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### Risk Reduction in the New Financial Architecture: Realities, Fallacies, and Proposals

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"There is no regulatory or supervisory agency in any country, including the United States, which fully and comfortably understands, for example, how leverage is accomplished, in what volumes, with what participants and products, the nature of the collateral and the minute-to-minute shifts of positions by the players."

Eugene H. Rotberg, former Treasurer of The World Bank, reporting to clients after the 1998 Bank-Fund meetings

Mark Twain remembered from the silver mines of Nevada a grizzled prospector who set up some tent poles beside a rocky ledge and stretched a canvas between the ledge and the poles to make a shelter for his bed and his gear. A cow came ambling down the hill, stepped onto the canvas and fell in on him; and he rebuilt his lean-to and went back to bed. Another cow fell in; and he rebuilt. Again. And again. Finally he reacted: "This danged thing," he said, "is getting monotonous."

Six times in the 1990s—in the American banking disaster of 1990-91, the failure of the European monetary grid in 1992, the unanticipated interest-rate hikes by the Federal Reserve in 1994, the Mexican collapse of 1995, the Asian disaster of 1997, and the Russian default of 1998—the world's financial structure shook and shivered, and a cow fell through the roof. "By any standard," said E. Gerald Corrigan of Goldman, Sachs, formerly president of the Federal Reserve Bank of New York, "the frequency and consequences of these events are simply too great."<sup>1</sup> The world's political leaders, like Mark Twain's silver miner, grew tired of the repeated experience, and went looking for something that could carry a heavier load. G-7, G-10, G-22, IMF, BIS, IIF, the finance ministries, economists and (more skeptically) the central banks have worked together to establish "a new financial architecture."

It may well be that a complete restructuring would do us good. Our discussions of financial matters have moved too far from the realities of getting and spending in real economies. Finance, which should be in the boiler room, has mounted the pulpit. Once perceived as parasitical but inescapable in a world where only partial information exists, trading in financial instruments has become the one and only yellow brick road to price discovery. We continue to use terms like "current account" and "capital account" that are meaningless in the age of the derivative. After generations of warning students against trying to compare apples and oranges, we seek algorithms to guarantee the arbitrage of quite disparate pieces of paper, from different countries (some with open economies, some with closed economies), issued at different times for different durations, carrying different promises and obligations. In the name of rational expectations, we accept volatilities that destabilize production plans and compel producers to pay the ever-growing costs of hedges that may not work when they are most needed.

Some proposals for a "new financial architecture"—especially the suggestions for restrictions on interbank lending—do indeed imply a willingness to sacrifice efficiency for congruence with a more complicated reality. Others—especially in the area of financial reporting, where honest accounting would sabotage the customs of so