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1. Sources of the crisis

Permissive Regulation and Shadow Banking

The present financial crisis has emerged from an over-supply of financial innovation and an under-supply of financial regulation within the core economies of the Organisation for Economic Co-operation and Development (OECD). The current crisis differs from those of the 1990s because it is located within the beating heart of finance capitalism, the United States, rather than within emerging market or transition economies. As such, the sources of the crisis differ significantly from crises of the 1990s associated with capital flight, currency mismatches in carry-trade activities, or hedge fund mania. While some of those elements are present in the current crisis, a key difference is the extent to which financial innovation and pro-cyclical lending blossomed in an environment of permissive regulation within the U.S. and other, primarily Anglophone, economies. For quite some time the U.S. institutional environment for financial innovation, most notably investment techniques and schemes related to securitisation - the pooling of income streams from financial assets into a security for sale to investors – permitted a recycling of capital that simply made money work much harder. This was only the case, however, if the bulk of underlying assets within securitised pools continued to appreciate. The current crisis has emerged from this disappointment in expectations of endlessly rising residential and commercial property prices. Bank collapses have occurred in many advanced economies that enabled mortgage securitisation within their financial systems while also relaxing access to credit for those previously considered to be less creditworthy (Schwartz and Seabrooke 2008). In Australia, the United Kingdom, Denmark, Spain, and Ireland, double-digit increases in real housing prices during some years within the 2002-05 period led to significant increases in personal indebtedness (Girouard 2006). Compared to these economies, the U.S. experience does not appear unusual. The difference in the U.S. case is its sheer scale and the links to the international financial system, including its capacity to bring in significant amounts of foreign investment.

Within the U.S. case, the role of housing markets was critical to the development of securitisation as the relative cost of credit for housing has lowered for some two decades. The role of Government Sponsored Enterprises, such as Fannie Mae and Freddie Mac, effectively quasi-public institutions until their recent placement under 'conservatorship', was important in providing institutional integrity to the system and gaining the confidence of domestic and international investors. In the 1990s Freddie and Fannie (along with Ginnie Mae, the oft forgotten 'sibling') used mortgage securitisation to help the U.S. achieve new levels of home ownership. However, the combination of increasing house prices and low real wage growth led to the exclusion of many potential homeowners from qualifying for 'prime' loans that were the bread and butter of Fannie and Freddie's business. Instead, under the Bush administration, a 'sub-prime' market flourished in an extremely permissive regulatory environment where banks were under less scrutiny and where non-bank financial institutions (NBFIs, or 'non-banks'), including brokers and insurance companies, aggressively entered the market. The prominence of non-banks within the U.S. financial system for mortgage lending combined with financial innovations in debt markets created a 'shadow banking' system in which borrowing short-term and investing long-term became increasingly commonplace. Given that non-banks are generally non-depository financial institutions that range from pawnbrokers to casinos to insurance companies, their regulation is haphazard and Know-Your-Customer information weak. As lending became more risky and the use of different schemes associated with mortgage securitisation more prominent, such as the combination of Structured Investment Vehicles to borrow in short-term

markets to invest in long-term Mortgage-Backed Securities and Collateralised Debt Obligations, the conditions for the current crisis were established. Under these conditions not only was Know-Your-Customer information weak, but there were positive incentives to avoid knowing. Put simply, the growth of shadow banking (a term coined by Paul McCulley from the investment firm PIMCO) permitted the expansion of liabilities considered equivalent to bank deposits, but without the regulatory oversight or capital adequacy requirements imposed upon conventional banks by national authorities and international agreements.

Where did the Money Come From? Where did it Go?

Why did investors choose to place their trust in U.S. markets for mortgage-backed securities? While in retrospect this may appear short-sighted, at the time the long period of growth and the historically low rate of default on home loans helped support foreign investment. Investors were attracted to relatively high returns in the long-term debt securities markets that received highly favourable credit ratings from agencies such as Moody's and Standard and Poor's. Foreign investment into these markets differs strongly from the 'Agency' market, supported by the 'siblings', and the purely private market where sub-prime played an important role. In the Agency market, where one-third of investment is foreign, the dominant investors are China and Japan. In the quasi-public market, given the implicit – and then explicit – government support for the siblings, investment stimulated housing growth that then fuelled Chinese exports (and the so-called 'Wal-Mart Effect'). In the private market the dominant investors are the Cayman Islands and the United Kingdom, through which U.S. and European Structured Investment Vehicles were extremely active and much more risk-friendly in how they invested.

Given that information opacity has been identified as a key source of tension in the current crisis, not least because it inhibits trust within the marketplace, thus exacerbating liquidity problems, who is viewed as the holder of genuine information is an obvious concern. The major international institutions have been critical of the role of credit rating agencies, in failing to identify the sources of the crisis. The Committee on the Global Financial System, for example, has argued that ratings agencies should have information on mortgage loan originators' processes and procedures, while the International Organisation of Securities Commissions has stated that while rating agencies are not auditors, they should be concerned with financial institutions' due diligence procedures.

The attention given to rating agencies by international institutions may, in part, be a consequence of how the latter have been ignored prior to the crisis while rating agencies have risen in prominence. Certainly the Bank for International Settlements, for example, identified clear cracks in the U.S. and international financial systems prior to the crisis BIS 2003: 151). The OECD also pointed to how property booms within various systems had extended far beyond a regular business cycle and were unsustainable. The rating agencies' status within the U.S. system as 'Nationally Recognised Statistical Rating Organisations' arguably provided them with a status of being quasi- but pro-market regulators. The spread of securitisation greatly assisted the ratings agencies' influence within the U.S. financial system as a source of independent evaluation. More importantly, the Basel II accord, developed under the auspices of the Basel Committee, includes 'External Credit Assessment Institutions' status that piggy-backed on the U.S. recognition of agencies and further legitimated their role in international finance without considering how biased their evaluations are towards procyclicality (Abdelal 2007: 194). In the end, the prominence of ratings agencies as a source of evaluation will be questioned by regulators and investors, who have lost a great deal of trust, or perhaps faith, in them. Such questioning may also reinforce distinct types of credit assessment and prudential regulation that are informed more by national and regional concerns.

Distinct types of financial systems fuelled the crisis in different ways – a point often overlooked in discussions of international financial reform, which tend to look at banking systems or derivatives markets. In particular, the role of non-banks in the U.S. case stands out when compared to other advanced economies. In 2005 around a quarter of outstanding loans to the household sector had been issued by non-banks, much more than the closest contender (Canada at around 16 percent) and distinct from European countries where non-banks have a minor or insignificant presence (IMF 2008: 3). As we know now, the securitisation of income streams tied to borrowers with poor credit histories and with loans that

could only be serviced during the economic boom left a raft of investors exposed. The increasing number of borrowers who could not, or chose not, to qualify under Fannie, Freddie and Ginnie conditions led to explosive growth in sub-prime markets after 2003 that also fed on non-bank lending. The securitised assets that followed this growth often contained loans of various creditworthiness grades, muddying their assessment (Schwartz 2009). As such, financial institutions that had used Structured Investment Vehicles in short-term markets to buy long-term Mortgage-Backed Securities and similar financial instruments became increasingly uncertain about the value of the assets supporting the securities. The lack of information on non-banks made matters worse. In such an environment of permissive regulation and opaque information, when sub-prime foreclosures doubled from five to ten percent between late 2006 and late 2007 the crisis began in earnest as a crisis of how to evaluate assets. For non-U.S. regulators, the above characteristics also made the crisis appear especially American in origin and contagion.

2. Responses to the crisis – and the case of the EU

Despite the presence of dense transgovernmental and policy networks and institutions to oversee the international financial architecture, governments have not responded to bank failures and system-wide credit market turmoil with one voice. In the first phase of the crisis, up to the summer of 2008, responses by national authorities were two-fold. The first type of response was a case-by-case approach to the predicaments of individual institutions, such as the bail-out and eventual nationalisation of Northern Rock in the U.K., the Fed-supported buy-out of Bear Stearns by JP Morgan Chase in the U.S., and the bail-outs of Sachsen LB and IKB in Germany. The second type of response was in a systemic context, wherein central banks injected liquidity and key standard fora, such as the Financial Stability Forum, produced recommendations on 'Enhancing Market and Institutional Resilience' (FSF 2008). The industry itself exhibited some humility with the publication of an Institute of International Finance report on market best practice which focused on risk management but also questions of executive pay and the role of credit rating agencies.

Policy responses intensified from September 2008 and have been framed in explicit systemic terms. Bail-outs and take-overs have been orchestrated, with the significant exception of the case of Lehman Brothers which underlined that teaching market discipline amid a crisis can pose its own challenges. Cross-border cooperation has been shown to work, as demonstrated in the instances of Fortis and Dexia and the involvement of Benelux and French authorities, or fail, as revealed by British and Icelandic disagreements in the aftermath of the near-failure and subsequent nationalisation of Landsbanki. Most importantly, however, specific rescue plans have been put in place, both in the U.S. and Europe. The U.S. 'Emergency Economic Stabilisation Act of 2008' ultimately makes $700 billion of funding available to troubled institutions by authorising the U.S. Treasury to buy mortgage assets. In Europe, packages in the U.K. and the euro area of the order of £300 billion and € 1,873 billion, respectively, allow for state-guaranteed lending, recapitalisation and the possibility of part-nationalisation. Restoring confidence in the system, in terms of ensuring liquidity, safeguarding large institutions and insuring deposits has been the order of the day. At the same time, discussions of the effects of the crisis on the real economy have become more central to analyses as the use of taxpayer funds is explained and justified, and the spectre of recession in many industrialised countries has called for renewed attention to the links between financial stability and monetary policy and the wider role of central banks.

At the global level, the focus at the end of 2008 was on coordination and a (re)discovery of the institutions and fora available for managing the crisis and debating reform of the system. High expectations are attached to the activities of the G-20, a group bringing together large advanced and emerging economies and both the role of the International Monetary Fund and the potential of the Financial Stability Forum as a body or possible institution are explored. These and other financial architecture questions will dominate discussions in the coming year.

Turning our attention to Europe more specifically, several observations can be made:

During the first phase of the crisis, the European response was characterised by complacency. As recently as September 2008 the focus was on the U.S. as both the source and the key 'loser' in the crisis and the 'regional' experience

of the U.K. and Switzerland as primarily affected within the European context (losses in those two countries were equivalent to those in the euro area as a whole as of September 2008) pointed to the crisis as one of structured finance where less involved institutions would be immune. In practice, European authorities were slow to grasp the interconnectedness within the system and the effects on confidence. They were also slow to note the types of lending and investment characterised as reckless within the U.S. system were also undertaken by many of their own banks, explaining away problems experienced by European institutions in terms of incompetence.

The response to the crisis has also been an affair of states. There was little EU initiative and limited early coordination among regulators and supervisors, despite the crisis unfolding for over a year; the role of financial stability teams also appears to have been marginal. Furthermore, the more coordinated action from October 2008 has developed in extreme crisis conditions and under the auspices of key states (France and U.K.), with EU-specific mechanisms and institutions acting as bystanders or nominally representing smaller states. Many have pointed to the importance of key state leadership and have questioned whether many of the EU's 27 members would have had the capacity to coordinate a response had they been in France's place as holder of the EU Presidency. This calls attention to three important characteristics of the EU financial system: (i) the possibility of disunity, as exhibited by much unilateral action with respect to deposit insurance (by Ireland, Greece, but also Germany) and the inherent incentives for 'beggar-thy-neighbour' policies when tensions between domestic politics and crisis management arise; (ii) the lack of EU competence in both financial regulatory issues and in terms of cross-border resolution, liquidation and burden sharing and (iii) important governance gaps at the EU level in linking up the European Central Bank and its functions with broader financial stability considerations in the euro area and beyond and also, the role of the European Central Bank as a potential regional lender of last resort, as exemplified by the Hungarian liquidity deal of October 2008. More broadly, the European Commission has remained one voice among many in the management of the crisis and ongoing discussions on the effects of the crisis on the real economy and this appears unlikely to change.

Having exposed the weaknesses of cross-border arrangements, the crisis has pressed EU leaders to re-consider supervisory responsibilities. The idea of a 'College of Supervisors' advocated in the report of the Financial Stability Forum has found fertile ground in the U.K. and subsequently the EU as a whole. Such colleges would be set-up for the largest global financial institutions, the number currently being set at 30. This is arguably a modest proposal which does not address the interlinkages between institutions as these have been exposed by the crisis; details about reconciling supervision beyond the institutional lines of banking, securities and insurance also remain sketchy. More recently, proposals for the European Central Bank to take a more active supervisory role have been taking shape – this would bring much needed coordination and consistency in the oversight of large Eurozone financial institutions and would be seen as a welcome development by the private sector but is likely to be met with much resistance by national agencies. The crisis does, however, provide an opportunity for consolidated supervision of cross-border institutions within the Eurozone and an end to the contradictions arising from a single currency and cross-border banking system on the one hand and a fragmented supervisory environment on the other.

The response to the crisis, as it unfolded in the latter part of 2008, indicated that Europe retains the ability to shape; once it moves, the European Union and its member states can have an influence both in terms of crisis management and policy content. Consensus, however, may be difficult to maintain; the positions of the United Kingdom, France and Germany are likely to be different in the long-term as the countries have different economic motivations as well as priorities post-crisis.

3. Next steps and hurdles for improved governance

This financial crisis, as most previous ones, emerged due to a combination of factors both at the micro and the macro level. The provision of credit to borrowers in the U.S. and elsewhere was often reckless. But that credit boom would not have been possible, at least not to the same extent, if foreign capital had not flown into the U.S., Iceland and

other countries with large, persistent current account deficits. Thus, reform of financial governance has to address both the micro and the macro levels.

Focusing on the micro level

Several measures are necessary at the micro level and their coordinated implementation will contribute to the future stabilisation of financial markets. In this section, we suggest that attention should focus on the following:

Derivatives markets need substantially enhanced transparency

In derivatives markets, the level of transparency can be increased significantly. One source of the current crisis has been the lack of knowledge about the exposure of individual financial institutions. Liquidity dried up as banks stopped trusting each other because they had insufficient information on counterparty exposure in a range of areas, including in the use of derivatives products. In this sense, 'shadow banking' greatly deepened the crisis because of the lack of information about non-banks, the proliferation of short-term borrowing for long-term investment, and the enormous volume of derivatives like Credit Default Swaps (CDS). For CDS, of which the notional amount outstanding was $57.3 trillion in June 2008 (BIS 2008: A103), have added substantial volatility to the marketplace at a time when holders of capital are cautious about lending it to anyone.

At a minimum, trading in credit derivatives should be organised through clearing houses. The main task of these clearing houses would be to register and monitor positions of individual financial institutions in the derivatives markets, making records easily available to market participants. Such a step would improve transparency, which has been lacking in the current turmoil and seek to prevent excessive leveraging. A more comprehensive step would restrict the trading of derivatives to exchanges, especially for products that do not require a great degree of customisation. Further still, credit derivatives could be regulated by their economic effects. CDS, for example, are akin to an insurance product. If they were regulated to require reserves to be marked to support potential claims, much of the volatility within this market may be tempered. Questions about how best to link regulators to a clearing house, through creation of Central Counterparties (CCPs), are currently active within the international financial regulation community, as well as receiving a strong push from key market actors. A 'Cleared Index CDS' test began in late December 2008 through the London International Financial Futures and Options Exchange and the transatlantic NYSE Euronext, with the European firm LCH.Clearnet acting as a CCP (http://www.euronext.com /fic/000/040/866/408665.pdf).Within the U.S. this experiment has been permitted by regulatory exemptions provided by the U.S. Securities and Exchange Commission until late September 2009 (U.S. Securities Exchange Commission, Release No. 34-59164, 24 December 2008: http://www.sec.gov/rules/exorders/2008/34-59164.pdf). The scheme requires cooperation between the U.K. Financial Services Authority and the U.S. Securities and Exchange Commission. Questions about who could and should provide long-term regulation in this global market remain open.

Of course, additional measures to control derivatives could be explored. An extreme measure would be to prohibit all derivatives products. The question, however, is whether this would enhance the overall stability and efficiency of both the financial sector and the real economy. Banning all derivative products, i.e. instruments whose value is derived from underlying prices or asset valuations, would make the financial sector a much more straightforward affair. But the real economy would lose some useful instruments. Without derivatives, companies would not be in a position to hedge their future earnings from exports into markets that use a different currency. Airlines would not be able to insure against dramatic volatility in fuel prices. Unless there is a return to a financial regime of fixed exchange rates, the banning of all derivatives is not a convincing proposal. However, more complex derivatives can yet be restricted. Since improving transparency has been identified as one of the key elements of the reform process, derivatives instruments that are based on other derivatives should be re-considered by supervisory agencies. The case for these opaque instruments has yet to be made and authorities will need to consider whether the risks of these instruments (borne by society at large) outweigh their potential benefits (often related to a selected few financial players).

Participation in credit performance

In market-based financial systems, a major problem, exposed by the crisis, has been the lack of adequate incentives

for prudent and sustainable behaviour. For example, the performance of a loan did not matter to the issuer of the loan once it had been repackaged into a security, with lenders rewarded on the basis of quantity of loans. Whether these were serviced properly hardly affected the compensation of the original lender, a factor that permitted the non-bank market to flourish in the U.S. For market-based financial systems to remain, the incentive structures need to be systematically altered. At all stages of the provision of a loan, measures can be introduced that improve the quality, not just the quantity of loans provided.

Specifically, banks that repackage individual loans into securities should be required to keep a certain percentage of the original loan in their balance sheets. EU Commissioner Charlie McCreevy has suggested a minimum of five percent, which appears low to warrant prudent lending practices. Of course, any figure will be arbitrary. However, a higher percentage figure would be more appropriate for the injection of prudence into the securitisation of loans, regardless of whether these concern real estate, credit cards or other retail credit.

Bank-based versus market-based financial systems

In the current reform debate, there has been a lot of emphasis on improving universally applied standards. However, the creation of universal standards might result in major conflict between countries with financially liberalised financial systems and others wishing to continue to have more restricted and controlled financial systems. Even among advanced economies, there is wide disparity between states and divergences will become even greater as emerging economies and developing countries are included in debates. It may be the case that within OECD economies with liberal regimes for extending credit, popular expectations about credit access will provide political impediments for attempts at regulatory harmonisation between bank-based and market-based systems. In many Anglophone countries, for example, it will be difficult to simply turn off the taps of credit allocation, even as we potentially enter an era of increased prudential oversight.

In the past, there have been intense discussions between countries that have preferred bank-based financial systems (essentially continental European and some Asian countries), on the one hand and countries that have preferred market-based financial systems on the other (mostly the Anglo-Saxon economies). The problem has been regulatory arbitrage. Countries with lower levels of regulation have been, by definition, more attractive to financial institutions than those with higher levels of regulation – leading the latter to follow in order to maintain an active financial sector. It should be noted that particularly during a boom phase, regulation is primarily a cost factor for financial institutions. The microeconomic logic of profit maximisation does not consider, and probably should not consider, the effects of a company's activities for the stability of the entire financial sector. Only in the event of a crisis do these considerations play a role - though even then competitive considerations do often prevail – Deutsche Bank in Germany and Barclays Bank in the U.K. have not made use of public funds available for reputational reasons. Indeed, in times of crisis, stricter regulation can actually offer rewards to financial institutions. Spanish banking institutions, for example, remained stable through the crisis, despite Spain's own real estate crisis. But the Spanish authorities never permitted their banks to transfer risk into off-balance sheet vehicles. Consequently, while Spanish banks have taken a hit from the real estate collapse, their high 'doubtful assets' coverage rates have provided financial stability and actually permitted Spanish banks to buy banks elsewhere (Banco de España 2008: 12).

As long as there is systemic competition between market-based and bank-based financial systems, universal standards can therefore contribute to a perverse lowering of regulatory standards. For the less regulated markets, any tightening of the rules would be an improvement, but for financial markets that did enjoy regulatory standards above average, a universal standard may in fact lead to deterioration. There continues to be widespread disagreement on which measures are useful and which measures too cautious. A new global financial regime should, as a matter of principle, be designed in a way that avoids regulatory arbitrage. In addition, countries wishing to implement a stricter and less innovative financial regime should have the freedom to do so. Universal standards appear to be counterproductive to such principles.

Accounting standards

The problem of universal standards is clearly demonstrated when looking at accounting standards, which played an important role in the emergence and spiralling of the current crisis. The need to mark-to-market has been shown to be problematic in the event of a comprehensive panic in financial markets when there is no independent and authoritative evaluator of asset quality. Even those market participants that had neither the need nor the intention to sell a particular asset, had to adjust the valuation once another company had sold the same asset. The previous valuation of assets at historical costs did not create that problem. Calculations were based on the value of an asset when it was acquired. For example, in the late 1990s Deutsche Bank had Daimler-Benz shares in their portfolio whose book-value was the purchasing price back in 1953. While this accounting method is much more restrictive than mark-to-market, it can inject an important degree of stability into the financial sector. In addition, it is possible to make some adjustments of valuations over time (Kütting 2008).

The idea that accountants should mark to market has been a central pillar of the "Anglo-Saxon accounting ideology" (Küting 2008). In theory, mark-to-market should have contributed to enhanced transparency in financial markets as companies cannot hide valuable assets in their books, but have to clearly state where the company stands financially. It should be noted, however, that the introduction of mark-to-market was motivated by the short-term timeframes in which companies have operated, both in terms of reporting and bonus payment calculations.

The authorities have acknowledged the disadvantages of mark-to-market in a climate of panic and have permitted the return to historical valuations, both in the U.S. and in Europe. But should a policy that has to be suspended in a financial crisis be the standard accounting practice? Accountants will be working on ways to dampen volatility in the current system as it is unlikely that a return to accounting at historical cost will be welcome to stakeholders or indeed to anyone concerned about creative accounting.

The list of measures suggested above is only a sample and does not cover all potentially useful regulatory changes. The discussion does, however, demonstrate that proposals for reform and re-regulation should be neither too timid nor politically naïve. As the creation of a consensus on a catalogue of national measures will be extremely difficult, a key component of financial reform has to be the introduction of measures at the international level that provide policy makers with a considerable level of autonomy at the national level.

The need for a revised international framework

For years, OECD countries have shown a remarkable level of complacency with respect to the reform of the international financial architecture. Financial crises have been happening elsewhere, and policy makers in industrialised countries saw little, if any, need to consider reform processes. Often, those pushing for reform were not political heavyweights and did not have sufficient capacity to generate change. In Germany, for example, the only government agency interested in a revision of rules in financial markets in recent years has been the Ministry for Economic Cooperation and Development. Of course, the effects of this Ministry's efforts to introduce a variation of James Tobin's tax on cross-border financial transactions were minimal. The situation in other OECD countries was no different. The reform of the international financial architecture was an exotic topic, carried out by activists and academics. This has finally changed.

Reforming the institutions

The current financial crisis has exposed the lack of a credible and legitimate institution that could provide guidance, crisis management and authority. All of the existing institutions demonstrate severe weaknesses. In their current form, none can become the central pillar of a future regime of financial governance.

At face value, the most obvious candidate for a more prominent role is the International Monetary Fund (IMF). The IMF, founded in 1944, has been an important, if heavily criticised, institution in previous crises. The IMF has a near universal membership of 185 countries, which is an advantage, though some member countries can be said not to be central to the

international financial system. But there are at least four problems associated with the IMF: It is dominated by the U.S. and Europe, has not provided convincing recommendations in the past, and its management of recent crises has been poor and consequently the Fund is despised or discredited in many countries. Calls to make the IMF the key institution for financial governance fail to consider, for example the lasting resentment in Asia about the Fund's performance in the Asian financial crisis. For example, most East Asian economies have been reluctant to participate in the IMF's voluntary Financial Sector Assessment Program (jointly run with the World Bank in developing economies). For the IMF to become the platform for financial governance, it would have to be a structurally different institution.

Issues such as voting rights, where the dominance of Europe and the U.S. is unsustainable, or even the location of its headquarters need to be addressed. There have also been proposals to introduce a double majority decision-making in the Fund (e.g. Chowla 2007). In contrast to the current regime, which only considers voting rights based on contributions to the IMF's capital, in future a majority for both capital and member countries could be required. Whilst one can discuss the details of the reform of the voting rights, the key issue here is to end the unjustified dominance of OECD countries in the IMF. Earlier proposals for such reforms have been heavily criticised but the current crisis calls for their re-examination.

Elsewhere, resistance against change is often based on functional arguments. Some have argued that given the Fund's customers, primarily developing economies, too much influence in the policy decisions of the IMF could lead to an abuse of IMF credit lines (Eichengreen 2007: 168) and that criteria for the allocation of IMF lending should not be determined by the borrowers. However, this argument does not hold water. Firstly, the IMF is not a commercial bank, but rather an international organisation. Most importantly, however, abuse of IMF credit by member countries can be prevented when some key principles for credit provision are implemented. Ever since Walter Bagehot's seminal work, a central characteristic of last resort lending has been interest rates that are above pre-crisis commercial level with loans only provided against good collateral. If these criteria are observed, there is no reason why IMF lending would automatically be misused if developing countries have a greater say.

For the IMF to have a more prominent role in the future, improving future assessments is paramount. The Fund failed to forecast the Asian crisis, but so did many others. More problematic has been the IMF's failure to understand the risks associated with the U.S. financial sector. In 2005, the IMF evaluated the situation in the U.S. economy and saw no immediate risk :

> *The robust housing market has caused financial regulators to tighten oversight of home equity and other residential loans. Notwithstanding strong house price increases in many regions … securitisation of mortgage debt has limited systemic financial sector risks by allowing significant diversification of real estate exposures (Article IV Consultation with the United States 2005, IMF Country Report 05/257).*

In contrast to other institutions, for example the Bank for International Settlements, the IMF saw no big risk in the combination of rising real estate prices and securitisation.

During the crisis the IMF has been asked to provide emergency lending to a number of economies. At the same time, however, the emergence of new lenders of last resort and a much enhanced role for regional monetary cooperation can be observed. The European Central Bank has been providing liquidity beyond the Eurozone, making a lifeline available to both Hungary and Denmark (which received a €5 billion loan and a €12 billion currency swap agreement, respectively). Despite continuing tensions, Japan, China and South Korea have agreed to establish a joint financial regulatory regime aiming at the stabilisation of financial markets. The U.S. Federal Reserve has provided liquidity not only to its own financial sector, but in November 2008 committed itself to $30 billion each in currency swap arrangements to Mexico, Brazil, South Korea and Singapore. Thus, the Fund is confronted by an environment in which regional and bilateral arrangements potential usurp its relevance and legitimacy.

The oldest institution in the area of financial governance is the Bank for International Settlements (BIS) in Basel, founded in 1930. In contrast to the IMF, the BIS has a much better track record in predicting unsustainable developments. For instance, the BIS issued warnings on the problem of high capital imports into the U.S. long before the crisis broke (BIS Annual Report 2004: 9). The BIS might be well placed to have a more prominent role in the future, but in its current form is too small and does not have sufficient human capital, let alone financial capital, to command a leading role. Another drawback is that the BIS is an organisation of central banks, resulting in limited political control of the activities of the institution.

Following the Asian crisis, the Financial Stability Forum (FSF) was also established to analyse developments in financial markets and give recommendations for policy change. Its members include the G-7 countries, as well as long-term BIS members (such as the Netherlands and Switzerland) and some non-European economies (such as Australia, Hong Kong, and Singapore). Importantly, the FSF also includes the major international organisations (IMF, World Bank, BIS, OECD), the ECB, and also standard-setters such as the Basel Committee on Banking Supervision, the International Accounting Standards Board, the International Association of Insurance Supervisors, and International Organisation of Securities Commissions. One important reform to consider is a more institutionalised and more inclusive FSF (see also Davies and Green 2008: 223-5), with greater representation from G-20 economies. Such a reform would permit the FSF to bring more parties to the table to discuss financial reform that may have greater legitimacy among both developing economies and private market actors.

Attention has also focused on the potential role of the Group of 20. The G-20 was also created in the aftermath of the Asian crisis, but in contrast to the FSF has a much more inclusive membership. Important new powers are represented, yet the group is small enough to enable effective operation. The first major event for the group in the current crisis has been the financial summit in Washington on 15 November 2008. As a forum to organise the coordination of crisis management, the G-20 is well positioned. In fact, there is no convincing reason why the G-20 should not replace the G-7/8 as a forum for policy coordination. However, in its current form the G-20 cannot be much more than that. It does not have the institutional capacity to monitor developments in financial markets, and therefore can only supplement the work of an institution that provides continuous financial governance.

This brief analysis of institutions suggests that a likely rethink of the Financial Stability Forum would be a useful development. The most promising avenue, however, would be a structural reform of the IMF, which would have to be much more comprehensive than the currently suggested (mostly) cosmetic changes of internal governance and lending policies.

The focus on the Bretton Woods institution also draws attention to questions of capital controls and restrictions on cross-border financial flows. A key aspect of the current crisis is that the U.S. was able to draw on the savings of Asia and continental Europe, drowning itself in a sea of foreign liquidity. Restrictions on capital flows would have prevented the U.S. crisis and subsequent global contagion as the U.S. would have had to finance its spending exuberance from domestic savings - since that would not have been possible, the bubble would not have inflated as much as it has. In their various formats (restrictions, taxes, reserve requirements) capital controls might therefore have been a legitimate tool of economic policy, at the very least signalling the risks associated with such operations.

Restrictions on capital flows are not a popular measure, however. For many, they represent unjustified government control over the decisions of private individuals and firms. We must also consider that China and Japan actively chose to recycle their capital through the U.S. Furthermore, it should be noted that the current financial framework and its guiding principles, globally as well as regionally as in the case of the EU, would be significantly altered should such measures be implemented.

Diverging interests: Is there a consensus on what a new regime should look like?

The financial crisis has not wiped out specific interests of individual countries. It is naïve to assume that as a consequence of the current turmoil, governments in the OECD and beyond have suddenly developed a consensus on

what to do. The current activism suggests merely that many governments agree on the need to do something. It is, for example, unrealistic to expect the U.S. to agree to a comprehensive re-regulation of financial markets. A brief look at recent U.S. economic history reveals a strong resilience of those in favour of the regulatory status quo. The close connection between Wall Street, the U.S. Federal Reserve and the U.S. government has been criticised many times, without resulting in any substantial change. In 1998, the American trade economist Jagdish Bhagwati criticised the "Wall Street Treasury Complex" (Bhagwati 1998). Despite some support for Bhagwati, policies in the U.S. remained unchanged. Unless a structural change occurs which severs these long-established links, any hopes for a significant reversal of U.S. financial regulatory policy are premature. The extent to which the crisis has opened the way for broader acceptance of reform within the public and private sectors alike remains to be seen.

Closing the loopholes

One of the most important questions in the debate on future financial governance concerns the handling of potential stumbling blocks. This relates to the role of offshore financial centres, which have thus far escaped regulation. But the question of loopholes also concerns OECD countries, especially the U.S. There is no guarantee that the U.S. will be interested in enacting substantial reform. In such a scenario, does the rest of the world have policy options about pursuing a new multilateral regime for international finance without U.S. support? The importance of the financial sector for the U.S. economy and the reluctance of U.S. policy makers to re-regulate after previous crises suggest a cautious approach.

4. Conclusion

In this GARNET Policy Brief, we have analysed the development of the crisis, the response with a special stress on Europe and some potential remedies. All three issues are important. We will not be able to improve the policy response of European governments if we do not understand the origins of the crisis. The current crisis is not an isolated event, but rather a big earthquake that was preceded by many smaller upheavals. Against this background, changes to the regulation of international finance should be based on the principle that precautionary measures are generally justified, whether at the micro or at the macro level. Any debate on future financial reform will have to be based on an analysis of policy options in which questions of power politics are placed upfront. Discussions of international financial architecture must be tempered by considerations of political will. Susan Strange reminded us 25 years ago in Casino Capitalism of what key interests lie behind practical international financial reform:

> *The only alternative to an international authority is a national one. The only national authority in any sort of position to influence the behaviour of major banks and financial institutions, and to set rules governing the major markets for credit, is that of the United States (Strange 1986: 165).*

The chance of a serious institutional overhaul under the new Obama administration is far from certain and piecemeal national responses may take precedence over internationally coordinated action. This is especially the case in the absence of a single European voice. Curbing financial excesses may be relatively easy in the short and medium term as national authorities assert themselves, but the ongoing challenge is to develop a regime that will be stable enough once the appetite for risk re-emerges.

The micro-level

- Derivatives markets need substantially enhanced transparency, including through adequate clearing systems for relevant products.

- Banning derivatives products is neither viable nor desirable - but a closer monitoring of derivatives products by supervisory agencies is required.

- Adequate incentives for prudent and sustainable behaviour need to be put in place.

- Universal standards for bank-based and market-based financial systems will be hard to achieve (including accounting standards) and may be counter-productive. Nevertheless, a new global financial regime should, as a matter of principle, be designed in a way that avoids regulatory arbitrage.

The international framework

- The Bank for International Settlements has a credible track record and could be given a more prominent role.

- The Financial Stability Forum (FSF) may become a more formal institution, especially if its membership becomes more inclusive, with greater representation from G-20 economies.

- The G-20 should replace the G-7/8 as a forum for policy coordination.

- The most promising and long-term change would be a structural reform of the IMF, with greater emphasis on the preferences and needs of developing countries.

Diverging interests or consensus for a new regime

- This is an important opportunity for Europe to consolidate its financial system and in turn, avoid the pitfalls of piecemeal national responses.

- Any debate on future financial reform will have to be based on an analysis of policy options in which questions of power politics are placed upfront.

- Curbing financial excesses may be relatively easy in the short and medium term as national authorities assert themselves, but the ongoing challenge is to develop a regime that will be stable enough once the appetite for risk re-emerges.

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