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TOWARD A NEW GLOBAL FINANCIAL ARCHITECTURE: SOME ISSUES AND APPROACHES

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The current debate on new Global Financial Architecture is, in a way, the continuation of the debate that was intensified consequent upon the Asian crisis. The Financial Stability Forum (FSF) which has been recently transformed into Financial Stability Board (FSB) and the G-20 which has gained higher profile in the context of the global financial crisis were products of the Asian crisis. The questions relating to governance, credibility and the effectiveness of several multi-lateral institutions such as IMF and BIS were discussed soon after the Asian crisis. At one stage a few years ago, it appeared that IMF was irrelevant, though some steps were taken to increase quotas of some EME's. Similarly G 20 was almost losing its relevance. The recent global financial crisis warranted urgent responses which meant activating and empowering the G-20 and IMF, and later expanding FSF into FSB. There is an agreement to expedite the reform of IMF while resources at its disposal have been enhanced. In the debates on reform, however, the issue of international monetary system has gained more importance now than ever before. This note highlights the importance of new approaches to the global financial architecture, with special reference to regulation and liberalization of financial sector.

Need for integrated approach

The issues relating to Global Financial Architecture have to be positioned within the overall approach to globalization while specifically relating it to financial sector. The recent events have shown that the challenges of globalization of finance could be different from the challenges relating to the process of globalization of trade. The Global Financial Architecture should also be viewed in the context of the totality of several inter-related layers. These are (a) national level public-policy institutions (government, central bank, regulator); (b) national level financial markets; (c) supra national level but sub-global level public policy institutions (such as Euro Area; Asian regional initiatives); (d) global level public-policy institutions, in particular IMF, World Bank, and UN at a formal level and G 20 or FSB at an informal level; and (e) financial institutions operating predominantly in the global financial markets. Appropriate Global Financial Architecture should take cognizance of the various elements of the system, and their interrelationships, rather than focus mainly on global level institutions.

Process of Rebalancing:

It is possible to consider the reform of globalization of finance and globalization of regulation under consideration as part of a process of rebalancing consequent upon the experience gained with the global crisis. Such a process has several dimensions. There is a need to rebalance the relationship between financial sector regulation, monetary policy and fiscal policy by formally recognizing the inter-dependencies at the national level. In principle, this rebalancing in favour of harmonized approach is evidenced by the emphasis on counter-cyclical regulations in financial sector. The redefining of relationship between the governments and the regulatory agencies is under consideration at the national level in several jurisdictions. The relationship between the regulators is also being rebalanced in some countries to ensure coordination in the interest of stability. There is a rebalancing of relationships between the governments within supra national, but sub-global levels such as in Asia and Euro area. Finally, there are global attempts to strengthen the Global Financial Architecture that should ensure stability. Conspicuously absent in the debates is the developmental dimension to the financial sector. In brief, the design of the Global Financial Architecture has to recognize the changing balances between different arms of public policy at national level;

state and market in different jurisdictions; and national and regional as well as global levels.

Decentralisation and Diversity

The current reform proposals are based on an assumption that creating new institutions is more complex and time consuming. While structural elements of reform of institutions such as IMF are considered to be time consuming by their nature, there is considerable discussion on strengthening the institutions in their existing forms of governance in order to meet emerging problems in global finance. In a way, this approach amounts to strengthening institutions which are admittedly suffering from governance deficit, credibility deficit, and arguably effectiveness. But, it is possible to consider an entirely alternate approach based on developing counter balancing institutions that could be devised either at global level or at decentralized level. For instance, it is possible to recognise and encourage several regional level arrangements for financial sector, including its regulation. It is possible for the IMF to play a facilitating role in developing the counter balancing institutional arrangements, to the extent acceptable, as regional-level bodies.

More generally, all the arrangements that are under consideration are indicative of centralization in the management of global financial sector. It will be interesting to imagine what would have happened if such a binding centralized framework existed, say 5 years ago. It would not have permitted the diversity in policies in financial sector and in monetary policy that had been adopted by India and China, for instance. Hence, there may be merit in diversity of public policies in different pats of the world in matters relating to economic issues on which there is far less certainty than in matters such as electricity and telecommunications. In other words, in dealing with human behaviour and human institutions as contrasted with physical sciences, full integration and centralization may be risky even when accompanied by what has been described as circuit breakers. In fact, it is possible to argue that the centralized approach implicit in the current debates may either require or may promote syncronised global boom and bust, which could be even more difficult to manage.

Strengthening regulation of international banks:

The approaches to reforms in Global Financial Architecture, in so far as they relate to regulation of financial sector, are focusing on globally acceptable regulatory frame work that reduces the risks of financial instability while facilitating globalisation of finance. The mismatch between global financial integration and its regulation is sought to be bridged through the various proposals for reform. But it can be argued that the global financial crisis originated in countries with a national level regulation that was particularly soft and by the financial conglomerates that concentrated on cross border finance and thus facilitated contagion. These financial conglomerates are generally based out of jurisdictions that have soft regulations. It will be useful to make a distinction between multi-lateral banks and international banks for analytical purposes. Multi-national banks may be defined as those which operate sizable foreign branches and subsidiaries in multiple jurisdictions and in their pure form, fund their positions locally in the host countries. In other words, they do not have significant cross border financial transactions. During the crisis, such banks showed better resilience. A second set may be defined as international banks which may operate out of one home country or from a major financial centre, but under the umbrella of a conglomerate. The main characteristic of the international banks and its associates is the dominance of their cross border business on their balance sheets.

It is possible that the global financial crisis arose out of the unique position of the international banks in conducting cross border business with significant benefits to themselves, high risks to the system and questionable gains to the cause of economic development. Empirical data may be necessary to establish this fact, but a quick assessment of the major institutions that suffered during the crisis is indicative of the fact that even within developed countries, mainly international banks or banks with cross borders exposures were involved.

It is useful to consider empirical evidence on whether international banks were responsible for devising financial instruments which specialized in injecting complexity to financial products in the name of innovation with two objectives, viz., a) satisfy the regulator that there is transparency, but defeat the purpose of transparency; and b) take advantage of the cross border operations to spread the risks to other financial institutions including those which are otherwise confined to the domestic financial markets.

It is possible that the international banks as part of financial conglomerates are in a privileged position for several reasons. First, they arbitrage between different sets of regulations in different jurisdictions. Second, simultaneously they operate between different sectors of the financial market. Third, they conduct their operations across tax regimes. Fourth, they are able to operate at different levels of formal legality in different jurisdictions. In other words, if there is a concern of public policy in regard to large bank balances in some jurisdictions with inadequate transparency, the money could not reach such jurisdictions or such places without the active involvement of international banks.

Finally it can also be argued that cross border activities gives them special advantage in a non tangible way. For example, they can induce race to the bottom in regulation. They can foster and facilitate cross border management of political economy. They are in a better position in relation to domestic regulators in several jurisdictions in terms of assuming risk and exercising their clout.

If the empirical evidence is indicative of the fact that the international banks, or banks which were active in cross border transactions operating essentially from international financial centers have been the main sources of financial crisis, then the attention of the reform of the Global Financial Architecture should be on the activities of such international banks.

Possible Redefined Approach

In the light of the approaches described, the focus in the debate on regulation of financial sector could be on the following lines:

(a) The regulation of financial sector should essentially be the responsibility of the national authorities, and every effort should be made to ensure that they serve the national interest, but in the process ensure that there are no serious risks for the rest of the global finance.

(b) In order to avoid the risks of soft regulation on the global economy, minimum standards of regulation could be prescribed for all countries, and more particularly in respect of institutions or the markets of the countries that have significance for the global economy.

(c) A degree of diversity consistent with the institutional as well as socio-economic context of different countries and different regions should be consciously encouraged.

(d) Scope for counter-balancing and decentralisation of the global level institutions to bring about a better balance between stability and efficiency, could be explored in parallel with reforming existing global level institutions.

(e) While focusing on the improvements in the global monetary system, the regulation of financial sector at a global level should concentrate on those institutions which are in the nature of international banks, mainly concentrating on cross border financial transactions. The focus of globally enforceable regulatory requirements should be most intense in regard to these institutions. This could be considered as globally systemically important financial institutions subject to global level regulation to supplement the rigour of national level regulation.

Professor Stiglitz's Analytical Framework for a Redefined Approach

Analytical framework for a redefined approach to the issue of global financial integration with special reference to regulation of financial sector is available in a paper by Professor Joseph E. Stiglitz, "Risk and Global Economic Architecture: Why Full Financial Integration may be Undesirable" (NBER Working Paper 15718 dated February 2010). The paper provides a general analytic framework within which the optimal degree and form of financial integration could be analysed. The paper indicates that full integration is not, in general, optimal.

In this regard, the paper identifies the problem relating to risks and as one relating to the contagion which should be contained through well designed networks such as imposition of capital controls. However, it can be argued that circuit breakers are not mounted after the event, but they are built into the system. Further, the financial sector has considerable element of behavioral dynamics relative to the networks in electric grid or telecommunications. Hence, there is a greater justification for continuous presence of such circuit breakers whose design and magnitudes should be calibrated depending on the behavioral dynamics in financial markets.

Professor Stiglitz also refers to the fact that the world is rife with non convexities, and hence global integration based on assumption of convexity may not be desirable. He notes, “The intuition behind why integration should be desirable was based on “convexity”: with convex technologies and concave utility functions, risk sharing is always beneficial. The more globally integrated the world economy, the better risks are “dispersed”. But if technologies are not convex, then risk sharing can lower expected utility”. In this regard, he refers to externalities such as bankruptcy and information costs. It can be argued in this regard that international banks and financial conglomerates may have the capacity to inject information cost and complexity.

Professor Stiglitz adds that “simulations within a variant of our model show that an appropriately designed circuit programme can be welfare enhancing”. However, it may be useful to examine whether the appropriate mechanism for financial market should be a circuit breaker or a voltage stabilizer, or a combination of both.

In conclusion, further debate on approaches to Global Financial Architecture should be based on questioning of fundamental assumptions behind the risks and benefits of deregulation and liberalization of financial sector that had been the foundation of our economic thinking in recent years.