Key Principles for Financial Reforms that G-20 Leaders Should Implement

by Stephany Griffith-Jones, José Antonio Ocampo, Sarah Burke-Rude

The financial crisis that began in the United States in the summer of 2007, and then spread to Europe, has now become global and increasingly serious. Although governments and central banks around the world have taken many costly measures, they have not yet been able to contain the crisis. The threat of global recession and the dire social consequences that could accompany such a downturn make internationally coordinated, but nationally different, expansion of fiscal spending to help maintain economic activity essential. It also calls for an urgent reform of the global financial architecture and regulatory system. Given the magnitude of the task, calls for the upcoming G20 summit on November 15th in Washington D.C. to initiate a "Bretton Woods II" process are cause for cautious optimism.

No fundamental – or global – reforms can be enacted if they do not arise from a process that is inclusive of both industrial and developing countries, and in which both large and small countries have a meaningful voice. In short, representative global institutions – not *ad hoc* groupings – must be at the center of reform efforts. Why? Any global solutions, whether short-term measures to stabilize the current situation or long-term measures that attempt to prevent future financial meltdowns, must be designed to protect not only the G7 or G20 economies but also emerging markets and, especially, the poor populations of developing nations. Otherwise, global economic stability cannot be restored, and both economic growth and poverty reduction efforts will be derailed.

The current deep crisis and previous ones that have hit developing countries demonstrate that crises are inevitable in liberalized financial systems without appropriate regulation. This is increasingly recognized by a majority of economists. As the need to contain the present crisis and to prevent future ones has become urgent on a global scale, the need for far-reaching regulatory reforms has increasing political support. However, this window of political opportunity for introducing deep regulatory changes may be narrow, so the task is urgent. A growing consensus exists that there must be reform. The key question is: how BEST to do it? Two key principles provide the framework for the necessary regulatory reforms: **comprehensiveness** and **counter-cyclicality**.

Comprehensiveness

In order for regulation to be efficient, it is essential that the domain of the regulator be the same as the domain of the market regulated. Otherwise, it will be impossible to avoid the massive loopholes that led to the current crisis. In the United States, for example, banks represent less than 25 percent of total financial assets, and only a portion of commercial banking activities are adequately regulated, with off-balance-sheet activities essentially excluded. Clearly, a regulatory system focused on the banking industry – and hardly at all on the rest of the financial system – will not suffice. The "shadow financial system" must be regulated. After all, the greatest problems in the present crisis have been created by those very unregulated agents and instruments, such as investment banks, in the first case, and Collateralized Debt Obligations, Structured Investment Vehicles and Over the Counter Derivatives, in the second.

Comprehensive measures are required at two levels. The first is **transparency** for all actors and activities, which would require both registration and disclosure of relevant variables for all financial institutions. This is a pre-condition for comprehensive regulation, but one that would also benefit other financial market participants and investors. The second is **comprehensive and equivalent regulation**, to cover all entities that invest or lend on behalf of other people and that would apply to all the activities they undertake in <u>all</u> jurisdictions, including off-shore centers.

Counter-cyclicality

In addition to being comprehensive, regulations should have a strong counter-cyclical focus to avoid the **excessive accumulation of leverage** and increase of risk-taking during booms, as well as to prevent asset-price bubbles from feeding into the credit expansion. Reliance upon the internal models of financial institutions, the major focus of Basel II, must be discarded. The present crisis has already shown how perilous the use of similar risk-models can be, as the herd-behavior demonstrated in de-leveraging led directly to greater financial instability.

Counter-cyclical policies should not be difficult to implement, as Spanish and Portuguese regulators have already shown in their requirement that banks have dynamic provisions (which amount to *de facto* counter-cyclical regulations). Although Spanish banks have not been immune from the crisis, they are weathering it much better than many other countries without such provisions. This positive experience needs to be built upon by other countries, either through forward-looking provisions and/or counter-cyclical capital. The key idea is that provisions and/or capital required should increase as risks are incurred – when loans grow more – and should fall when loan-expansion slows or reverses. This would strengthen banks in boom times and discourage them from excessive lending. At the same time, it would make it easier for banks to continue lending in difficult times because of the cushions they had accumulated.

Global Financial Reform

Any system designed on these key principles should be based on a **well-functioning network of national and regional authorities**, with stronger powers given to the apex of the system, which in this sense could be refered to as the "global financial regulator**"**. The creation of such a network and global regulator, which would have a global reach, including all financial and offshore centers, should be studied urgently. A substantially reformed Financial Stability Forum working with Basel banking regulators, IOSCO (the securities regulators) and insurance regulators, could form the basis for such network. However, its membership and representation would have to be significantly broadened and democratized to include strong representation of emerging and developing countries.

The IMF should be revamped in four significant ways. One, its Special Drawing Rights should be transformed into the basis for developing a truly global reserve currency to overcome both the inequities and the instability inherent in a global reserve system based on national or regional currencies of industrial countries. Two, it should be redirected to concentrate on macroeconomic policy coordination, rather than the G7 (or any "G") doing it, as this is the only way to give developing countries a voice in this issue. Three, the IMF should become more like a central bank, providing liquidity in a rapid and agile way, and without crippling conditionalities. The recently-created SLF (Short-Term Liquidity Facility) of the IMF is a step in the right direction, but access to it should be broadened to more countries. Fourth, the IMF should discuss what types of regulations on cross-border flows make sense to avoid the strong boom-bust cycles and contagion of financial crises to emerging and developing countries.

Finally, a Bretton Woods II should use the occasion of the **Review Conference on Financing for Development**, to take place in Doha at the end of November, as a major opportunity to launch a participatory process leading to a reform of the global financial architecture, with the backing and close collaboration of the United Nations and the Bretton Woods institutions.

Links to papers from which this statement has drawn:

"Towards a new Global Economic Compact: Principles for Addressing the Current Global Financial Crisis and Beyond"
http://www0.gsb.columbia.edu/ipd/programs/item.cfm?prid=133&iyid=13&itid=1551
Joseph Stiglitz, from a speech delivered to the United Nations General Assembly, 30 October, 2008

“South Centre calls for Revamping the Global Financial Architecture”
http://www.southcentre.org/index.php?option=com_content&task=view&id=871&Itemid=1
Statement by Jose Antonio Ocampo and the other Board Members of the South Centre, 29 October, 2008

“The Urgency of Reforming Financial Regulation Now”
http://www0.gsb.columbia.edu/ipd/programs/item.cfm?prid=133&iyid=13&itid=1500
Stephany Griffith-Jones

“Agenda and Criteria for Financial Regulatory Reform”
http://www.fondad.org/uploaded/D%20Arista%20-%20Griffith-Jones/DArista-Griffith-Jones%20on%20Financial%20regulatory%20reform.pdf
Jane D’Arista and Stephany Griffith-Jones

“Responding to the Financial Crisis: An Agenda for Global Action”
http://www0.gsb.columbia.edu/ipd/pub/Bhattacharya.pdf
Amar Bhattacharya, Kemal Dervis and José Antonio Ocampo