Eggs in the wrong basket? Global rules for trade but diverging rules for finance

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Now that the CHOGM caravan has moved on it is time to focus on a serious multilateral meeting the forthcoming G-20 Summit in Cannes. The meeting will be dominated by the European debt crisis. However, even without the uncertainty in Europe this Summit, just like CHOGM, is unlikely to produce any meaningful results. Whilst the G-20 has been somewhat successful in providing crisis management and a co-ordinated response to the subprime crisis, it has failed to introduce new approaches to crisis prevention. In contrast to the majority of commentators that have lamented the inability of the G-20 to come forward with global rules for global finance, we offer the heretical suggestion that this is an opportunity rather than a failure. Diversity in financial regulation and what the 2009 Warwick Commission called an ‘unlevel playing field’ would enhance, rather than weaken, the international financial system.

With hindsight, the development of global standards in finance has not resulted in a more stable international financial system. For example, the main standard, Basel II, has not prevented the two most recent crises – the sub-prime crisis and the crisis in Europe. Rather, both crises were fuelled by ill-designed rules. Two factors account for this failure. First, financial regulation by definition is based on past experience. Reform is an exercise in shutting the stable door after the horse has bolted. New regulation invariably fails to envisage, or is pre-empted by, new developments in finance. Second, global rules can be, indeed frequently are, traduced by financial sector lobbying. Time and again bankers have succeeded in pressuring policy makers to accede to what Gordon Brown famously called “light touch regulation”. G-20 indications that it intends to toughen up regulation, because of the divergence of interests of the participating economies, continue to lack credibility.

Our contrasting view would give preference to tailor-made national and/or regional level solutions. A diverse regulatory landscape would be the result. While such an approach would not automatically prevent financial crises, the effects of turmoil might be mitigated because, as we know from biology, diversity stabilises complex systems, whereas monocultures transmit and more easily exacerbate shocks. Of course, if the record of both regulators and academic observers in identifying future risks were better than history tells us it is then the case for diversity would be weaker. But as numerous financial crises have demonstrated, the widespread assumption that authorities are able to learn from past mistakes has time and again led to hubris and turbulence. Global rules may eventually result in global crises. There is no evidence that our ability to predict future risk is so well developed that the implementation of more global standards in finance will contain it. Simplifying is not axiomatically stabilising.

At the very least, global rules should not discourage the introduction of additional regulatory measures at the national level. One example of this approach to regulation can be found in Switzerland, where authorities are asking for a “Swiss finish”, a whopping six percent of additional core capital for the two largest banks, UBS and Credit Suisse. Let us not forget we still live in a world of states. Sovereignty remains national not global. The ability and right to legislate remains primarily national not global and state policy makers insist on exercising this right; in theory, if not always in practice, in the interests of society at large and not just those of the financial sector.

But we are not naive. We are under no illusion as to the limitations of this approach. Tougher regulation at the national or regional level will also be exposed to intensive lobbying. Players will relocate to less restricted market places. It was ever thus. But the benefits of a soundly regulated national financial sector outstrip the costs.

Conversely we would argue that in the other domain of global economic relations – as both economic theory and the history of the trade regime tell us – global rules are appropriate and do indeed provide additional benefits to the global economy. It is thus ironic and regrettable that we have observed a declining commitment to the norms and practices of the multilateral trading system and a proliferation of bilateral and regional trading arrangements. The World Trade Organisation is in dire straits, primarily because of the unwillingness of the United States of America and other key players to support the conclusion of the Doha Round. The forthcoming G-20 Summit should try to solve this deadlock and provide a clear mandate for the biennial trade ministers meeting in December 2011 to provide a positive signal to the global economy. Global rules in trade continue to be the first-best solution as all acknowledge. This is less is obvious both historically and contemporaneously in the financial domain where diversity in regulation stakes a stronger claim to optimality.

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