



# Clingendael Policy Brief

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## Upgrading the Global Financial System

### The Why and How

Peter van Ham

This Policy Brief takes stock of the multilateral attempts to tackle the financial crisis, and examines the main proposals, accomplishments and problems in putting forward effective solutions. Despite the gravity and depth of the crisis, the required reform of established institutions and the financial markets is insufficient. Instead, inertia and classical compliance problems hamper enhancing financial regulation, reinforcing international cooperation and reforming International Financial Institutions. This Clingendael Policy Brief highlights the potential to salvage what is left of the political will to modernize the existing global financial system, and concludes with an overview of the most promising policy suggestions to realize this goal.

#### Introduction

The state of the global economy can be summarized by one word only: crisis. Although the US economy has seen a slow and half-hearted recovery, Europe shows stalled growth, rising unemployment, uncertainty about the future of the Euro, as well as discredited EU institutions. Even concerns about the sustainability of growth in Brazil, Russia, India and China (BRICs) raises questions about the dynamic of emerging economies. The global financial crisis proves that states and markets have become highly interdependent, and cannot take shelter from the linkages and spillovers of an integrated world economy. In short: the ongoing crisis confirms that the existing global financial architecture is structurally flawed. Hence the rising demand for effective economic and financial policy governance on a global scale.<sup>1</sup>

The growing role of the G20 illustrates the belief that a collective consultation process amongst advanced and emerging economies is beneficial. Since the

November 2008 Washington summit, reinforcing international cooperation and reforming international financial institutions (IFIs) have topped the G20's agenda. Representing 85% of the world GDP, 10% of the total number of countries, and two-thirds of the world population, the G20 comes close to a global economic and financial steering committee. Although the G20 may have lived up to its task as a financial crisis manager, it still lacks a shared philosophy and a common understanding of how to overcome the crisis and to develop a new, global financial rulebook. Most states and regions are working themselves out of the crisis at different speeds, following different policy strategies. Despite unceasing efforts by the financial and economic 'global community', success in building a more stable and resilient international monetary system is modest.

1. Katrin M. Arnold *et al.*, *Facing The Challenges: Three Scenarios for Global Economic Governance in 2020*, [www.gg2020.net](http://www.gg2020.net) (May 2011).

This Policy Brief takes stock of the multilateral attempts to tackle the financial crisis, and examines the main proposals, accomplishments and problems in putting forward effective solutions. Despite all efforts, the global financial and economic governance system remains largely unchanged. The visions and interests of key players hardly ever overlap, and often clash. Despite the gravity and depth of the crisis, the required reform of established institutions, the financial markets as well as the general public's way of thinking is insufficient. Instead, inertia and classical compliance problems hamper enhancing financial regulation, reinforcing international cooperation and reforming IFIs. This Policy Brief highlights the potential to salvage what is left of the political will to modernize the existing global financial architecture, and concludes with an overview of the most promising policy suggestions to realize this goal, as a first stage of an essential debate.

## Divergent visions and interests

The sense of urgency – one could also call it panic – that peaked after the fall of Lehman Brothers in 2008 has been made to good use by upgrading the role of the G20, some modest institution-building (especially the Financial Stability Board, FSB<sup>2</sup>), and the historically unprecedented increase in the resources available through the International Monetary Fund (the IMF, currently the New Arrangements to Borrow amounts to US\$565 billion). At the September 2009 Pittsburgh meeting, G20 leaders committed themselves to a 'framework for strong, sustainable and balanced growth.' A Mutual Assessment Process (MAP) was set up to evaluate the 'collective implications of national policies for the world economy.' The IMF has been tasked with this exercise of technical surveillance, aimed at offering an early warning of developments that could result in macroeconomic imbalances impairing global growth prospects. The IMF has also produced a flurry of Sustainability Reports for the G20 economies, for the same purpose.<sup>3</sup>

The G20 has also taken the initiative for global regulatory reform to persuade banks to improve their risk management. The result – called Basel III, endorsed in November 2010<sup>4</sup> – is seen as an

opportunity for banks to set up robust financial management systems, and is expected to be phased in by national governments between 2013 and 2019. The Financial Stability Board already created a charter setting new standards covering a wide range of financial issues and sectors. Clearly, there is no lack of new regulatory bodies offering good advice.

The problem is, however, that most – if not all – the regulations and standards are non-binding, based on so-called 'soft law'. In short: they are politically binding, but are often not fully implemented due to domestic contestation. G20 leaders have to strike a careful balance between offering the required guidance, and excessive micro-management. Lacking formal authority, the G20 remains an agenda-setter and compromise-builder, leaving technicalities and implementation to national governments and IFIs. Even the MAP has proved to be more controversial than expected, since there is no agreement on economic and financial priorities and the ways to approach them. The (growing) asymmetry across countries (where situations differ in terms of growth, inflation as well as public finance) increases the scope for disagreement, and curbs the readiness to accept IMF advice.

2. The Financial Stability Board acts as a coordinator in the area of financial regulation and supervision. G20 leaders created the FSB in April 2009. The FSB encourages compliance with international financial standards, using a peer review process. It lacks a formal legal standing and its charter imposes no 'hard law' obligations on its member states. The FSB has a very small staff (seconded temporarily from other IFIs).
3. Edwin M. Truman, G-20 Reforms of the International Monetary System: An Evaluation, *Peterson Institute for International Economic Policy Brief* (November 2011).
4. Basel III is a framework endorsed by the G20 aimed at establishing tougher capital standards through more restrictive capital definitions, higher risk-weighted assets, additional capital buffers and higher requirements for minimum capital ratios and liquidity. It is managed by the Basel Committee on Banking Supervision, a private club for the world's leading central bankers.

The compliance problem reflects the main obstacle to financial architecture reform: competing visions of what is desirable and effective based on divergent economic and political interests. Not only are Western economies pitched against the BRICS, even *within* the Western 'bloc' a more Anglo-American (UK and US) liberal tradition is confronted with a continental European call for (amongst other things) tougher regulatory standards. Unease about the prospect of a failing Euro explains continental Europe's emphasis on fiscal consolidation, whereas the US has followed the more Keynesian path of economic stimulus programmes.

But the deadlock exceeds this traditional US-European dispute. The lack of compliance also illustrates the diffusion of global financial power. The ability of Western states to upload their own norms and standards towards the global level has markedly declined. The era where a 'benign hegemon' could set global standards has obviously come to an end. The G20's ascent can be considered an historical phenomenon since it is the first time that non-Western powers were incorporated into the pinnacle of global economic and financial governance. Although China is not considered a spoiler, it will certainly change the IFI's neo-liberal approach to economic governance. Beijing will use its influence to make the G20 more 'neutral', which will make it even harder to impose market-based policies on other countries through the IMF's system of conditionality.<sup>5</sup>

Although the G20 encompasses both dominant Western financial powers and the BRICs, the competitive deregulation dynamic (which is triggered by powerful private financial interests) effectively cancels out the international community's regulatory efforts. The G20, the Financial Stability Board and IMF all lack enough authority to enforce compliance and implementation. The FSB even still lacks formal legal standing which makes imposing 'hard law' obligations on member states impossible. The remaining peer pressure (based on the public reporting of the G20's Coordination Framework) remains insufficient to overcome domestic demands. Lacking WTO-style sanctions against non-complying states, global financial governance remains a paper tiger.<sup>6</sup>

Doubts about the implementation of Basel III illustrate this predicament. The EU, Australia and several Asian countries (Japan, Hong Kong, Singapore) are likely to adopt the new regulations, although the EU has draft legislation (Capital Requirements Directive IV) that diverges from Basel III in areas such as the definition of capital. The US (which ignored the older Basel II provisions) will only comply in so far as the new regulations facilitate their own domestic Dodd-Frank Act<sup>7</sup>. The rest of the world – from Russia, to Africa and the Middle East and Asia Pacific – may cherry-pick Basel III, and opt in and out as they see fit. Russia, for example, has already indicated that it will apply its own internal ratings-based approach, followed by several key Middle Eastern countries.<sup>8</sup> Add to this the ongoing saga about the US-China currency controversy (should China adopt an open and flexible renminbi?), and the reform deadlock becomes understandable.

### Inertia beats reform

The call for IFI reform has gained credibility and weight since neither the IMF nor any other institutions have issued warnings about the crisis we are still facing. As a result, the perception that the IMF-based governance system is broken has become widespread. Criticism centres on two issues: the legitimacy of IFIs, and the inadequacy of their policies and instruments. Especially emerging economies have not wasted this crisis, and reinforced their case for reform.

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5. Frans-Paul van der Putten, 'Harmony with Diversity: China's Preferred World Order and Weakening Western Influence in the Developing World', *Global Policy* vol. 3 (2012).
  6. Brooke Masters, 'Conflicting Signals', *The Financial Times* (April 2, 2012), p. 7.
  7. The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed by President Obama in July 2010. The 2000-page plus reform act aims to create rules on executive compensation and corporate governance. It is highly criticized since its rules not only affect US banks, but overseas arms of US banks as well.
  8. Implementing Basel III: Challenges, Options & Opportunities, *Moody's Analytics White Paper* (September 2011).

Since 2000, the G8 has gradually opened its doors to the leaders of emerging economies, which not only included the BRICs, but Mexico and South Africa as well. Especially the outmoded IMF Charter reflecting the post-World War Two order has met with disapproval, above all by the BRICs. Although the G20 already existed (since 1999), its prominent role in dealing with the global financial crisis is indicative of both the inevitability and the political will to reform IFIs. Since November 2008, the G20 has become a heads-of-state summit, rather than a forum for finance ministers. In 2009, G20 leaders assured developing countries a greater voice in the IMF, shifting some 5% of the quotas (as of January 2011) from advanced to emerging economies. Further changes in the IMF quota formula are in the making, and should be agreed upon by January 2014. Other reforms include the initiative of the Netherlands and Belgium to share a rotating presidency (every four years) of an IMF constituency comprising 15 countries (as of November 2012). In March 2012, BRIC leaders argued that the continued lending capacity of the IMF will be contingent upon swift and fundamental change, shifting significant voting weight towards emerging market economies.

Surely a greater role for emerging economies in IFIs is called for, and reform is outrageously overdue. Since every IMF member's voting power is based on its economic importance, the economic weight of emerging economies has to be reflected in political influence. But the IMF's role in managing the global financial system should not be overstated. Its toolbox is limited to lending, surveillance and (technical) assistance. In the end, its regulatory role is limited and largely depends on the willingness of member states to abide by the rules.

Perhaps the more important call for reform concerns the IMF's toolbox, and particularly the introduction of an ambitious Global Stability Mechanism (GSM), which should contribute to a global financial safety net. The 2011 Cannes G20 summit set its aim high, offering a vista of a fully reformed International Monetary System (IMS), built upon the crumbling ruins of the Bretton Woods system. At the request of France, the UK presented a Governance Review which, amongst others, stressed the need to keep the

G20 as an informal body. Although a decision was taken to formalize the Troika of past, present and future presidencies, no steps were taken towards further institutionalization. Without reform, the G20 remains a motley crew of advanced and developing economies, joining debtor and creditor countries cherishing wildly diverging approaches to key economic and financial questions.

The way forward is contingent upon bridging the gap in the visions and interests of key players, most notably the US, the UK, Germany and China. Interesting ideas about introducing an IMF-style constituency system (see below) will remain of marginal use as long as the G20 lacks a shared vision about the nature of the world's economic and financial problems, and the most effective approach to deal with them. This includes the debate about the opportunities for broadening the G20's agenda to include matters like climate change, poverty, and energy and resource security (see below). For now, hope is vested in the fact that these are pressing issues facing all G20 members, and that the team spirit of working together as a group over the past five years has accrued sufficient political will to make at least modest progress possible.

### The predicament of complexity

How should we understand the modest pace of reform of the global financial architecture? Should we qualify the current set-up as a 'non-system', as the Palais-Royal Initiative of February 2011 (taken by a group of influential policymakers and academics)<sup>9</sup> suggests? The lack of traditional Western leadership is certainly a major factor in any explanation. But hovering over the reform debate is the fundamental question whether any kind of leadership, coordination, management or even makeshift governance is possible at all.

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9. *Reform of the International Monetary System: A Cooperative Approach for the Twenty-First Century*, Palais-Royal Initiative (February 8, 2011), p. 1.

At the moment, the G20 is the most ambitious platform for macroeconomic policy coordination, although its role and mission in the world economy continues to be uncertain, as well as – still – informal. Since 2008, a kind of triangular governance structure has emerged, with the G20 on top, calling upon the IMF, FSB and the Basel Committee (amongst others) to implement their proposals and guidelines. Within this set-up, multilateral surveillance through the MAP has been enhanced, and clear indicators and guidelines for the identification of required policy actors have been agreed (by G20 finance ministers in April 2011). Seven economies have been categorized by the IMF as ‘systemic’ (the so-called Systemically Important Countries, or SICs: China, India, France, Germany, Japan, the UK and the US), implying that they have automatic access to the IMF’s Flexible Credit Line (FCL). IMF reports are now highly detailed, outlining widely divergent policy commitments depending on the countries’ economic and fiscal circumstances.

But on top of the usual compliance and implementation problems, the growing complexity of the global economic and financial system raises questions about the relevance of the MAP’s indicators and guidelines. Although the focus of most IFIs continues to be on avoiding global imbalances, the Euro crisis indicates that other concerns – from massive public debt to sovereign solvency risks and rising inflation – may warrant similar attention. Moreover, it is well known that the MAP’s focus on traditional channels of transmission shocks (flows of goods, services and capital, as well as prices) fails to factor in the interdependence through cross-border holdings of finance. Since most of the shocks are asymmetric, the selection of systemic countries (whose problems would have the most impact on the rest of the world economy) is appropriate, but certainly not sufficient.

In a recent speech, IMF Managing Director Christine Lagarde argued that ‘[g]iven the size, complexity and interconnections of the system, we need consistency, coordination and cooperation that should span institutions, markets and borders. If we do not have consistency, we have a gap. If information is not shared across jurisdictions, we have a gap. The system

in its entirety can only be as strong as its weakest link.’<sup>10</sup> This is both a true and rather depressing statement, since consistency requires focus and a shared vision. For the moment, coordination and cooperation remains inadequate, especially since a certain ‘compliance fatigue’ has set in (especially in emerging economies). Many of the initiatives by the G20 and IMF have come to nothing, and both bodies are ‘burdened by a very large backlog of commitments’.<sup>11</sup> Despite laudable reform efforts, the IMS has plenty of weak links, and there are no quick fixes to strengthen them.

The discussion on the future of financial governance has become even more diffuse by the trend to broaden the G20 agenda. At the June 2012 Los Cabos G20 summit, political leaders not only discussed financial issues, but trade, climate change as well as food security.<sup>12</sup> Some warn against the ‘hijacking’ of the G20’s agenda, whereas others suggest that this is a unique opportunity to turn the G20 into a ‘form of world supervisory board, or a ‘minilateral’ leadership forum for an interdependent world.’<sup>13</sup> But broadening the agenda and reaching out to a wider range of countries (even on an ad hoc basis) has its drawbacks. Taking more issues and countries on board may increase legitimacy, but undermine effectiveness.

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10. ‘Completing the Task: Financial Sector Reform for Stability and Growth’, Address by Christine Lagarde, IMF Managing Director (New York, June 8, 2012).
  11. Paola Subacchi and Stephen Pickford, *Legitimacy vs Effectiveness for the G20: A Dynamic Approach to Global Economic Governance*, London, *Chatham House Briefing Paper* (October 2011), p. 8.
  12. *Perspectives on the G20: The Los Cabos Summit and Beyond*, The Centre for International Governance Innovation (2012).
  13. Robin Niblett, ‘Beyond Los Cabos’, *First Magazine* (June 2012).

For the moment, the efforts of the international community to upgrade the global financial system seem to fit within the so-called Garbage Can model, which compares organizational decision-making with ‘organized anarchies.’<sup>14</sup> Problems and solutions rummage around (just as in a garbage can), depending on the mix of recognized problems, the choices available, and outside influences on the decision makers. The Garbage Can model allows problems to be addressed and choices to be made, but does not necessarily follow a rational process; on the contrary. As a result, legitimacy and compliance are problematic and haphazard.

This does not mean that efforts to reform the IMS are futile. Since even the longest of journeys begins with a first step, global financial governance reform has to start with small and concrete steps and realistic expectations of what can be achieved. Some of these steps have already been taken, although certainly not by all relevant actors (and perhaps not even always in the right direction). Which ideas and initiatives are most promising to overcome inertia, and rekindle the aspiration of upgrading the financial global system?

### Recommendations: the way forward

Two different approaches can be taken. *First*, develop a shared long-term vision on economic and financial governance aimed at the authoritative management of the world’s macroeconomic and financial problems. Such an approach would require a novel financial architecture, a new rulebook and a shift from peer pressure and ‘soft law’, to a WTO-like system of arbitration and ‘hard law.’ This would encompass the institutionalization of informal bodies such as the G20, and shifting it from an agenda-setting into a rule-setting mode. The *second* approach may aim at the same objective, but takes the incremental path of concrete, piecemeal steps towards policy coordination. It does not aspire to any radical, top-down reform, and acknowledges that today’s global complexity eludes ambitious policy cooperation.<sup>15</sup> Given its modesty and pragmatism, the second approach seems to be the most promising.

The following policy suggestions are (or should be) under consideration, and merit both further academic research and discussion by policymakers:

- Keep the G20 informal, and do not move towards an IMF-like constituency system. Although this may well be a laudable long-term goal, squandering diplomatic and political energy on weighing votes and decision-making procedures would be unwise. The current system of offering so-called ‘wildcards’ to five countries to join a G20 summit adds flexibility. This system should be developed and made more transparent;
- If institutionalization is considered inevitable, it should not go beyond a small secretariat assisting the Troika, preferably based within an existing IFI (the IMF comes to mind). The idea of developing a ‘cyber-secretariat’, where member states can discuss issues online, should be examined;
- The G20 should shy away from encroaching upon the policy territories of other International Organizations, and leave fighting poverty to the World Bank, dealing with climate change to the UN, and energy security to the IEA and national governments. The G8 continues to be the appropriate forum to discuss security and foreign policy issues. The approach of Russia (which will take over the G20 Presidency in 2013) to ‘go back to basics’ is a step in the right direction;
- Identifying systemic countries with certain privileges is the way to go. Since financial integration is still most pronounced within the traditional G7 economies, the BRICs should only be given a larger voice on trade matters. Instead, given their financial relevance, countries such as Switzerland and the Netherlands should be more often included in matters of financial governance.

14. Michael D. Cohen, James G. March, and Johan P. Olsen (1972). ‘A Garbage Can Model of Organizational Choice’, in *Administrative Science Quarterly*, vol. 17, no. 1, (1972).

15. Ignazio Angeloni and Jean Pisani-Ferry, *The G20: Character in Search of an Author*, *Bruegel Working Paper* (March 2012), pp. 40-8.

- Membership of G20 working groups on financial matters should be open to other important financial actors. This would greatly enhance the legitimacy of G20 decisions on the IMF, while not hampering efficiency;
- The challenge of legitimacy should not be exaggerated. The G20 should build on the street-credibility which it has gained by tackling the global financial crisis head-on. It should acknowledge that most – if not all – of its authority derives from output-legitimacy. Setting the right priorities on a global agenda, and building compromises between opposing camps, is what should matter most. The main prize: maintaining good economic and financial relations between the US, Europe and China, should always be kept in mind;
- Overly ambitious plans to coordinate policies and harmonize regulations are likely to result in even more fragmentation and protectionism. If experience in efforts to regulate banks and markets is any guide, global solutions prove powerless vis-à-vis the messy practicalities of national regulatory authorities which protect their national interests. In the meantime, we should aim for a commitment to uniform global *principles*, rather than a set of harmonized global *rules* that will be impossible to implement; and
- Strengthen the ‘political culture’ of the G20, enhancing the understanding that this is the body where global leadership should come from. Setting priorities and a concrete and relevant agenda, first and foremost in the economic and financial sphere of governance, remains the key challenge. Legitimized by their own domestic authority, G20 leaders can use their influence in IFIs and other forums to advance broader international policy coordination.

### About Clingendael

Clingendael is the Netherlands Institute of International Relations. We operate as a think-tank, as well as a diplomatic academy, and always maintain a strong international perspective. Our objective is to explore the continuously changing global environment in order to identify and analyse emerging political and social developments for the benefit of government and the general public.

### The Author

Dr. Peter van Ham is a senior research fellow at the Clingendael Institute (The Hague), and a visiting professor at the College of Europe in Bruges (Belgium).

Published by the Netherlands Institute of International Relations ‘Clingendael’, P.O. Box 93080, 2509 AB The Hague, The Netherlands, Phone: +31(0)70 3245384, fax: +31(0)70 3282002, website: [www.clingendael.nl](http://www.clingendael.nl), e-mail: [info@clingendael.nl](mailto:info@clingendael.nl)

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