Chaire M.A.D.P.

« Les régulations non-étatiques dans la globalisation »

vendredi 13 février 2009, de 9h00 à 13h00
Table ronde organisée par

La Chaire "Mutations de l'Action Publique et du Droit Public", Sciences Po

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« ***Some reflections on financial regulations »***

I. Current governance of global finance: institutions and regimes

1) Institutional regulatory mechanism:

- Multilayered and dispersed
- Complex networks across local, national, regional and global levels
- Across private and public sectors

2) Some examples (beyond IMF and OECD) of (a) informal networks of government officials and (b,c) private bodies

a) Basel Committee on Banking Supervision – BCBS (membership of central bank governors: 13)

Three pillars:

- Minimum capital requirements
- Supervisory review process
- Market discipline

b) Basel II (2008): credit rating agencies as private bodies operating within frameworks set by hybrid public-private or public bodies.

c) International Organization of Securities Commission – IOSCO

- Non-governmental international organization
- Membership: national securities regulators (102), often times allows for outright delegation of decisions to private actors
- Devised to harmonize cross-border securities market regulations

3) Legitimacy of the contemporary financial governance can be questioned especially of three accounts ***("democratic deficits")***:

- ***Input legitimacy***: the extent to which the interests of constituents are included
- ***Output legitimacy***: efficient problem-solving capacity
- ***Accountability*** of global policy processes and outcomes to the broad range of constituencies, ultimately facilitating the inclusion of wider constituencies as participants in the input phase.

II. Indicators of the recent financial turmoil

1) Insufficient information on credit composition led to a credit crunch: due to lack of comprehensive publication of financial company information and data dissemination

2) Progressively smaller number of corporate conglomerates is dominating the banking securities and insurance industries: new trend towards concentration and monopoly (in order to avoid – partial - nationalization) which created excess profits, reduced incentives to innovation and consumer protection.

3) Monetary profit schemes / financial derivatives (i.e. money made through paper transaction and speculation only, for example hedge funds) versus ***productivity***: increased decoupling of finance from the ***"real economy".***

4) Contemporary global finance is mainly self-referential and unilaterally fixed on maximizing profits, it becomes an end in itself rather than a means to general material betterment.

5) Greed and irresponsibility on the part of some: Risk taking disproportionate to capital levels ***("greed is in, ethics are out")***, neglect of social justice and stability in the pursuit of personal profit (moral hazards). Indication of a need for

   - The control / prevention of the risks undertaken by professionals
   - Aiming to assure clients and the financial system as a whole

6) Hazards concealed by inaccurate credit ratings

7) Lack of global governance mechanism to discipline self-interested behavior: present instruments promote unbridled private interests rather than the ***common good and common purpose***.

8) Private actors – through self-regulatory processes (deregulation) – have gained a strong voice within the national and international political economics

9) On the other hand, largely unaccountable technocrats hold sway over global finance to an extent rarely found in other areas of contemporary governance. Trans-state networks and private regimes in the governance of global finance remain largely divorced from public participation and public accountability

10) The decades-old ways relying less on rules and their enforcement (Paul Krugman: "runaway financial industry") and more on faith in the financial market discipline in order to limit risk to the system have been a manifest collective failure on the part of private as well as public stakeholders to make hard choices for a 21st-century regulatory framework and a new rules-based regime.

III. Case study: sub-prime mortgage crisis

The sub-prime mortgage crisis was created by the banking industry itself due to a lack of binding state enforced regulations with regards to lending. While the banking sector had created some self-regulatory norms, state observance was practically nonexistent. The banks and hedge-funds were largely left to self-govern because of their promising results in terms of financial gains.

This output legitimacy further reinforced the idea that they should be left to self-govern. However, in so doing, state officials ignored the relationship between input legitimacy and output legitimacy and therefore the need for a ***stakeholder participatory balance***. State participation and oversight are necessary to minimize destructive and perilous behavior.

Rule-based systems appear more predictable, more durable and a better protection against abuses.

IV. Key issues and principles for governance of global finance

Short-comings in efficiency, stability, ecological integrity, social justice and ethical guidelines to be dealt with by the following principles of societal order:

1) ***Capitalism, economic liberalism, deregulation***:

- Much of the prosperity of the last 50 years has been stimulated by the state giving more opportunities to private business and by transferring power to them through deregulation and privatization. It begs the questions: What are the consequences of this transfer of powers for economic diplomacy (process of economic decision –making by state- and non-state actors)? What responsibilities should the state keep, what should private business undertake and how can state and business work together?

- Capitalism should not be unbridled, but work within a state-supervised normative framework of civil empowerment, social equity, human welfare and financial order. It should strengthen the global system based on international discipline and the principles of trade, open and competitive markets, free flow of labor and capital and the guarantee of property to lay a new foundation of wealth.

- Neither undue state-intervention / interference nor protectionism nor state regulatory overkill, but financial market system to be overviewed, reframed and re-adjusted under the watchful eye of government along ethical values and truths (such as fair play and tolerance) and in relation to the ***"real production" of goods and services***, (for example with the introduction of a "leverage ratio" – beyond Basel II – for liquidity management and a higher capital ratio which would require banks to put aside more money to offset potential losses).

- Profligate government has contributed to a culture of economic recklessness and untamed capitalism that produced the recent financial meltdown: Excess (including excessive liquidity and credit policy) has perpetuated even more irresponsible risk taking.

2) ***Global communitarianism***

- Globalization and **global governance** inspire the need for a global communitarianism increasingly important for human welfare: cosmopolitan realities (human rights regimes, environmental regimes) demand a commitment to ***shared responsibility for common interests, values, goods and risks eventually leading to new rules, standards and mechanisms of accountability throughout the global economic and financial system.***

- ***Need for paradigm shift of holistic thinking and acting along ethical*** awareness and shared responsibility ***("collective intelligence"***).

3) *Future role of the state*

- While the regulation mechanisms based in private sector agencies and sub-state actors have gained substantial significance in the governance of global finance, states are still, on the whole, the primary actors in the governance of finance conditions of contemporary globalization.

- States produce the normative environment which is the conditions for these forms of private transnational governance to even exist.

- Private transnational regulation may face a problem at the implementation level due to the lack of enforcement mechanisms (which states do have). It will often be the case that transnational regulators need the support of public authorities in order to play a meaningful role. Therefore, when states call on private actors to form a private network there always exists a fall-back regulatory option, i.e. in conjunction and in the shadow of the hierarchical state. Based on its sovereignty as responsibility the state remains – in last resort – the ***guardian of core issues such as financial order.***

- The 21st century world can no longer be governed by mid-20th century institutions, now 60 years old. The legitimacy of states will now be measured by their pragmatic capacity and political will to create such a societal order and legal framework for ***working mechanisms***.

- This is the time for state authority to take the initiate and to live up to its responsibility with anti-cyclical and anticipatory actions sharing the burden of politically difficult decision and spreading the load while remaining in control of the agenda. To wait for self-regulatory private mechanism would be the wrong signal.

V. Options for future global finance regulations and the shaping of a new international financial system

- Widespread consensus (among EU, US, developing countries) on the need for change in the global financial architecture and the strengthening of current regulation structures: ***global crisis requests global responses***. Europe led the way in recognizing the necessity for government action within the banking sector. American policy makers got on board only after European governments moved first.

- G 7 meeting on October 11, 2008 followed by ***G 20*** Washington Declaration on November 15, 2008 laying out ***six points*** (G 20: the most powerful developed and developing nations):

  a) Reinforce transparency and responsibility (with robust monitoring of regulators and those they regulate. Robust monitoring requires "watching the national and global watchdogs" by a college of supervisors)

  b) Promote sound (wise) regulations "with teeth"

  c) Enhance prudential controls (i.e. giving warning of impending catastrophes or taking strong action against the excesses that are fueling it. This could also include the creation of a special-function international judicial institution charged with assisting the enforcement of the new rules in banking and finance, adjudicating disputes, and offering uniform authoritative interpretations of the rules)

  d) Promote integrity within financial markets

  e) Reinforce international cooperation

  f) Reform international institutions

- Far reaching shake-up of regulation and a hammering out of a global system of financial regulation to be expected at the G 20 meeting in London on April 2, 2009

- According to the ***principle of subsidiarity a bottom-up approach*** of regulation could be taken:

  a) On the national level:

     (Public and private) regulatory powers could be limited beforehand by national legislative framework through regulatory objectives allowing for a participatory balance reconciling stakeholder and state interests and enforced by judicial review.

     Obama (Le Monde 20-1-2009): « La réforme de la regulation financière – intelligente et dure – sera l'une des priorités législatives numéro un de mon administration. » (for details see the Group of 30 Report on Financial Reform chaired by Paul A. Volcker). Planned U.S. legislation forsees a strengthening of the financial controlling powers of the Federal Reserve Bank.

  b) On the EU level:

     Coordination of national regulations: Without issuing peremptory demands on how to deal with the financial crisis Europe should lead by example with one voice and not wait for the new US administration to formulate its position.

     Merkel (Le Monde 20-1-2009) said with reference to social market economy, transparency, minimum social standards and the protection of the environment: "Nous, les Européens, sommes à même de proposer des valeurs et des principes fondamentaux qui peuvent contribuer au nouvel équilibre de l'architecture économique et financière international."

     Jean-Claude Trichet, president of the European Central Bank, pointed out that the treaties that created the euro suggested that the ECB could be given responsibility for banking supervision.

     In any case, the US needs a strong EU for a revitalized and more balanced transatlantic partnership: a unified and pro-active Europe is preferable to a divided one.

  c) On the global level:

     Three main reasons for delegation of public power to an ***International Regulatory Authority (top-down approach):***

     - Impartiality against state interventions (Ben Bernenke, chairman of the Federal Reserve: "The world is too interconnected for nations to go it alone in their economic, financial and regulatory bodies")

     - Inviting experts into decision-making

     - faster adaption

  d) Principles-based Regulation at the global level: Financial stability as a Common Good

     -Possible forms of inter-regulation

       - Government networks (MOU, gentlemen's agreements)
       - Adaptation of current inter-regulation bodies:

         - IOSCO, BCBS
         - G 20 perspective to ascribe ***surveillance and supervision*** (with governance elements of early warning) to ***IMF and Financial Stability Forum*** (G 8).
           Chancellor Merkel heading the G 8 Summit 2007 tried – in vain – to inject transparency into financial markets by calling for greater openness by hedge funds

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-former IMF Managing Director Horst Köhler (presently German President): a reformed IMF should become the guardian over the stability of the international finance system.

(The IMF stands out as the most capable to do so in relative terms but there are legitimacy issues in terms of representation and governance. It would require major retooling)

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- ***Creation of a new World Finance Organization*** (Merkel at G 20: "Economic Council" at the UN alongside the Security Council – and stronger than the ECOSOC – with a UN Charter for Global Economic Order,
- similar: Pascal Lamy, WTO, with binding rules / hard law)
- Strauss-Kahn, IMF, sees the need for regional and /or global regulators.

VI. Conclusions: "Ethics in Governance are in, greed is out"

Dealing with the financial crisis in a holistic, systemic way a fundamental change of mindset and creative activism is needed. Market forces are the engine for economic growth. But they need to be well regulated to ensure fairness and equal opportunity for all. Business ultimately has to serve not just share-holders but society at large.

A ***participatory balance of public and private stakeholders in the form of cooperative governance*** could overcome the criticism of any democratic deficit, if it includes the demand for greater public transparency (information, clarity and publicity), accountability and control. This ***communitarian approach*** provides a realist concept for ***a new two-tier global financial architecture*** which could serve as an early warning system (***newly mandated IMF***, beyond currency and monetary competences) as well as a principles-based structure for financial order to avoid recurrence of such a crisis ***("Economic Council"***).

The financial crisis offers a chance to improve the ethical base for business as a constructive social actor by ***returning to ethical values and responsibilities*** in financial regulations. Such an exemplary chance to create a cooperative financial crisis management should not be missed by courageous leaders (acting beyond their simple political/electoral cycle) and academics (responsible to society) since the next global regulatory crisis looms just around the corner in the shape of global digital communication (Internet and ICANN, the Internet Corporation for Assigned Names and Numbers). It now needs the political will and dynamic for a new global principles-based financial regulation.

In the words of Paul Krugman (IHT, January 24/25, 2009): "If we don't get drastic action soon, we may find ourselves stuck in the muddle for a very long time."

The next Chatham House Conference on March 24, 2009 titles accordingly: "A global regulatory system – to be or not to be?" The paradigmatic question of our future is therefore: homo ludens or homo sapiens?