalization funds at the current juncture, even though they may be inching in that direction.

Notwithstanding these difficulties, since the outbreak of the global financial crisis in August 2007, the FSB and its predecessor the FSF and the associated standard setting groups have produced a substantial body of work in a very short time period.

Two factors have contributed. First, crises focus attention. Second, the attention of the G-20 leaders, in turn, accelerated the decision-making calendars of the FSB and associated standard-setting groups. The decisions were made by the experts, but the leaders drove them to decide expeditiously. A good example is that Basel II took five years to develop from 1998–2003, though thinking started several years earlier in the mid-1990s, and it was not fully implemented by major jurisdictions at the start of the global financial crisis in 2007. In contrast, both Basel II.5 (covering market risk and securitization) and Basel III (principally aimed at strengthening capital standards but involving much more) took only three years though implementation is not yet complete.

Bank of Canada Governor Mark Carney, who as chair of the FSB reported to the G-20 leaders in Los Cabos, Mexico in mid-June, said the challenge facing the international financial community today is consistent implementation. The risk is that, as national jurisdictions implement the financial regulatory reforms that have been agreed over the past five years, they will tailor their implementation to their own financial systems. As Governor Carney said, “a focus on full and consistent implementation is essential to preserve the advantages of an open and globally integrated financial system. . . . A return to a nationally segregated global financial system would reduce both financial capacity and systemic resilience, with major consequences for jobs and growth across our economies.”5

Controversies and externalities are multiple. One example is the focus of the FSB on over-the-counter derivatives. In late 2010, the FSB issued a report that recommended increased standardization, central clearing, increased transparency, and enhancement of exchange and electronic trading. Implementation has proved to be particularly contentious among the various relevant jurisdictions with respect to the recommendations on central clearing and the use of central counterparties (CCP). This is a two-level debate. On one level are concerns about the risk management of the counterparties. On a second level is a jockeying of position vis-à-vis the location, supervision, and potential extraterritorial reach of the CCP which may impact the attractiveness of various financial centers. The British authorities want to defend the unique position of London, the continental European authorities want to defend themselves against Anglo-Saxon domination of financial market supervision and regulation, and the US authorities want to do what they want to do.

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A second example is the so-called Volcker rule placing limits on proprietary trading by US banks and potentially other US financial institutions. The Volcker rule started out as a five-page legislative proposal, morphed into 12 pages in Section 619 of the Dodd-Frank US financial reform legislation, and now is the subject of a 127 page federal register notice with respect to regulation implementing the legislative provisions. The Dodd-Frank Act has been criticized because it was developed in a national framework rather than a multilateral framework. This strikes me as a largely irrelevant criticism. The US legislation was developed in parallel with the FSB and other discussions, and most observers agree the provisions of the Dodd-Frank Act are broadly compatible with international agreements reached in the aftermath of the global financial crisis.

Tucked into the original five-page proposal was an exemption for “trading in obligations of the United States or any agency thereof . . . and obligations of any State or political subdivision thereof . . .” Therein is the rub. On the one hand, the Volcker rule and other provisions of the Dodd-Frank Act apply generally to the activities of US financial institutions in their operations outside the United States, though the extent of that application has yet to be fully defined. Thus, they are extraterritorial in their application and effects. On the other hand, the Volcker rule provisions, in principle, discriminate between the obligations of the United States and other governments. In the process, they are alleged to adversely affect the liquidity and, therefore, the cost of debt issued by other governments. US regulators could choose to exempt foreign government securities, and they have invited comments on this point. Given the unhappy experience with Basel I and its application of zero risk weights to claims on governments that are members of the Organization for Economic Cooperation and Development and the recent experience with the mark downs, restructurings, and write downs of obligations of certain European sovereigns, I suspect that any enlargement of the exemption under the Volcker rule for government securities to other countries will be very circumscribed.

A third example is the recent debacle at JP Morgan Chase’s London unit. Who should have been responsible for supervising this unit? Should the rules governing off-shore entities of US banking organizations be tightened? Who determines what a level playing field is for whom? These are complex issues. Many have been around since the Herrstatt and Franklin National Bank failures in the 1970s. They will not be resolved quickly, and at a minimum they will require greater cooperation.

In summary, progress has been substantial in the area of financial supervision and regulation. The emerging regime lacks an overarching legal framework. This forces reliance on cooperation and, in some respects, avoids some issues of sovereignty because each country, or jurisdiction, in the end makes its own decision on implementing non-binding international agreements. However, countries are choosing to share their sovereignty in this area.

European Sovereign Debt Crises

The European sovereign debt crises raise issues of national sovereignty at a different level than globally because European cooperation today is governed by a succession of treaties, starting with the 1957 Treaty of Rome setting up the European Economic Community.

From the start, the European integration project involved a balance of economic and political motivations. The economic motivation was to capitalize on the efficiency benefits of integration in trade, market structure, and practices. The political motivation was to bind together peacefully the nations of Europe and, in the process, project a larger European role on the global stage.
Over the past several years, the question for Europe has been whether the European integration project will move forward or backward. Clearly the status quo is untenable. If the project moves forward toward deeper integration politically as well as economically, what form will it take?

If the project moves backward, the questions are how extensive will be the unwinding and what will be the economic, financial, and political ramifications within Europe and for the rest of the world. My presumption is that moving backward would prove to be costly for all.

If the project is to move forward, the task is, first, to stop the bleeding from the sovereign debt crises in the euro area, and, second, to take concrete actions to move beyond the economic and monetary union (EMU) enshrined in the 1992 Maastricht treaty. That treaty created a halfway house. It laid the foundation for the establishment of the European Central Bank and the issuance of the euro. But it did not establish supporting institutions. Moreover, the consequences of the launch of the euro in 1999 were not fully advertised and appreciated by the general public. The view was that the euro was win-win for everybody in every country at all times. This view was supported by a protective pride in the accomplishment of EMU that ignored criticism and surveillance from outside, including the IMF.

Pride and a lack of a fully developed set of decision-making institutions have prevented the Europeans from forcefully coming to grips with the sequential emergence of sovereign debt crises over the past two and a half years. After 19 summit meetings, the Europeans last month ultimately may have turned the corner on their crisis. We will not know with any confidence for another six months or so.

Meanwhile, if someone had said in January 2010 that the crisis in Greece, a country with a GDP of less than 3 percent of the euro area total, would be allowed to fester and spread to five other euro area countries, most observers would have said that the Europeans would not follow such a dangerous course. The implicit objective of the course that has been chosen is to instill greater economic and financial rectitude in the euro area and to lay the foundation for a more perfect European Monetary Union. But this is a high risk and costly strategy.

The European sovereign debt crises illustrate what happens when countries fail to share sovereignty ex ante or to cooperate effectively ex post in a crisis. Starting in May, 2010 the Europeans endeavored to create a firewall to prevent the spread of the Greek crisis to other countries. They should have developed a safety net for the countries that followed Greece into crisis. Either way, the economic consequences of their failures are substantial and inexcusable.

Over the past year or so, the euro-area crisis has been the principal negative element affecting the global economy. In April of this year, in the World Economic Outlook, the IMF staff forecasted that the level of world economic activity in 2013 would be 1.5 percent lower than the level they had forecasted only one year previously. The loss of world GDP amounts to $1.1 trillion.\(^6\) Moreover, the April IMF forecast assumed that the Europeans would be successful in dealing with the euro area crisis, but the crisis has deepened as the IMF has recently noted.

For the euro area alone, the projected shortfall of economic activity is 3.3 percent or $730 billion, which is more than two times the total annual GDP of Greece in 2010 ($305 billion). Even for Germany, the projected shortfall economic activity in 2013 is 1.5 percent. The lack of cooperation in Europe, based largely upon inability to recognize the need to pool sovereignty, has been expensive. Put the other way, the benefits of having the ex ante basis for greater cooperation, which would have

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\(^6\) In the growth rate calculations, I have cumulated the growth rates predicted by the IMF staff for the 2011 to 2013 period in April 2011 and April 2012 and taken the difference. In the estimates of lost GDP, I have calculated the percentage change in the level of GDP in US dollars from a base of 2010 in the April 2011 World Economic Outlook (WEO) forecast and applied it to the base of 2010 in the April 2012 forecast, and taken the difference.
required the abandonment of a symbolic, but largely useless, sovereignty within the euro area, would have been significant if European leaders and the general public in Europe were prepared to take the necessary steps.

Turning to the economic costs that the euro area crisis has imposed on the rest of the world, for the advanced countries as a group, the IMF’s projected shortfall in 2013 economic activity is 2.5 percent, or $1.3 trillion. In other words, Europe has imposed a loss of about half a trillion US dollars on the other advanced countries. The projected impact on US economic activity in 2013 is 1.0 percent or $156 billion. The impact on Canadian economic activity is 0.3 percent, but only $5 billion because of the appreciation of the Canadian dollar by 2.5 percent over the period since 2010. (This has boosted the US dollar value of Canadian GDP by an equivalent amount.) The projected shortfall in economic activity in 2013, on average, for the emerging market and developing economies is only 0.9 percent; all subgroups, starting with Central and Eastern Europe and the countries in the Commonwealth of Independent States, are projected to be adversely impacted.

Whatever the outcome of the European sovereign debt crises, Europe faces a continuing economic and political decline. A reasonable prediction is a decade of stagnation with real growth averaging less than 1 percent per year. Europe accounted for one third of world GDP in 1980 on a purchasing power parity basis, one-third more than the United States. The IMF’s projection is that Europe’s share in 2017 will decline to less than 18 percent of the world, equivalent to the United States. And the euro area, which in 1980 had the same share as the United States, will be only two-thirds as large. Moreover, there are three Europes—the euro area, the European Union, and geographic Europe—which will complicate the evolution of Europe.

Things could get much worse if the euro area disintegrates. Macroeconomic Advisers recently produced a scenario for the US economy of a full-blown European crisis triggered by a Greek exit from the euro or any number of other potential mishaps. Growth in Europe and the rest of the world fall substantially; the euro area has a five quarter recession. The US dollar appreciates, and US exports decline. The economic and financial chaos impacts US consumer spending and investment. Even with a vigorous response by the Federal Reserve, which would be felt with a lag, the US economy experiences a three quarter recession.

Thus, the citizens of the United States, as well as Canada, have a substantial self-interest not only in the Europe’s turning the corner on its crisis, but also in helping Europe to do so. Unfortunately, that is not the way the winds are blowing. On June 26, 2012, Rasmussen Reports published a survey of 1,000 of those living south of here. Although 70 percent thought Europe’s economic woes were getting worse, 77 percent opposed more US help to bail out Europe.

Conclusion

National sovereignty and multilateral cooperation are indeed complementary, but not in Mark Mazower’s 19th century sense of mutual support. They are complementary in the sense that without greater international cooperation, the value of national sovereignty is nugatory. Without international cooperation, the international financial institutions are rendered powerless. Contrary to the current pattern in Europe where the name of the game appears to be political confrontation, but fortunately not of the military type, cooperation is essential to maintain and promote economic growth and stability.

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Our grandchildren have introduced me to a game called *Forbidden Island*. It is an unusual game in that the players must cooperate in order to win the game by escaping the island before it disappears into the sea; either all players win or no one wins. We are far from the exercise of this utopian type of common sovereignty within Europe or in the world as a whole.

However, I am a pragmatic optimist. While many denigrate the G-20 leaders’ process, for example, I think the establishment of the G-20 at the leaders’ level is a substantial step forward. It has acted when it can, but it has also begun to lay the foundation for more extensive multilateral cooperation. That cooperation must be built on a degree of trust, which requires discarding an unrealistic defense of national sovereignty. It requires the capacity to identify common problems, to reach an agreed diagnosis, and to act cooperatively. It requires robust international financial institutions, and a transformation of the governance of those institutions. The governance transformation is underway, but incomplete. In addition, many of the countries, in particular the non-advanced G-20 countries, must accept substantially greater responsibility for the performance of the system as a whole if the international financial institutions are to perform their appropriate roles in an increasingly integrated global economy and financial system.

The challenge today and tomorrow is whether progress in increasing the supply of international cooperation will keep up with rising demands to address the inevitable financial crises of this century.