

Dialogue on Globalization

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Re-Defining the Global Economy

Introduction: Joseph Stiglitz

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FRIEDRICH EBERT STIFTUNG

Dialogue on Globalization

Dialogue on Globalization contributes to the international debate on globalization – through conferences, workshops and publications – as part of the international work of the Friedrich-Ebert-Stiftung (FES). *Dialogue on Globalization* is based on the premise that globalization can be shaped into a direction that promotes peace, democracy and social justice. *Dialogue on Globalization* addresses "movers and shakers" both in developing countries and in the industrialized parts of the world, i.e. politicians, trade unionists, government officials, business people, and journalists as well as representatives from NGOs, international organizations, and academia.

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Preface:
Adam Smith's Market Never Stood Alone

From Adam Smith's single reference to the "invisible hand" in *The Wealth of Nations*, one would be hard pressed—even delusional—to derive a theory of the self-sufficiency of the market economy. Quite the contrary. As the headline of a commentary by Harvard economist/philosopher Amartya Sen proclaimed in the *Financial Times* on 11 March 2009, "Adam Smith's market never stood alone".

Indeed by understanding that the self-interested individual may sometimes be "led by an invisible hand to promote an end which was no part of his intention"[1], the founder of modern economics laid open the possibility that the invisible hand could yield either positive or negative, unintended results. The global economic crisis we are in demonstrates the negative consequences of promoting a financial "free market" that approaches human needs—like social protection, health care, education, justice and community—only in terms of their profitability. The crisis also presents an opportunity to explore the need for shared, international responsibility, to engage—in an ongoing way—the political governance of the global economy.

The idea for *Re-Defining the Global Economy* grew out of a meeting on the financial crisis that took place on 13 November 2008, just two days before the original G-20 Summit and two weeks before the United Nations Review Conference on Financing for Development. Co-sponsored by Initiative for Policy Dialogue at Columbia University and the Friedrich-Ebert-Stiftung New York office, the meeting was led by Nobel Laureate Joseph Stiglitz, who was joined by more than 50 expert academics, international regulators, banking representatives and policymakers from the US, Europe, Asia and Latin America in a frank discussion of the financial crisis, its causes and the future of financial regulation and institutions. Following the meeting, we in the Friedrich-Ebert-Stiftung wanted to organize a broader discussion based upon the questions raised by each of these events and by the unfolding crisis itself. In particular, we hoped to solicit more input from the developing world and on behalf of trade unions and other parts of society whose needs and concerns did not necessarily have a representative voice within the G-20.

We invited expert authors—politicians, practitioners and academics with extremely thoughtful, and therefore sometimes controversial views on how to respond to the crisis—to contribute short articles to what we envisioned would become a general, political reader, something to promote discussion at conferences, meetings and town-halls around the world. We are therefore honored that Joseph Stiglitz's "Social Democratic Response" to the financial crisis, crafted in the immediate aftermath of the November G-20 Summit, will introduce the publication.

Re-Defining the Global Economy takes three approaches to the project implied by the title. The first relates to the institutional arrangements necessary for a just, well-

[1] Adam Smith, Wealth of Nations, Book IV, Ch. II, pg. 485 Modern Library Edition, New York

governed and well-functioning financial system. Authors **José Antonio Ocampo**, **Eric Helleiner**, **Tony Porter**, **Kemal Derviș** and **Peter Bofinger** contributed to this section and addressed problems related to development-friendly reforms, making governance more accountable for both informal, transnational networks and formal institutions, and whether there is a role for public sector rating agencies.

The second approach tackles the thorny question: does a just, well-governed and well-functioning financial system require *global*—as opposed to national or regionally coordinated—regulation? Authors **John Eatwell**, **Arturo O'Connell**, **Stanislaw Kluza** and **Avinash Persaud** contributed to this section and wrestled with concepts like how a global regulator would function, what role central banks need to play in the new order, and the necessary relationship between global and nationally-based prudential regulation.

The third outlook on the crisis concerns what political and economic arrangements are necessary for securing social protections. Authors **Dean Baker**, **Damon Silvers**, and **Prabhat Patnaik** contributed to this section and confronted questions such as how to create political space for effective regulation, defining labour's perspective on democratizing financial regulation, and—most fundamentally important—food security, of which Prabhat Patnaik contends, "Neither the seriousness of the world food problem nor the intimate relationship between the world food problem and the world financial arrangements has received the attention it deserves".

There is no singular outlook represented in this reader. Each author's views are solely his own. However, they share the outlook that financial markets have to be actively and responsibly governed, not left to an invisible hand, when the interests of people are at stake. They share the outlook that the crisis yields an opportunity to fundamentally reshape the present global economic architecture in such a way that preserves the project for development that is sustainable and human-centered. Perhaps most of all, these authors' contributions argue for a shared, international responsibility, to engage—in an ongoing way—the political governance of the global economy.

We would like to bring this discussion to you.

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1. A Social Democratic Response

By Joseph Stiglitz

Four principles guide the social democratic response:

- **Solutions must be consistent with basic values of social justice and social solidarity as well as basic notions of fairness**
- **The bonds of social solidarity cross national boundaries; we cannot take actions to help ourselves at the expense of those in the developing world**
- **Solutions must reflect an understanding of the necessary balance between government and markets**
- **Respect for the basic principles of democratic due process, including full transparency.**

There is by now a consensus that the current global financial crisis may well be the worst since the Great Depression. As solutions are proposed, there is strong pressure from Wall Street to make sure that their way of doing business is protected. They don't want to see finance suffer from too much regulation.

In times of crisis, we all have to pull together; sacrifices are asked of us all. But in a democracy, that does not mean silent ascension to whatever is proposed. The voices of Social Democrats and those who reject the free market mantra of the US, should be listened to as the debate about how to proceed moves forward. We must be allowed to help formulate the government responses to the crisis. There are stark differences of opinion as to the best way to proceed.

The response of the US should have focused more on helping the millions of Americans who were losing their homes, ensuring that the economy not go into the predictable (and predicted) recession into which it has been sinking, and minimizing the inevitable resulting hardship. The US has one of the worst unemployment schemes in the advanced industrial countries. The US is one of the few countries that does not recognize access to medicine as a basic human right; and when Americans lose their jobs, they lose their health insurance. This says something about priorities and values.

The American bail-outs were arranged behind closed doors; some were bailed-out, others not; some were bailed-out under punitive terms, others walked away with marked increases in marked value as a result of government capital injections. Some of the financial institutions being helped were told to change their management, others were not. The only consistency is the lack of consistency and non-transparency, and the failure to do anything direct about the underlying problems. While money was being poured into the banks, they were allowed to pour money out to their shareholders in dividends. No obligation to increase lending was imposed.

The Social Democratic response begins with concerns about equity; but it is based on a deeper understanding of market economics than the responses of the Right. The Social Democratic response begins too from the perspective that the economy and financial markets should serve the citizens of our society. They are a means to an end, not an end in themselves. It is not necessarily the case that what is good for Wall Street is good for the rest of the economy.

Moreover, any adequate response cannot be based on trickle down economics—the notion that helping those at the top will benefit all has been repeatedly rejected. The US response was predicated on exactly that proposition: throw enough money at Wall Street, and eventually, some of the benefits may eventually help ordinary Americans.

If managers of firms have incentives for distorted accounting, excessive risk taking, or a focus on short-term profits they will take risks and focus only on the short-term. Nontransparent stock options and bonuses based on the short term aggravate this problem.

Market failures arise from conflicts of interest and lack of good information that can ensure sound allocation of resource allocations. Where there is a separation of ownership and control, managers do not necessarily act in the best interests of shareholders, let alone other stakeholders. Unregulated markets do not act in society's best interests. American financial managers' unbridled pursuit of self-interest—greed—has imposed a high cost on all of us.

We will not be able to restore confidence in our financial markets unless we change their behaviour through regulation. Regulation must be comprehensive. Regulatory institutions too have to be reformed; too often, the regulatory process has been captured by those who were supposed to be regulated. The voice of those injured as a result of inadequate regulation—pensioners who lose their life savings, homeowners who lose their homes, workers who lose their jobs—has to be paramount. Such regulation could encourage real innovation, not the kind focusing on regulatory, accounting, and tax arbitrage that has marked America's financial markets in recent years, or the derivatives that were supposed to manage risk but instead created it; but innovations that might allow average citizens to remain in their homes in the face of the economic vicissitudes which they face. Banks were allowed to become too big to fail and that was dangerous for all of us.

It is ironic that Social Democrats are sometimes accused of not understanding market fundamentals. After all it was the great economist John Maynard Keynes who some 75 years ago saved capitalism from the capitalists. It was Keynes who explained how government action could help the economy recover from the Great Depression. Today, his ideas have become part of conventional wisdom, agreed to by the right and the left.

Once again, social democrats are providing a roadmap for saving capitalism from the capitalists. Their proposals for recovery, and for preventing another such calamity, will in time be accepted as conventional wisdom. But time is of the essence: the quicker that governments can rally behind these ideas, the shorter will be our downturn, the quicker will be our recovery, and the fewer the number of innocent bystanders whose lives and dreams will be dashed in this tragic episode. We are living in a man-made crisis that was made in the United States. It could have been avoided, had Social Democratic principles been more widely adopted and implemented.

Joseph Stiglitz
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2. A 7-Point Plan For Development-Friendly Reform

By José Antonio Ocampo

The financial crisis has shown how dysfunctional the current global financial architecture is for managing today's global economy. The need to govern globalization has never been clearer, but at the same time the present institutional arrangements have never been so impotent. Calls for deep reforms and even for a second Bretton Woods Conference are, therefore most welcome. Similar calls for reform were made after the Asian and Russian crises, which engulfed most of the developing world in deep recessions, but they led at best to marginal reforms. The fact that this time the industrial countries are at the center of the storm may lead them into action, but it also creates the risk that measures of direct interest to developing countries will be marginalized from the agenda.

There are also two fundamental problems with these calls for reform. The first is that they lack scope: most proposals relate to macroeconomic action to counter the world recession (including helping developing countries counter strong external shocks) and to regulatory reform. In both cases they are largely confined to national policies rather than to reform of the global architecture. Most of the issues presented in this paper are left out of the agenda. Second, the process started the wrong way, by excluding most countries from the table. It is obviously good for major industrial countries to show leadership, but no fundamental reform can take place if it is not enacted in an inclusive process. History has shown that crises represent opportunities to redraw old arrangements—even in radical ways.

1. The process and the institutional design that it develops must be inclusive.

It is important for major countries to show leadership. This now includes major developing countries. However, a desirable reform process must give voice to industrial and developing countries alike, and to both large and small countries. So, the major objective of the reform process is not to replace the G-7/G-8 by another G. The G-20 is certainly better in this regard, but it is still an ad hoc arrangement in which major developing countries (e.g., Nigeria), major industrial countries (e.g., up to very recently Spain), and most particularly, medium and small-sized countries are unrepresented.

This also means that the governance system that the current process should design must be based on representative institutions, not on any G, which will always face problems of legitimacy. And it is necessary, for the same reason, to involve the United Nations, the most representative global institution, perhaps by taking the step, recommended in the past by many, of creating a Global Economic and Social Council in the United Nations, with effective powers of coordination over the system of global economic and social governance. Such a body would have to be based on a constituency system that takes into account the different weight of nations, such as that on which the International Monetary Fund (IMF) and World Bank boards are constituted (with significant redefinition in the way these “weights” are measured), rather than on the “one country one vote” system on which the UN is built. The UN Financing for Development process could become the institutional framework from which to launch a participatory process leading to such reform of the global financial architecture, with the backing and close collaboration of the United Nations, the Bretton Woods Institutions and the Bank of International Settlements (BIS).

This process should, furthermore, place at the center of the debate the discussion of voice and representation of developing countries in international economic decision making and norm setting, as mandated by the Monterrey Consensus approved in the 2002 UN Conference on Financing for Development. This includes not only the IMF, the only place where some (though extremely modest) reforms have been adopted, but also the World Bank (where such discussion is in place), the Bank of International Settlements, the Basel Committee on Banking Supervision, the Financial Stability Forum and other world regulatory bodies.

2. A coordinated global macroeconomic policy package must be adopted.

The global recession now under way calls for a strong policy response. This means clear expansionary monetary, credit and fiscal policies in all industrial countries. Europe has lagged behind in all these dimensions relative to the US and Japan. Developing countries should also be part of the solution, and should adopt equally expansionary policies. The fact that many of them have accumulated large amounts of foreign exchange reserves in recent years, and have lower external and public sector debts than during previous crises, implies that they do have more maneuvering room to adopt expansionary policies than in the past.

However, the strong retrenchment of private capital implies that support from multilateral institutions (the IMF and multilateral development banks) as well as bilateral development cooperation would be crucial to facilitate counter-cyclical policies in the developing world. The major problem is the scale of such financing. According to the Institute of International Finance, emerging markets will face net negative private credit flows of US$30 billion in 2009 vs. net positive flows of US$632 billion in 2007. International Financial Institutions will only add US$28 billion in financing (i.e., about 4 percent of the shortfall!). So, a major initiative to increase the availability of multilateral financing is required which, as I argue below, should be based on a major counter-cyclical issue of Special Drawing Rights (SDRs). The G-20 took the right steps in the direction of reactivating SDR issuance and increasing multilateral financing. However, in the case of the IMF, additional financing will rely on “arrangements to borrow”, which is the least desirable of all available mechanisms; increased quotas and allowing unutilized SDRs to finance additional IMF lending are much better in this regard.

Multilateral financing—and additional ODA in the case of poor countries—is particularly important for those countries that have more limited room to maneuver, due to the imbalances accumulated during the previous boom, the capital outflows and/or the collapse in their terms of trade. But this means that it is essential to avoid the IMF conditionalities of the past, which forced developing countries to adopt contractionary macroeconomic policies during crises. The composition of the policy packages is also essential, both in terms of the monetary/fiscal mix as well as the relative size of packages adopted by different countries. The strong balance sheet adjustment and associated financial deleveraging taking place in the private sector of the industrial world, and particularly in the United States, means the demand for credit by private agents may be weak, even if the health of the financial sector is restored. This enhances the need for expansionary fiscal policies. To the extent that tax benefits are likely to be saved rather than spent, public sector spending policies are also clearly preferable.

Furthermore, industrial and developing countries with external surpluses should lead the way in adopting expansionary policies. Relying excessively on the expansionary policies of the world's major deficit country, the United States, runs the risk of igniting (or, rather, reigniting) fears of disorderly adjustment to global imbalances, which would add another highly undesirable dimension to the current crisis—or abort an eventual US-led world economic recovery. More generally, relying on an export-led recovery is highly undesirable in the face of the ongoing collapse of international trade, as it may encourage already visible protectionist pressures in many countries. The most undesirable outcome of the current crisis would be repeating, even in weaker forms, the "beggar thy neighbour" policies that magnified the effects of the Great Depression.

The IMF should be placed at the center of global macroeconomic policy coordination. This is the only way to provide a clear institutional structure for such coordination and to give developing countries a voice on the associated processes. Indeed, the current crisis provides the opportunity to put the IMF back at the center of global macroeconomic policymaking, as its original design envisioned. Such coordination has tended to take place outside the Fund since the breakdown of the original Bretton Woods arrangements in the 1970s, including in recent decades through the role assumed—in a very weak form, anyway—by the G-7. The multilateral surveillance of global imbalances launched by the Fund in 2006 was an interesting step in that direction, but it lacked binding commitment by the parties and an accountability mechanism.

3. The regulatory deficit of global finance must be corrected.

The magnitude of the current crisis is clearly associated with inadequate regulation and supervision of financial activities. Since the Asian crisis, it was accepted that financial liberalization must be accompanied by stronger prudential regulation and supervision. This principle was applied in many parts of the developing world but was entirely disregarded in the US, where further liberalization was accompanied by deregulation and weak supervision of financial intermediaries.

The discussion on regulation must start by agreeing on basic regulatory principles. The first principle is that regulations should have a strong counter-cyclical focus, thus avoiding excessive indebtedness (leverage) and forcing financial institutions to accumulate increasing capital, provisions (reserves) and liquidity cushions during booms. Absolute limits on leverage should be part of the solution. This also implies that, when pricing assets according to their market value to maintain transparency, the system must have mechanisms (such as counter-cyclical loan-to-value ratios) to avoid asset price bubbles from feeding into the credit expansion, and asset price busts from feeding into the credit squeeze.

Regulations must also be comprehensive, to avoid the massive loopholes through non-banking intermediation that led to the current turmoil, and that has in fact been central to the increased systemic leverage during booms that preceded financial meltdowns in many countries. This will also include regulating the types of transactions that led to the current crises, particularly securitization and derivatives, and will force all the markets to be open and transparent and thus limit over-the-counter operations. Systemically important financial intermediaries must be subject to particularly harsh supervision, and perhaps to stronger regulatory standards. Reliance on the internal models of financial institutions, the major focus of Basel II, should be discarded. It has already shown how perilous it can be, and how the use of similar risk models by financial institutions can lead to greater instability.

To these principles we must add other, well-established ones: consumer protection, restricting monopoly power (a major issue looking forward, as private finance is experiencing rapid concentration), and encouraging portfolio diversification. Suffice is it to say that even these well established principles were not followed in recent years. The first of these functions should be considerably enhanced to avoid the supply of toxic mortgages and highly risky investment vehicles offered to unsophisticated agents during the recent boom in many countries.

Creating a single world financial regulator is probably not viable or, for that matter, desirable, given different regulatory traditions around the world. So, the system that is designed in this area should be based on a well functioning network of national and regional authorities (still missing in the EU) and should include truly international supervision of financial institutions with a global reach (such as the college of supervisors proposed by the G-20). The IMF should not be at the center of the regulatory system. The BIS and the Basel Committee are better placed, but this would require a fundamental reform to broaden (preferably universalize) their membership and address two major problems that the Basel Committee has faced in recent years: the lack of representation of developing countries—a problem that has now been partly corrected by extending its membership to all G-20 countries—and the capture of regulation by large multinational banks. Clear accountability mechanisms would also have to be introduced in all regulatory bodies, both national and international.

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4. The International Monetary Fund should be revamped.

Four essential reforms of the IMF should be part of the agenda. The first, as pointed out, is placing this institution at the center of global macroeconomic policy coordination. The second is creating a meaningful and truly global reserve currency. The third is improving the crisis response effort. The fourth is a more active use of capital account regulations. The IMF was created on the basis of the dual gold-dollar system (the so called “gold-exchange standard”). This system collapsed in the early 1970s and was replaced by one based on fiduciary dollars, and secondarily on competing fiduciary reserve currencies—i.e., on the use of a national currency (or national and regional currencies) as a global currency. This system is inequitable and unstable. It is inequitable because it forces a transfer of resources from developing countries to the developed nations that provide reserve currencies—a transfer that has actually increased through time due to the realization by developing countries that “self-protection” in the form of large foreign exchange reserves is the only defense they can rely on in a world of acute financial instability.
The system is also unstable because it is plagued by cycles of confidence in the US

dollar, when the US alternatively adopts expansionary policies—reflecting the fact that the system does not impose firm macroeconomic discipline on the reserve issuing country—followed by contractionary policies, which may help restore the credibility of the dollar as a reserve currency. During both phases of this cycle, policies of the reserve currency country are adopted without consideration as to their international impact. A system based on competing reserve currencies would not solve the inequities and instability of the current system and—to make matters worse—would add another one: the instability of exchange rates among major reserve currencies. Indeed, this problem is already partly present in the current system.

The inequities and instability of current arrangements is why the world monetary system should be based on a truly global reserve currency: a fiduciary currency backed by the central banks of the world. This is what was hoped for when the SDRs were created in the 1960s. This process must be completed, by either transforming the SDRs into such a global currency or by creating a global reserve asset that could be used in at least some private financial transactions. Among other advantages, this system would provide a mechanism for the IMF to play a more active role during crises, by issuing SDRs in a counter-cyclical way. Indeed, a large counter-cyclical issuance of SDRs is the best mechanism to finance large official support to developing countries during the current crisis. This would be the global equivalent to what the US Federal Reserve Bank has been doing on a massive scale since September, expanding lending to the private sector by more than one trillion dollars (with more to come under current policies)—with no consideration as to whether this is consistent in the long run with the role of the dollar as a global reserve currency. This has not been a major problem in the short run, due to both "flight to quality" and the transfer of resources to the US to cover the withdrawal of funds from financial intermediaries that is taking place as a necessary part of the ongoing de-leveraging process.

The third issue is the need for the IMF to lend during balance of payments crises rapidly and without the overburdening conditionalities of the past, particularly when the sources of the crises are rapid reversals of capital flows or sharp deteriorations in the terms of trade. This means putting in place a preventive credit line for capital account crises and making resources available in adequate magnitudes to compensate for adverse terms of trade shocks. This implies that the IMF would act more like a central bank, providing liquidity in an agile way, the way central banks have actually been providing funds in industrial countries on a massive scale in recent months. Positive steps in this direction were adopted by the IMF on 24 March 2009, particularly the creation of the Flexible Credit Line for crisis prevention purposes, the considerable expansion of other credit lines and the major reform of conditionality (relying more on ex-ante conditionality and eliminating structural performance criteria). It remains to be seen whether the Flexible Credit Line would be actively used (its two predecessors were not). This line also runs the risk of unduly dividing developing countries into two categories: those with good policies and those with bad, which entails significant additional risks for the latter. As indicated, the financing for such liquidity could be a large counter-cyclical issue of SDRs.

The current IMF agreement does not commit countries to capital account convertibility and thus leaves them with full autonomy to adopt capital account regulations, either to restrict excessive capital inflows during booms or to control capital flight during crises. The evidence of strong linkages through which both financial euphoria and panic are transmitted worldwide indicates that it would be wise to make more active use of capital account regulations. The Fund should be encouraged not only to tolerate but actually to advise countries on what regulations to impose under given circumstances. Indeed, the regulatory structure that must be developed to manage financial stability in the global era should include provisions that apply to cross-border capital movements, such as: generalized reserve requirements on cross-border flows, minimum stay periods, and prohibitions to lend in foreign currencies to economic agents that do not have revenues in those currencies.

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5. A counter-cyclical role for development cooperation should be fully utilized.

A large increase in Official Development Assistance (ODA) to low income countries can play an important role, not only to combat poverty but also to contribute to the generation of aggregate demand at the global level. Meeting existing ODA commitments (which will face strong competing fiscal demands in industrial countries) but also making additional aid available is particularly important to counter contractionary policies in the poor countries in the face of a deterioration in their terms of trade due to a collapse of commodity prices.

Past crises have also shown that multilateral development banks (MDBs) can play an essential role when private financing dries up. The major problem, as we have seen, is the scale of their resources. So, a major initiative to increase the resources available to multilateral development banks is crucial. Additional capital injections are one solution. Another is to allow these banks to benefit from the counter-cyclical issue of SDRs, by authorizing the IMF to buy MDBs' bonds (or investing part of the SDRs received by industrial countries in such bonds).

Crises, including the current one, have also shown that one particularly problematic issue that developing countries face is the curtailment of commercial credit available to exporters, which then becomes an additional contractionary effect and severely limits an essential mechanism through which deficit countries can recover from crises. So, the launching by MDBs of a large scale program of commercial lending, such as that proposed by the World Bank, should be at the center of the crisis-response efforts. MDBs can also play a role in risk mitigation by operating as "market makers" for innovative instruments, such as GDP and commodity-linked bonds, and move fully (or even completely) into lending to developing countries in the national currencies of recipient nations.

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6. An international debt court must be created.

The lack of a regular institutional framework to manage debt overhangs at the international level—i.e., a court similar to those created to manage bankruptcies in national economies, the decisions of which are legally binding—is one of the major deficiencies of the current international financial architecture. The only regular institutional mechanism in place is the Paris Club, which deals exclusively with official financing. The system has relied in the past on ad hoc mechanisms, such as the Baker and Brady Plans of the 1980s and the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiatives (MDRI) since the mid-1990s, or on traumatic individual debt renegotiations. The problem with all these mechanisms is that they have generally come too late, after high indebtedness has had devastating effects on countries. This is also true of the Paris Club, due to its traditional reliance on sequential debt rescheduling, which again means that countries are left with debt hangs for excessively long periods. The system is also inequitable, as it does not treat all debtors or all creditors with uniform rules. Even Paris Club creditors regularly complain that private lenders do not follow their agreements. Unilateral renegotiations can also lead to an unfair treatment of borrowers depending on their weight and influence.

The discussion of the new international financial architecture should solve this problem by creating an international debt court to serve both as mediator and eventual arbitrator of both public and private sector international loans and bond issues. Privately-run restructuring mechanisms, based on the active use of collective action clauses, are clearly insufficient, as debtors would delay using the mechanism to avoid antagonizing creditors, debtors would not be uniformly treated, and there would not be a uniform treatment of official and private creditors. Any workout mechanism that is developed has to start with defaults by debtor countries, which would then trigger negotiations. And the system must be based on the principle of a "fresh start", allowing borrowers to make a (relatively) swift return to markets. Furthermore, active use of multilateral development bank lending and guarantees could play a role in supporting such a return to markets.

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7. The system must rely more on regional institutions.

In all of the areas of reform, the global architecture should rely more broadly on regional institutions. Indeed, in a heterogeneous international community, the creation of networks of global, regional and national institutions will provide a better system of governance than arrangements based on single global organizations. This is based on old federalist principles: regional and sub-regional institutions give stronger voice and sense of ownership to smaller countries and are more likely to respond to their demands. In some areas this is recognized today, such as in the system of multilateral development banks, where the World Bank is complemented by regional development banks and, in some parts of the world, sub-regional and inter-regional banks.

Applying the system of networked institutions is particularly urgent in the monetary area, where the IMF should make more active use of regional institutions, such as the Chiang Mai Initiative or the Latin American Reserve Fund, and support their creation in other parts of the developing world. Indeed, the IMF of the future should be seen as the apex of a network of regional reserve funds—that is, a system closer in design to the European Central Bank or the Federal Reserve System than to the unique global institution it currently is. Similar institutional design could be adopted for prudential policies and for the international debt court.

Developing countries are in an excellent position to contribute to this task, given their large foreign exchange reserves. Using those reserves more actively for swap arrangements among central banks, pooling them in reserve funds, or using them to support the development of regional bond markets are all mechanisms to multiply the room to maneuver that they provide. These reserves and existing sovereign wealth funds could also be used to create or capitalize multilateral development banks owned by developing countries, and to invest in bonds issued by such institutions. The multiplication and growth of sub-regional development banks and inter-regional banks owned by developing countries are one of the most fertile grounds for South-South cooperation—though an underexploited one.

José Antonio Ocampo
Former UN Under-Secretary-General for Economic and Social Affairs, former Finance Minister of Colombia, and currently Professor, School of International and Public Affairs, Columbia University

3. Making Transnational Networks More Accountable

By Eric Helleiner and Tony Porter

We identify three distinct accountability problems associated with the transnational networks of financial officials which oversee the coordination of financial regulation internationally:

- **Uneven representation of countries**
- **Their overly technocratic character**
- **Those at risk of capture by the financial industry.**

There is widespread agreement that the current global financial crisis has highlighted a number of problems of accountability. Much attention has been focused on the accountability of various private actors, ranging from mortgage lenders and investment bankers to credit rating agencies and chief executive officers. In our view, more attention needs to be paid to that of the transnational networks of financial officials which oversee the coordination of financial regulation at the international level. The crisis, after all, was generated not just by market actors but also by a failure of international regulation which was developed in these networks. Moreover, these same networks are now taking the lead role in international initiatives to reform financial regulation.

After briefly describing the importance of networked governance in international financial regulatory politics, we identify three distinct accountability problems associated with these networks: those relating to the uneven representation of countries, those relating to their overly technocratic character, and those relating to the risk of capture by the financial industry. The first section highlights a number of official initiatives that have been launched since the start of the crisis to address the first problem. Although considerable progress has been made in this area, more needs to be done and we advance some specific proposals for reform. The second section notes that policymakers have devoted much less attention to the second and third problems to date. In our view, this is unfortunate and we suggest a number of ways in which this relative neglect could be corrected.

Networked International Financial Governance

When policymakers discuss accountability problems relating to international financial institutions, they usually focus on the Washington-based Bretton Woods Institutions. In the regulatory realm, however, the more significant institutions have been less well known, like the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the International Accounting Standards Board (IASB), and the Financial Stability Forum (FSF). These institutions are relatively powerless in a formal sense; their official role is simply to facilitate networks of informal cooperation and information-sharing. And yet, financial officials working through these network-based institutions have constructed increasingly elaborate international common standards for national regulators to follow.

The standards established by these various bodies are usually simply “best practice” guidelines, "memoranda of understanding", general "frameworks" and "principles" which are not legally binding between regulators, do not require ratification by legislatures, and allow significant flexibility of implementation at the national level. To a number of critics, the crisis has highlighted the weaknesses of this loose "soft-law" approach to international regulatory cooperation. What is needed now, they argue, is more precise and binding international commitments backed up by some kind of a new supranational authority, more along the lines of trade regime.

We believe, however, that the existing network-based, soft-law form of governance is likely to persist in the international financial regulatory realm. The forces of inertia and path dependency are one reason: regulatory cooperation along these lines has evolved since the mid-1970s and has generated an increasingly dense institutional environment. This approach has also been consistently chosen for the functional reason that financial officials see it as more flexible and cost effective, and because it bears some similarity to administrative and regulatory agencies domestically.

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Even more important, the strategic place of finance in domestic political economies means that the delegation of financial regulation to supranational authorities is politically sensitive. In this context, the resort to networks is understandable. It provides a way of reconciling the enduring commitment to national sovereignty in the regulatory arena with the need for some kind of international cooperation and accountability. While the enforcement and implementation of financial regulation continues to be done at the national level, transnational networks help to foster cooperation in the development of rules through persuasion, sharing of information and best practices, as well as deeper socialization processes that cultivate trust, mutual accountability, relationships and reputational concerns *vis-à-vis* norms of the network.[1]

If networked governance is here to stay, it is time for reformers to take it more seriously. In particular, the crisis has highlighted the need to explore new ways of making this form of governance more accountable for the quality of international financial regulation that is developed under its auspices. In our view, the current crisis has revealed and/or reinforced three distinct accountability problems: one involving relations between public authorities from different countries and intergovernmental organizations, and the other two involving the relationship between public authorities on the one hand, and business, and citizens on the other. While the first has attracted considerable attention already, the second and third have so far been more neglected on the international reform agenda.

Transnational Networks and State Representation

Let us begin with the issue that has attracted considerable attention already: the uneven representation of countries within the networks themselves. Many policymakers from developing countries have long resented the fact that the membership

1 On networks, see more generally Anne-Marie Slaughter, A New World Order (Princeton: Princeton University Press, 2004). On the transnational financial networks see Tony Porter, Globalization and Finance (Cambridge: Polity, 2005).

of many of the standard-setting bodies has been restricted to select groups of industrialized countries. Over the past decade, developing countries were increasingly pressured by markets and the Bretton Woods institutions to adopt financial standards and codes whose content they played little or no role in developing. Not surprisingly, the content of those standards and codes was often deemed inappropriate for local conditions and also designed to favour industrialized country interests.

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The resentment of developing countries at being excluded from the decision-making processes only grew with the onset of the current crisis. It was not just that the crisis was triggering the development of an entirely new set of standards which they would be asked to adopt. Equally important was the fact that the global nature of the crisis highlighted the vulnerability of everyone to the poor regulatory practices of industrialized countries at the core of the world economy. Developing countries, it was plain to see, were affected by international standards even when they did not adopt them.

In the current crisis, the frustration of developing countries with these accountability problems has generated some significant new changes. The G-20 leaders' summit in November 2008 urged that by 31 March 2009 the FSF must expand to a broader membership of emerging economies, and that other major standard setting bodies should promptly review their membership. In the subsequent months, there were a number of important reforms. In January 2009, the IASB expanded its members from 14 to 16 and guaranteed geographical diversity on its Board for the first time: four members from Asia/Oceania, four from Europe, four from North America, one from Africa, one from South America, and two others. The next month, the key body reviewing and initiating regulatory initiatives within IOSCO—its Technical Committee—invited securities regulatory authorities from Brazil, India and China to join a body that previously included only G-7 countries, Australia, Hong Kong, Mexico, the Netherlands, Spain, and Switzerland. In March, it was the turn of the BCBS to expand its membership when it invited Australia, Brazil, China, India, Korea, Mexico, and Russia to join the existing members who had previously all been from developed countries (the G-7 plus Benelux, Spain, Sweden, and Switzerland).

Most dramatic of all was the announcement that same month to expand the FSF to include all G-20 countries (Spain and the European Commission were also included). Before this reform, the FSF's country membership had been restricted to the membership of the G-7 plus Australia, Hong Kong, Netherlands, Singapore and Switzerland (the body also includes international financial institutions, international regulatory and supervisory groupings, committees of central bank experts, and the European Central Bank). This reform was particularly important because the FSF has played the lead role in coordinating the international regulatory response to the crisis so far. The decision to expand its membership to include all G-20 countries reinforced a pattern established by the G-20 leaders after the November 2008 summit when they set up four working groups, each chaired by one developed country representative and one developing country representative, to guide their initiatives (two of these groups dealt directly with regulatory issues).

The expansion has still left some unanswered questions. Before the expansion, there were two classes of countries: the G-7 members each had three representatives (finance ministry, central bank, and supervisory authority), whereas the other five countries were only allowed one representative. It is not yet clear how many representatives the new members will be assigned or whether the concept of different classes of countries will be rethought in some way. An explicit goal of the FSF is to bring different worlds of finance ministries, central banks and supervisors closer together. For this reason, G-7 countries are likely to resist efforts to dilute their tripartite representation. At the same time, if all new entrants were to bring three representatives, the body would become very large. To address this issue, the London G-20 summit in April 2009 announced that the FSF—which was now renamed the Financial Stability Board (FSB)—would create a smaller steering committee to guide the Board's work. In our view, it might be useful to bring regions more explicitly into such a structure, particularly given the way that Europe's position on regulatory issues is increasingly consolidated and negotiated at the regional level. East Asian countries are also considering the creation of an Asian FSF which could move that region in a similar direction.

The reforms to expand the membership of these key bodies are important, but they do not fully address the representation problems. The uneven geographical expansion across the different standard setters is striking. So too is the fact that membership has generally been expanded to include only the largest or most systematically significant countries. Because of these patterns of expansion, there are still a large number of countries which are affected by the decisions of these bodies, but which remain outside of their membership. More voice within the networks needs to be given to them to ensure that there is no longer such a stark division between insiders and outsiders, between rule-makers and ruler-takers.

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In general, there are two types of solutions to this problem. While both can be pursued simultaneously, we find the second to be the most promising in the short and medium term. The first solution is to expand the membership of each body to be much closer to a universal model. The IAIS, for example, represents regulators and supervisors from over 140 countries. To handle the practical problem involved in decision-making with such a large group, it has established an Executive Committee with representatives from different regions (which has included developing country representatives). Similarly, IOSCO's Technical Committee reports to the full membership of the organization which includes representatives from over 100 countries. Like the IAIS, IOSCO also has an Executive Committee which draws heavily on a principle of regional representation. These institutions provide possible models for how the BCBS or FSF could operate if they moved to a more inclusive and universal membership model. They could also draw on the example of the constituency system of the IMF Executive Board.

A second alternative is to make these bodies more accountable to other institutions that individually or collectively are more universally representative. This could be a single intergovernmental body such as a reformed IMF or a new Global Economic Coordinating Council of the United Nations that the "Stiglitz Commission" and German Chancellor Angela Merkel have proposed. The Larosière report on financial supervision in the European Union recommended the former, suggesting that the FSF report to the IMF's International Monetary and Financial Committee (particularly if that committee were transformed into a formal decision-making Council at the ministerial/governor level allowed for under the Articles of Agreement). At their London summit, the G-20 leaders moved in this direction, recommending that the FSB report to both the IMFC and G-20 on issues relating to "build up of macroeconomic and financial risks and actions needed to address them".

It is also worth considering the creation of lines of accountability to other bodies representing different constituencies, whether these are organized regionally, by level of development, or by policy preference. These constituencies could be informal parts of the network itself or more formal organizations. For instance, the BCBS has well-established relationships with regional groupings of bank regulators around the world and has also involved groups of non-members in specific projects. So far many of these relationships have been vehicles for incorporating emerging market regulators into initiatives controlled by the Basel Committee with its exclusive membership, but they could be converted into relationships that make the Basel Committee more accountable to non-members.

The character of the accountability relationship could vary from a simple obligation to solicit comments and provide responses to them, to a requirement to obtain approval. The same could be true of the new FSB (which has already committed to "step up its regional outreach activities to broaden the circle of countries engaged in work to promote international financial stability"). Since the growing significance of developing country officials in global financial markets stems not just from the size of home markets but also from the role of their governments as major investors, perhaps the new International Working Group of Sovereign Wealth Funds—–or its soon-to-be-created Standing Group—could also be involved in consultations in some way. These proposals carry the well-recognized risk associated with multiple lines of accountability, namely the ability of transnational regulators to exploit the lack of unity among constituencies to enhance their autonomy. In our view, however, this drawback is outweighed by the greater advantages of the checks and balances that this introduces, and by the way that it can foster more autonomous capacity among the constituencies.

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Even if the transnational networks are made more accountable to developing countries in these various ways, their capacity to influence the debates may still be constrained by the informal nature of networked forms of governance. In some ways, this informal quality is part of the appeal of a body such as the FSF to developing countries *vis-à-vis* the more formal and rigid decision-making structure of the IMF that has cemented the dominance of current great powers. Indeed, the flexibility of the FSF to become more inclusive of emerging powers simply by expanding its membership stands in contrast to the interminable debates about chairs and shares that have afflicted the IMF. However, powerful states can also manipulate informal settings where there are no clear rules or procedures to protect the weak. Without the same technical capacity, developing country representatives may lose out in an informal setting where expertise can become a form of influence.

These risks could be partially reduced by creating stronger secretariats of existing bodies, particularly that of the FSF/FSB whose existing staff is very small given the roles it is now increasingly being assigned. Even more helpful would be to boost support staffs of multiple bodies that are more exclusively controlled by developing countries, such as the G-24, in order to ensure that those countries can develop autonomous and effective voices in the bodies in which they participate. Some developing countries already have sufficient resources that by pooling their efforts they can significantly strengthen their influence. It should also be in the interests of wealthier countries to support the technical capacity of developing countries in order to make negotiations over technical matters more efficient. Competition among centers of standards development dominated by wealthier countries may also provide incentives for those countries to solicit support from groups of developing countries, since the standards with the widest support are likely to win out.

The benefit of pursuing the various reforms discussed in this section is not just that the transnational networks would become more widely accountable to all the world's states rather than a wealthy few. Equally important, this outcome would help to make all the world's states more accountable to global standards, since the standards would have been formulated with broader representation. To be sure, many have questioned whether networked arrangements can be as effective in ensuring the accountability of states to global standards as more formal centralized organizations. But there are many cases of powerful states abandoning the latter and, moreover, this kind of accountability is reinforced not by the capacity of the organization itself but rather by the degree to which the organization can count on the support of other members to sanction defectors. In our view, this is just as likely to be forthcoming in networked arrangements. Indeed, if the governance of transnational networks can be reformed more easily and more quickly in response to changing distribution of power in the world, it may prove more effective in generating this kind of support.

Transnational Networks and Society

Accountability problems highlighted by the crisis include the relationships not just among public authorities from different countries but also between officials in transnational networks and their constituencies outside the official sector. There are two interrelated aspects of this. The first is the concern that the networks increasingly resemble a kind of transnational technocracy that is non-transparent and unresponsive to the broader public interest. The second is that transnational networks of officials are especially susceptible to "capture" by the financial firms they are supposed to be regulating.

Many transnational officials have valued the insulation that allows them to devise optimal technical solutions free from the ill-informed compromises and opportunism that they see as associated with politics. The crisis, however, has starkly revealed deficiencies in technical solutions, such as the procyclicality of Basel II or mark-to-market accounting. The opacity of the highly technical public and private risk management systems that were developed has now become an issue. So has the narrowness of the experts' focus (for instance a massively complicated agreement for regulating banking combined with massive neglect of the shadow banking system) and an over-reliance on mathematical modelling as opposed to more institutional mechanisms for identifying or mitigating risk (such as audits or discussions between regulators and risk managers in firms). The transnational networks also focused too heavily on risks specific to the financial industry and not enough on the connection of these to broader economic and social risks such as a decline in house

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prices. These are all problems to which the inadequate accountability and excessively technocratic character of transnational networks of experts can be linked.

These problems of technocracy have been greatly exacerbated by their association with the second problem: capture of the regulatory process by the industry it is supposed to regulate. The loose, elite, and highly technical character of regulatory networks provide privileged access points for business. For instance, the Institute of International Finance, the leading global association of financial firms, worked very closely with the Basel Committee on Banking Supervision, successfully suggesting and promoting the use of the internal risk models that have proven to be inadequate in the current crisis, as well as consulting closely on other aspects of Basel II. Non-governmental interlocutors other than representatives of the financial industry were almost entirely absent from the consultative process. Those involved may claim that this privileged access brings into the regulatory process the firms with the technical and practical knowledge that is needed to anticipate problems. But it is hard to see how this privileged access did not contribute to rules that failed to rein in the profitable but reckless behaviour of the industry.

This problem of capture at the transnational level is amplified by the propensity for a similar problem between regulators and the industry at the domestic level. While this problem has been the subject of considerable study in developing countries, the current crisis has triggered widespread criticism of the same issue on Wall Street itself. There are many who perceive that the circular door between Goldman Sachs and other leading firms and government has led to ineffective regulation and privileged treatment for financial firms. As Simon Johnson, former chief economist at the IMF, put it: "the finance industry has effectively captured our government—a state of affairs that more typically describes emerging markets, and is at the center of many emerging market crises".[2]

In official responses to the current crisis, the problems of technocracy and capture at the transnational level have not received as much attention as the accountability questions addressed in the previous section. One place where they have been clearly identified, however, has been in connection with accounting. With some prompting from the G-20's November 2008 summit, the private IASB agreed to establish a new transnational public-sector monitoring board that will appoint the trustees who oversee its operations. At the subsequent London summit, the G-20 also called for prudential regulators to be more involved in its activities.

As for the official regulatory networks, multilateral political oversight of the technocrats has been strengthened and broadened beginning in the 1990s with the more aggressive involvement of the G-7 (for instance through ongoing monitoring and guidance by leaders at the summits and direct involvement of finance ministers in the FSF), and then with an escalating role for the G-20, at the financial and central bank level from 1999 and at the leader's level from 2008. The failures of the transnational regulatory networks in the current crisis, however, indicate the inadequacy of this type of oversight alone to address the problems of technocracy and capture. To be sure, the crisis has drastically intensified democratic scrutiny of the

2 "The Quiet Coup," Atlantic, May 2009.

regulators' work—witness the degree of legislative and media scrutiny of international regulatory initiatives at the moment. But this is unlikely to work by itself as an ongoing mechanism of accountability once the crisis wanes. Similarly, some of the G-20 initiatives—such as extending regulation to all systemically significant parts of the industry or restricting the use of offshore centers to escape regulation—will reduce the ability of the industry to pressure regulators by engaging in regulatory arbitrage. But greater reform of the regulatory process is needed to ensure that these new rules are implemented and updated effectively as time goes on.

What More Can Be Done?

- **Construct countervailing public sector arrangements, such as peer-review process**
- **Mitigate proglems of technocracy and capture**
- **Restrict the types of rules generated by transnational regulatory networks**
- **Develop a "global public interest" and a "global public sphere".**

How then can the design of the system be altered so that the twin problems of technocracy and capture can be managed in a more sustainable way? Four overlapping sets of initiatives would help. First, countervailing public sector arrangements could be constructed. One such arrangement might involve a peer review process of the operations of the network along the lines of the DAC Network on Development Evaluation, which initiated peer review of international organizations such as UNDP and UNICEF. In the case of the financial regulatory networks, we are encouraged that the G-20 at the London summit noted that all members of the new FSB have agreed to periodic peer review. In our view, it would be useful if the peers could include not just participants in the networks but also at least one reviewer from outside the financial policy area. The OECD, which invented transnational peer review, could provide advice, working together with an organization with more developing country representation.

Another countervailing public sector arrangement could be to encourage networks of legislators to collaborate more closely in monitoring the work of the regulatory networks, as the Parliamentary Network on the World Bank is attempting to do with regard to development. Similarly, linkages between the non-financial ministries of the G-20 should be established, as has occurred within the G-7 and these ministries should be consulted on the broader implications of financial regulatory initiatives. It might also be useful to create a small multilateral body with the sole responsibility of identifying problems in transnational regulatory networks, similar to the role of an auditor-general in national politics, or the Independent Evaluation Office that was established to make the IMF more accountable. Finally, responsibility for particular projects could also be explicitly allocated to competing public organizations. For instance, in many cases, there are overlapping capacities between the regulatory networks, the BIS, the IMF, and collaborative networks established by the OECD and the World Bank. At present, they ostensibly are only committed to cooperate with one another, but in practice they can tacitly compete for mandates, and this could be explicitly encouraged.

A second set of initiatives would pay careful attention to the way that markets can be designed to mitigate the problems of technocracy and capture. One option is to foster market actors that have a strong material interest in systemic stability and stronger regulation. These actors would then lobby against financial actors that profit from excessive risk taking or regulatory arbitrage and lax regulators that assist them. The insurance industry plays this countervailing role relative to the auto industry in vehicle safety regulation. If rules can be established to alter incentives in the insurance industry to convert its role from the disastrous one epitomized by AIG to the type of role it plays in vehicle safety, then it could be an effective countervailing force in finance as well.

The networks could also be subjected to a private-sector audit that certifies compliance with a set of process standards, perhaps managed by the International Organization for Standardization (ISO). Institutionalizing rewards for whistle-blowing, or what Braithwaite labelled regulatory "bounty-hunting" are also worth considering.[3] So too are proposals to create a class of banks that are strictly precluded from risky or lightly regulated activities and that will therefore have an incentive to lobby against attempts of competitors to engage in regulatory arbitrage. In addition, the size of banks could be restricted to mitigate the risk of capture. More generally, when designing market rules, authorities should consider not just the effect on stability in the market itself, but the ways this can mitigate problems of technocracy and capture in the regulatory system. For instance, the clearing arrangements that the G-20 is requiring for credit default swaps should be set up so that the bodies running them have an incentive not just to manage their own transactions prudently, but to identify and protest against regulatory initiatives that would create opportunities to undermine or bypass clearing arrangements. For this to be successful, some separation must be maintained between the ownership of the clearing arrangement and the firms that have an incentive to bypass or undermine it.

A third set of initiatives involves the imposition of restrictions on the types of rules that can be developed or endorsed by the transnational regulatory networks, or that govern their own activity. This can include deliberately keeping the system simple and only allowing activities that can be regulated in ways that can be understood by actors other than the financial firms that engage in the activities. The importance of such rules is recognized by the G-20's call for risk-based capital requirements to be supplemented with "a simple, transparent, non-risk based measure which is internationally comparable" as well as by those calling for credit derivatives to be traded on exchanges. Since there are strong indications that efforts will be made to revive structured finance and securitized markets[4], the issue of simple transparent rules will need to continue to be developed and promoted.

Another example of the use of rules has arisen in the pro-cyclicality debates where many people have argued that counter-cyclical bank regulation (e.g. dynamic provisioning, or varying capital charges) should not be left to the discretion of national regulators because they will inevitably be subject to private lobbying pressure in boom times not to tighten. Clear, simple, non-discretionary and transparent rules (e.g. GDP-linked, or linked to asset price growth) are offered as a solution. Internationally agreed conflict of interest rules for regulators could also be established, such as mandatory public disclosure on the websites of regulatory bodies of all past and present industry ties of individuals on those bodies, and rules specifying a minimum number of years before regulators can shift to private-sector lobbying and vice versa.

The fourth and final set of initiatives involves mechanisms to enhance the development of a "global public interest" and a "global public sphere". A problem with net-

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3 Braithwaite, Regulatory Capitalism, p. 60. See also Walter Mattli, "Enforcement of global regulation through market mechanisms" (working paper 2009).

4 For instance the same G-20 declaration calls for credit rating agencies to produce differentiated ratings for structured products (p. 6) and to implement Basel II with its reliance on banks' opaque internal risk models (p. 2).

works of regulators has been their failure to take the implications of their work for non-financial actors and interests sufficiently into account. Accountability to their home governments does not solve this problem because they tend to report back to parts of the government with responsibility for finance, and national mechanisms for reconciling these financial interests with broader public interest may be weak. A number of the standard-setting organizations have adopted notice-and-comment procedures in recent years, which has helped to provide new "access points" for citizens to provide direct input into their activities.[5] We are also encouraged by the FSF's April 2009 statement that the new FSB will "engage in stronger public relations outreach to raise the visibility of its work and role in the international financial system". But to offset the risk of capture by private sector groups of the transnational networks, more needs to be done to provide what Walter Mattli and Ngaire Woods call "participatory mechanisms that are fair, transparent, accessible and open". As they have effectively argued, regulatory institutions that provide these mechanisms "are more likely to produce common interest regulation".[6]

Initiatives could include the construction of a wider set of global public policy networks with NGO involvement and UN leadership,

Specific initiatives to address this problem could include the construction of a wider set of global public policy networks with NGO involvement and UN leadership, such as those advocated by Kofi Annan. The OECD and the World Bank—the two intergovernmental organizations that most explicitly have a mandate that integrates economic and social policy—could also be mandated to work with NGOs to consider on an ongoing basis the broader social implications of the level of risk permitted by transnational financial regulatory standards. Along the same lines, competing nongovernmental shadow regulatory committees could be encouraged and publicly financed. With public financing should come a requirement for diverse perspectives on such committees. Some of the other initiatives discussed above, such as audits of regulatory bodies, could involve experts from the NGO sector and provide NGOs incentives to upgrade their technical capacity in financial regulation.

Prospects for Change

Because transnational networks are likely to continue to play a central role in international financial regulation, it is important to devote more attention to their accountability. As Anne-Marie Slaughter (now director of policy planning at the US State Department) put it more generally, "government networks are a key part of world order in the twenty-first century. But they are under-appreciated, under-supported, and under-used to address the central problems of global governance".[7] One aspect of their accountability has to do with the lack of adequate representation of many states, particularly developing countries, in the transnational regulatory networks. Some significant progress has been made in this area since the start of the crisis, but much more could be done. In the short-to-medium term, we have suggest-

5 Walter Mattli and Ngaire Woods, The Politics of Global Regulation (Princeton: Princeton University Press, 2009), p. 18

6 Mattli and Woods, The Politics, p. 4.

7 Anne-Marie Slaughter, "Disaggregated Sovereignty: Towards the Public Accountability of Global Government Networks," Government and Opposition. 39(2)(2004), p. 160

ed the most promising reforms are likely to be those that make the transnational regulatory networks more accountable to a variety of other formal or informal bodies which individually or collectively would be more representative. We have also recommended a strengthening of the autonomous technical capacity of developing countries to put forward their interests and participate within this “checks and balances” system.

Two other overlapping accountability problems have received less attention in the international reform initiatives to date: the problem of exclusivity *vis-á-vis* societal actors created by heavily technical character of the networks, and the problem of capture when the regulators are excessively influenced by the industry they are supposed to be regulating. We have proposed four sets of initiatives that could help address these problems: the construction of countervailing public sector arrangements; the design of markets to mitigate the problems; restrictions on the types of rules that can be developed or endorsed by the transnational regulatory networks, or that govern their own activity; and enhancements of the development of a “global public interest” and a “global public sphere”, for instance through greater involvement of NGOs and non-financial officials. These four sets of initiatives are complementary with one another as well as with the mechanisms we identify to improve representation and accountability among public authorities.

What are the prospects for the implementation of the proposals for greater accountability that we have discussed? Certainly the severity of the crisis means the range of policy and regulatory options that are being seriously considered is far wider than would have been thought possible a short while ago. It is also certain that this policy window will begin closing once the crisis ebbs. In our view, greater accountability is not simply one of many goals to be hitched to the financial reform wagon. On the contrary, accountability problems were at the heart of the crisis and addressing them is crucial for ending the crisis and repairing global finance. In a great many areas of the economy and the political system, the types of accountability that we have advocated for transnational regulatory networks would be unremarkable. At the retail level, for instance, most banks would not question the need for strict conflict of interest policies. It is a measure of how very unaccountable global financial governance had become that measures such as these have only begun to make their way onto the reform agenda. If trust in the global financial system is to be restored, the transnational regulatory networks need to be able to raise standards of accountability in markets, but they too must be seen to be accountable.

The proposals that we have discussed pick up on mechanisms that are already present to varying degrees in global governance. They work with and not against the grain of the practices and rules that have been devised in this and other transnational issue areas to address extraordinarily complex, rapidly changing, and varied sets of global problems. They seek to make better use of existing institutions, markets, and relationships while proposing incremental changes that taken together will bring about very significant improvements in the regulatory arrangements. While these proposals’ feasibility is important, working with the existing networked properties of global governance is not simply a second best alternative that less powerful states and citizens must reluctantly accept because of their lack of influence. It is instead the best way right now to work towards a system in which relatively small numbers of unaccountable elites will never again be able to bring down the world economy.

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4. A Way Forward: Formal and Informal Aspects of Economic Governance

By Kemal Derviș

The economic crisis that started to unfold in 2008 has made it even clearer that we are now living in a strongly interdependent world, where factors such as trade, capital flows, financial products, but also carbon emissions or threats from nuclear proliferation or infectious disease tie us together, more than ever before. Interdependence is also reinforced by more "intangible" factors, such as the rapid "contagion" in expectations as well as the transmission of tastes and social trends. The crisis may lead to a temporary retreat from some of the policies that have accompanied globalization, but the technological and socio-economic factors that have led to increased interdependence are not going to disappear.

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It is possible, for example, that there will be some retreat from trade liberalization, as countries try to protect domestic employment. In the aggregate this would be self-defeating, since one country's imports are another country's production and jobs. The world witnessed the destructive effects of "beggar thy neighbour" trade policies in the 1930s. There may be a somewhat more justified retreat from cross-border financial liberalization. Massive cross-border speculative capital has more cost associated with it than benefit. Long-term productive foreign investment is a positive force for development, however, as it helps the diffusion of technology and accelerates overall productivity in the world economy.

Looking forward, it will be desirable to have the right incentives and regulations in place to promote productive investment and the spread of knowledge, and at the same time discourage and control destabilizing behaviour. Another critical area of global interdependence is of course due to carbon emissions and climate change. The interesting fact in this context is that even if countries decided to cut all contact with each other, carbon emitted in one country would still affect all other countries: global interdependence could not be avoided even by autarchy!

Interdependence and technology-driven globalization is here to stay. There is huge potential for both ill and good in globalization. The key challenge for the 21st century, therefore, is how to build a global system of governance that allows the management of global issues, the adequate provision of global public goods and the most effective forms of collective action. The arrangements and mechanisms of cooperation we should try to build in this first part of the 21st century will still have to rely on nation-states as the legitimate "building blocks" of the global system. The nation-state is constrained by global forces and cross-border externalities. It is still, however, the key decision maker. In most domains, it alone can enforce the law, national or international. The nation-state is still the basic carrier of legitimacy, both through electoral processes and through the sentiments of allegiance it is able to mobilize. Global governance cannot be global government. It is instead a system involving many types of international cooperation that facilitate collective action.

The economic crisis and the summit meetings it has triggered have placed economic governance at the heart of the international debate in 2008 and 2009. Below I will focus on the economic aspects of global governance, and some of the institutions that are most important for economic governance. Global governance relating to other areas, such as security (and the UN Security Council), or global health and other non-economic areas of global collective action are beyond the scope of this paper.

Informal and Formal Mechanisms of Global Economic Governance

The convening of the two "leaders level" G-20 meetings, first in Washington on 15 November 2008 and then in London on 2 April 2009, has been a major step forward in enlarging the table that was for decades reserved for a group of rich countries' meeting as the G-7, and then, with the addition of Russia, a single middle income country, as the G-8. These two very visible G-20 meetings have added momentum to the debate on global economic governance, at a time of great crisis in the world economy.

The current debate on how to reform global governance reflects a tension between two types of arrangements: formal multilateral institutions established within an international legal framework—the UN system, the Bretton Woods Institutions and the WTO—on the one hand and the informal approach reflected in the G-20.

The current debate on how to reform global governance reflects a tension between two types of arrangements. On the one hand, there is a set of formal multilateral institutions established within an international legal framework, which includes the United Nations system, the Bretton Woods Institutions, and the WTO. The United Nations system itself includes a great variety of treaty- or formal international agreement-based organizations with special mandates, such as the ILO dealing with employment issues, the UNDP dealing with development or UNESCO dealing with science, technology and education, to give just three examples.

The G-20 meetings reflect another, informal approach. These gatherings are not treaty based. They are simply meetings of nation-states trying to discuss global or regional issues in an informal setting, with the aim of either making some decisions together or of preparing decisions to bring them to the formal governing organs of the treaty based international organizations. I will call the various groups that are being talked about the G-N, where N ranges from 7 to 20 or more. It is important to distinguish between the two different forms of international cooperation, formal and informal. Both need to be improved to enhance global economic governance.

Starting with the first G-7 meetings in the 1970s, initiated by then French President Valery Giscard d'Estaing, the informal arrangements have endured and have become institutionalized, but they face serious problems of legitimacy given that many countries are excluded, not only from taking part, but also from being represented. The fact that the G-20 rather than the G-8 has now moved to center stage in the efforts to address the on-going financial and economic crisis, is certainly a step in the right direction in terms of enhancing representation, inclusiveness and legitimacy. It was also significant that the meetings of the G-20 were convened at the level of heads of state or government, with the second "Leaders" meeting having taken place in London on 2 April 2009.

Moreover, both in Washington and in London, the group that met was actually larger than the original G-20. In London, it included Spain and the Netherlands, as well as Ethiopia and Thailand, representing Africa and ASEAN (the Association of South East Asian Nations). But despite this enlargement, and to some degree because of it, it is unclear what the future of these meetings will be. On the one hand, even enlarged as they have become, there is a problem of legitimacy, with many of the excluded very unhappy at not having a seat at the table. On the other hand, with the group expanding, some argue that it is already too cumbersome, and that further expansion would defeat the purpose of having a relatively small number of leaders interact in an informal way that is conducive to real debate and also to actual decisionmaking. So what would be a best way forward?

A Leader's Group?

An enlarged G-20, at Leaders Level, call it an L-N, should take place regularly once a year, and not only in a period of crisis.

An enlarged G-20, at Leaders level, call it an L-N, should take place regularly once a year, and not only in a period of crisis. We have had an L-20 + meeting in Washington in November of 2008 and another one in April in London. A third Leaders level meeting has been announced for the Fall of 2009, to be hosted by President Obama. Institutionalizing the L-N would naturally take as its starting point the 20 included in the original G-20. But in addition to countries representing only themselves, it would be good to enlarge participation to include more formally some rotating representatives of smaller and medium sized countries, in addition to the EU that is already present as the "20th" member, in the original group.

Three additional members could represent three regional groupings: for example Africa, Asia, and Latin America and the Caribbean. There are several possibilities when it comes to determining the countries representing larger groupings. Alternatively, the "representative" participants could be elected to represent the regional geographical groups at the United Nations—in that case Eastern Europe would constitute a fourth grouping. Alternatively they could be designated by regional organizations such as the African Union and ASEAN, as was done for the London meeting.

Apart from allowing such regional representation, key leaders of multilateral organizations should be present in these meetings. The UN Secretary General, as the Senior Leader of the system of multilateral organizations, should always be invited, as he was to the Washington and London meetings, alongside the Managing Director of the IMF and the World Bank President. The Managing Director of the WTO should also be present as he was in London, given the absolutely central role trade has in international affairs. Perhaps the Director of the ILO should also be invited, at least in 2009 and 2010, as "decent jobs" is the single most important political and social challenge facing the world today. As the OECD becomes more global in the coming years, there would be a good case for inviting the Secretary General of the OECD. In any case, Angel Gurría was a "non-resident" star of the London meeting, given the OECD's leadership role on the "tax-havens" issue.

With key leaders of the international organizations present, there would be about 30 people around the table—a large number: in many ways too large for actual decision making. But an L-N meeting that truly brings together major leaders from around the world and wants to be reasonably inclusive can no longer be much smaller. There are alternative proposals worth careful evaluation in the process of institutionalizing an annual L-N meeting—for example the G-8 + 5 formula, adding China, India, Brazil, Mexico and South Africa to the G-8—but it will be very difficult to "dis-invite" major G-20 countries such as Korea, Turkey or Indonesia, particularly when one compares them in terms of population and GDP to some of the "old" G-8 members.

The Managing Global Insecurity (MGI) project sponsored by the Brookings Institution and New York University has proposed adding three more countries to the G-8 + 5 formula (Indonesia, Turkey and Nigeria or Egypt). The resulting L-16 would represent a huge improvement in inclusion and realism over the G-8. A good argument can be made that the MGI project's 16 is a very reasonable compromise between inclusiveness and manageability. It reflects very careful deliberations and consultations on this issue. The uncomfortable fact, however, is that any enlargement of the G-7 that is reasonably inclusive will end up with a number of participants that will make these meetings more into high-level "forums" rather than meetings conducive to formal decisions. The London meeting may have been exceptional as the worldwide crisis spurred the leadership of the G-20 nto actual decision making mode. And yet it should be recognized that the original G-7 (or G-8) is now very far from reflecting the realities of the world of the 21st century and has outlived its usefulness.

On balance, and given where the world has arrived at with the London meeting in April of 2009, the annual "Leaders Table" should probably take the G-20 as its starting point and include some formal and rotating regional representation. The participation of the executive heads of the major international organizations already has brought a more truly global and inclusive dimension to the meetings and can constitute a link between the informal L-N setting and the discussions taking place within the framework of the treaty based organizations themselves. A form of regional representation linked to regional groups at the UN, or possibly to elections of the three of four regional representatives by ECOSOC, the UN's overarching economic and social governance body specified in the UN charter, would have the advantage of building an even stronger "bridge" between that inclusive world body and the new L-N group, increasing the wider appeal of the meetings to the community of nations, while still keeping the size of the L-N to manageable proportions.

An L-N that evolves with the times would have a wholistic perspective on world affairs, provide a valuable forum to deal with a broad agenda, allow key leaders to meet and to get to know each other better, and project an informal and yet reasonably business-like approach to discussing pressing issues that require global approaches.

It is very important to stress, however, that an L-N group, even if kept smaller, would not—could not—be a formal governance body. Decision- and resource use-oriented global economic governance has never been, and can never be anchored in an informal group, but has to use formal treaty based mechanisms and institutions such as the IMF, the World Bank, the UN itself, or the WTO. How else can countries worldwide commit themselves in a binding way to certain policies, dispute resolution mechanisms, or to sharing resource burdens? These inherent limitations on any L-N do not at all make such gatherings useless. On the contrary, an L-N that evolves with the times would have a wholistic perspective on world affairs, provide a valuable forum to deal with a broad agenda, allow key leaders to meet and to get to know each other better, and project an informal and yet reasonably business-like approach to discussing pressing issues that require global approaches. The Washington and London meetings have been very useful in that way.

The L-N can inspire and influence the formal and specialized international institutions but cannot replace them or their governance. Moreover a new institutionalized annual L-N would obviously not preclude other regional or other desirable and smaller "Leaders-level" meetings. Institutionalizing an L-N would be a breakthrough in the architecture of international cooperation, but it would have to be complemented by decisive reform of the more formal parts of economic governance.

Reforming the Formal System of Economic Governance

The major multilateral institutions—the UN, the Bretton-Woods Institutions, the WTO—represent constituencies with universal or near universal memberships and have legal mandates that are critical to addressing a range of global issues in a way that allows resource use and burden sharing. The governance of each one of these organizations has become outdated and needs far reaching reform. Both the governance and activities of these institutions have to better reflect today's realities and challenges. In the London meeting the largest economies in the world have expressed their desire to see the IMF play a very central role in the world economy, in the fight against the current economic crisis and beyond. The final G-20 communiqué calls for a threefold increase in the resources of the IMF. The future of the IMF is going to be a central part of the future of global economic governance. The remainder of this note on economic governance focuses, therefore, on the IMF, given the size and critical importance of this institution. The London summit also gave support to Financial Stability Forum, renamed Financial Stability Board, and called on it to work closely with the IMF.

A renewed and reformed IMF could be the key international institution providing the critical "global public good" of precautionary finance and macroeconomic stability. National policies will always be central, and other international and regional organizations also matter a great deal—but the current crisis has shown how desirable international macroeconomic policy coordination is in today's world economy. The need to manage a worldwide recovery provides a unique opportunity to reform the IMF and make it into an effective and legitimate organization that facilitates macroeconomic policy coordination and has sufficient resources to play a lead role in cooperation with national treasuries and central banks in the provision of cross-border precautionary and emergency finance.

A renewed and reformed IMF could be the key international institution providing the critical "global public good" of precautionary finance and macroeconomic stability.

Part of the reform has to do with substantive policy issues, in which the role and the nature of the IMF's policy advice needs to be strengthened and improved to ensure that it is effective. This includes a stronger and truly global role in macroeconomic policy reviews and policy coordination, with an enhanced commitment by all member states, including rich countries, to this process. The fact that the richest countries did not really engage with the IMF on their domestic policy issues in the past was a key source of weakness and lack of legitimacy. The times when the IMF's role was to advise and exercise surveillance with respect to developing countries only, should be gone. The current crisis has demonstrated that all countries need advice and formal policy review. This has been recognized in the London meeting. The reform should also include a more rapid and less constraining process for providing liquidity to countries facing balance-of-payments problems due to external shocks. The IMF has developed a new facility to address the current crisis and future precautionary needs. There is also an ongoing review of existing lending facilities in the context of the substantial expansion of resources that is under consideration. An expansion in the allocation of Special Drawing Rights (SDRs) and an enhanced role for the SDR or, better, a new SDR with compositional weights that reflect today's realities in the global economy, should be part of this reform.

The discussion about the resources of the IMF, its role and its governance are all interlinked. Reforming the governance of, and decision-making at the IMF, to enhance both legitimacy and effectiveness, is critical to the use of its resources. At the end of 2008 and the beginning of 2009, we witnessed the strange situation of mounting resource needs in many emerging market economies hit by the crisis and the presence of a new short-term liquidity facility at the IMF, without any demand for that facility materializing! Part of the reason for this lack of demand, despite pressing needs, has been the continued stigma attached to IMF programs and the internal political problems IMF programs create for national governments. One new facility developed in time for the London meeting already has Mexico as its first user. But it is too early to say whether the political and stigma issues have been resolved.

Some are proposing that the key to governance reform at the IMF should be the transformation of the International Monetary and Financial Committee (IMFC) into a governing Council of Ministers that would elevate the level of governance, reflecting the vastly enlarged financial role that the institution is called on to play. The proponents of this proposal view it as a way to strengthen multilateral economic governance, in the interests of all, but particularly also in the interests of the developing countries. And yet most developing countries have resisted the call for a Ministerial governing “Council”, because they perceive it as a vehicle that would further strengthen the *de facto* influence of the rich countries, with Treasuries able to draw on much more staffing and resources than their developing country counterparts. Moreover, a governing Council of Ministers mirroring the existing distribution of seats and voting weights of the IMF board, with European countries being strongly overrepresented, would make things worse, rather than better in the eyes of the developing countries.

A Ministerial Governing Council for an organization of the importance of the IMF would be an important step forward, provided the new stronger governance arrangements take into account the role and weight the developing countries have gained in the world economy. The seats on the Council and the weighting should be adjusted—not once and for all, but in a continuous and dynamic way - to reflect the new economic realities. Without a real reform in the voting weights, there can be no governance reform at the IMF. And without governance reform, the institution will have difficulties in playing the critical role it is being called on to play.

It would be natural to continue with the step by step reweighing of the existing constituencies, a process started in a very modest way at the occasion of the Singapore annual meetings in 2006. The next steps should be bolder, however, and include both, quota increases, changes in country weights but also a major re-organization of the existing constituencies. A major next step should be taken at the Istanbul annual meetings in the fall of 2009. Other steps should follow, every two or three years. The key advantage of the constituency based system is that it can be both universal (every country can participate) and have at the top a reasonably small and compact group of senior leaders, with weighted voting reflecting objective criteria rather than historical accident or the *de facto* persistence of the past.

If a country gains weight in the world, this should over time be reflected automatically in the voting weights in the top governing body. There is and will continue to be a debate on exactly what these weights should be—but this can be resolved given the overall framework of universal participation and representation through constituencies. There may be a need for other types of changes, including a cautious extension of the double majority system for the most important class of decisions (a double majority of 85 percent of the weighted votes and 60 percent of member countries already is needed for a change in the Articles of Agreement or for the exclusion of a member). An appropriate balance must be kept between the requirements of inclusion and legitimacy, on the one hand, and the need for IMF governance to function decisively, on the other. Double majority voting as well as the possible direct inclusion of population weights into a system of weighted voting has precedents in the EU Treaties, for example, and should be discussed in the context of improving the legitimacy of the IMF's governance.

If eventually agreement can be reached on the transformation of the IMFC into a governing Council of Ministers, the role of the IMF Board would change. It would no longer be a "policy maker"; it would rather advise and supervise. The Board would continue to approve individual programmes, but do so reflecting a systemic rather than case by case approach. The Ministerial Council would make policy and decide on the types of programmes and facilities, with the Board checking whether individual programmes meet the broad parameters of the policies set. The Managing Director would continue to chair the Board, while the Council would be chaired by an elected and rotating President.

Some argue that even with major governance reforms, the IMF will always be too constrained by national policy makers and their immediate political interests to be able to come out with the tough and totally impartial policy analysis and early warning messages that are required. In addition to these formal governance mechanisms, the IMF's legitimacy and effectiveness no doubt would benefit from more institutionalized peer review and opening to broad expert advice. It would be desirable to establish a "Policy Advisory Group" made up of 12 to 15 eminent outside experts, geographically diverse and drawn from personalities with proven track record policy making, academia, civil society or the private sector. They should NOT all come from the financial sector. This group should be appointed for several years, and once appointed, should enjoy total independence. The group would work closely with the Evaluation Department of the IMF, but it would focus on the future and make recommendations on specific policies and programmes. The recommendations would not replace the normal functioning of governance arrangements, but the work of the group would provide a forum for vigorous debate, the possibility of thinking about unorthodox approaches and the inclusion of different perspectives in the policy debate. Too often in the past the debates in the IMF reflected a purely financial sector perspective, narrowing their scope in a manner that has made it more difficult to fully appreciate the weaknesses in the financial sector itself, and making it harder for the IMF to communicate more broadly with a much broader set of stakeholders.

It would be desirable to establish a "Policy Advisory Group" made up of 12 to 15 eminent outside experts, geographically diverse and drawn from personalities with proven track record policy making, academia, civil society or the private sector. They should NOT all come from the financial sector. This group should be appointed for several years, and once appointed, should enjoy total independence.

The communiqués of the summit meetings have also called on the IMF to work with an expanded Financial Stability Forum and other regulatory and standard setting bodies on advancing the financial sector regulation agenda. The extent to which the IMF itself should be involved in actual financial regulation is an on-going debate, not dissimilar from the debate taking place inside nation-states: should financial regulation be entrusted to national central banks or should it be with a separate financial regulatory authority? What is not in doubt is that while financial regulation needs to be anchored nationally, much stronger international cooperation will be needed in the future. This calls for making regulatory and standard setting bodies such as the Basel Committee and the Financial Stability "Board", working in cooperation with a reformed and more effective IMF, much more inclusive and participatory. paper.

Conclusion

The enlarged L-20 meeting in London at a time of threatening worldwide crisis has given visibility and impetus to the debate about global economic governance. The institutionalization of such a meeting would overcome the outdated nature of the G-7 and constitute a big step forward in bringing the new dynamic developing countries into the evolving system of global economic governance. This should not lead one to forget, however, that the informal G-N processes should reinforce the reform dynamic in the international institutions and their more binding and more formal decision making processes. Global issues management and collective action require both types of governance and networking mechanisms. Hopefully the current crisis will be an opportunity for a real breakthrough, not only in the reform of the IMF, but in the reform and the strengthening of the multilateral institutions as a whole.

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5. Public Sector Credit Rating Agencies = More Stable Financial Architecture

By Peter Bofinger

The design of a more stable global financial architecture is currently the most important topic on the international agenda. But compared to the dimensions of the financial crisis, the solutions that have been put forward seem rather modest. While there is no doubt that more transparency as well as better designed and stronger capital buffers will help to make the global financial system more stable, it is far from clear whether such a piecemeal approach will help to prevent major crises in the future. The almost unlimited government support of banks in the current situation raises the stakes even higher and has increased the incentive problems facing bank depositors and lenders.

Current Reform Proposals Are Not Radical Enough

The most radical reform that would be required to make the global financial system more stable is the establishment of effective international banking supervision instead of the extremely fragmented supervisory landscape we have at present. It is naïve to believe that national regulators will be able to regulate and supervise a highly integrated international financial system in an effective way. More coordination among national supervisors, especially in the form of supervisory colleges, and an early warning system under the auspices of the International Monetary Fund (IMF) are certainly helpful in this respect but they are an imperfect substitute for a global regulator.

While fundamental reform faces the almost insurmountably high hurdle of national interest, a radical solution is actually more realistic.

While fundamental reform faces the almost insurmountably high hurdle of national interest, a radical solution is actually more realistic. When one tries to identify the main culprits of the current crisis, there is little doubt that the credit rating agencies have played a leading, if not the decisive role. Without their reckless ratings-structured products the excessive growth of these assets would not have been possible, and more generally the shift from a bank-based to a market-based financial system would have evolved in a much more gradual way. In the brave new world of market-based finance the rating agencies have played several important roles:

- First, they advised banks to design portfolios of low quality assets such that a large share of seemingly high quality assets would be created.
- Second, they rated their own creations, which made it possible for banks, pension funds and insurance companies to invest in such assets. In this way the rating agencies played the role of “delegated monitor” that—thus far—has served the needs only of the banks.
- Third, as not only private investors but also bank supervisors all over the world

did not question the quality of the ratings, the agencies *de facto* served as privately-owned bank supervisors for the growing segment of asset-backed securities.

The Moral Hazard Problem of Private Rating Agencies

It is now widely agreed that the conflicts of interest which arise out of the dual role of consulting (in the process of structuring) and rating (the products created in such a process) need to be addressed. But the role of rating agencies as delegated monitor and *de facto* private supervisor of the universe of market-based finance has so far not been questioned.

This is surprising since the performance of the agencies has been far from satisfactory. In the past three decades no financial crisis has been anticipated by these institutions. Famous examples include the Asian crisis in 1997 (Ferri et al. 1998), the breakdown of Enron in 2002 and of course the current crisis. In the case of Lehman Brothers, up until 12 September, 2008 the ratings of this investment bank were beyond reproach and had not been changed for months (Standard& Poor's: A, Moody's: A2, Fitch Ratings: A+).

The dismal performance of rating agencies can be explained by their incentive structure.

The dismal performance of rating agencies can be explained by their incentive structure. When the rating business began in 1909 with railway bonds, the agencies were paid by investors who needed information on the quality of the issuers (Partnoy 2006a). This changed in the second half of the 20th century when the rating agencies were paid by the issuers of securities. This result produced an incentive to be lax since more generous ratings increase the volume of business. The incentive problem is magnified by the fact that the agencies do not assume any responsibility for their ratings. The agencies regard themselves as journalists and their ratings as "opinions" protected by the First Amendment of the US Constitution (freedom of speech). In other words, while the profits of overly generous ratings accrue to the agencies, the costs must be borne by investors or by governments when they have to bail-out the issuers. This is the typical structure of a moral hazard problem: an agent incurs excessive risks since he is protected against losses by another institution.

It has been argued that effects of this asymmetric incentive structure are constrained by the negative effects of inadequate ratings on the reputation of the agencies (Covitz and Harrison 2003). But this argument overlooks the fact that due to the oligopolistic market structure there is no effective competition between the three major rating agencies. Given repeated failures in the rating process, market forces should have had the effect of driving at least one agency out of business. However, while many banks and other financial institutions have become insolvent or have had to be nationalized in the past 18 months, all three rating agencies have survived the storms of the financial crisis remarkably well. In other words, the market process has not been able to sanction the rating agencies for their overly positive assessment of highly dubious assets.

If one takes into account the important role attributed to external ratings in the regulations of Basel II, it seems very questionable that a more stable financial architecture can be achieved as long as rating agencies remain in private hands. While it will be possible to improve the performance by a better code of conduct (CRA Code of Conduct 2008 by the International Organization of Securities

Commissions[1]) and a public regulation of rating agencies, it seems almost impossible to overcome the fundamental problem of an asymmetric incentive structure of private rating agencies that operate in an oligopolistic environment without any liability for their ratings.

If one takes into account the important role attributed to external ratings in the regulations of Basel II, it seems very questionable that a more stable financial architecture can be achieved as long as rating agencies remain in private hands.

Hayek and the Rationale of Public Rating Agencies

The obvious alternative is a state-owned credit rating agency. Without a profit motive the incentives would no longer be biased. Of course, if ratings are given by a public institution the governments would be responsible for mistakes in the rating process. But as the current crisis shows, governments are already now obliged to bail-out banks that have relied on the ratings of private institutions. Ratings by public institutions would thus be consistent with the principle of competence and liability. The shift from private to public agencies could induce a relatively conservative rating culture but given the huge social costs of imprudent ratings by private agencies such a conservative bias is exactly the element of stability that is required for a more robust financial architecture.

The case for public credit rating agencies can also be made by referring to Friedrich A. Hayek's fundamental justification of the market mechanism. In his famous American Economic Review article, he writes:

"If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them. We cannot expect that this problem will be solved by first communicating all this knowledge to a central board which, after integrating all knowledge, issues its orders. We must solve it by some form of decentralization".[2]

Thus for Hayek, the rationale for the market and private agents rests fundamentally on their advantages in terms of gathering and processing decentralized pieces of information. But this justification does not apply to rating agencies. A global financial system with only three major agencies comes very close to Hayek's model of central planning:

"The statistics which such a central authority would have to use would have to be arrived at precisely by abstracting from minor differences between the things, by lumping together, as resources of one kind, items which differ as regards location, quality, and other particulars, in a way which may be very significant for the specific decision. It follows from this that central planning based on statistical information by its nature cannot take direct account of these circumstances of time and place".

In other words, there is no reason to assume that the three major private rating agencies have any advantage over a state-owned agency in terms of collecting and processing information.

In other words, there is no reason to assume that the three major private rating agencies have any advantage over a state-owned agency in terms of collecting and processing information. Thus, given the biased incentive structure of private

[1] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD263.pdf

[2] Friedrich A. von Hayek, The Use of Knowledge in Society, *AER*, 1945

agencies, the global financial architecture would become more stable with public credit rating agencies.

A European Initiative Would Be Sufficient

As external ratings are of decisive importance for the universe of market-based finance, public rating agencies would overcome the very incentive problems of private agencies which should now be regarded as a main cause of the current turmoil.

As two US agencies (Standard & Poors and Moody's) play a predominant role, it is not very likely that the United States would support the case for public credit rating agencies. But in contrast to other reforms this approach does not require an international backing. It would be sufficient that the European Union member states decide to set up a public European credit agency. The establishment of another major agency would increase the global competition between rating agencies. In addition a public rating agency with a more conservative approach would have the effect that the competing private institutions have to adopt more rigorous standards. For the member countries of the EU such a public rating agency would have the additional advantage that its ratings could be used as a benchmark for bank supervisors for all banks within the EU. If the public agency does a better job than the private agencies, it would drive them out of business over time (Beetsma 2008). Thus it is not necessary to nationalize the existing agencies.

It is often said that every crisis brings a chance for things to be done better. This also applies to the financial market crisis which has now opened a window of opportunity to establish better regulations and institutions for the global financial system. While most of the proposals discussed so far are very useful, they lack the willingness to achieve fundamental reforms. As external ratings are of decisive importance for the universe of market-based finance, public rating agencies would overcome the very incentive problems of private agencies which should now be regarded as a main cause of the current turmoil. If this opportunity is not taken now, the international community will have to wait for the next crisis.

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[3] Fitch is owned by Fimalac a French company

6. The Future of International Financial Regulation

By John Eatwell

> "The modern risk-management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year".
>
> *Alan Greenspan, evidence to US House of Representatives, 23rd October 2008*

The financial crisis poses a major challenge for financial regulators. As the Chairman of the UK Financial Services Authority has admitted (following Alan Greenspan), the intellectual framework on which regulation was constructed over the past 35 years is seriously flawed—resulting in seriously flawed regulation (FSA, 2009). Creating an effective financial services regulator will not simply involve "more regulation". It will require completely different regulation. And, if the new approach is to be successful, at the heart of that difference will be the international dimension.

The intellectual framework on which regulation was constructed over the past 35 years is seriously flawed—resulting in seriously flawed regulation.

The Conventional Wisdom

The analytical foundations of regulation over the past three decades are clearly defined in the structure of Basel II. The first and third pillars rest on the proposition that markets are efficient. Accordingly risk management by firms will ensure the management of risk for the economy as a whole, and exposing firms to greater competition and market scrutiny will enhance systemic efficiency. It is clear that neither of these propositions holds. Not only has the efficient markets hypothesis been exposed as a chimera, but also, perhaps even more remarkably, the neglect of the externalities associated with firms' risk taking was a fundamental analytical error. Given that the economic analysis was so misconceived, it is perhaps not surprising that the statistical theory and practice of risk management should have gone so badly awry. Even if the difficulties of modelling extreme events and the limitations of historical data in a fast changing market had not been so cruelly revealed, the economic framework within which statistical modelling was developed was deficient.

Yet it has been the combination of efficient markets theory, the neglect of systemic externalities and the accompanying statistical analysis that has driven not only the practice of regulation, but also structure of the financial services industry over the past thirty years. Without the tools that economic theory and statistical analysis (and modern data processing capacity) provided, the disintermediation of financial services would not have been possible. The combination of securitization and the techniques embodied in credit derivatives provided the means of pricing exotic and Over-the-Counter (OTC) instruments, and of rating credits. Add the confident belief that liquidity is marketability, and the seeds of current difficulties are sown and abundantly fertilized.

The familiar trology formed the heart of the "Basel consensus":

- **Geater transparency**
- **More disclosure**
- **More effective risk management by firms.**

The growth of disintermediated markets was fuelled by demand (high returns with relatively low risk on instruments tailored to buyers' needs), supply (the growth of profitable off-balance sheet instruments, with equity returns enhanced by growing leverage) and by the regulators, happy to endorse the securitised dispersion of risk to "those with greater risk appetites". The familiar trilogy—greater transparency, more disclosure, and more effective risk management by firms—defined the heart of the "Basel consensus", all that was required for regulation of efficient markets. This trilogy dominated the creation of principles and standards by the Basel committees and by national regulators, and is still a disturbingly dominant theme today. It is particularly striking that the trilogy remains at the core of the proposals from the Financial Stability Forum after the onset of the crisis. (See FSF, 2008a, 2008b). It was the policies derived from the trilogy that "hard-wired" pro-cyclical forces into the financial system (Turner, 2009).

Amongst the litany of analytical failings (all derived from the presumed social efficiency of financial markets) probably the most important was the belief that efficient risk management by firms would lead to socially efficient results. In an industry with major externalities, firms are incapable of managing the risks to which they are exposed (by others), and competitive, transparent markets are inefficient. The standard theoretical answer is to "complete the market", hence internalising the externality. Something of this thinking motivated the risk buckets of Basel I. But in financial markets risks are transmitted macro-economically, through interest rates or exchange rates, and, most important of all, through the general level of confidence. The value of financial assets is determined by their expected flow of future returns. Once confidence in future returns evaporates, so does their value. Hence, when the market for securitised sub-prime mortgages was in obvious difficulty, the consequent loss of confidence affected all securitised instruments, resulting in the collapse of first the entire market in securitised Collateralized Debt Obligations (CDOs) and subsequently of the marketability, i.e. liquidity, of a wide range of financial instruments—destroying the ability of the banks to issue liabilities and hence to lend.

Macro-prudential Regulation

Given that the fragility of financial markets derives in large part from macroeconomic linkages, future regulation will be macro-prudential, as well as micro-prudential.

Given that the fragility of financial markets derives in large part from these macroeconomic linkages, future regulation will be macro-prudential, as well as micro-prudential (As will be made clear below, the two dimensions do, to some extent, contradict one another). At least seven major macro dimensions have been identified:

First, regulators must introduce stress testing for the system as a whole. Financial firms are encouraged by supervisors to conduct thousands of stress tests on their risk models, but few have been conducted by regulators on a system-wide scale (The failings of firm-based stress testing are outlined in Haldane, 2009). If it is possible to have system-wide stress tests on the impact of Y2K, or of avian flu, why not loss of liquidity? The regulator should conduct system-wide stress tests of those scenarios most likely to produce systemic stress—such as a 40 percent drop in house prices. The information gleaned in this exercise should feed into regulatory measures that are likely to be quite different from those suggested by the risk management of an individual firm. After all, banks end up concentrating their resources in places where their individual risk management systems tell them, erroneously, they are safe. So the risk management by individual firms should be determined in a framework defined predominantly by macro-risk modelling by the regulators, micro-prudential regulatory interventions being based on macro-risk assessment (Brunnermeier et. al. 2009; FSA, 2009).

Second, as an important component of macro-risk management, financial institutions must be required to undertake pro-cyclical provisioning, raising their capital reserves in good times and using those reserves as a cushion in bad times. The rules determining these reserves would be quite different from those governing the regulatory capital that financial institutions are required to hold today. That capital is a charge, not a buffer. Since the firm must hold a certain capital reserve to be allowed to operate, it cannot use that reserve to tide it over in bad times (of course, capital charges may need to be raised too). The provisioning requirements should be based on the health of the economy as a whole, so capturing systemic strength and weakness. A policy with some of these characteristics has been pursued in Spain (so-called "dynamic provisioning") where, despite the massive real-estate crisis, the banks have so far remained strong. Astonishingly, it had been proposed that the Spanish system should be dismantled because it is not in accord with international financial accounting standards.

Third, the adoption of highly leveraged positions, both in the banks, and in the chain of banking counterparties, has proved to be a significant weakness of the system as a whole during the current downturn. High leverage should attract high capital charges. In addition, it may be necessary to impose limits on leverage (leverage collars) as capital charges alone are not sufficient to limit leverage expansion in an upswing. In addition to the overall level of leverage, serious mismatches between liabilities and assets have exposed firms to liquidity risk. A distinction should be drawn between short-term funded leverage and longer-term funding. Consider, for example, the current debate over the impact of mark-to-market accounting. From a risk management perspective, the problem with the current value accounting rules is that the focus is on the asset: its perceived liquidity and the intention of the asset holder to hold it to maturity or to trade it. Asset liquidity and holder intentions can change rapidly in a crisis leading to an increasingly artificial view of value and solvency. It would be far better to focus on the funding liquidity of the asset. Where assets are funded with short-term liabilities, then whatever the perceived liquidity or intentions of the asset owners, it is appropriate to mark the value of that asset to market in case funding dries up and the assets need to be sold tomorrow. But where assets are funded with long-term liabilities or set against long-term liabilities, as is typically the case with a young pension fund, then marking asset values to market is not appropriate and can lead to an artificial view of risk and investment decisions based on a risk that is not important to the holder. Indeed, an incentive to match assets and liabilities would remove much of the sting from mark-to-market accounting.

Fourth, detailed supervision of firms' business models should be conducted within a context of macro-risk assessment. The second pillar of Basel II, "enhanced supervision", is firm-specific. As the failings of the Basel approach have become clear, more and more has been piled on this pillar. But when the content of supervision is limited to the individual firm, the essentially qualitative process is not capable of bearing the weight of the social cost of externalities, especially in an international context (Ward, 2002). However, if business models are related to macro-prudential goals, supervision may play a part in reinforcing regulatory strictures.

Fifth, a return to the separation of "utility banking" from the "casino banking" of the investment banks. This proposal, popular with some and deemed impossible by others, seeks to break the dangerous chains of counter-party relationships in the disintermediated financial system. If commercial banks had no access, or very limited access, to wholesale funding and the markets for securitised instruments, they would have to source their funding from their depositor base. This could not be achieved in one country.

Sixth, there should be strict regulation of non-tradable financial instruments, encouraging instead the issue of standardised instruments, readily susceptible to clearing. This has been characterised, erroneously, as increased transparency. But most securitised instruments are perfectly transparent, accompanied as they are by hundreds of pages of detailed documentation. The problem is not transparency, but complexity. Limiting the issuance of complex, customised, often non-tradable instruments would reduce the risk of the massive write-downs seen over the past 12 months, and provide a ready flow of information on market stress. In addition, commercial banks might be restricted to instruments that can be cleared on markets with central counterparties, a sort of "Glass-Steagall lite".

Seventh, to secure effective macro-risk management financial regulation must escape from its present focus on the nature of institutions—commercial banks are regulated differently from investment banks, hedge funds are not regulated at all—and concentrate instead on function. Major macro-risk stems from the liability side of the balance sheet, which is in turn linked to chains of counter-party transactions in the disintermediated system. After all, the two systemically critical failings in the US occurred outside the banks, in an investment bank, Lehman Brothers, and an insurance company, AIG. Targeting regulation on highly leveraged financial institutions, whatever their formal legal status, would be an important step. Some years ago the only significant highly leveraged institutions were commercial banks. Today, leverage is a characteristic of firms throughout the financial system, whether they are deposit-taking banks, investment banks, hedge funds, mutual funds, private equity firms or insurance companies. It is this leverage that threatens market gridlock. Regulation must switch from an institutionally defined approach to a functionally defined approach as a vital component of systemic regulation. National juridical boundaries are equally irrelevant.

Some Difficulties

The development of macro-prudential regulation will require a substantial integration between securities and markets regulation and the management of monetary stability. One of the peculiarities of the practice of monetary policy over the past few years has been the apparent lack of concern about the balance sheets of banks and other financial firms, the focus predominantly being on interest rate policy and targeting the inflation rate of current goods and services. In other words, there has been a lack of concern about the growth of credit and the dynamics of asset prices. However, not only do balance sheets matter in the determination of overall monetary demand, but also credit dynamics have a direct impact on money demand. And it is these balance sheets that will be the focus of macro-prudential regulation.

Another difficulty will be to develop an approach to risk management by firms that does not undermine macro-prudential regulation. Firms' risk management procedures, enforced and/or endorsed by regulators, have "hard-wired" pro-cyclicality into financial markets, and have contributed significantly to current difficulties (see Alexander, et.al., 2007, sections 1.32 and 1.33). Yet micro-risk management is a necessary part of prudential regulation. Higher capital charges will be a valuable means of diminishing the appetite for risky investments, but will not overcome the problem that adoption of similar risk models, based on similar data, will result in stressed firms doing the same thing at the same time. Offsetting this herding effect may become a major challenge for macro-surveillance and rules.

The International Dimension

But the biggest challenge to the new macro-prudential framework derives from its "macro" character, since in a world of open financial markets the macroeconomy is the global economy. The risks taken in one jurisdiction may well have macro consequences in other jurisdictions, and, conversely, macroeconomic financial events abroad may well impinge on firms at home. This takes the international dimension of regulation far beyond the issues faced in the past 35 years.

The biggest challenge to the new macro-prudential framework derives from its "macro" character, since in a world of open financial markets the macroeconomy is the global economy.

The impact of international factors on financial regulation was felt almost immediately after the liberalization of financial markets began in the early 1970s. The liberalization left financial regulators trapped in increasingly irrelevant national juridical boundaries. The failure of the Herstatt Bank in 1974 exposed the dangers in the new regime by threatening all banking settlement in New York, whilst both the Federal Reserve (not our bank) and the Bundesbank (not our market) disavowed responsibility. The response was the establishment of the Basel Committees by the G-10 club of central bankers, whose first task was to sort out home-host responsibilities. Over the succeeding 34 years the Basel committees became the main forum for the establishment of international banking standards, most notably in the specification of capital requirements in the Basel Accord of 1988 (Basel I) and Basel II. These international banking committees have been joined by international groupings of securities markets regulators (IOSCO) and insurance regulators (IAIS). All these organizations propagate principles and standards, and rely on national bodies for implementation. They operate by consensus, with no treaty status, creating "soft law" (Alexander, 2000; Alexander et.al. 2006, chpt. 4).

In 1999, following the Asian financial crises and the near collapse of Long Term Capital Management (LTCM), the G-7 established the Financial Stability Forum, bringing together finance ministers, central bankers, regulators and the IMF, the World Bank and the BIS to formulate responses to international regulatory problems. In the same year the IMF and World Bank began their Financial Sector Assessment Program (FSAP), to study the conformity of national regulatory structures to the principles and standards established by the Basel committees, IOSCO and the IAIS. And in 2001, the IMF established its International Capital

Markets Department (now the Monetary and Capital Markets Department) "to enhance … surveillance, crisis prevention and crisis management activities". It proposed that the new Department's responsibilities would include "systematic liaison with the institutions which supply the bulk of private capital worldwide".

All these institutions developed and/or implemented policies-based principles and standards derived from the Basel trilogy, a micro-prudential approach. This approach tends to concentrate on conduct of business regulation, with prudential issues confined to the risks encountered by the individual firm. As a perceptive, but ignored, IMF study noted in 2004:

"The objectives of regulation and regulatory components could be more expressly linked to the goal of system-wide financial stability. The standards are useful to regulators charged with assessing the strength of regulated entities within each sector. However, their use in addressing system-wide stability issues is limited, partly because they were not written for this purpose. The standards take little account of structural issues, or of interlinkages among different types of financial firms and markets" (IMF, 2004).

The Micro and Macro Factors in International Regulation

The micro-prudential approach, focussed on transparency, disclosure and the process of risk management, is peculiarly susceptible to international agreement and implementation.

This contrasts significantly with the international dimensions of the seven macroprudential measures.

The micro-prudential approach, focussed on transparency, disclosure and the process of risk management, is peculiarly susceptible to international agreement and implementation, for three reasons:

First, once home-host issues have been sorted out, the regulatory domain is national.

Second, the international dimension of the regulatory process takes the form of principles and standards that can be adapted to national legislation.

Third, the micro concerns of the regulators do not impinge directly on other aspects of national economic policy. Such impact as there may be is confined to regulatory arbitrage (encouraging the growth of financial services by "lighter" regulation) and tax avoidance.

This contrasts significantly with the international dimensions of the seven macroprudential measures outlined above:

First, in a regime of liberalised international financial markets, macroeconomic factors are necessarily international.

Second, it will be necessary to capture macroeconomic externalities by means of common rules, since a seamless market will require common actions irrespective of juridical boundaries.

Third, macroprudential measures will impinge directly on other aspects of national policy, whether monetary policy, credit, housing and other asset markets, corporate structure, and so on. Moreover, the management of seemingly micro-risks, such as currency mismatches, might be better managed by macromeasures, such as capital controls.

To these new issues should be added the divergence of national interests that will be generated by countries being at different stages in the economic cycle. If cycles are not coordinated (and coordination is very undesirable) the implementation of macro-measures appropriate to the cycle (such as counter-cyclical capital charges) could lead to macro-prudential regulatory arbitrage.

Institutions

These are major problems. However, they are probably susceptible to pragmatic solutions if there is sufficient international commitment (recognition of national self interest), and an effective institutional structure within which policy may be developed and implemented. An ideal type might be the World Financial Authority (Eatwell and Taylor, 2000). But whilst the concept provides a useful template against which to test existing institutional structures, there is clearly no appetite at present for the creation of such a potentially intrusive organization.

These are major problems: pragmatic solutions are possible with sufficient international commitment (recognition of national self interest), and an effective institutional structure within which policy may be developed and implemented.

So if there is to be macro-prudential supervision, and this is necessarily international, what will be in the institutional framework within which it is conducted? The Turner Report (FSA, 2009) suggests that there should be a single rule-making financial services regulator for the European Union. More broadly, the two major candidates would seem to be the Financial Stability Forum (FSF) and the IMF. Both have major weaknesses.

The FSF has recently widened its membership beyond the G-7, adding the G-20 members that are not already members, Spain and the European Commission. As the major international financial “think tank” the FSF would be a logical location for the development of the new rules (notwithstanding the depressing Basel trilogy dominated reports of 2008). It has the right sort of membership—gathering together regulators, central banks, and treasury departments—and it could form a macro-prudential counterpart to the Basel committees. Its major weakness, is their major weakness. It is a consensual, soft law, organization, not well designed for surveillance and the propagation of rules.

The IMF is a treaty organization, with powers in its articles of association to conduct macroeconomic surveillance, and it has taken steps in recent years toward a role in international financial regulation. It may well be given a financial surveillance role in any future structure. However, the IMF’s powers have in recent years typically been used with respect to developing countries, where its approach has, to say the least, been controversial. It has “baggage”. Moreover, the IMF has not been effective in dealing with the major advanced economies that might be deemed financially systemically relevant. The United States, for example, simply refused to participate in the Financial Sector Assessment Program FSAP, and it is well known that IMF surveillance reports on advanced economies are subject to considerable national “influence”.

However, there is clearly at present a shared perception of national interests in effective international macro-prudential regulation, and there may well be a willingness to establish a new framework that combines the policy making potential of the FSF with the treaty sanctioned surveillance powers of the IMF. The resultant entity would be legitimised by a wide membership (G-20+), and would perhaps be the subject of general scrutiny at the Fund annual meeting. It will, of course, need to steer a difficult course between national interests, but if this is within a coherent intellectual framework (and the trilogy is superseded) then there may be significant progress. It will not be easy.

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7 What Role for Central Banks?

By Arturo O'Connell

The Need for a New International Financial Architecture

The world is confronted with one of the worst crises in terms of financial disruption, cuts in output, income and jobs witnessed in more than half a century. The way out of such a crisis both in terms of a reorganization of the financial sector and a recovery of economic expansion, stability and job prospects is still unsure. Temporary upswings in financial markets have come and gone, and forecasts for the performance of output and employment have been repeatedly downgraded. Procedures applied by governments to sort out the financial crisis have thus far failed to revive credit, and subject to public scrutiny, have unleashed a bitter debate about the implied—somewhat less than transparent—results in terms of social fairness. The more vulnerable sectors of the population both in advanced and underdeveloped countries are confronted with sudden and drastic cuts in income and job prospects. Worst of all, expectations of a way out have become gloomier with each passing day.

A New International Financial Architecture (NIFA) should address the need to support a balanced expansion of the world economy as well as the development of all countries and the advancement of all sectors of the population, most specifically those with lower levels of income and welfare. A NIFA should also establish rules and procedures that could cope with the tendency of financial markets to run into crises. And, if in spite of efforts in such a direction, a crisis should crop up, resources should be available for each and every country to avoid the worst consequences of a crash.

A pro-cyclical vein runs through the system that allows excesses in the upswings of the world economic cycle while rushing to impose predetermined strictures on the conduct of government policies in the downswing.

On the other hand, a NIFA should overcome the present-day limitations of the network of formal institutions, fora and generally-accepted rules that make up the one Architecture we have today. The problem is not only that some fields of action remain uncovered or ill-addressed—like tax havens or the "shadow banking" sector—or that an element of lack of coordination leads to some *cul-de-sacs*, like contradictory accounting and desirable prudential rules in banking. Most crucially, a pro-cyclical vein runs through the system that allows excesses in the upswings of the world economic cycle while—with notable but partial exceptions—rushing to impose predetermined strictures on the conduct of government policies in the downswing. Only the most powerful nations—and then only occasionally—will dare to risk opposing such limitations, and in this they are not always successful. For underdeveloped or peripheral countries there are no options; the bitter medicine has to be swallowed, and the most vulnerable sections of the population are bound to suffer the consequences

The Development of Central Banking and its Place in International Financial Architecture

Central banks are national institutions created at specific historical junctures in the life of their home countries to sort out a variety of problems. These problems have not always been the same. More than a few of the first central banks were supposed to facilitate the financing of government in exchange for being granted a monopoly on the issuance of fiat currency. Other central banks were created right after a serious crash had led to massive and generalised bankruptcies to act as the domestic banking system's "lender of last resort", providing almost unlimited liquidity to cope with a run on deposits. Still more central banks, particularly in underdeveloped countries, were created to centralize not only bank reserves but also foreign exchange reserves, so as to cope with balance of payments crises.

Furthermore, although there are some exceptions, central banks are typically in charge of managing currency issues and dealing with foreign exchange questions as well as ensuring the fundamental stability of the financial system. In this last task, central banks are charged with supervising other banks, precisely in the attempt to avoid crises that—it has been taken for granted—are recurrent. In fact, devoid of any grand theory to explain why, there is a consciousness that markets for financial instruments demand much more public intervention than an "invisible hand"-inspired theory of a market economy would suggest.

In addition, although, today it sounds almost outlandish, most central banks have also been an instrument of development policy and international competitiveness—and in a very few cases—of supporting the development of a powerful financial sector for either domestic purposes or—as has been surmised in the case of Great Britain—to become and remain a world financial hub.

Central banks, therefore, under formal or consensual agreement with authorities, have become potent instruments of national economic policies—and in the case of some of the more powerful nations—this includes foreign policies. The question of which specific national interests dominated the orientation of such policies, however, is a matter of much debate. Under gold standard rules, for instance, the maintenance of gold parities under adverse movements in the balance of payments led central banks to raise interest rates, resulting in deflation and/or unemployment. By the beginning of last century, this practice would be increasingly challenged by agrarian or workers movements and political parties, leading to a failure to reinstate the gold standard after WWI.

In the era of the first globalization, dominated in the financial sphere by the gold standard (GS) system, an international financial architecture of sorts did arise. Central banks were part of this architecture—the most powerful of them playing at the edges of the system—even though they were developed as instruments of national policy. Here and there they worked in cooperation to provide each other loans in moments of crisis that were massive enough to be beyond the powers of any single institution to cope with. In doing so, they also combatted possible contagion. After WWI central banks became active participants in an attempt that as already mentoned was eventually frustrated to re-establish the GS system on a permanent basis. In addition, some of the major central banks participated in rescue operations for newly-born nations pre-announcing IMF operations. Their participation in international affairs also included giving advice on the creation of central banks along the lines of what—in the late decades of the 20th century—would become conventional orthodoxy, that central banks should be "autonomous" of governments and devoted to preserve monetary stability above any other consideration.

The domestic and international financial crises of the interwar period—associated with widespread banking failures and the collapse of stock exchange prices –pulled banking and consequently the central bank's role in a different direction. Deposit insurance was introduced to avoid bank runs: in the United States, for instance, which had become the world's major economy, with New York becoming the most important world financial center, deposit-taking institutions were placed under the strict supervision of the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC). In addition, deposit-taking institutions were separated from investment banking activities. Floating exchange rates, competitive devaluations and the introduction of exchange controls became rampant.

Only a couple of instances of international cooperation involving central banks may be recollected, e.g., the creation in 1930 of the Bank of International Settlements (BIS). Originally the BIS was supposed to handle payments associated with German reparations (that stopped under the 1931 Hoover moratorium), but it also was granted statutory power to promote "central bank cooperation". In fact, attempts were made early on to organize support for the Bank of England before sterling left the Gold Standard. The Tripartite Agreement of 1936 was struck between France, the UK and the US—and with explicit central bank participation—as an attempt to stabilize exchange rates involving sterling, the US dollar and the French franc, after the last one was devalued under the Popular Front government that came into power in 1936. The BIS became instrumental after the Second World War in setting up mechanisms of cooperation like the European Payments System (EPU) before the return to convertibility of European currencies in early 1959.

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WWII brought a further tightening of bank regulations and government control of finance. Previously private central banks were nationalised and placed under the strict control of governments that were handling international economic and financial affairs more closely than ever before. In both advanced and underdeveloped countries central banks were instructed to support not only government finance but also credit policies orientated toward reconstruction and development as well as balance-of-payments support. This was done by establishing differential reserve requirements and applying sectoral credit allocations, credit and interest rate ceilings. Of course, central banks would also apply the more general instruments of monetary market intervention through overall reserve requirements, open market operations on the basis of government paper and not only private debt instruments plus intervention in foreign exchange markets. Also, a good many of the existing central banks, particularly after the massive unemployment experience of the interwar period, were asked, either informally or formally, to promote full labour employment.

In terms of International Financial Architecture, war cooperation and the urge not to allow the international turmoil of the interwar years to make a comeback, led to the creation of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). The Bretton Woods era that followed (1945-1971), was one of limited financial development both domestically and internationally. Exchange rate parities were mainly fixed, even if some of them eventually devalued against the US dollar that had become the true pillar of the system. Financial systems were fundamentally bank-based but at the same time strict controls placed on their operations resulted in the near disappearance of crises and, therefore, of the need for emergency central bank intervention. -Private flows of finance across borders were very limited. The Bretton Woods Institutions (BWIs) took first place as well as Multilateral Development Banks in various regions of the world and also official bilateral flows of finance, as either aid or export credits played an important role.

Central Banks exchanged information and received or provided technical assistance to each other mainly through the means of the IMF mechanisms. Some of the more important banks also started using BIS—and informal fora under its umbrella, reinforced by a less reluctant US participation—to start exchanging views on policies and desirable institutional reform, both of the banking sector at large and of their own institutions. The ground was thus laid for building up the rules that would be instituted in the later decades mainly on the matter of financial supervision.

The Transformation of Banking and Central Banks and the Comeback of Financial Globalization

The last quarter of a century has witnessed major changes in the character of banking—and consequently of the power of central banks over financial markets—as well as in the orientation and responsibilities of central banks within such a context. In its turn, the inter-play between national and international concerns became much more intense in the financial sphere during this period, additionally eroding the sovereignty of nations and the power of single central banks.

The last quarter of a century has witnessed major changes in the character of banking—and consequently of the power of central banks over financial markets.

Financial systems have since become ever more market-based and less dependent on bank loans, particularly in the more advanced "Anglo Saxon" countries, the proportion of financial instruments in the hands of commercial banks having declined. Banks, also, with the official "blessing" of central banks and governments have adopted the so-called "originate and distribute" model under which loans do not remain for long in their portfolios. Once granted, these loans are packaged and sold directly to the public or to other specialized intermediaries in the so-called "securitization" process. A distant relation was thus created between borrower and ultimate creditor that weakened what had traditionally been a direct relation between and bank and customers. The loss of information and dispersion of responsibility that resulted made a significantly negative contribution to financial stability. At the same time both governments and companies started avoiding banks as lenders and went "over their heads" directly to the markets to place their debt obligations. Banks also resorted to markets—including the interbank market—to handle liquidity and to complement the resources provided by depositors.

Far from being a "natural" development, such an evolution was to a great extent the result of specific policies followed by the authorities and by the same central banks. International Financial Institutions also played an important role by promoting the "Anglo-Saxon" model over the "Continental European", bank-based model. Consequently, central banks found themselves commanding an ever shrinking part of the financial system. Also, as central banks relinquished some of their traditional prerogatives in supervising the financial system, in exchange many of them obtained the long cherished aim of "independence", *vis-à-vis* governments. These same central banks then began to refrain from lending to their government, although they continued to trade in government paper in order to manage interest rates through open market operations and “repos” or “reverse repos” (transitory purchase operations carrying the obligation of a future, short-term repurchase).

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The recent history of central banks, in both advanced and underdeveloped lands—with very few exceptions—has been one of reforms with the single-minded task of keeping goods-and-services inflation low. Central banks have followed and promoted this framework while congratulating themselves repeatedly on their success in this endeavour. Inflation did actually come down all over the world, ushering in what has been called the era of the ‘Great Moderation”.

But that same era—even in spite of the brave warnings coming from everyone from independent observers to some of the institutions of the existent Architecture—was also one where crises returned with a frequency matched only by the interwar period, even in advanced countries like some of the Nordic ones. The world was thrown into an unprecedented era of financial de-regulation in which “markets” became masters in charge of an increasingly complex system arising out of the “securitization” and “disintermediation” processes. “This time is different”, argued the protagonists of the recent era, as well put across in the title of a recent contribution by Kenneth Rogoff and Carmen Reinhart to the examination of several centuries of financial crises. Risk had supposedly been washed away from the system by “atomistically” distributing it among so many agents that a disruption here and there would not bring down the whole system, even if some individuals or institutions could be badly hit.

Individuals and institutions who were encouraged to estimate risks on their own by closely tracking market prices and modelling past behaviour, adopted similar rules all around or relied on ratings produced by less than a handful of agencies that also followed the same modelling of risks. Thus, the rules of behaviour for different agents became remarkably similar and—when linked to the behaviour of market prices—in fact, ended up encouraging all agents to act in the same ways. The “atomistic” dispersion of risk therefore became a mirage.

Financial markets do recurrently enter into crisis. This has been verified by the experience of many centuries but has also been consistently ignored, even when—as in recent times –a scientific explanation for such crisis has been provided. Therefore, prices in markets that repeatedly fail, surely cannot furnish good guidance for pricing financial instruments. Worse, the same experience and scientific reasoning indicate that financial market failures bring along phenomenal, economy-wide, negative effects that have always required massive public intervention. Consequently, de-regulation on the premise of well-functioning markets was always a mistake, a mistake in which central banks took on in their other role besides that of inflation fighting, that of banking supervision.

Not that inflation fighting, at least when taken to the extreme, is necessarily an objective that if reached could ensure that the economy would work to expand jobs and opportunities or promote rapid growth in underdeveloped countries. The Federal Reserve System—the central bank of the US—after all, operates by a double mandate under which it has to fight both inflation and unemployment. For instance, the previous Governor of the Bank of England, who adopted “inflation-targeting” as the main guideline for the Bank’s policies, is on the record stating “we are not inflation-nutters”, i.e., other considerations like employment levels were still a valid consideration. But consider the dominant mandate adopted in the last few decades, as consecrated in the European Central Bank (ECB) statutes: “The primary objective of the ESCB [European System of Central Banks] shall be to maintain price stability”. This statute comes with a kind of escape clause linking this article (105) to Article 2 in the Consolidated Version of the EU treaty that instructs the Bank to “…support the general economic policies in the Community with a view to contributing…” to “…promote economic and social progress and a high level of employment and to achieve balanced and sustainable development”. Nevertheless, the overarching objective of the ECB has been to ensure a low rate of inflation.

Additionally, the single instrument necessary to achieve that end was supposed to be intervention in the short-run interest rate market. Reserve requirements were not used, let alone applied to either macroeconomic or for industrial policies. The same thing happened with credit controls—overall or discriminatory—in spite of a growing literature that emphasized managing credit levels more than money levels as the more effective instrument for central bank policies.

For all the rigmarole about the need to avoid inflation—and that any rate above low single-digits is bad for the health of the economy and jobs and bound to become explosive through price-wage spirals—empirical work has been most inconclusive, particularly in the case of underdeveloped countries. Trade-offs between high interest rates—raised to counter inflation—and employment or growth have been ignored or explained away by new theories. In fact, the era of the “Great Moderation” has become—with the exception of the immediate phase previous to the present-day crisis—an era of much lower growth and higher unemployment levels than that of the previous quarter century.

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Under such transformations in banking, aspects of the current International Financial Architecture have been designed by central banks. This is at least true of those in the industrialized and most advanced among the underdeveloped countries. Their governors and many of the highest-placed officials attend a multiplicity of meetings among themselves where a common vision of problems facing the world economy is debated. This way, a so-called “epistemic community” has become established, i.e., an informal consensus about what is appropriate for a central bank to do is reached and some rules are accepted, such as the so-called Basel Committee rules on prudential regulations, to be followed by all institutions like capital ratios or risk measures that are applied without any public debate, let alone approval by legislative or executive bodies in a majority of their countries. The fashion for “independent” central banks—independent from publicly elected authorities in each country—has only reinforced such a “community” as they have been granted an authority above political debate that allows those consensual views and rules to be put into practice.

On the matter of the International Financial Architecture, central banks have a tradition of cooperation—or conflict—on specific matters like exchange rate policies or foreign reserve accumulation, leading in the more amicable cases to reciprocal swap lines being established both in the advanced regions (see US Federal Reserve recent swap lines with Europe and a few “emerging market” countries) and more recently among some underdeveloped ones, like the Chiang Mai initiative in East Asia or the Latin American Reserve Fund (FLAR for its initials in Spanish). There is also an active exchange of officials on many specific technical matters that although innocent looking do contribute to a great extent to the development of the above mentioned “epistemic community”.

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Among the various objectives and instruments that have been taken away from the terms of reference and toolbox of central banks, is that of an exchange rate objective and the instruments needed to achieve this objective. For underdeveloped countries (and as the experience of the US in the late 1980s and right now also shows), the exchange rate is a crucial price. It not only enters decisively into price formation—and therefore in the cherished objective of inflation control—but it is also a major determinant of the international competitiveness of the economy, as patently shown by the serious consequences to countries that allowed currency overvaluation. Massive damage to their industrial structure, external deficits, debt accumulation and eventually a balance of payments cum foreign exchange cum debt crisis accompanied in many cases by a domestic financial sector crash and serious fiscal difficulties, all of which resulted from allowing their own currency to overvaluate. Those multiple crises resulted in a drastic fall in output and incomes, sudden increases in poverty levels and socio-political turmoil.

Moreover, under the present-day international "rules of the game" (for instance as consecrated in the Articles of Agreement of the IMF) countries in exceptional circumstances, but still under the obligation to avoid any obstacles to external payments in their current account are authorized to place controls on capital movements. The use of this prerogative was habitual, even in advanced countries, until very recently, but it lost support and—to the contrary—became a matter of conviction to advocate capital account liberalization. This conviction was exercised so strongly that in the late 1990s significant progress was made to amend the IMF Articles of Agreement to establish that members—encompassing most countries–should eliminate each and every instrument of capital movements administration. The onset of the Asian crisis, as well as those that followed, led to a postponement of the question. Various governments pursued the idea through bilateral means, notably the US, which introduced clauses to that effect in Free Trade and Investment treaties it signed with a number of countries.

The idea that "hot-money" flows were behind many of the problems of the interwar period—particularly under the attempt to rebuild a somewhat mythical pre-WWI, liberal international economy –resulted in the above-mentioned sections of the IMF agreement. Unstable flows searching for better profit opportunities had played havoc with balance of payments and resulted in the resort to protectionist and deflationist measures to compensate for the effects of those de-stabilising forces. Today global balance of payments imbalances are rampant, and the counteracting capital flows are unstable, even when they come out of foreign-exchange-reserve accumulation by central banks trying to self-insure themselves against foreign shocks after the experience of the 1990s.

Instability induced by "hot-money" flows is only one consequence of their liberalization. Research from impeccable sources—such as work produced at the Research Department of the IMF under the direction of two of the last Directors- has shown that capital account liberalization is not a sufficient condition for growth of underdeveloped countries, even to the point of becoming a negative force on its own. Most explanations for these negative effects blame either the raising of limits to consumption (by providing easy finance rather than increasing investment) and/or the forcing of currency overvaluation in the upswing, with negative consequences for international competitiveness and a deleterious impact on external instability.

Central Banks have allowed these processes to prevail by abandoning management of exchange rates and relinquishing—with the acquiescence of governments—their capacity to control capital movements. The consequence has been repeated and serious crises as well as lower rates of growth for their economies.

The Role of Central Banks in a New International Financial Architecture

A NIFA cannot be a straight-jacket with the narrowminded objective of avoiding inflation without regard for the cost in terms of growth, jobs and general welfare. It is clear that the present Architecture—which to a great extent is responsible for the present day crisis—has to be fully overhauled and lessons drawn about the myth of "self-regulated" financial markets. On the contrary, a NIFA should prioritize the promotion of full employment and development of the less-favoured nations. It should also establish stern rules both for domestic and cross-border financial activities. A NIFA should produce a decisive shift in central bank priorities and terms of reference. Since central banks are national institutions, a tension, will no doubt always be present between their internal obligations and those related to cooperation in the international sphere. International cooperation and common rules for the NIFA—at both a global and a regional level—it is necessary to avoid "free riding" and "regulatory arbitrage".

Some of the shifts and changes in central banks, which should be included in a new NIFA are:

1. Central banks should re-build their regulatory controls over the banking system, including the "shadow" banking system. No agent or institution involved in leveraged financial intermediation should be beyond its reach;
2. Regulations should be based on macro as well as micro considerations to preserve the system rather individual institutions;
3. Most specifically, provisions should be introduced to counter the pro-cyclical character of the banking and the financial system in general;
4. Regulations should also support the development of each and every country by allowing and actively promoting credit allocation and overall control of credit as part of a development policy rather than only concentrate on passive deposit accumulation;
5. Regulations cannot be based on the notion of "self-regulated" markets but on the general welfare of the population and their enhancement. The mandate to disregard the whims of the financial market and to fight their pro-cyclical tendencies should be handed down from regulators to the regulated;
6. Central banks should recover their capacity to intervene in the exchange markets, not only through the back door—as is practiced in many countries—but as an objective as valid as that of inflation or financial stability, in fact, all of them quite tightly interrelated;
7. Capital controls in the form of direct administrative measures and/or taxes à la Tobin have to be introduced, if not by all countries, at least for those conscious of their need; and
8. Support for government enterprises and public works should be utilized as springboards for development rather than being curtailed.

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Although the author is a member of the Board of Governors of the Central Bank of the Argentine Republic, the views expounded in this paper should not be construed as the opinion of the Central Bank neither of the Argentine Government authorities but only an expression of his personal ideas.

8. Country-Based vs. Global Regulation: Failures of the Present Framework

By Stanislaw Kluza

The last two years have seen a period of turmoil in the financial markets which revealed numerous weaknesses of the current system. Lack of oversight supervision with regard to structured financial instruments contributed to the rise in unsound underwriting practices, especially by mortgage lenders. Historically low interest rates in combination with a high risk credit policy, abuse of Originate-to-Distribute (OTD) model, as well as increasing use of leverage are well known examples of the decline in standards in financial markets. Therefore, governments and supervisors must respond to these challenges and consider what changes in the regulatory framework are needed to strengthen the stability and resilience of the financial system.

National regulatory frameworks are not interconnected enough to provide solutions on a global level, mostly because of the lack of cross-border cooperation between supervisors.

Over the course of the current crisis, authorities' ability to deal with the risk of default of cross-border financial groups both on a local and global level has been tested on several occasions. These tests have proved that national regulatory frameworks are not interconnected enough to provide solutions on a global level, mostly because of the lack of cross-border cooperation between supervisors. Inadequate cooperation arrangements and varying crisis regulatory toolkits may have compromised effective supervision of financial institutions.

In the context deteriorating global economic conditions there is a significant need for a global standard setter. However substantial divergences between national economies imply that the transposition of such global standards should take into account specific national economies and their legal frameworks. It is justified to claim that adapting regulations to local circumstances may be beneficial to the stability of undeveloped, emerging markets, because tailor-made implementation of global rules contributes to more efficient supervision of the financial sector in these markets. The example of the Polish economy can serve as an argument to underpin this thesis.

This paper focuses on the experience of consolidating Polish regulations with European Economic Area (EEA) area regulations. It examines issues linked with the harmonization of supervisory regulations in the context of host supervisor (in EEA area the Polish supervisor acts as the host for most banks) and conclusions resulting from current financial crisis.

Priorities for the New Regulatory Regime

What do we mean by global regulation? This term refers to standards developed for global cooperation. The implementation of those standards by national legal systems is the next step necessary to increase the quality of the global regulatory framework. A coherent and harmonized system of principles and rules is necessary since the largest financial institutions operate as cross-border financial groups. Comparable requirements for prudential supervision are advantageous for both supervisors and supervised entities. Harmonized regulations make it more efficient to combat international financial crime. A good example of the need for a global initiative to ensure a high quality of regulation is the Wolfsberg Anti Money Laundering Principles for Private Banking established by the Wolfsberg Group consisting of the largest international banking groups. These groups agreed to comply with the stricter rules of this global principle, so as to ensure that their institutions have the same level of protection against money laundering crimes.

When considering the correlation between domestic and global regulation, one has to take into account that the current diversity of national legal frameworks makes cross-border coordination of supervisory practice almost impossible. The absence of a global regulatory concept of the efficient supervision of international financial groups is rooted in specific legal frameworks in particular jurisdictions (different corporate and insolvency law regimes) as well as the lack of a globally workable deposit-guarantee scheme. The security of domestic investors is a priority for all supervisors: it is their primary responsibility. The harmonization of regulations is indispensable for stabilizing markets and improving the efficiency of the global economy.

The relationship between country-based regulation and global regulation (understood as an authority as well as regulatory system) should ensure three basic regulatory goals: protection of the customers, safeguarding of the financial stability and the sustainability of economic growth. However, key responsibilities regarding the licensing process, ongoing supervision and consequences of these should be assigned to the country-based regulatory scheme.

The relationship between country-based regulation and global regulation should ensure three basic regulatory goals:

- **Protecting customers**
- **Safeguarding financial stability**
- **Sustainability of economic growth.**

Taking into account the current situation of the global financial market, it would seem to be justified to undertake more intensive measures in order to introduce a closer consultation of country-based regulation with market participants. Local supervisors should exchange information about the new trends and processes that appear on their markets, with particular regard to the new financial instruments, the means for using these products and the nature and extent of the risks being taken by using these instruments.

Global Standards, Local Implementation

One of the most important issues for the further coordination of global and local regulation is the improvement of risk-control for cross-border financial groups. In EEA member states the problem is covered by the Credit Requirements Directive, which ensures that the same rules of assessment and reinforcement of additional capital on institutions are applied when necessary. The advisory Committees to the European Commission (so-called 3L3 Committees) play an important role through the issuance of relevant guidelines that aim at the coordination of supervisory practices at the EEA level.

The coordination of regulation globally should also make provisions for problems arising from local markets and specific risks linked with the local economic environment. The same principles included in global and local regulations should not necessarily imply exactly the same set of measures and techniques to supervise institutions. Bearing in mind that the primary objective is a sound financial system, in order to carefully identify the risks associated with supervised institutions, supervisory measures should take account the diversity of institutions' activities and risks. For example, risk assessment methods may differ as a result of certain distinct types of institutions operating in different countries (eg. investment banks vs. small cooperative banks).

The shift of powers—from the country to the international level—should always be accompanied by an appropriate shift of responsibilities.

Implementing global regulation, one may also bear in mind the possible introduction of laws that would empower international bodies to decide on issues within the scope of national jurisdictions. It has to be underlined that the shift of powers (from the country to the international level) should always be accompanied by an appropriate shift of responsibilities. For instance, a harmonized regime of financial supervision—envisaging that decisions are based on international regulations and/or made by international authorities—should also ensure that responsibilities are borne accordingly. It is particularly visible today—a time of economic slowdown, or even recession, when so many financial institutions require capital injections and banks' clients expect that their deposits are guaranteed to the highest level possible. In both cases national governments are ultimately the ones who had to provide necessary support. So, countries (and their relevant authorities) cannot be deprived of powers if at the same time they are still obliged to be "the lender of the last resort". As the citizens of any country are rather unlikely to be willing to bear the costs of helping other economies, then the focus should be on regulatory coordination rather than on creating supranational authorities.

Another key element of a sound regulatory regime, in the context of regulations' convergence, is effective implementation and compliance with established regulations and principles by institutions. This issue concerns regulations at both the local and global level. The effective implementation of regulation is especially important but difficult with reference to the rules regarding qualitative aspects, such as risk management and internal control systems. Since it is impossible to set up one common solution concerning detailed risk management techniques that would fit all institutions, it is their responsibility to properly identify, measure, control and mitigate the risks embedded in their activities. In this regard one of the supervisors' tasks is to verify that the institution complies with both external and internal regulations as well as to assess risk management systems, especially those with an overreliance on assessment-results made by external institutions that may create risks.

The harmonization of regulation is desirable when one takes into account the global nature of economy and financial markets. Coordination improves financial stability and allows for better management of cross-border financial institutions. Existing differences in global regulations (e.g. different reporting duties, bankruptcy law or definitions of economic capital) complicate the process of crisis prevention and recovery. Furthermore, the present day crisis has shown that financial decisions and actions taken in one country may significantly impact other countries. Nevertheless, taking into account a diversity of banking systems around the world, harmonization and convergence of regulation has its limits. Harmonization should not affect the national sovereignty and should respect existing differences. Regulations should take into account risks and factors specific to local markets. Therefore, the European Economic and Financial Affairs Council, during the meeting on 9 October 2007 agreed to develop the appropriate policy instruments stressing that: "Arrangements and tools for cross-border crisis management will be designed flexibly to allow for adapting to the specific features of a crisis, individual institutions, balance sheet items and markets. Cross-border arrangements will build on effective national arrangements and cooperation between authorities of different countries".

Transferring Responsibility to the Global Level Is Not the Best Solution

In order to ensure the effectiveness of the new approach to potential financial crisis, all actions taken should be proportionate to the nature and the complexity of the risks inherent to the business of companies. The above could be recently seen in some cases, such as the current troubles of the AIG group. As a result, the relation between global and country-based regulation of the insurance market should be assessed regarding the financial market as a whole.

The necessary relationship should be based on the following process: regulation should become global, but enforcement of these laws must be treated locally.

Bearing this in mind, the right division of the supervisory powers between the group and the local level remains important (i.e. in the context of the risk-based supervision, adopted or planned to be adopted by a number of financial market supervisors). The necessary relationship should be based on the following process: regulation should become global, but enforcement of these laws must be treated locally. The local authority will generally have a better knowledge of the specific issues relating to the particular market. As a result, they will be better prepared to act accordingly in case the global turmoil impacts the local market. Nevertheless, an extensive cooperation and exchange of the relevant information is required in this respect. It is also necessary to eliminate the most grave differences between the laws of different countries. However, in talking about the relationship, the questions should be about not only the systemic laws within countries, but also the practice of using them correctly. In designing the international regulations, it should be stressed that they will be effective only when domestic regulators are compelled to examine the fulfillment of these regulations by the proper institutions. Finally, with relation to the insurance supervision, we cannot forget about the customers' protection. Usually, insurance contracts relate to the sensitive or at least important issues from the client's perspective. Thus, the relevant level of clients' protection remains one of the main tasks of insurance supervision. And although global cooperation enables a quick response to market troubles, the proximity of the supervisory authority ensures the greater level of confidence to the market from clients' perspective. International and European leaders should concentrate on building a united front against the global financial crisis. The necessity for global dialogue and coordinated actions has never been greater.

Having this in mind, we must say that setting the right relationship between country-based and global regulation is not easy. To give an example, we may refer to the European Commission's proposal for the Solvency II Directive in respect to group supervision. One of the aims of the Directive's proposal should be to find appropriate ways of streamlining the supervision of insurance groups in the EU. However the initial proposal introduced a solution to this problem based on the concept of a "group supervisor", a single authority responsible for supervising the top entity of the group, with concrete coordination and decision powers like group solvency, intragroup transactions, risk concentration, risk management and internal control. In this respect, the draft directive waives certain powers belonging to the local supervisory authorities in favour of the (re)insurance undertakings licensed, when those undertakings have been part of a group. This concept itself may raise questions of a legal nature: the group supervisor would be compelled to adopt legally binding decisions for entities or supervisors outside its jurisdiction. Moreover, the group supervisor empowered to make such decisions would not be responsible for them.

The even more important questions refer to the responsibility of local supervisors for the solvency of the authorized undertaking and the adequate level of policyholder protection resulting from that. According to the draft directive, the local supervisor was not originally allowed to enforce solvency of the undertaking it had authorized (nor was the group supervisor allowed to do it). In addition, the local supervisor was also banned from adjusting the undertaking's capital requirements by way of imposing a capital add-on when the insurance undertaking's risk profile was not adequately captured.

Both powers normally exercised towards other insurance undertakings he had licensed but which were not in a group and were not therefore encompassed by group supervision. At the same time, the undertaking's obligation to pay out all claims resulting from concluded insurance contracts is not waived. In no way are those obligations transferred to the dominant entity within the (re)insurance group, nor is any responsibility for the insolvency of the undertaking transferred onto the level of group supervisor. In case of ultimate problems, it is the local authorities who have to deal with them.

The analysis of the issues raised by the Solvency II Directive leads to the conclusion that the group supervisor—as a legal figure—is not necessarily the optimal solution to provide cross-border supervision. However during the negotiation process for the Directive, the original proposal was changed by member-states, and the final resulting Directive shows the direction of some rule—makers, which in their opinion will provide the convergence and better supervision of insurance institutions. But indeed the Directive waives the supervision of group entities' solvency and as a consequence, can bring about their insolvency and inadvertently weaken the stability of the entire group. In light of the current situation in financial markets, this kind of solution should be perceived as imprudent and unsafe.

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The Proper Balance Between Global Stability and Local Responsibility

The crucial factor that shaped trends in international financial markets in 2007 and 2008 was the excessive default of US mortgage loans, including high-risk subprime loans. In the process of securitization, the credit risk of subprime loans was transferred from originators to other financial institutions, such as with the Originate-to-Distribute model. Market participants did not possess sufficient information on which institutions assumed which risk and what was the scale of their exposure.

The subprime crisis has had the greatest impact on the money market in the United States and the Eurozone. The situation in the international financial market has impacted the Polish market to only a limited extent since the Polish financial sector is subject to a tight micro-prudential regulatory framework. The influence of market turbulence in the US on domestic financial institutions has not yet led to a substantial deterioration of the financial sector's situation.

The Polish banking sector has a significantly different structure than its American or West-European counterparties, (e.g. it can be characterized by small volume of securitization transactions and rare usage of OTD model). Banks hold credit risk related to extended loans in their balance sheets. In addition, Polish banking law has quite a conservative approach toward capital adequacy requirements. Therefore, Polish banks are much less tempted to neglect risk assessment than was the case with their US and Western European counterparts.

The performance of the Polish financial sector in 2008 was good. The average level of credit institutions' capital adequacy ratios in Poland continues to be higher than the regulatory minimum, however the international turmoil has influenced domestic institutions to a moderate extent. Consolidated regulatory rules on a global level may enable a more effective response to the increasing integration of the financial market and to the matter of emerging new global prudential regulations.

Simultaneously with intra-national discussions on the models of regulation, another process has become an issue of great controversy in the European Union: the home state/host state relations in financial supervision over large financial groups. In the course of legislative work over the Solvency II Directive and Capital Requirements Directive (CRD), we observe a tendency for shifting supervisory powers over subsidiaries of international financial groups (e.g. the approval of capital requirements from host-state to home-state authorities (the latter being described as "consolidating supervisor" in CRD and "group supervisor" in the version originally proposed by the European Commission of Solvency II Directive). At the same time, all responsibility for the outcome of a solvency crisis in any of the subsidiaries of the group remains in the host country. Therefore, it is not a beneficial situation from a regulatory perspective if some relevant regulatory competencies are transferred from a local supervisor to the group one.

As far as the formal EU procedure regarding amendments to the CRD is concerned, our authority consistently claimed that financial regulations on a global (European) level will make host supervisors responsible for ensuring that standards are met by subsidiaries with their registered seat in the host country. We believe that host supervisors have the best possible credentials to properly assess and—if necessary—enforce the sound manner in which financial institutions conduct their business activities. Some of the locally incorporated Polish banks belonging to the EU (EEA) cross-border banking groups are systemic and significant for the Polish banking system. At the same time, their importance at the group level is marginal (a small percentage share in the group's risk-weighted assets).

We believe that host supervisors have the best possible credentials to properly assess and—if necessary—enforce the sound manner in which financial institutions conduct their business activities.

And what is the case for Poland, is also true for other European countries. For example, in the process of model validation at the group level (by the home supervisor for the parent company), the home supervisor will in practice not spend resources on host-country local model assessment. Practical examples show so far that assessment of local models, being part of the group application, is unnecessarily subject to the final authority of the consolidating supervisor. Such a solution is burdensome and adds an additional layer of bureaucracy at the home level. What should be a decision of concern mostly or solely to the local subsidiary becomes an unreasonable preoccupation for the home group supervisor. Therefore it is clear that local models created according to the advance internal-rating based approach should be subject to the decision (validation) of a host supervisor, who would work in coordination with a consolidating supervisor.

Conclusions

The attention of those creating global regulation should be focused on better coordination between home- and host-country supervisory authorities as well as on the enhancing of certain regulations covering macro- and micro-prudential policies. From a European perspective it is remarkable that introducing common standards for supervisory practices and interpreting financial regulations is considered fundamental for a stable and efficient financial market. There is a clear need to improve the convergence and cooperation mechanisms between regulators in particular countries especially with regard to cross-border financial institutions.

The macro-prudential regulatory framework is meant to be global, but micro-prudential oversight and the supervision of conduct of business should remain local.

However, any legislative actions should be aimed first at re-establishing confidence, stabilizing financial markets and enabling business and people to get through the global collapse. Second, they should aim at reforming and reinforcing the global financial and economic system to ensure such a crisis cannot occur again. New regulations may require statutory change, institutional reconstruction and diplomatic efforts. Finally, we have to do everything possible to put the global economy back on track. It is inevitably true that the global regulations to be developed will provide common, universal standards for financial institutions to operate. It is a necessary prerequisite for operational convergence of corporate standards worldwide. However one must bear in mind that necessary adjustments to these common rules will have to be made on the local level. The macro-prudential regulatory framework is meant to be global, but micro-prudential oversight and the supervision of conduct of business should remain local.

Stanislaw Kluza
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The views expounded are an expression of the author's personal ideas.

9. Dear Prudence (Regulation Needs To Be More Global *and* More National)

By Avinash Persaud

There is a widely held view that the Credit Crunch of 2007-2009 was a result of an insufficient reach of regulation and the solution is to take existing regulation and spread it without gap across institutions and jurisdictions. This would be a mistake for a few reasons. One reason is that highly regulated institutions in regulated jurisdictions lay at the heart of the crisis: Northern Rock, IKB, Fortis, Royal Bank of Scotland, UBS, Citigroup, et cetera. If there were no mortgage fraud in the United States, no tax-secrecy in Switzerland, no conflict of interest at rating firms, this crisis would still have occurred. This crisis was a national regulatory failure. The solution is not therefore more of the same, but better regulation, in particular, greater macro-prudential regulation. More macro-prudential regulation is coming at last. It has been recommended by the G-20 Leaders in their 2 April 2009 Communiqué, the UN Commission of Experts, the Turner Review in the UK and by the G-30, Jacques de Larosiere and Geneva Reports.

There is a widely held view that the Credit Crunch of 2007-2009 was a result of an insufficient reach of regulation and the solution is to take existing regulation and spread it without gap across institutions and jurisdictions.

This is not the first international banking crisis the world has seen. It is probably the eighty-fifth. If crises keep repeating themselves it seems reasonable to argue that policy makers need to carefully consider what they are doing, not just double-up. It also means that policy makers should not superficially react to the characters and colours of the current crisis. The last eighty-four crises occurred without credit default swaps and Structured Investment Vehicles. The last eighty something had nothing to do with credit ratings. Schadenfreude at bankers' expense is satisfying, but as US President Obama has observed, anger does not get us very far. This crisis is the loudest call yet to plug fundamental market failures that have either been ignored or improperly dealt with in financial regulation so far. The biggest of these concern national and international systemic risks.

Systemic Risks

It seems banal by now to point out that the reason why we try to prevent financial crises is that the costs to society are invariably enormous and exceed the private cost to individual financial institutions. We regulate in order to internalize these externalities on to the behaviour of financial institutions. The main tool regulators use to do this is capital adequacy requirements, but the current approach is too narrow. It implicitly assumes that we can make the system as a whole safe by ensuring that individual banks are safe. This sounds like a truism, but it represents a fallacy of composition. In trying to make themselves safer, banks and other highly leveraged financial intermediaries behave in ways that collectively undermine the system.

Selling an asset when the price of risk increases, is a prudent response from the perspective of an individual bank. But if many banks act in this way, the asset price will collapse, forcing risk-averse institutions to sell more and the cycle turns round and round, leading to generalized declines in asset prices, enhanced correlations and volatility across markets, spiraling losses and collapsing liquidity. I have previously described these horizons where liquidity appears abundant before vanishing, as a liquidity black hole. But the critical point is that liquidity risk is not a solid to be measured and easily categorized, it is endogenous to market behaviour.

Through a number of avenues, some regulatory, some not, often in the name of transparency and standardization, the increasing role of current market prices on behaviour has intensified this endogeneity. These avenues include mark-to-market valuation of assets; regulatory approved market-based measures of risk, such as the use of credit default swaps prices in internal credit models or price volatility in market risk models; and the increasing use of credit ratings, which tend to be correlated with market prices.

Endogenous Risk and the Economic Cycle

In the up-phase of the economic cycle, price-based measures of asset values rise, price-based measures of risk fall and competition to grow bank profits increase. Most financial institutions spontaneously respond by (i) expanding their balance sheets to take advantage of the fixed costs of banking franchises and regulation; (ii) trying to lower the cost of funding by using short-term funding from the money markets; and (iii) increasing leverage. Those that do not do so are seen as under leveraging their equity and are punished by the stock markets. In the more prosaic words of Chuck Prince, CEO of Citigroup, “when the music is playing you have to get up and dance”.

When the boom ends, asset prices fall and short-term funding to institutions with impaired and uncertain assets or high leverage dries up. Forced sales of assets drive up their measured risk and, inevitably, the boom turns to bust.

One of the key lessons of this crisis is that market discipline provides the wrong kind of discipline in booms.

One of the key lessons of this crisis is that market discipline provides the wrong kind of discipline in booms. It is noteworthy that those institutions that have been most resilient to the crisis, such as HSBC and J. P. Morgan, had lower stock market ratings than those who proved most vulnerable, Northern Rock, Bear Sterns, Fortis and Lehman Brothers. Market discipline has a role to play in financial sector development more generally, but it cannot be in the front line of our defense against financial crises.

One of the reasons why market discipline was seen as such an important pillar in the previous approach to banking regulation is that the implicit model of crisis regulators had in their minds—that financial crashes occur randomly as a result of a bad institution failing and that failure becomes systemic, nationally and internationally. But our experience is different. Crashes follow booms. In the boom, almost all financial institutions look good and in the bust they almost all look bad. Differentiation is poor. This current crisis is nothing but yet another instance of this all too familiar boom and bust cycle. But if crises repeat themselves and they follow booms, banning the products, players and jurisdictions that were circumstantially at the centre of the current crisis will do little to prevent the next one. Unless we tackle the booms there will always be an unbanned instrument to take the place of the banned.

Moreover, the notion that financial products are safe and some are not and the use of unsafe products is the problem also looks suspect in a world of boom-bust and endogenous risk. Booms are often a result of things appearing safer than they are. Securitization was viewed as a way of making banks safer. Sub-prime mortgages were viewed as safe as houses. Micro-prudential regulation is necessary to weed out the truly reckless institutions and behaviour, but the main thing we need to do is to supplement micro-prudential regulation with macro-prudential regulation to calm the booms that the micro-prudential regulation lets slip through; and to soften the inevitable busts.

Micro-prudential regulation is necessary to weed out the truly reckless institutions and behaviour, but the main thing we need to do is to supplement micro-prudential regulation with macro-prudential regulation to calm the booms that the micro-prudential regulation lets slip through; and to soften the inevitable busts.

Micro- and Macro-Prudential Regulation

Micro-prudential regulation concerns itself with the stability of individual institutions. Macro-prudential regulation concerns itself with the stability of the financial system as a whole. Micro-prudential regulation examines the responses of an individual bank to exogenous risks. By construction it does not incorporate endogenous risk. It also ignores the systemic importance of individual institutions such as size, degree of leverage and interconnectedness with the rest of the system.

One of the key purposes of macro-regulation is to act as a countervailing force to the natural decline in measured risks in a boom and the subsequent rise in measured risks in the subsequent collapse. How this is to be implemented is as important as what is being implemented. Supervisors currently have plenty of discretion, but they find it hard to utilize it because of the politics of a boom. Almost everyone wants a boom to last. Politicians are looking to reap electoral benefit from the sense of well-being and prosperity of booms. Policy officials convince themselves and try to convince others that the boom is not an unsustainable credit binge, but the positive result of structural reforms they have put in place. Booms have social benefits. They are associated with a higher appetite for risk and a perception that risks have fallen and this often means that access to finance rises for the unbanked and underinsured rises. Booms are not quite a conspiracy of silence, but there are few who gain from the early demise of a boom and so booms are accommodated, growing larger and larger and thus reaping more damage when they eventually collapse.

Counter-cyclical and Liquidity Charges

In the light of the observations above, there is a growing consensus around the idea that capital requirements need to be counter-cyclical in order to moderate the boom-bust cycle, or at the very least not amplify it. Counter-cyclical regulation is explicitly supported by the 2 April Communiqué of G-20 and by the earlier reviews and reports cited earlier. In practical terms, Professor Charles Goodhart of the London School of Economics and I have recommended regulators increase the existing or base capital adequacy requirements (based on an assessment of inherent risks) by two multiples.

The first is related to above average growth of credit expansion and leverage. Where they are separate, regulators should meet with monetary policy officials in a Financial Stability Committee. An outcome of that meeting would be a forecast of the degree of growth of the average bank's assets that is consistent with the central bank's target for inflation (or some other macro, nominal target). The forecast would have a reasonable band around it. If a bank's assets grow above this band it will have to put aside a higher multiple of its base capital charge for this new lending and if its assets grow less than the lower bound, it may put aside a lower multiple.

It is important to note that Financial Stability Committees already exist in many countries. They generally do not work because while worthy people meet and fret together, there is no consequence to their deliberations. A consequence, such as agreeing to the level of sustainable bank asset growth would focus these Committees in a more productive way.

The second multiple on capital charges should be related to the mismatch in the maturity of assets and liabilities. One of the significant lessons of the Crash of 2007/8 is that the risk of an asset is largely determined by the maturity of its funding. Northern Rock and other casualties of the crash might well have survived with the same assets if the average maturity of their funding had been longer. The liquidity of banks' assets has fallen far more than their credit quality of the assets or their performance.

However, if regulators make little distinction on how assets are funded, financial institutions will rely on cheaper, short-term funding, which increases systemic fragility.

However, if regulators make little distinction on how assets are funded, financial institutions will rely on cheaper, short-term funding, which increases systemic fragility. This private incentive to create systemic risks can be off-set through the imposition of a capital charge that is inversely related to the maturity of funding of assets that cannot normally be posted at the central bank for liquidity. The 2 April 2009 Communiqué of the G-20 also explicitly mentioned the need for the greater regulation and management of liquidity. The Turner Review argues for liquidity buffers and minimum funding ratios though the measurement and effect of these are similar to our "liquidity charge": posting additional capital to reflect liquidity risks.

Measuring the liquidity maturity of assets and liabilities is not straight-forward. A ten year, AAA, government bond has almost immediate liquidity. Assets that cannot be posted at the central bank for liquidity can be assumed to have a minimum liquidity maturity of two years or more. If a pool of these assets was funded by a pool of two-year term deposits there would be no liquidity risk and no liquidity charge. If on the other hand the pool of funding had a maturity of one month and so had to be rolled over every month, the liquidity multiple on the base capital charge would be near its maximum—say two times, so the minimum capital adequacy requirement would rise from 8% to 16%. In a boom when the counter-cyclical multiple is also at 2 times, the final capital adequacy requirement would be 32% of risk-weighted assets (8% x 2 x 2). I recognize that liquidity multiples will make lending more costly given that banks traditionally fund themselves short and lend long. However, the liquidity multiple will give them an incentive to find more long term funding and where they cannot, will address a real, systemic risk. Moreover, recall that bank capital in excess of 20% of risk-weighted assets was common in the industry before the crash and proved insufficient.

To further reduce the spiral of sales in a crisis and support financial institutions lengthening the maturity of their funding, I also propose that instead of suspending mark-to-market value accounting, financial institutions should compliment mark-to-market accounting with mark-to-funding valuations. Under mark-to-funding valuations there are essentially two alternative prices for an asset: today's market price and the present discounted value of the future earnings stream. In normal times, these two prices are near-enough the same. In a liquidity crisis the market price falls substantially below the PV. If an institution has short-term funding, the realistic price is the market price. If it has long-term funding, the PV price is a better measure of the risks being faced by the institution than the market price. In mark-to-funding accounting, a weighted average of the market price and PV is taken depending on the weighted average maturity.

To Each According To Their Risk Capacity

There is a very big idea lying a little hidden in this approach to liquidity charges. By placing a charge on the degree of maturity mis-match between assets and funding we are discouraging institutions without a capacity for liquidity risk from holding it and, perhaps, encouraging institutions to develop a capacity through longer-term funding. The response of financial regulators to the crisis has been that we need to require banks to set aside more capital, in part because we had previously underestimated systemic risks. If risk is allocated to places without a capacity for that risk, the amount of capital required to protect the financial system from systemic crisis is beyond the economics of banks. At this point governments step in. However, an alternative approach is to try and incentivize risks to flow to places with a capacity for that risk. If this could be done the system could be safe with less capital. But what does this mean?

There are broadly three types of financial risks: credit risk (the risk of a default), market risk (the risk that prices fall) and liquidity risk (the risk that the previous market price can only be achieved over some period of time). In thinking about risk capacity it is useful to think how these risks are best hedged. Credit risk rises the more time there is for a default to occur. Credit risk is best hedged by diversifying credit risks and trying to find credits that are supported by circumstances that undermine others. Banks have the greatest capacity for credit risks because they generally have the greatest access to differing credits and expertise in credit. A pension fund or insurance company has much less capacity for credit risk. Liquidity risk is best hedged through time. Pension funds, insurance companies and other investment vehicles with long-term funding or liabilities therefore have the greatest capacity for liquidity risk because they can hold on to assets that cannot be sold straight away and wait for buyers to return. Market risk is best hedged through a combination of diversification across other market risks and through time.

In a financial system where risks are allocated to capacity we should therefore expect to see banks holding most credit risks, least liquidity risk and some market risk. We should expect to see long-term investors holding most liquidity risk, least credit risk and some market risk. However, the previous approach to financial regulation ignored issues of capacity and as a result, credit risk sailed to long-term investors and liquidity risk sailed the other way, increasing the system's aggregate fragility and increasing the amount of capital financial institutions needed to avoid systemic failure. Requiring margins or capital charges for liquidity mis-matches and separately analyzing the risks of a portfolio of credits could go a long way to pushing risk to where there is a capacity for risk, increasing systemic stability and ultimately reducing the amount of deadweight capital required for there to be confidence in the system.

Many people, most notably *Sir* Alan Greenspan, voice the concern that it is very hard to know when you are in a boom or not.

Can The Cycle Be Measured?

Many people, most notably Sir Alan Greenspan, voice the concern that it is very hard to know when you are in a boom or not. Of course measuring the cycle is what inflation-targeting central banks do day-in, day-out. But this misses the point a little. If the purpose of counter-cyclical capital chargers were to end boom-bust cycles, then we would need to be more confident about the calibration of booms than we are today. However, if our purpose is to lean against the wind, our calibrations can be less precise. Recall that without counter-cyclical charges the natural inclination in a boom is to lend even more because measured risks fall. The previous approach took the economic cycle and amplified it. Our approach would at worse squeeze the financial cycle back to the magnitude of the economic cycle, and at best would serve to moderate that economic cycle through changing the cost of lending through the cycle. The goal is to moderate the worst excesses of the cycle, not to kill the cycle. Indeed, the cycle is an important source of grand ambitions and creative destruction.

Macro-Prudential Issues Beyond the Cycle

Not all financial institutions pose the same systemic risks. It stands to reason that regulation should acknowledge that some banks are systemically important and the others are less so. In each country, supervisors establish a list of systemically-important institutions that experience closer scrutiny and greater containment of behaviour.

All banks, and any other financial institution subject to deposit insurance, should be subject to some (low) minimum capital requirement as a protection for the deposit insurance fund. Systemically-important institutions would be subject both to micro-prudential regulation and to macro-prudential regulation, related to their contribution to systemic risk. This can be done by adjusting the micro-prudential ratio by a coefficient corresponding to their macro-prudential risk.

However, we do not share the zeal of some for governments to be involved in the decisions of private firms in matter of executive compenzation at systemically important institutions. While not ruling out particular measures to lengthen bankers' horizons, we hope that macro-prudential regulation will push banks to develop incentive packages that are more encouraging of longer-term behaviour. If that failed, regulators should do more. Incentives are important.

Macro-Prudential and Host- vs. Home-Country Regulation

A gathering view is that financial institutions are global and so financial regulation needs to be global. This is poetic. But the reality does not rhyme. More international meetings would not have averted the crisis and the crisis has taught us that there is much we need to do at the national level to strengthen regulation.

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I have argued above that the most critical steps we need to take to reduce the incidence of financial crises are counter-cyclical capital charges, charges for liquidity and movement in the direction of incentivising risk to shift to where there is risk capacity. These measures cannot be implemented or set globally, but need to be done nationally. Economic cycles are not global, they are sometimes regional and most often national. Even in 2009, in the middle of the mother of all global recessions, most countries are at different points along the economic cycle. What is appropriate for India and Brazil today, is not appropriate for the US and UK. Liquidity and risk capacity are also best measured locally, not globally.

There is a clear need for information sharing and coordination of regulatory actions. Convergence of regulatory principles would also improve the flow of global finance. In some aspects of regulation such as anti-money laundering efforts and value accounting, global standards are important—but these are not crisis prevention measures. In the avoidance of crisis, through the setting of capital rules and bank supervision, I recommend a switch back from "home-country" regulation to "host-country" regulation.

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This is currently an unfashionable view, but it has practical benefits.

This is currently an unfashionable view; I believe it has three further practical benefits. First, if foreign banks were required to set up their local presence as independent subsidiaries that can withstand the default of an international parent, it would reduce exposure to lax jurisdictions more effectively than trying to force all to follow a standard that would likely be inappropriate to many. The second benefit applies to a common-currency area—formal or otherwise. Nationally-based counter-cyclical charges could give the common-currency area, a much needed additional policy instrument that could provide a more differentiated response than a single interest rate does, to a boom in one member state and deflation in another.

The third benefit is that it gives developing countries more policy space. Large financial centers often use rule-setting behaviour as a form of protectionism. It is my personal note, that while tax evasion is a common occurrence on OECD countries, and foreign investment in many OECD, on-shore financial centers carries little or light taxation, black lists on jurisdictions with harmful taxation policies do not include any OECD countries. We are led to believe from this process, where OECD countries are judge, jury and excluded from equal scrutiny, that a lynchpin in the global financial crisis was Costa Rica.

Final Word

Warren Buffet famously remarked that you only see who is swimming naked when the tide runs out. By this I think he means that while the frauds and unethical practices are going on unseen all the time, they come to the surface when the veil of rising market prices are removed. But they are not the cause of the tide going out or the cash. They are merely revealed by it. We must continue to clamp down on frauds and ethical abuses but this is not a sufficient crisis-avoiding solution. We cannot avoid crises without avoiding the booms which are always underpinned by a good story that explains why it is prudent for individual institutions to lend more. Micro-prudential regulation is not enough and must be supplemented by macro-prudential regulation that catches the systemic consequences of all institutions acting in a like manner. An interesting point, however, is that macro-prudential regulation is best carried out nationally, not internationally. Cycles are national and protecting the financial system from lax regulation elsewhere requires stronger national boundaries. While we cannot hope to prevent crises completely, we can perhaps make them fewer and milder by adopting and implementing better regulation. Spreading a regulatory mechanism that has failed further a field, or focusing on the products and players of this crisis, is unlikely to be a successful route to follow.

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10. Creating Political Space for Effective Financial Regulation

By Dean Baker

Three public policy principles for constraining the power of the financial industry:

- **increased central bank accountability to democratically elected officials**
- **limit the size of the financial industry**
- **increase accountability of public officials in economic policy positions.**

The economic crisis has led to a flurry of efforts to rewrite rules of financial regulation to prevent similar disasters in the future. While many useful proposals have been put forward, even the best set of rules can only ensure stability if they can be effectively enforced. This in turn will depend on creating a political environment in which it is possible for government regulators to rein in the excesses of the financial industry.

At present, this sort of environment does not exist. The financial industry, most apparently in the United States, has sufficient political power to obstruct effective regulation. There were numerous incidents over the last decade in which regulators at various levels of government sought to rein in some of the excesses of the financial industry but were prevented from doing so by individuals with close ties to the industry.

Perhaps the best example of this sort of interference with effective regulation occurred in 1998 when Brooksley Born, the Chair of the Commodity Futures Trading Commission (CFTC), was prevented from regulating credit default swaps and other financial derivatives by then Treasury Secretary Robert Rubin and Federal Reserve Board Chairman Alan Greenspan. Two years later, Senator Phil Gramm, a politician with close ties to the financial industry, pushed through the Commodity Futures Modernization Act, which explicitly prohibited the CFTC from regulating credit default swaps.

There are many other publicly known instances where the financial industry's political power obstructed efforts at effective regulation over the last decade. There are undoubtedly many more cases in which the industry thwarted effective regulation that have not yet been publicly exposed. However, the known evidence should make it clear that effective regulation requires constraining the political power of the financial industry.

This essay outlines three principles for public policy that are essential for constraining the power of the financial industry:

1) Increased central bank accountability to democratically elected officials;

2) Measures to limit the size of the industry, such as financial transactions taxes; and

3) Measures to increase the accountability of public officials in economic policy positions.

The first principle opposes a view that had gained widespread support among economists: that central banks should be independent of political control. The argument here is that rules to guarantee independence from political control effectively gave the financial sector more control over central bank policy. While it is not desirable to have central bank policy manipulated to further the political ends of whichever party or parties happen to hold power, it is also not in the public interest to have central banks run to increase the profitability of the financial industry.

The general argument for restricting the size of the financial industry is two-fold. First, finance is an intermediate good; it does not directly provide utility in the way that sectors like housing or health care do. In this sense, an efficient financial industry is a small financial industry. Measures that limit the growth of the financial sector can restrict the growth of rent-seeking activities. These activities can be very profitable for the actors involved, but they may add little or nothing to total welfare. The second argument for constraining the size of the industry is simply to limit its political power. A smaller industry is likely to be less powerful than a large one. If the size of the industry can be limited, then it will be easier to maintain a regulatory structure that can prevent abuses.

The third principle is to create a new ethic of accountability among public officials and civil servants in economic policy positions. The warning signs for the current economic crisis were everywhere, most obviously in the form of unsustainable housing bubbles in the United States and many other countries. Yet, very few economists in government positions, or at international institutions like the IMF or Organization for Economic Cooperation and Development (OECD), warned of the problems on the horizon. Since these economists are currently suffering no consequences for this failure, they will continue to have little incentive to question the prevailing wisdom.

These three points will be addressed in turn in the subsequent sections, however, it is worth taking a brief digression on the meaning of “regulation” and “deregulation” in the context of the financial industry. It has become common to describe the last three decades as being a period of deregulation in the financial sector, with the problem being that deregulation went too far and we now require the re-regulation of the sector. This characterization is misleading in ways that carry important political and economic connotations.

In reality, the financial industry was never deregulated in the sense of not requiring government involvement. This is seen most readily in the public sector deposit insurance systems that are in place in the United States and other wealthy countries. (In some cases, the insurance is private, but it almost always involves public oversight). The public involvement also is apparent in the “too big to fail” doctrine under which the government intervenes to protect the creditors of faltering major financial institutions in order to prevent a cascade of financial collapses.

In both cases the government is effectively providing insurance to the financial industry. This insurance can be enormously valuable to the industry since depositors and other creditors can then lend money to firms in the industry without being concerned for the soundness of the industry’s lending practices. Naturally the industry would like to have this insurance at the lowest possible cost, and with the least restrictions, thereby maximizing its value.

The drive for “deregulation” must be understood in this context. It was not literally a drive to get the hand of the government out of the financial industry. There were

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few, if any, voices calling for an end to deposit insurance and strong unequivocal denunciations of "too big to fail," whereby governments assured bank creditors that they would not be protected under any circumstances. Rather, the drive for "deregulation" was about removing the restrictions that went along with the government insurance: restrictions that reduced the probability that taxpayer dollars would be used to pay off the financial sector's liabilities. Those pushing for deregulation in the financial sector didn't really want to get the government out; they just wanted government insurance without being forced to pay for it. Calling these people "market fundamentalists" is an inaccurate and overly generous description of their position.

Making Central Banks Accountable

In both wealthy and developing countries there has been a growing trend to promote central bank independence over the last quarter century. The conventional view in the economics profession is that an independent central bank will be better able to resist pressures to pursue inflationary monetary policy. While the evidence on this point is more mixed than is generally recognized (Epstein, 1994), controlling inflation is only one responsibility of central banks. Central banks must also take responsibility for sustaining high levels of employment and maintaining the stability of the financial system. "Independence" may make central banks less well suited to meet these other goals.

In reality, removing the ability of democratically elected officials to affect central bank policy does not mean that central banks can operate exclusively in the public interest, free from the influence of special interests. By their nature, central banks are going to be closely tied to the financial industry, unless there are strong measures put in place to limit these links. This stems from the obvious fact that—as banks are key players in the financial sector—there will be regular contact between bank officials and executives in the private financial sector. There is also likely to be a regular flow of personnel between the central bank and the private sector.

In addition, apart from a relatively small number of people employed in academia or other sectors of government, most of the people who have the ability to understand and pass judgment on the details of central bank policy are in the private financial sector. As a result, the media largely depends on the private financial sector for its analysis of central bank policy. (News articles on central bank policy routinely rely largely or exclusively on analysts employed by the financial industry as their sources). These factors create a situation in which central banks are likely to be overly responsive to the concerns of the financial industry, while downplaying or neglecting altogether issues that matter more to society as a whole.

A central bank that is more directly accountable to democratically elected officials may be more willing to risk modest increases in the inflation rate in order to reduce the unemployment rate.

The close ties to the financial sector may help to support central bank efforts to curb inflation, since the financial sector will generally have an interest in maintaining low rates of inflation. However, the ties to the financial sector may obstruct efforts to promote high levels of employment, precisely because these entail a greater risk of inflation. Instead, the financial sector is likely to encourage a single-minded focus on low inflation. On the other hand, a central bank that is more directly accountable to democratically elected officials may be more willing to risk modest increases in the inflation rate in order to reduce the unemployment rate.

In this respect, it is important to recognize the high degree of uncertainty surrounding the levels of unemployment that are consistent with stable rates of inflation. There was near unanimity in the economics profession in the United States in the mid-90s that the unemployment rate could not get below a range from 5.6-6.4 percent without triggering an acceleration of the inflation rate. As it turned out, the unemployment rate fell to 4.0 percent for a year-round average in 2000 with only a modest uptick in the core inflation rate. The estimates for the non-accelerating inflation rate of unemployment in the United States have been far more stable than in most of other countries. It was only due to Alan Greenspan's idiosyncratic background that he was willing to risk higher inflation to allow the unemployment rate to drop. Almost any other recent Fed chair would not have allowed this drop in the unemployment rate.

A central bank that is closely tied to the financial industry is likely to be especially ill-suited for protecting the stability of the financial system, especially when this involves combating asset bubbles. Almost by definition, an asset bubble cannot take place without substantial involvement from the financial sector. This means that attacking an asset bubble would require attacking a main source of profitability in the sector most closely allied with the central bank. This is not likely to happen.

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The set of events around the collapse of the Long-Term Capital hedge fund in the United States are perhaps instructive in this respect. Alan Greenspan argued that it was necessary for the Fed to get involved in the unraveling of Long-Term Capital's position in order to prevent serious damage to the financial system. Of course if this assessment was correct, then it implied a serious failure of regulatory oversight since the reckless actions of an unregulated hedge fund were able to jeopardize the stability of important banks. Yet, no measures were put in place to prevent the recurrence of such incidents. The Fed sought neither stronger regulations on hedge funds, nor restrictions on their loans from regulated banks, leaving open the possibility of such incidents in the future. A central bank that was more directly accountable to democratically elected officials might have insisted on stronger regulatory measures in response to this incident.

In order to prevent more incidents like the Long-Term Capital collapse or the far more dramatic events associated with the collapse of the housing bubble, central banks must have greater independence from the financial sector and be more accountable to elected officials. There is no simple mechanism that can ensure the desired degree of independence from both the financial sector and the political needs of the governing party, but at this point it is clear that central banks are too close to the financial sector.

In the case of the United States, an important step could be to remove any direct role of private banks in the governance of the Fed. Specifically, all of the bank officials who play any role in setting monetary or regulatory policy should be appointed by the president and approved by Congress, as is currently the case with the Board of Governors. These officials can be given lengthy terms (the governors serve 14 year terms) in order to limit their dependence on the government in power.

The policy setting meetings of the central bank governors should be fully open to the public and ideally broadcast over television or the web. Everything possible must be done to increase central bank governors' accountability to elected officials and the public at large. The notion of central bankers as a priesthood that sets monetary and regulatory policy in a vacuum must be put to an end. These policies involve important political decisions that must be subjected to public scrutiny.

It is undoubtedly true that many of the people who currently serve in top positions in central banks would object to the level of openness and oversight described here and may not serve under such conditions. That is appropriate. If people object to such scrutiny then they probably should seek other lines of employment. The current group of central bank managers was obviously not well-suited to meeting the responsibilities of the job, so it would not be a loss if they did not want to serve in a reformed central bank.

Downsizing the Financial Industry

It is important to keep in mind that finance is an intermediate good; it does not directly provide utility. For this reason, it is desirable that the financial sector be as small as possible, so that fewer resources will be used up in this activity.

It is important to keep in mind that finance is an intermediate good; it does not directly provide utility. For this reason, it is desirable that the financial sector be as small as possible, so that fewer resources will be used up in this activity. The economic purpose of the financial sector is of course to intermediate between savers and investors, but there are also enormous potential gains from various types of rent seeking, including tax and regulatory arbitrage. If the sector is growing as a share of the economy, as it has over the last three decades, it is more likely attributable to resources being devoted to rent seeking than to productive activity.

For this reason, it is appropriate to have policies that try to restrict the growth of the sector. One obvious policy that will restrain growth is a modest tax on financial transactions. Taxes that are set at low levels, for example 0.25 percent on each side of a stock trade (the current rate in the United Kingdom) or 0.02 percent on the purchase or sale of a future contract, will substantially reduce trading volume while having very little impact on long-term investment or the ability to raise capital or protect oneself against price fluctuations.

A properly designed set of taxes could also slow the spread of complex derivative instruments, since such instruments might be subject to taxation at several different points. For example, an option on stocks would be subject to the tax when the option was bought or sold. If the option was exercised and the stock was purchased or sold, then the tax would apply to this transaction also. If the financial instrument involved an important innovation that substantially reduced risk or provided some other benefit, then these taxes would not prevent its usage. But, if the innovation was primarily intended to provide a vehicle for short-term speculation, then the taxes would be an important disincentive to its use.

As a general rule, there should be a strong bias against complex financial instruments for two reasons. First, experience has shown that the regulators and even the inventors of complex instruments are unlikely to fully understand how they will affect the economy and what patterns they may follow in response to unusual events. For this reason, new financial instruments can inject a large amount of uncertainty into the system.

The second reason for restricting the complexity of financial instruments is that complexity works directly against transparency and effective oversight. If there are only a small number of people who understand a new financial instrument, then it will be almost impossible for policymakers or the general public to understand its implications. In effect, complexity leads to the same situation as secrecy.

For these reasons, it is appropriate to design the financial system in a way that is unfriendly to innovation. While this may occasionally delay the widespread adoption of useful financial products for a number of years, thereby reducing the efficiency of the sector, that would be a small price to pay for more effective oversight and greater transparency. If a system of financial transaction taxes (FTT) makes the environment more hostile to financial innovations, then this is another benefit from the tax.

The reduction in trading volume from FTT would substantially reduce the income of the financial industry. A financial transactions tax could also generate enormous amounts of revenue. In the United States, the revenue from a modest set of taxes could easily exceed US$100 billion a year (Pollin, Baker, and Schaberg, 2002). The government revenue would be coming largely at the expense of the industry. A smaller industry will be an industry that is more easily regulated since it will have less political power.

Holding the Economists Accountable

The fact that virtually no economists in government, academia, or the financial industry even saw the US housing bubble, which is at the core of the current crisis, much less understood the enormous implications of its collapse, is a remarkable failure of the profession. However, it is perhaps even more remarkable that this failure has thus far prompted very little analysis of its causes either by those within or or those outside the profession.

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The basic problem—an unsustainable housing bubble—should have been very easy for economists to recognize. Nationwide, US house prices tracked inflation for 100 years from 1895 to 1995, as has been documented by Yale economist Robert Shiller. In the decade from 1996 to 2006, they rose by more than 70 percent after adjusting for inflation, creating more than US$8 trillion in housing bubble wealth.

There was no remotely plausible explanation for this increase in house prices based on the fundamentals of either supply or demand in the housing market. There was also almost no increase in real rental prices over this period, indicating that there had been no change in the fundamentals of the housing market. If there is a huge divergence from a 100-year long trend, with no explanation based on fundamentals, how could the run-up in prices be anything over than a bubble?

It was also extremely simple to calculate the magnitude of the bubble. At its peak in 2006, the difference between the bubble-inflated value of housing and the 100-year trend level exceeded US$8 trillion (US11$110,000 for every homeowner). It was inconceivable that the country could withstand this loss of wealth, plus the collapse of the housing sector, without enormous consequences for the economy.

The fact that this would lead to a serious financial crisis should have been apparent. Even in the best of times housing is a highly leveraged asset with homeowners typically buying homes with down payments of 10-20 percent. It was hardly a secret that lenders were accepting much lower down payments (often zero) during the bubble years. This meant that a plunge in house prices would put large numbers of homeowners underwater in their mortgages, leading to very high default rates and large losses for banks. All of this could be easily inferred from any quick analysis of the data, yet almost the entire profession could not be bothered with such details. If there are no professional consequences for being so completely wrong on such an important public policy issue, then there is little reason to expect that economists will perform any better in recognizing future crises.

It will not be possible to fully offset the pressures for conformity within the economics profession. But, it is important that these pressures be recognized so that they can be countered to at least some extent. This means maintaining more open doors for outside opinions.

In the current situation there is a very one-sided structure to the incentives in the profession. Taking issue with the prevailing views in the profession carries enormous risks. Economists who warned of the bubble and the threat it posed to the economy risked ridicule and jeopardized their careers. If these economists had been wrong—as it turns out, they were not—their future prospects in the profession would undoubtedly be seriously diminished as a result of foolishly raising such alarms.

On the other hand, when the consensus within the profession is wrong, there are no obvious consequences. None of these economists are losing their jobs. In fact, it is unlikely that many are even missing out on a scheduled promotion as a result of having failed to see the largest financial bubble in the history of the world.

It would be appropriate for public bodies to investigate the conduct of top economists in important policy positions and ask them how they failed to recognize the growth of the housing bubble and the threat it posed to the economy. This failure should be viewed as serious malfeasance and treated accordingly. It would certainly be appropriate to dismiss high level civil servants who failed to recognize and warn of the bubble given the enormous consequences of this failure, however at the very least these economists should have promotions and pay increases set aside.

There must be serious professional consequences for a failure of this magnitude, otherwise economists in policy positions will never have the incentive to do anything other than to just repeat the conventional wisdom. It is essential that making the same mistake as every one else not be accepted as an excuse. These people are being paid for their professional analysis, not just repeating what others have said on a topic.

It will not be possible to fully offset the pressures for conformity within the economics profession. But, it is important that these pressures be recognized so that they can be countered to at least some extent. This means maintaining more open doors for outside opinions. Ideally this will mean more support for economists who apply unorthodox approaches and who are outside of the economic mainstream, particularly when their analysis is supported by real events. Recognizing the pressure for conformity also means not accepting the excuse that everyone else made the same mistake.

Conclusion

It is important to have an effective set of rules for regulating the financial sector. However, even the best rules will be inadequate if the regulators lack the power to enforce them. The current crisis was brought about not so much because the rules were inadequate, but rather because the regulators, at key moments, did not have the political power needed to impose effective regulations.

In order to have effective enforcement it will be necessary to rein in the power of the financial industry. This essay raises three policy directions that can limit its power. This list is far from exhaustive, and following through on these principles will not be easy either politically or practically. However, it is essential that the public and policymakers recognize the need to place serious limits on the political power of the industry. If this crisis does not qualitatively reduce the financial sector's power in the political sphere, then we will inevitably see more financial crises in the not distant future

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11. Democratizing Global Financial Regulation: Labour's Perspective

By Damon Silvers

Human civilization has become global in a way that few could have imagined even twenty-five years ago. The internet, and in particular, the extraordinary low cost and high band width of communication of all kinds has utterly transformed the way nations and cultures interact with each other. Globalization is most profound in economic life, and within economic life, in the financial sector—where markets, institutions, and financial products now appear to know no boundaries.

In comparison with the intensity and depth of global life, global governance is strikingly weak. Individual states remain the real units of political and military power, but they struggle to apply that power to circumstances that are beyond their grasp—global movements of ideas, global markets, global flows of people, global environmental problems, and ultimately, global crises.

In comparison with the intensity and depth of global life, global governance is strikingly weak.

There is a paradox of democratization involved in globalization. On the one hand, globalization has given voice to people previously marginalized—if a government opens fire on a street protest almost anywhere in the world, footage of the shooting will be circulating worldwide in minutes. Companies engaging in socially irresponsible business practices can find themselves the target of worldwide anger in a matter of days, if the conduct touches a nerve among the wired classes. But at the same time, the place where democratization happened was in the nation-state. Successful democratic states are where institutions of popular participation have grown and matured. Their inability to govern global society leaves the field to a variety of frankly undemocratic forces—forces of wealth and privilege, small bands of ideologues of various stripes, and on a more benign, but no less undemocratic, level, experts asserting, and perhaps believing, that they stand above mere people and their messy democratic processes.

Labour movements have been central to the development of democracy in countries and times as different as early Victorian England, Bismarck's Germany, Brazil in the 1980's and Zimbabwe today. Though the labour movement from its inception has had an international ethos, the reality of the labour movement's achievements is that they have largely been within national contexts. Thus the labour movement has always looked at proposals for global regulation with a mix of hope and suspicion—hope that a truly democratic global governance system could emerge, much as it ultimately did at the national level, and suspicion that workers will never be heard in any global governance system, and the result of which will be the destruction of democratic institutions at the national level.

Now, in the midst of a persistent and apparently accelerating global economic crisis, there are rising demands for global governance of what is undeniably now a global financial system. The labour movement reacts to this agenda with qualified support—financial markets and financial institutions have clearly outgrown national governments' ability to regulate them, with seriously destructive consequences. But the question the labour movement globally asks is—what kind of governance and by whom? Will global financial regulation mean a world that is made safe for bankers and financial firms—where all profits are privatized and all losses socialized? Or will global financial regulation really be managed in the interests of a global public—harnessing the vast energy of the financial markets to the vast needs of the real global society beyond the airports and luxury hotels that define the horizons of global elites?

The Case for Global Regulation of Financial Markets

How global has finance become? At one level the answer is extremely global—key firms like Goldman Sachs or Deutsche Bank are managed globally—shifting resources seamlessly among the key financial centers and locating deals wherever constantly shifting market conditions favour their clients. Stock exchanges have become international conglomerates. Trading operations take place in the ether, not in the gilded rooms that actually were the centers of economic activity less than ten years ago. London, New York, and Hong Kong compete to coordinate global flows of capital with each other, not with Chicago or Manchester or Harbin.

But at another level, national regimes still very much matter. It is not possible to do a securities offering without complying with the laws of some national state. Broad access to investors in any given country requires detailed compliance with those countries' securities laws. In banking, national regulation remains preeminent, as does national responsibility for failure. This continued importance of national regulation is critical to understanding the choices and challenges posed by thinking about how to accomplish an effective global governance structure for finance.

As financial market globalization accelerated in this decade, it gave rise to clear pathologies. These pathologies demonstrate the case for a global approach to financial regulation.

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Inability to Effectively Regulate Financial Innovations

In a fully globalized financial world, national regulators refuse to do their jobs for fear they will scare activity off shore. These dynamics have occurred recently at the highest levels of global political life—most tellingly in the case of hedge fund regulation. In early 2007, German Chancellor Angela Merkel approached leaders of the G-8 seeking a common approach to minimal regulation of hedge funds and other forms of shadow capital. Merkel's initiative failed because of determined opposition of the US and Britain defending important financial interests in Wall Street and the city respectively. Treasury Secretary Hank Paulsen publicly rebuffed this appeal, and it was clear that in doing so the United States was shielding the British government from having to object themselves. The result was that not only was no action taken at the G-8 level, but no action was taken within the European Union or within Germany itself in regard to hedge fund regulation. At the European Union, this project went nowhere until the fall of 2008, when an effort led by the leader of the European Socialists, the former Danish Prime Minister Poul Nyrup Rasmussen, gained traction in the context of the broader financial crisis.

Ironically, Paulsen found himself a year later trying to manage the collapse of Bear

Stearns, the major provider of brokerage services to hedge funds, without sufficient information to understand the implications of Bear Stearns' dealings with those same funds. This experience appears to have contributed to Paulsen's eventual embrace of hedge fund regulation, but has yet to lead to any actual regulation of hedge funds in the US.

Race to the Bottom

Following the Enron and Worldcom scandals, the United States adopted tough rules on the responsibilities, independence and oversight of outside auditors, the independence and authority of boards of directors, and the responsibilities of company officers for the truthfulness of company financial statements. These rules came to be known collectively as Sarbanes-Oxley, after the major piece of legislation enacted by the US Congress at this time.

The post-Enron tightening of rules in the US represented a business opportunity for non-US capital market centers—particularly London's AIM market, oriented toward smaller, highly speculative users.

While the NY Stock Exchange and NASDAQ were hobbled by regulation, in London and Hong Kong pre-Enron rules lived on.

These rules were bitterly resented by elements of US business, though they were supported by a number of key business leaders concerned about the credibility of the US business community after Enron. These rules were similarly resented by the directors and officers of non-US companies that listed in the United States.

This tightening of the rules in the United States represented a business opportunity for non-US capital market centers, and particularly for London's AIM market, which was oriented toward smaller, highly speculative issuers. In short order, both the London and Hong Kong exchanges made it a point of telling companies considering public offerings that while the New York Stock Exchange was prestigious, and NASDAQ was the home of Microsoft, they were now hobbled by regulation, while in London and Hong Kong the pre-Enron rules lived on.

There appeared as a result to be some flow of Initial Public Offerings (IPOs) to London, and Hong Kong captured IPOs of a number of major Chinese and other Asian companies. But the data suggested it was unclear at best whether there really was a major drain of business away from US markets, which continued to give investors higher multiples, due in part many argued, to the increased investor confidence generated by the post-Enron reforms.

What was not unclear was the political uses these developments were put to within the United States. The US business community asserted that the US capital markets were facing a "competitiveness crisis" caused by overregulation, a crisis that would lead to the eventual demise of the US financial sector at the hands of zealous regulators and foreign competition. The Bush administration agreed, and continued to push deregulation in the name of competitiveness until it was drowned out by the roar of the financial crisis. In the course of these efforts, the Bush Administration did considerable damage to the Securities and Exchange Commission by hobbling its enforcement efforts, and it blocked domestic efforts to regulate the shadow capital markets until it was too late to avert the coming storm.

Leakage. Tax havens and regulatory havens represent leakage from the global financial system. But they are utterly dependent on regulated, taxed economies. A financial market involving a closed system of Luxembourg, Switzerland, the Channel Islands and the Cayman Islands would be of little interest to anyone. In the absence of global governance of financial markets, capital based in opaque jurisdictions can find its way in and out of regulated jurisdictions, and financial actors that depend upon the developed states of the major economies can avoid paying the taxes to support those structures. The problem, though, is not what it appears to be. It is not the challenge of persuading one or another tax haven to behave better. It is the challenge of persuading the major markets to collectively close their doors to financial actors based in pseudo-states. That is why it is an issue of global governance.

Contagion. Any investor with a bank account and access to the internet can invest in any publically traded security. This is even more true for institutional investors with resources to enter into global custodial relationships and the like. The result is that regulatory weakness in any meaningful jurisdiction is potentially a worldwide threat. To take only the most prominent example, a bursting housing bubble in the US triggered a crisis not only in the US mortgage market, but also bankrupted Norwegian villages. The combination of mortgage regulators in Eastern Europe that allowed mortgages to be priced in foreign currencies, combined with banks in Western Europe prepared to believe that Eastern Europeans would somehow be able to pay loans in hard currency when their own currencies collapsed has now created a whole new international economic crisis.

The Paradox of Lack of Global Financial Regulation. The problem of contagion gives rise to a paradox. Not everyone has been equally harmed by the global financial crisis. Some countries, most notably India, kept their banks out of global capital markets, and as a result, now have more or less sound banks. The paradox here is that the lesson one could draw from the contrasting experience—say of India on the one hand and Austria, on the other—is that the smartest thing to do at a national level is to wall your financial institutions off from the global market.

What are the implications? An unregulated global market is likely not to be stable in the long run, as national authorities realize the best thing to do to protect their own economies and financial systems is to decouple. This is not protectionism in the sense of shielding domestic institutions from more efficient competition, it is the instinct to shield domestic institutions from toxic practices. In practice of course, the impulses blur, but the result remains the same—an unsustainable global system—with a tendency to re-fragment.

What Form Should Global Financial Regulation Take?

Currently, there is debate about whether there should be a concerted effort to found some sort of global financial regulator. This approach, which appears to be favoured at least publicly by the major continental European governments, is competing with the approach of international coordination, through bodies like the G-20 and the Financial Stability Forum.

The labour movement has participated in the G-20 process, and has consistently urged at a minimum the creation of a global regulatory floor.

The labour movement has participated in the G-20 process, and has consistently urged at a minimum the creation of a global regulatory floor, particularly to address the challenges posed by the rise of shadow capital markets—hedge funds and private equity funds on the institutional side, derivatives and securitizations on the product side. But the more profound challenge is the question of how financial regulation should be governed on a global scale. Unfortunately, we have many examples of exclusivity in the governance of global institutions. In some cases, like the G-8, that exclusivity became so clearly dysfunctional it had to be abandoned in favour of the inclusion of the major economies of the developing world, which led to the creation of the G-20.

But the paradigm of exclusion remains the norm, whether in older institutions like the International Monetary Fund (IMF) and the World Bank, or in newly minted institutions like the Financial Stability Forum. Exclusion operates on two levels. At the most obvious level, exclusion is about what countries get seats at the table. As a general matter, the labour movement has always supported the inclusion of the global South in key international financial institutions. If anything, the current financial crisis heightens our concern in this regard. Financial rules cannot be written as though the only actors that mattered were developed-world banks and brokerages.

There are complex issues embedded in questions of exclusion, issues which raise thorny problems for the labour movement.

However, there are complex issues embedded in questions of exclusion, issues which raise thorny problems for the labour movement. For example, the global labour movement has been uncomfortable with Chinese participation in many key global institutions because of China's refusal to allow workers to form independent trade unions or to exercise the right to strike. On the other hand, China's is the world's most populous and fastest growing country, whose large trade surpluses and foreign currency reserves are key facts of international economic life. It is hard to imagine how to address issues like global market regulation without having China (and Hong Kong) in the room, and indeed the Chinese are in the room in the G-20.

But exclusion has another face—which is the exclusion of workers and the larger global public from real participation in international bodies. Here the landscape is somewhat more complex. On the one hand, there is the OECD, which despite being an exclusive club in relation to the developing world, has formal consultative structures—The Trade Union Advisory Committee and the Business and Industry Advisory Committee—representing labour and business on equal terms. Then there are the practices at the IMF and the World Bank, which over the years have developed more informal structures for consulting—not just with the global labour movement—but with a wide range of non-governmental organizations. Unfortunately, there is a world of difference between consultation and democratic governance, a difference that is fully reflected in the continuing worldwide debate about the role played in the world economy by both the IMF and the World Bank.

When one looks at the embryonic global financial regulatory institutions, one sees the kind of structures that would appear to predate the sort of sensitizing that has occurred even at the World Bank and the IMF. The Financial Stability Forum has no consultative processes with parties broadly representative of the public. IOSCO, the international organization of securities regulators, has no interaction with investors, let alone broader public constituencies. The Basel process appears to be even more closed to influences outside the community of banks and central bankers—despite the apparently ruinous consequences of leaving this matter to banking insiders in terms not just of insolvent banks but of the banking system's withdrawal of financing from productive activity in sectors like the German *mittelstand*.

The call by the G-20 for the global governance of capital markets to be delegated to the central bankers in a re-named Financial Stability Board is particularly objectionable even if the number of bankers has been expanded to include representatives from every G-20 government. A body of central bankers, the community that sees itself as "politically independent" and that signally failed to anticipate the crisis, cannot be relied on, with little or no democratic accountability, to reform the regulatory structure of the global capital markets.

The labour movement has been involved in most of these processes, and is all too aware of the potential for "reform" to actually work to further entrench the power of wealth and weaken democratic structures. We also have seen how sometimes even consultative rights can have a significant effect. An interesting example of these dynamics from the recent past was the process by which the OECD Principles of Corporate Governance were developed in the aftermath of the Asian financial crisis in 1999. While in theory these principles were for OECD countries and were only principles, it was apparent that the real agenda in enacting them was to provide a template for the IMF and World Bank to insist on reforms to corporate governance in Asia. Of course, given the makeup of the OECD, the apparent audience for the document—countries like Indonesia and Thailand were not present. But as the deliberations got underway, it became apparent that a number of countries that had embraced the Anglo-American style of capitalism were hoping to use the OECD process to delegitimize European structures for worker involvement in corporate governance. The combination of a handful of sympathetic governments and an aggressive trade union presence was sufficient to thwart that particular anti-worker agenda, and the result was a document which, in the first rounds at least, was minimally acceptable to the labour movement.

But the more troubling lesson is the great difficulty in getting international institutions to respond to public needs. Here the exclusion of the global South adds to the weakness of workers' voices in advanced countries on many issues.

At one level, the lesson of the OECD experience is the importance of workers having a voice, even an advisory voice, in international institutions. But the more troubling lesson is the great difficulty in getting international institutions to respond to public needs. Here the exclusion of the global South adds to the weakness of workers' voices in advanced countries on many issues. In international institutions dominated by rich countries, globally integrated business interests, particularly in the financial sector, are better positioned to have a continuing organic influence on both the delegations of individual countries and on the staffs of the international institutions than on workers' organizations, NGOs or even the grassroots of developed countries' political parties.

Consequences of Undemocratic Approaches To Financial Regulation

This imbalance of power in international institutions becomes particularly costly at a moment of crisis such as we are now experiencing. Behind the current financial and economic crises are larger, global structural problems—the profound threat of climate change and energy shortages, critical educational and infrastructure deficits in the developing world, most of all problems involving water, and the problems developed countries are having maintaining broad affluence in a globalizing world economy.

It is not enough to imagine global financial regulation as a solution to the threat that more Norwegian villages will be victimized by American mortgage bankers. Policymakers need to consider how to better connect capital—both financial and human—with needs. That is an extremely complicated discussion, involving potentially revisiting the current balance in global capital markets between markets and institutions, considering creating global safe zones for investment similar to the roles played by insured bank deposits in national financial systems, and most of all, mechanisms for financing changes that must happen if our global civilization is to survive over time.

But this type of policy thinking is truly unthinkable in the context of global regulatory institutions, old and new, that are closed off to the views and interests of the majority of the world's population. For while it is true that on matters like global warming we are all in the same boat, that is of little relevance if we are not all in the same room when it comes to addressing these problems.

Some Final Thoughts On How To Achieve Democratic Global Regulatory Structures

To the extent that relatively open financial regulatory structures have been achieved at the national level, it has been in the context of a larger democratic politics. The labour movement's historic mission has been to create the context for that kind of politics. It is hard to see how, at the global level, open, democratic institutions will be built without pressure from some sort of global public, much as occurred at the national level. Historically, the labour movement has participated in global institutions at one remove from workers themselves. Our institutions send emissaries to global institutions—we do not generally view global institutions themselves as places to mobilize our members. That may need to change.

In terms of immediate demands, the global labour movement is now seeking inclusion of the global South in international financial institutions, and the increased inclusion of workers' voices in the governance of these institutions. We need to think more creatively not just about how to ensure that institutions like the IMF and the OECD do no harm, but about how they can be reimagined as key actors in an effort to mobilize underused global resources to meet desperate global needs.

In the past, this sort of talk, imagining a global New Deal, has been seen in the developed world as a Utopian conversation about charity on a grandiose scale. Today, it should be seen differently. If the US housing bubble tells us anything, it is that developed countries need to make better use of their temporary abundance of human and financial capital. At the same time, if developed countries continue their levels of carbon emissions and general resource usage, and developing countries aspire to achieve the same levels and to do so on the cheap, we will all suffer the ruinous consequences. Renewal in the face of crisis is not charity—it is necessity.

Renewal in the face of crisis is not charity—it is necessity.

The challenge then of regulating finance is part of a larger project of effective global economic governance to deal with a truly globalized economy of the future. This is a necessity for the global labour movement, and it simply will not happen as long as global financial regulatory structures are private clubs where only rich country bankers and finance ministers can gain entrance.

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The views expressed in the article belong to the author alone, and do not necessarily represent the opinion of the AFL-CIO or the Congressional Oversight Panel.

12. Food Security and Finance in the World Economy

By Prabhat Patnaik

Neither the seriousness of the world food problem nor the intimate relationship between the world food problem and the world financial arrangements has received the attention it deserves.

Neither the seriousness of the world food problem nor the intimate relationship between the world food problem and the world financial arrangements has received the attention it deserves. Let us begin with the former. Over at least the last two decades there has been an absolute decline in the per capita cereal output for the world as a whole. For the period 1980-85 the average annual per capita world cereal output, according to the UN Food and Agriculture Organization (FAO), was 335 kilogrammes; this declined to 310 for 2000-05. This decline in per capita output has certainly been accompanied by a decline in world per capita consumption, which means that the world on average is hungrier today than it was two decades ago.

What is significant however is not just this, but also the manner in which this reduction in consumption has been effected. During this period, there has been a substantial increase in the average world per capita income; since the demand for cereals (taking into account not only direct but also indirect demand, via processed food and animal feed) rises with income, this demand should also have grown. In the face of declining output, this should have caused rising food prices relative to money wages around the world, and hence also relative to the prices of manufactured goods. We should therefore have expected in this period of declining per capita cereal output a shift in the terms of trade between cereals and manufactures in favour of the former.

But this did not happen. On the contrary, cereal prices fell relative to manufactured goods prices by as much as 46 percent between 1980 and 2000! This suggests that the decline in per capita cereal output, in a situation of rising per capita income, did not generate any specific inflationary pressures on cereal prices, as one might have expected. The reason it did not is because in the very period when per capita cereal output was declining, a parallel process of compression of money incomes of large sections of the world's population was going on. The reduction in cereal consumption of the world's population was effected not through a rise in prices relative to money incomes but through a compression of money incomes relative to prices, for which the term "income deflation" is used below.

It is not often recognized that income deflation plays a role similar to inflation in

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[1] The implicit assumption here, following Kalecki (1954), which is both plausible and commonly-made, is that manufactured goods prices are a mark-up over unit prime costs, which are linked to the level of money wages.

[2] I am grateful to Shouvik Chakravarty, research scholar of the Jawaharlal Nehru University, for making these terms of trade figures available to me from his ongoing Ph.D. thesis.

compressing demand. Of course the term "inflation" itself is an ambiguous one. In current "mainstream" economics it refers to a state of affairs where all prices, including money wages, are rising simultaneously, so that there is no worsening of the condition of the wage-earners per se and the only sufferers are those with cash balances, most of whom are likely to be rich. But inflation as we know it in real life, both in developed countries and, in particular, in developing countries, where the bulk of the workers do not have wages indexed to prices, is one that hurts the working masses. Keynes called this latter kind of inflation "profit inflation" . In situations where supply cannot be rapidly augmented, "profit inflation" compresses demand to make it adjust to supply. It does so by raising prices relative to money wages, and thereby bringing about a shift of income distribution from wages to profits (whence the term "profit inflation"), which, because a larger share of profits tends to get saved than of wages, has the effect of lowering overall demand.

It is not often recognized that income deflation plays a role similar to inflation in compressing demand.

Now, this demand-compressing effect of a profit inflation can also be achieved through an income deflation imposed on the working masses. For example, if the money wage rate is 100 and the price is 100 to start with, a reduction in the wage rate to 50 with price remaining the same has exactly the same effect of lowering workers' demand as a rise in price to 200 with the money wage rate remaining at the original level.

In the particular case we are considering, a squeeze on the money incomes of a segment of the working population, which also happens to be the consumer of cereals, can make cereal prices fall relative to the money wages of another segment of the working population to which manufactured goods prices are linked. This would both compress cereal demand and also cause the terms of trade between cereals and manufactured goods to shift against the former. In fact even if the manufactured goods' workers also become victims of income deflation, the same result, namely a reduction in cereal demand together with a shift in the terms of trade between cereals and manufactured goods in favour of the latter can follow. Income deflation on a part or the whole of the working population, in short, can both make food shortages disappear and move the terms of trade between food and manufacturing in a direction opposite to what David Ricardo had visualized.

Even though income deflation and profit inflation have exactly identical effects by way of compressing the demand of the working masses, finance capital prefers the deflation to the inflation since profit inflation entails a decline in the real value of financial assets vis-à-vis the world of commodities, and may in extreme situations make wealth-holders turn to holding commodities in lieu of financial assets altogether. Income deflation therefore, even while keeping excess demand in check, exactly as profit inflation would have done, has the added "advantage" of keeping finance capital happy! Not surprisingly, it becomes the preferred means of overcoming food shortages in the era of globalization, which is characterized by the rise to hegemony of a new kind of international finance capital based on a process of globalization of finance .

[3] See Keynes (1930).

[4] I have discussed the nature of this new kind of finance capital in Patnaik (2000).

[5] This was aggravated by a rush to commodities as a form of wealth-holding by panic-stricken wealth-holders in the immediate aftermath of the collapse of the Bretton Woods System.

The early 1970s were characterized by a tremendous rise in the prices of primary commodities, both in absolute terms and relative to the prices of manufactured goods, owing to an excess demand for such commodities. The subsequent abatement of this inflation, and the shift in the terms of trade against primary commodities other than oil, is often explained as the consequence of a rise in the output of these commodities. But this is untenable. The rise in output, as we have seen in the case of cereals, was absent or insignificant for a whole range of such commodities. Inflation disappeared because it was substituted by an income deflation on the working people over large parts of the world.

II

Three processes leading to income devlation:

- **relative reduction in the scale of government expenditure**
- **the destruction of domestic productive activities under the impact of global competition**
- **long-term shift in the terms of trade against petty producers of primary commodities, particularly the peasantry.**

The primary means of income deflation in the era of globalization—with respect to Third World economies—are the neoliberal policies that come with it. There are at least three processes spawned by neoliberalism that lead to income deflation. The first is the relative reduction in the scale of government expenditure. Globalization, as mentioned earlier, consists above all in the globalization of finance. Huge amounts of finance capital move around the world at a dizzying pace in the quest for speculative gains. Because economies caught in this vortex of globalized finance can be easily destabilized through sudden flights of finance capital, retaining the “confidence of the investors” becomes a matter of paramount importance for every economy, for which their respective states have to show absolute respect to the caprices of globalized finance.

Finance capital in all its incarnations has always been opposed to an interventionist state (except when the interventionism is exclusively in its own favour). An essential element of this opposition has been its preference for “sound finance” (i.e. for states’ always balancing their budgets, or at the most having a small pre-specified fiscal deficit as a proportion of the GDP). The argument advanced in favour of this preference has always been vacuous, and was pilloried by Professor Joan Robinson of Cambridge as the “humbug of finance”[6]. The preference nonetheless has always been there, and has become binding in the era of globalized finance, when states willy-nilly are forced to enact “Fiscal Responsibility” legislation that limits the size of the fiscal deficit relative to GDP. At the same time, this move towards “sound finance” is accompanied by a reduction in the tax-GDP ratio, owing to tariff reduction and to steps taken by states competing against one another to entice multinational capital to set up production plants in their respective countries.

The net result of both these measures is a restriction on the size of government expenditure, especially welfare expenditure, transfer payments to the poor, public investment expenditure, and development expenditure in rural areas. Since these items of expenditure put purchasing power in the hands of the people, especially in rural areas, the impact of their curtailment, exaggerated by the multiplier effects which are also to a significant extent felt in the local (rural) economy, is to curtail employment and impose an income deflation on the rural working population.

The second process is the destruction of domestic productive activities under the impact of global competition, from which they cannot be protected as they used to be in the period of active State intervention, because of trade liberalization that is an essential component of the neoliberal policies accompanying globalization. The

[6] See Robinson (1962).

extent of such destruction gets magnified to the extent that the country becomes a favourite destination for finance, and the inflow of speculative capital pushes up the exchange rate.

Even when there is no upward movement of the exchange rate and not even any destruction of domestic activity through the inflow of imports, the desire on the part of the getting-rich-quick elite for metropolitan goods and life-styles, which are necessarily less employment-intensive than the locally available traditional goods catering to traditional life-styles, results in the domestic production of the former at the expense of the latter, and hence to a process of internal "de-industrialization" which entails a net- unemployment-engendering structural change. This too acts as a measure of income deflation.

The third process through which income deflation is effected is a long-term shift in the terms of trade against the petty producers of primary commodities, and in particular the peasantry. What is being referred to here, it should be noted, is the terms of trade movements not between sectors but between classes. Even when there is no shift in the terms of trade against particular commodities, there is nonetheless a decline in the terms of trade obtained by the producers of those commodities because of the increasing hold of a few giant corporations in the marketing of those commodities. This has been a common feature during the neoliberal period, and has the effect, via a shift in income distribution from the lower-rung petty producers to the higher-rung marketing multinational corporations, of curtailing the consumption demand of the former, and hence the level of world aggregate demand, which in turn curtails inflationary pressures on primary commodities themselves.

Globalization in other words unleashes massive processes of income deflation which, while playing exactly the same role as profit-inflation in curbing excess demand pressures, keep commodity prices in check. And this is what we have been witnessing in the entire period between the inflation of the early seventies and the recent revival of inflation.[7]

III

Disturbing aspect of income deflation: unlike profit inflation, which creates an incentive to increase output, it does not have a supply-augmenting effect.

We come now to the disturbing aspect of income deflation. Obviously if there is a reduction of per capita cereal output, then the burden of it has to be borne by the consumers, in particular the working people, either through a profit inflation or through an income deflation. But while a profit inflation, by raising the profitability of foodgrain production, creates at least an incentive for an increase in output, which is all the greater in so far as the terms of trade move in favour of foodgrains and against the manufacturing sector from which some of its current and capital inputs come, an income deflation does not have any such supply-augmenting effect. On the contrary there are at least two distinct reasons why an income-deflation can have a detrimental effect on supplies.

The first relates to the fact that with the income deflation the terms of trade can move, and have moved, against the foodgrain sector and in favour of manufacturing. This, by increasing the input costs relative to final price, has a depressing effect on profitability which is detrimental to output increase. The second relates to the fact

7 For a discussion of income deflation in developing countries and in India see U.Patnaik (2003).

that among the victims of income deflation are the peasants themselves, which affects their capacity to increase production, and can make even “simple reproduction”, i.e. the maintenance of a given output, difficult for them.[8]

Income deflation has a restrictive effect not only on the demand side but also on the supply side, while the restrictive effect of a profit inflation is confined only to the demand side; indeed on the supply side it has, if anything, an expansionary effect.

Income deflation in short has a restrictive effect not only on the demand side but also on the supply side, while the restrictive effect of a profit inflation is confined only to the demand side; indeed on the supply side it has, if anything, an expansionary effect. It was mentioned earlier that the manner in which the decline in per capita cereal consumption was effected in the world economy was as disturbing as the decline itself. The reason lies in the fact that this manner of effecting a decline in consumption, via an income deflation, does not just compress demand, which of course has to be done when per capita output declines; it also perpetuates the tendency towards output decline and hence sets up a vicious cycle that undermines world food security. The neoliberal policies, characteristic of the current phase of globalization, thus have the effect of undermining food security for this reason.

There is however a powerful additional reason as well. Neoliberalism does not just undertake income deflation; it entails a whole arrangement whereby the state withdraws from supporting peasant agriculture and petty commodity production in the name of “leaving things to the market”. It entails for instance a winding up of state extension services; a withdrawal of state subsidies, including of cheap institutional credit that used to be given to peasants (and petty producers) either under state directive or by state-owned institutions; a throwing of the peasantry into a direct relationship with the multinational companies *vis-à-vis* which they have unequal bargaining power; and a winding up of the system of procurement operations, which both assured remunerative prices to the peasants and curtailed the amplitude of price fluctuations, thereby reducing risks. When we consider all these aspects, we can appreciate the intimate connection that exists between the neoliberal policies of a globalized regime and the growing hunger that currently afflicts large segments of the world.

IV

We have seen how income deflation (and other policies associated with neoliberalism) affect both the demand and the supply sides in the foodgrain sector. While this fact keeps the sector in a relatively stagnant state, generally without engendering any serious inflationary pressures, even within this state there will be some periods with excess demand and others with excess supply. The inflationary spurt in foodgrains in 2007-08 was one such period when demand might have outstripped supplies, but this situation was severely aggravated by the US government’s decision to divert foodgrains for the production of bio-fuels.

There is a view that the inflationary spurt can be explained by the excess demand arising from the fact that in rapidly-growing developing economies like China and India, a variation in the dietary pattern is taking place, entailing an increased demand for commodities like meat, the production of which requires more

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8 Since in a state of simple reproduction there is no net investment in the sector as a whole (otherwise there will be expanded reproduction), the entire net output is consumed by the producers. When simple reproduction itself becomes difficult, that means that the producers cannot maintain even their existing level of consumption over time. The mass suicide of peasants in India and elsewhere in the period of globalization suggests that this has been the case.

foodgrains in the form of animal feed. But this is a completely untenable explanation.

No doubt the rich in both these countries are diversifying their diet and are absorbing, directly and indirectly, more foodgrains per capita. But if we take the per capita foodgrain absorption for the population as a whole, both directly and indirectly (via processed foods and animal feed), then we find that in India there is a decline compared to the late eighties.[9] Even in the case of China if we take the per capita absorption of cereals for food and feed (the definition of foodgrains is different in China compared to India), then there is a steady and sharp decline between 1996 and 2003, which gets reversed thereafter, but the level in 2005 is still lower than in 1996.[10]

Since the rate of growth of population in both these economies has been slowing down, the decline in the per capita foodgrain absorption entails a decline in the rate of growth in the overall demand for foodgrains. In the face of such a decline, it follows that—if excess demand pressures arise in the world foodgrains economy—then the reason must lie in an even more rapid decline in the rate of growth of the supply of foodgrains. Hence it is not from the side of Indian or Chinese demand but from the side of foodgrains supply (including the reduction in supply owing to diversion for bio-fuels) that we explain the food scarcity in the world economy in 2007-08.

It follows from the foregoing that the elimination of world hunger requires—apart from eschewing arbitrary diversion of foodgrains for use as bio-fuel—an increase both in the demand and the supply of foodgrains in the world economy. For this it is essential to overcome the financial regime that promotes income deflation and the withdrawal of state support from the peasant and petty production sectors. The current recessionary crisis, itself a fall-out of this financial regime, provides an opportunity to put in place an alternative regime that is more conducive to overcoming world hunger. Let us examine this alternative.

The current recessionary crisis, itself a fall-out of this financial regime, provides an opportunity to put in place an alternative regime that is more conducive to overcoming world hunger.

V

Getting out of the present recessionary crisis requires an injection of demand into the world economy through larger state expenditures financed by enlarged fiscal deficits. If even a part of this enlarged world fiscal deficit is devoted to expenditures for increasing world foodgrains production, then the process of recovery from the crisis will simultaneously entail larger foodgrain production. True, there will be a time-lag between the expenditure devoted to increasing food production and the actual increase, during which there may be food price inflation. But as world foodgrain stocks are fairly comfortable at the moment, such inflation can be kept in check.

The very process of undertaking expenditures for increasing foodgrain production, which will have to focus on Third World countries, will put purchasing power in the Third World countryside. The demand for food generated by this will be immediately met by running down world food stocks, which will get replenished as

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9 See U.Patnaik (2008).

10 I am grateful to Sriram Natarajan for making his research on China's foodgrain absorption figures available to me.

food output increases over time. And if this process continues then we shall have a reversal of the vicious cycle caused by income deflation: both demand and supply of food will rise over time, causing a progressive amelioration of world hunger.

Many have argued that overcoming the current recessionary crisis without recourse to protectionism, requires a coordinated fiscal stimulus among a number of major countries, a suggestion that had been originally put forward during the Great Depression itself by a group of German trade unionists and also by John Maynard Keynes.

Many have argued that overcoming the current recessionary crisis without recourse to protectionism, requires a coordinated fiscal stimulus among a number of major countries, a suggestion that had been originally put forward during the Great Depression itself by a group of German trade unionists and also by John Maynard Keynes. If a specified percentage of the increased government expenditures in these major countries which would be incurred as part of the fiscal stimulus is made available as grants to the developing world, on the condition that these grants should not be simply added to foreign exchange reserves but should be used to sustain larger public expenditure—through enlarged fiscal deficits in the recipient countries for increasing food production and for improving the living conditions of the working people—then a number of objectives can be simultaneously achieved. First, there will be a direct improvement in the conditions of the working population, through larger healthcare, education, sanitation, housing, infrastructure and other facilities. Secondly, there will be a larger demand for foodgrains, directly because of the multiplier effects of the larger public expenditure, and indirectly because some of the current expenditure of the working population on the exorbitantly expensive healthcare and education facilities (the only ones they can currently access) can be released for the purchase of foodgrains once cheaper public facilities become available. And thirdly, there will be a larger supply of foodrgains over time. The improvement of food security in the Third World that will come about as a result, will of course improve world food security.

In addition to the above (or in lieu of it if the above is not accepted), there can be another arrangement, namely that the entire increase in current account surplus which will come about as a result of the coordinated fiscal stimulus, can be mandated to be given as grants to the developing world, again on the condition that it is not simply added to foreign exchange reserves but spent—among other things—on improving food security and conditions of life for the working people.

There is an obvious justification for this: in the absence of a coordinated fiscal stimulus, the increased current surplus would not have arisen at all. In other words, if a habitually-surplus country simply enlarged its own government expenditure, then the most it could hope for is no worsening of its balance of payments compared to the initial situation. If it gets an additional surplus over and above what it had to start with, then that is entirely because of the fiscal stimulus undertaken in other countries. Its enlarged current surplus in short is a booty that lands on its lap because of the actions of other countries. If this surplus is taken away from it, then its employment and output would still remain unchanged, but it would simply have been divested of this booty. Of course it is free to use this booty for raising the consumption of its own working population, but in that case there would be no surplus left afterward. If there is a surplus, then clearly it comes from holding on to the booty thrown on to its lap by the actions of other countries. A case exists for divesting it of this booty.

With these grants, the demand for imports—now emanating from the less developed countries—will increase. And no matter which countries this import demand is directed to, it will succeed in eliminating all increases in surpluses and deficits. If the increased current surplus, say US$100, which is given as grants, is used to buy goods from the countries whose deficits had increased (and they would have increased by exactly US$100 from the initial situation), then the increased deficit would have been simply wiped out. If on the other hand the grant of US$100 is used to buy goods from the increased-surplus countries, then they would be redirecting their sales from the increased-deficit to the grant-receiving countries, which again would wipe out the deficit of the increased-deficit countries. Whichever way we look at it therefore a system of such grants will not only raise world output and employment, but also eliminate all increases in the net indebtedness of countries relative to the initial situation of recession. The grant-receiving countries will not get into debt. What would otherwise have been increased-deficit countries on account of the coordinated fiscal stimulus will have this increased deficit wiped out; and so therefore would the increased surplus countries.

The recession entails, by its nature, a generalization of hunger among the world's population because of the generalized income deflation it gives rise to. But after the recession is over, since the increase in employment will mean that the newly employed would have shaken off the income deflation to which they had been subjected during the period of their unemployment, the rest of the world's population will feel the impact of hunger even more acutely. To prevent this from happening, there has to be an increase in the rate of growth of world food output, which alone can promote world food security. The very mode of overcoming the recession therefore should be such that in the process food security is promoted. The system of grants should be used for this purpose as far as possible. Our collective concern over the problem of hunger requires that proposals such as the above, which reverse the vicious cycle of food insecurity to which the working population of the world, especially the Third World, has been subjected during the neoliberal regime that has imposed income deflation upon it, are urgently implemented.

There has to be an increase in the rate of growth of world food output, which alone can promote world food security.

The very mode of overcoming the recession should be such that in the process food security is promoted.

A system of grants to the developing world should be used for this purpose as far as possible.

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