Chapter 9

International and Regional Institutions

"Regulatory practices are likely to increasingly diverge at the national and regional levels. An international regulatory regime centred on host country control, twinned with less ambitious international cooperation, presents a better political fit with this new world"

Regional Alternatives

International financial crises not only affect individual countries but also regional economies. We know from other financial crises in the past three decades that particular regions have suffered more than others. The frequency of crises in South America is but one example. The Commission recognises that regional problems have called for regional solutions and that there is a great deal of institutional diversity and flexibility that should be embraced. A system of host country regulation marries well with more regional solutions since it empowers national regulators to foster strong lines of communication and information sharing with their neighbours as well as with international organisations. Regional solutions can also provide policy solutions that are not tied to 'one-size-fit-all' approaches to international financial governance.

The Commission recognises that there are significant regional variations in financial regulation that provide both opportunities and constraints. These variations are not only important for economic development within regions, but are also politically important in fostering the will for cooperation and consensus. Such variations may embrace more international or transnational institutions, but it may also exclude them, as discussed below. We note a number of initiatives within different regions which stress how, with varying degrees of importance, regional alternatives can provide policymakers with greater autonomy to answer the question 'what is a financial system for?' within their own context.

BOX 4: More or Less European Financial Governance?

The financial crisis caught the European Union at an uncomfortable half-way point: on the one hand, several European countries share a single currency and an increasingly concentrated financial industry while on the other, regulatory and supervisory functions, and lender-of-last resort responsibilities remain fragmented along national lines. Added to this is the peculiar situation of the U.K., with its large and in some ways dominant financial sector and independent monetary policy. Attempts to remedy the contradictions arising from this situation have been made in the past, especially in the context of the Lamfalussy process, but the crisis highlighted both the urgency of reform and the politics that has prevented further change thus far.

This Commission, in line with formal reports published in the past few months, agrees that the EU has two clear options: a greater centralised European role in financial governance or a return to a nationally fragmented system. We argue in this Chapter that Spain has shown that you can have national regulations that are different without undermining the single market. Indeed, additional national regulatory instruments could serve to support the single interest rate of the euro area when some countries are in boom and others are not. However, we believe this option to be politically unlikely and thus, following from the De Larosière recommendations, we expect to see more, not less, centralised activity in the EU, covering both systemically important institutions and the key principles and rules of financial regulation and supervision.

In the context of our recommendations, we consider it likely that the EU rather than Member States will become the 'host' regulator and there will be EU wide colleges of supervisors and systemic regulators. This leaves open a number of questions, including the interpretation of the rules in the actual decision-making location, and the independence of the specialised consolidated bodies dealing with systemic issues in terms of pushing through warnings and decisions and not merely acting as information collectors. Additionally, fiscal responsibilities and lender-of-last resort questions would not be consistently addressed in the emerging framework.

We address the question of whether European financial governance can provide regulatory solutions in Box 4. We also note that the Euro-area is a special case because of the commitment to a single economic space. The example of Spain, however, reminds us that it is possible to be in the euro area yet follow a more autonomous capital requirements policy for the local operation of financial institutions.

East Asian governments also increased their efforts to promote regional alternatives following the 1997-98 crisis. A series of initiatives have been launched to increase regional self-sufficiency, ranging from information sharing to financial swap arrangements and a regional bond market. The Chiang Mai Initiative, designed to provide liquidity support for member countries that experience short-run balance-of-payment deficits, and the Asian Bond Fund Initiative, which aims to create Asian reserve assets, are among the most important ones. They also serve to deepen and build regional financial markets in Asia.

East Asia's Counterweight Strategy: The Choice of Not Making Choices

Injoo Sohn

Having been trained primarily as a political scientist and a specialist on China and East Asia, I found it both exciting and rewarding to join the Warwick Commission on International Financial Reform. This issue intrigued and concerned me while observing the Asian financial crisis in Seoul,

studying and working in Washington DC and Princeton, and teaching in Hong Kong.

In my view, East Asia confronts a deep uncertainty about the evolution of both global and regional financial institutions. At the global level, the prospects for fundamental reforms in the G-7-centered global institutions have remained remote in the eyes of many Asian policymakers. Although the G-7 had begun to engage more expansively in dialogue with the rest of the world through the Financial Stability Forum and the G-20 following the Asian financial crisis, such adjustments have yet to meet the expectations of East Asian countries. Deep crises like the current financial crisis hold great potential for deep financial reforms. But global financial reforms are still full of uncertainty and contradictions. The interests of the major players of the G-20 do not necessarily coincide. And the conservative tendencies of status quo powers and the bureaucratic inertia of existing international institutions can considerably constrain the pace and scope of the global financial reforms.

Meanwhile, at the regional level, scepticism about the feasibility and desirability of Asia's efforts to create more cohesive arrangements or institutions have prevailed both within and outside the region. A series of potential political and economic hurdles (e.g. rivalry between China and Japan for regional hegemony) appeared to cast a shadow over the future of Asian financial cooperation. The ambiguity and uncertainty inherent in changing global institutions and creating regional institutions has become a central driver of current East Asian policy. Against this background, East Asia has pursued the risk-averse counterweight strategy, which intends to create new regional financial arrangements, thereby avoiding overdependence while sustaining collaborative relations with the G-7 dominated global institutions. Asian countries seem to explore both global and regional options lest it should limit the range of strategic options available to them. East Asia intends to get more say over the running of the world economy and resist the pressures of the reigning powers (e.g. the U.S.) through its counterweight strategy. At the regional level, East Asia has been making a soft commitment, instead of a strong form of commitment (threats of tightening an exclusive economic alliance) and watering down the exclusive nature of the regional arrangements by advocating the linkage of the Chiang Mai Initiative with the IMF and the Asian Bond-Eurobond linkage. This has helped to avoid a major fissure in its relations with key actors outside the region while further developing regional institutions. At the global level, East Asia seeks to manage or reduce the uncertainty associated with global financial reforms via the creation of credible exit options, that is, regional financial arrangements. Until substantial adjustments are made to reflect East Asia's growing economic power in the IMF and other Bretton Woods institutions, and address East Asia's vital concerns about the international financial system, East Asian countries are less likely to lose motivation to seek a regional alternative through a moderate, incremental and low-profile counterweight strategy. East Asia is unlikely to put all its eggs in one basket, namely, with only global financial institutions.

In Latin America, regional efforts have been devoted to providing additional development finance through a number of regional institutions with various degrees of geographical coverage. This implies a strengthening of regional cooperation and a wish to improve informational sharing. In Africa financial development has been substantial in recent years in a number of countries, but it is still at a relatively low level as measured by the amount of credit per capita or GNP. Countries in the region are mainly

concerned with the deepening of banking and credit markets and the availability of long-term finance. Regional initiatives are assisting national policymakers and regulators, who also seek to strengthen their capacities through working with international institutions (see Box 5), to which we now turn.

The Need for International Cooperation

In this report, we have discussed the need for host regulation by national governments to be the main foundation of financial stability. At the same time, we have mentioned already that host regulation would be sensibly coupled with international cooperation for a number of reasons which can be summarised briefly.

To begin with, not all governments may have the capacity to implement effective host country regulation. This task may be particularly challenging for governments in small, poorer countries whose financial systems are dominated by large foreign financial institutions. International cooperation will be needed to boost the regulatory capacity of the governments of these and other countries.

Even governments with effective capacity would benefit from information exchange concerning different national experiences managing similar kinds of risk. International information exchange and research cooperation would also be very useful for identifying the potential significance of global cycles for macro-prudential regulation and for developing early warning systems on the accumulation of systemic risk.

International cooperation could also address the risk that national authorities might use host country prudential rules as a protectionist device to restrict foreign financial institutions in domestic markets. One way to head off this possibility might be through international commitments to a 'national treatment' principle in the implementation of host country prudential regulation.

International cooperation is perhaps most important for addressing the externalities that lightly regulated foreign financial systems can generate for national regulators. These externalities may take the form of offshore evasion of national rules by banks and other domestic actors, or competitive pressures to deregulate in order to match lax foreign standards. National regulators may also face instability emanating from systemically-important financial markets or products abroad that are not regulated effectively by foreign authorities. In these situations, we have already discussed ways in which national regulators can use host regulation to protect their national financial system against these kinds of externalities.

But international cooperation provides another mechanism to minimise these problems. For example, national authorities could better anticipate, and minimise their exposure to, these kinds of externalities if up-to-date information was exchanged between countries concerning such things as: systemically-important markets and products, national regulatory initiatives, and the international financial activities of nationally-regulated entities.

BOX 5: Capacity Building for Financial Innovation in Developing Countries

Financial innovation can bring rewards to countries with a combination of specialists with financial, legal and mathematical skills and a permissive regulatory environment, but can also backfire and undermine economic growth as was the case when the regulatory spillovers and financial innovations originating in OECD countries recently impacted adversely on developing countries with weaker financial systems, regulatory support, and technical know-how. How then can we enhance developing countries' capacity to determine which financial innovations are useful to them, how to treat instruments under their system of host country regulation, and which kinds of investments are best avoided? Three prime sources of capacity building seem to emerge. The first one, education, provides training to postgraduates and policymakers whose newly acquired skills ensure continuous strengthening of developing countries'

financial systems. Local institutions of higher learning and regional training institutions can play a significant role in this regard by enrolling a large number of participants.

Many countries are engaged in bilateral programmes that are supported through aid networks or subsidisation. The Commission supports such activities, while also recognising that the skills and knowledge imparted are often abstract rather than tailored to domestic environments, highly dependent on colonial legacies, tied to broader deals such as through Preferential Trade Agreements, or subject to specific foreign economic policy concerns. The Fund and the World Bank have already established capacity building institutions such as the Joint Vienna Institute, which, since 1992, has trained over 22,000 participants from the former Soviet Union and Central Europe. Such initiatives must be encouraged in different regional centres as a key means to enhancing skills in financial innovation and regulation.

Programmes aimed at strengthening surveillance and consultations constitute the second capacity building avenue. For instance, Financial Sector Assessment Programmes (FSAPs) are conducted by the Fund in OECD economies, and jointly with the World Bank in developing countries, on the grounds that they provide information on a country's financial sector that is also shared with the marketplace. However, they have a mixed record regarding capacity building. On the one hand, they provide a forum for policy dialogue where mutual learning can and does take place. On the other hand, economists of the IMF and the World Bank have a strong incentive to provide positive assessments of a country's financial system, which undermines their credibility in international markets.

Policy dialogue and harmonisation of best practices, especially among countries of the same region or in similar circumstances, would provide a third, practice-based, confidence-building approach. This mutual learning process should be free of public market-based evaluation traditionally conducted by the IMF and the World Bank. Consultation of these two institutions with member-states should be in confidence to minimise the potential for conflict of interest of their staff and separate development management from competitive asset pricing. Whichever avenue or combination is chosen, we need to be mindful that capacity building in financial innovation is not an afterthought and has its requirements, in money and time, that cannot be ignored or neglected lest future crises are more devastating than the current one.

Equally useful would be efforts to coordinate regulatory policy at the international level. Because we have noted the importance of national differentiation and policy space, we favour only cooperation on key principles that set some minimum standards to which all countries are committed. These standards could relate not just to the kinds of principles for macro-prudential bank regulation that are outlined in this report (counter-cyclicality and risk allocation), but also minimum standards for systemically important markets and products of the kind that the BIS has suggested in its recent annual report, such as the use of central counterparties for clearing for over-the-counter markets. Compliance with minimum standards could be encouraged via peer monitoring.

More Democratic Representation in International Fora

Stephany Griffith-Jones

Central to debates on international financial reform is the question of who is represented within various international fora. The international community has taken important steps toward global coordinated regulation, and G-20 leaders have committed to further steps in this direction. However, their efforts, though welcome, seem

clearly insufficient given the depth of the globalisation of private finance and its often negative spillovers on innocent bystanders. Global markets are undemocratic, a problem that can only be addressed through intergovernmental cooperation and regulation, as well as democratic representation within international institutions and fora. Because capital and banking markets have large parts that operate globally, it is important that there is stronger global regulation, to avoid regulatory arbitrage by financial actors among nations in areas such as derivatives transactions. This would make it possible for developing countries to regulate destabilising carry trade, for example.

Greater representation for developing countries is required in order for them to have a voice on international standards for financial regulation and information sharing. There is momentum towards greater inclusion of developing countries in international regulatory fora. An important institution to guide international financial reform on information sharing and coordination of regulation is the Financial Stability Board (FSB), which expanded its membership to the G-20 in 2009. Similarly the Basel Committee has finally expanded its membership to include all G-20 countries. These are very welcome steps.

But inclusive and more democratic governance of finance needs to go further. There is a sound economic and political logic on why. Small and medium economies, still not represented need representation within international regulatory fora not only for their own sake, but also for the sake of the system as a whole. Regulators within smaller economies are more likely to oversee smaller financial sectors, and they are also more likely to have more autonomy from financial interests that may seek to capture them. Adding their voices to current discussions on how to monitor financial behaviour and financial products across the globe will add a great deal of diversity and help stop the 'group-think' that we have seen in recent years (such as through Basel II). I suggest that such a system is entirely consistent with the Commission's principle of empowering host regulation, since it would encourage greater intellectual diversity among regulators who are responding to the concerns of their societies rather than to large private international financial institutions.

In my view, such steps can also be taken much further. To ensure greater stability non-financial stakeholders could also be included, such as pension funds, unions and non-financial corporations, who are the users of the services that the financial sector provides. Including such groups would place greater emphasis on long-term growth sustainability over short-term profit, as well as improve information on what is going on with national and international credit cycles. It would also lead to a better allocation of capital within national economies and the global system. Ultimately, a more democratic and inclusive global financial system based on national host regulation, and coordinating globally national regulation of global markets, would ensure that governments would be more able to answer their citizens during a crisis on the question of 'what is a financial system for?' Even better, such a system could attempt to avoid costly crises altogether, and prevent some of the damage caused.

Summing up, international cooperation would play an important role in an international regulatory regime based on host country control, but the kinds of international cooperation would not be the same as under existing home country controls where international rules are negotiated in fine detail. Instead, cooperation would be focused on activities such as international research, early warning, financial protectionism, information

exchange, capacity building, and principles-based regulatory coordination. The latter could cover minimum standards for systemically important markets and products, as well as national treatment, and could be reinforced by peer monitoring, penalties and incentives. Providing an overarching framework would also be the principle that countries have the right to implement host country control (including restrictions on cross-border lending and borrowing that may be associated with prudential regulation).

This more limited kind of international cooperation is quite well suited to the changing international political context. Political economists remind us that the kinds of detailed international prudential agreements that were reached over the past two decades – such as the Basel accords – were politically possible only because they were supported by the two dominant financial powers of that time: the U.S. and the U.K. A more multipolar financial order is emerging from this crisis where power is more diffused and other countries' willingness to follow U.S. and U.K. regulatory leads is diminishing. In this political environment, it will be more difficult to reach detailed international agreements (let alone the creation of some kind of powerful global regulator which some favour). Instead, regulatory practices are likely to increasingly diverge at the national and regional levels. An international regulatory regime centred on host country control, twinned with less ambitious international cooperation, presents a better political fit with this new world.

A Reformed Financial Stability Board

What body would best facilitate the kind of international cooperation we are recommending? The obvious candidate would be the new Financial Stability Board (FSB), albeit in a reformed state. The FSB was created by the G-20 leaders at their April 2009 London summit not as a new supranational regulatory authority along the lines of the WTO. Instead, building on its predecessor the Financial Stability Forum, it is a relatively powerless body designed primarily to facilitate networks of cooperation among financial officials and regulators.

Many of its mandated functions in fact echo the kinds of cooperative roles we are proposing such as: conducting early warning exercises; assessing vulnerabilities affecting the financial system; promoting coordination and information exchange among authorities responsible for financial stability; monitoring and advising on market developments and their implications for regulatory policy; and advising on and monitoring best practice in meeting regulatory standards. Members are also required to commit to peer review and to some broad principles such as the pursuit of the maintenance of financial stability and the enhancement of the openness and transparency of the financial sector. They have also agreed to implement some key existing international financial standards and the G-20 leaders are considering proposals to develop a toolbox of measures to encourage compliance among non-cooperative (non-member) jurisdictions (as they have already done vis-à-vis tax information sharing).

To be effective in the kind of roles we are proposing, the representation of the FSB would need to be widened. At the moment, its country members include the G-20 countries as well as Hong Kong, the Netherlands, Singapore, Spain and Switzerland. Without more universal membership, the FSB's ability to foster information exchange, capacity building, and principles-based regulatory coordination across the world would be severely hindered. There would also be enormous resentment if it assumed a role of supporting multilateral sanctions against countries that were not meeting minimum standards. The promotion of worldwide compliance will only be effective and legitimate if it is combined with initiatives to provide all the world's countries with a voice in the development of such minimum standards.

The FSB need not become an enormous and unwieldy institution to achieve more universal country representation. One solution is that the FSB could be made accountable to a more universal body such as the Global Economic Council of the United Nations that the Stiglitz Commission has recommended, or the existing International Monetary and Financial Committee of the IMF (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 in April 2009, the G-20 leaders moved in this latter direction, recommending that the FSB report to both the IMFC and G-20 on issues relating to the "build up of macroeconomic and financial risks and actions needed to address them". A more inclusive solution, however, would be for more universal representation to be provided within the FSB through the use of IMF-style constituency systems or regional representation (especially if the trends described in the previous section of closer regional regulatory cooperation in Europe, Asia and elsewhere accelerate).

The Politics of International Regulatory Change

Eric Helleiner

I come to the Warwick Commission as a political economist long interested in the politics of international financial regulation. During this crisis (as in most past crises), economists have dominated the discussions about international financial reform. For the most part, their analyses are focused on the causes of crises and/or proposals for reform. What is usually missing from their work is analysis of what actually drives international regulatory change. Economists often assume that policymakers implement regulatory reforms based on a careful consideration of the pros and cons from the standpoint of maximizing global economic welfare. Two decades of study by political economists has shown how misleading that assumption is. To be sure, the ideas of economists do play a role in influencing the direction of international financial reform. But the empirical evidence shows the content and direction of regulatory reform is also driven by various political factors such as power, interests, ideologies, and so on.

Understanding the political economy of international financial regulation should help us to design a less crisis-prone system in two ways. First, it can help to explain the political failures of policymakers and regulators that contributed to the crisis. Many of the Warwick Commission's recommendations are designed with this political economy thinking in mind. The focus on host country control, in particular, emerges in part from a critical evaluation of political problems associated with alternative arrangements.

The political economy scholarship of the past two decades should also be useful to reformers in a second and more cautionary way: it highlights the limits of what is politically possible. Many proposals look perfect on paper but stand no political chance of being implemented at the moment. Academics can debate their merits, but time-constrained reformers need to look elsewhere to proposals that dovetail more closely with existing configurations of political forces. To what extent do the Warwick Commission proposals fall within the limits of the possible?

There is no question that a number of them challenge existing practices in major ways. In normal times, the dispassionate political economists would predict these had little chance of being implemented. But our deliberations have taken place in very unusual political times. This has been the worst global financial crisis since the Great Depression, a crisis that has discredited important ideas and interests. It is also coinciding with some substantial shifts in the tectonics of global power. As Commissioners, we were urged by specialists and practitioners over and over again to think big. There is, it seems, a yearning for ambitious thinking, for change, even within normally conservative circles.

That said, there is change and there is change. Our ideas will no doubt be too ambitious for many. We have tried, however, to develop proposals that fall within the limits of the possible, and I believe they

do indeed meet this criteria. Much will depend, of course, on how long the political momentum for change that has accumulated during this historical moment will endure. There are worrying signs that it is already dissipating. I hope, however, that our proposals help to keep the debate and momentum alive.

The FSB would need to be accountable not just to more countries but also to wider societal interests. We have already noted how financial regulatory policymaking – both national and international – is dominated by a narrow stratum of technocrats who risk intellectual insularity as well as capture by large financial institutions. Host country regulation will help to address partially the question of private capture by making regulators less inclined to see international regulatory discussions as an opportunity to promote the interests of their home firms. But just as important would be the development of mechanisms for wider societal interests to have a voice.

At the moment, the FSB's membership includes officials from ministries of finance, central banks, regulatory and supervisory authorities, and international financial institutions and standard-setting bodies. If some officials from outside these financial technocratic circles could be included in the FSB's peer review process, there might be both more blunt and productive talk as well as less of a likelihood for 'group-think'. The activities of the FSB could also be made more responsive to the broader public interest if more access points to international regulatory discussions were provided for citizens' groups (e.g. notice-and-comment procedures). Transnational groupings of legislators could also be encouraged to monitor the FSB's work, as the Parliamentary Network on the World Bank is attempting to do vis-à-vis that institution. So too could an arms-length body similar to that of the Independent Evaluation Office of the IMF or non-governmental shadow regulatory committees.

While accountability is important, it also has its limits. Certain kinds of sensitive information-sharing among financial regulators will only take place in narrow settings where guarantees of confidentiality can be provided. Similarly, staff working in the FSB framework and involved in international research and early warning systems must be guaranteed independence from political forces in order to establish credibility. (The size of the FSB's staff must also be expanded considerably from its present very small size in order to boost their capacity to develop independent advice.) In other words, at the same time that the FSB is made more accountable, it will be important to differentiate the various functions of the FSB and draw careful walls around those that require special treatment.