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A Plan B for global finance

In a guest article, Dani Rodrik argues for stronger national regulation, not the global sort

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THE clarion call for a global system of financial regulation can be heard everywhere. From Angela Merkel to Gordon Brown, from Jean-Claude Trichet to Ben Bernanke, from sober economists to countless newspaper editorials; everyone, it seems, is asking for it regardless of political complexion.

That is not surprising, perhaps, in light of the convulsions the world economy is going through. If we have learnt anything from the crisis it is that financial regulation and supervision need to be tightened and their scope broadened. It seems only a small step to the idea that we need much stronger global regulation as well: a global college of regulators, say; a binding code of international conduct; or even an international financial regulator.

Yet the logic of global financial regulation is flawed. The world economy will be far more stable and prosperous with a thin veneer of international co-operation superimposed on strong national regulations than with attempts to construct a bold global regulatory and supervisory framework. The risk we run is that pursuing an ambitious goal will detract us from something that is more desirable and more easily attained.

One problem with the global strategy is that it presumes we can get leading countries to surrender significant sovereignty to international agencies. It is hard to imagine that America's Congress would ever sign off on the kind of intrusive international oversight of domestic lending practices that might have prevented the subprime-mortgage meltdown, let alone avert future crises. Nor is it likely that the IMF will be allowed to turn itself into a true global lender of last resort. The far more likely outcome is that the mismatch between the reach of markets and the scope of governance will prevail, leaving global finance as unsafe as ever. That certainly was the outcome the last time we tried an international college of regulators, in the ill-fated case of the Bank of Credit and Commerce International.

A second problem is that even if the leading nations were to agree, they might end up converging on the wrong set of regulations. This is not just a hypothetical possibility. The Basel process, viewed until recently as the apogee of international financial co-operation, has been compromised by the inadequacies of the bank-capital agreements it has produced. Basel 1 ended up encouraging risky short-term borrowing, whereas Basel 2's reliance on credit ratings and banks' own models to generate risk weights for capital requirements is clearly inappropriate in light of recent experience. By neglecting the macro-prudential aspect of regulation—the possibility that individual banks may appear sound while the system as a whole is unsafe—these agreements have, if anything, magnified systemic risks. Given the risk of converging on the wrong solutions yet again, it would be better to let a variety of regulatory models flourish.



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Who says one size fits all?

But the most fundamental objection to global regulation lies elsewhere. Desirable forms of financial regulation differ across countries depending on their preferences and levels of development. Financial regulation entails trade-offs along many dimensions. The more you value financial stability, the more you have to sacrifice financial innovation. The more fine-tuned and complex the regulation, the more you need skilled regulators to implement it. The more widespread the financial-market failures, the larger the potential role of directed credit and state banks.

Different nations will want to sit on different points along their "efficient frontiers". There is nothing wrong with France, say, wanting to purchase more financial stability than America—and having tighter regulations—at the price of giving up some financial innovations. Nor with Brazil giving its state-owned development bank special regulatory treatment, if the country wishes, so that it can fill in for missing long-term credit markets.

In short, global financial regulation is neither feasible, nor prudent, nor desirable. What finance needs instead are some sensible traffic rules that will allow nations (and in some cases regions) to implement their own regulations while preventing adverse spillovers. If you want an analogy, think of a General Agreement on Tariffs and Trade for world finance rather than a World Trade Organisation. The genius of the GATT regime was that it left room for governments to craft their own social and economic policies as long as they did not follow blatantly protectionist policies and did not discriminate among their trade partners.

Fortify the home front first

Similarly, a new financial order can be constructed on the back of a minimal set of international guidelines. The new arrangements would certainly involve an improved IMF with better representation and increased resources. It might also require an international financial charter with limited aims, focused on financial transparency, consultation among national regulators, and limits on jurisdictions (such as offshore centres) that export financial instability. But the responsibility for regulating leverage, setting capital standards, and supervising financial markets would rest squarely at the national level. Domestic regulators and supervisors would no longer hide behind international codes. Just as an exporter of widgets has to abide by product-safety standards in all its markets, global financial firms would have to comply with regulatory requirements that may differ across host countries.

The main challenge facing such a regime would be the incentive for regulatory arbitrage. So the rules would recognise governments' right to intervene in cross-border financial transactions—but only in so far as the intent is to prevent competition from less-strict jurisdictions from undermining domestic regulations.

Of course, like-minded countries that want to go into deeper financial integration and harmonise their regulations would be free to do so, provided (as in the GATT) they do not use this as an excuse for financial protectionism. One can imagine the euro zone eventually taking this route and opting for a common regulator. The Chiang Mai initiative in Asia may ultimately also produce a regional zone of deep integration around an Asian monetary fund. But the rest of the world would have to live with a certain amount of financial segmentation—the necessary counterpart to regulatory fragmentation.

If this leaves you worried, turn again to the Bretton Woods experience. Despite limited liberalisation, that system produced huge increases in cross-border trade and investment. The reason is simple and remains relevant as ever: an architecture that respects national diversity does more to advance the cause of globalisation than ambitious plans that assume it away.

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