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Has Global Finance Finally Been Tamed?

By Barry Desker and Pradumna B Rana

Synopsis

Unlike the 2001 default which shook the world, last week's Argentinian default has had more muted impacts and bondholders are sanguine. Has global finance finally been tamed?

Commentary

LAST WEEK, Argentina defaulted for the second time in 13 years after failing to reach a deal with a group of so-called "holdout" creditors. Unlike the December 2001 default which had reverberated around the world and created panic everywhere, the adverse impacts this time around have been more muted and are being felt mainly at home. Has global finance finally been tamed? No, a lot has been done to reform the global financial architecture, but yet more remains to be done.

Financial crises of the past three decades have underscored the dangers of unfettered finance and led to major reforms. Global financial architecture has emerged firmly as the fourth pillar of the rules-based international economic architecture established at Bretton Woods, complementing the monetary, trade, and development architectures. Mirroring the efforts to promote global financial safety nets for crisis prevention and crisis management, reforms of the global financial architecture have been multi-pronged: multilateral, regional, and national.

Multilateral efforts

A key multilateral level effort in the post-Global Financial Crisis (GFC) period has been the upgrading of two institutions established in response to the Asian financial crisis (AFC). The dominant powers moved quickly to (i) create the G20 Summit by upgrading the G20 finance ministers and central bankers forum which had started since 1999 and (ii) upgrade the Financial Stability Forum (FSF) to the Financial Stability Board (FSB) with the responsibility for financial sector oversight.

The establishment of the G20 was a historic event as important emerging countries were for the first time included in the core of global economic governance. But the G20 continues to suffer from issues related to "input" legitimacy – its exclusive nature and lack of broader representation – and "output" legitimacy – its ability to strengthen international cooperation and come up with effective solutions. Its agenda is also over-crowded and it does not have a permanent secretariat. The G20 which had made

substantial progress in promoting global policy coordination at its first three summits – that is, until the Pittsburgh summit – is now a relatively weak institution. For example, its pledge to transfer six percent of quota and voting power and two chairs at the IMF Board to large emerging markets has been held up by the US Congress despite pleas from the G20 itself, the IMF Managing Director, and academics.

Under the oversight of the FSB, various standard setting bodies, most notably the Basel Committee on Banking Supervision, have developed standards and codes and best practices to strengthen financial regulation and supervision, and risk management practices. Some of these were diluted somewhat in response to opposition from the industry.

Regional and country efforts

Regional efforts are most notable in Europe where EU-wide supervisory agencies have been set up for banks, securities market, and the insurance industry. More recently, the euro-zone countries have agreed to establish a banking union. The European Central Bank is to supervise large Euro-zone banks. A single-resolution mechanism has been established to close down or restructure euro-zone banks if they run into trouble. Binding rules for imposing losses on shareholders and creditors have been agreed. An EU-wide deposit guarantee fund is also to be established by collecting taxes from banks.

In Asia, calls have been made for the establishment of an Asian Financial Stability Board by involving financial regulators, and central bank and finance ministry officials. This Board will promote capital market rules and regulations and maintain financial stability throughout the region through early warning systems. It would also ensure that the Asian context and situation is adequately understood in financial sector policies and regulatory reforms.

Countries all over the world have implemented policies to strengthen their financial regulations. In addition to the steps taken in Europe (discussed above), in July 2011 the US approved the Dodd-Frank Wall Street Reform and Consumer Protection Act. The major components of this Act are the establishment of a bureau in the Fed to tackle abusive mis-selling of mortgages and other products and the introduction of the Volker Rule to prevent deposit-taking banks from proprietary trading.

Emerging markets all over the world have also taken steps to strengthen their financial sector and financial markets and these are regularly monitored by the IMF and the FSB. The health and robustness of the financial sectors in these countries have, therefore, improved significantly.

Remaining agenda

Despite a raft of policies that have been implemented, a lot more remains to be done. There are many remaining gaps such as, to mention a few, ending the “too-big-to-fail problem”, collusion in fixing LIBOR and foreign exchange rates, establishing crisis resolution mechanisms, and reforming credit rating agencies, hedge funds, and shadow banks. Also many of the agreements that have been reached at the multilateral and regional levels have yet to be legislated at the national level and implemented. Similarly announced national efforts have to be expedited. There is also a need to promote complementarity between multilateral, regional, and national efforts so that they can reinforce each other in a seamless manner. There is, therefore, no room for complacency. Who knows when the next crisis might hit!

Barry Desker is the Dean and Pradumna B. Rana is Associate Professor at the S. Rajaratnam School of International Studies (RSIS), Nanyang Technological University (NTU).
