Improving International Policy Coordination in the Wake of the Financial Crisis

The ongoing financial crisis has exposed the weaknesses of the risk management practices pervasive in the financial industry and the limitations of a domestic regulatory structure that fails to provide any federal regulator with the responsibility and authority to comprehensively oversee the financial system. Of course these problems have not been limited to the United States, as banks based abroad, like UBS, and economies around the world have also been shaken by the crisis. The crisis has also exposed the shortcomings of the international regime for economic and financial policy coordination.

In its first months in office, the Obama Administration has begun to sort through the long-term policy responses needed to resolve the current crisis and prepare for the next one. An area that deserves special attention is the mechanism available for making and coordinating economic policy internationally. The challenge for the Administration is both internal – where a multitude of cabinet departments and “independent” regulatory agencies play roles – and international where there exists a hodgepodge of groups that bring together sundry parties in multiple overlapping and competing efforts to forge an international policy consensus. The June 2009 report from the Treasury Department, “A New Foundation: Rebuilding Financial Supervision and Regulation”, contains several promising initiatives. However, in key respects it stops short of the recommendations merited both by experience and prudence.

Within the U.S., the financial sector is overseen by dozens of regulators with overlapping and sometimes conflicting mandates. The U.S. has five

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national-level bank regulatory agencies (the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration, and the Federal Deposit Insurance Corporation), two financial markets regulators (the Securities and Exchange Commission and the Commodities Futures Trading Commission), a government-debt market regulator (the Department of the Treasury), 50 state banking regulators, 50 state insurance regulators, and a dozen or more quasi-governmental self-regulatory organizations. Under this system, a complex financial institution can be subject to five or six separate regulators each of which has its own statutory mission and regulatory construct. The Obama Administration's recommendations in this area were timid at best – substituting promises of more coordination between agencies for the substantive integration of the regulatory regime, with the exception of the proposed merger of the Office of Thrift Supervision and the Office of the Comptroller of the Currency.

While the particulars of any organizational reform proposal are debatable, there is still a strong case for improving regulation by rationalizing the regulatory structure. For one thing, the current regulatory muddle complicates the ability of the U.S. to speak with one voice in international financial meetings. While the Treasury Department is nominally in the lead for the U.S. Government, it lacks the statutory mandate necessary to speak authoritatively for the federal and state agencies that hold the preponderance of the actual regulatory authority over financial markets and institutions. In light of this mismatch between responsibility and authority, the U.S. Government routinely sends multiple representatives from different agencies to meetings and depends on the individual representatives to coordinate adequately to ensure that the U.S. has the appearance of coherence in these settings. For example, three agencies (the Treasury, the Federal Reserve, and the Securities and Exchange Commission) represent the U.S. at the Financial Stability Board and three of the seven total agencies that participate in another prominent international regulatory cooperation forum, the Senior Supervisors Group, are American. As anyone vaguely familiar with the operating cultures of these agencies can attest, instead of American interests dominating these fora through sheer numbers, the cacophony of U.S. voices undermines the U.S. position (however one might define it) and frequently prevents the groups from making substantive progress as the world’s largest economy struggles to sort itself out.

While the Obama Administration and Congress consider what shape domestic regulatory reform should take, the Obama Administration
should also publicly and privately empower the new Treasury Secretary to speak with authority for the U.S. Government internationally on these issues. Practically, this will require making clear to the appointees of the regulatory agencies that on matters of international affairs the President expects that they will (within the bounds of the applicable statutes) follow his lead. Reports that the Treasury dropped from its reform plan more ambitious organizational reforms, in part, because of opposition from the potentially affected agencies is a troubling sign of the Obama Administration’s unwillingness to insist on executive branch unity. The incoming Administration also should affirm the primacy of the Treasury Department in international financial issues. While the State Department’s economics bureau is a vital part of the U.S. Government team, the foreign and civil service officers assigned to the State Department lack the expertise of the Treasury officials in financial affairs and are stretched too thin covering the bureau’s broad responsibilities, which range from agriculture to aviation to energy, to serve as the lead agency.

Internationally, there has been a proliferation of international groups bent on improving coordination among the world’s economies. The primus inter pares of the global coordination groups is the G-7 composed of the leading industrial economies as of 1976—Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. While this grouping purports to offer a manageable meeting size for detailed discussion, the choreography for these meetings has developed such that by the concluding session of the day-long minister-level meetings more than 40 senior officials are in the room, limiting the possibilities for a frank, informal, or meaningful discussion. The G-7 also suffers from a lack of a permanent secretariat and any formal mandate from the heads of government to make decisions that will in fact be implemented. Finally, the limited membership poses broad questions of legitimacy and questions of effectiveness for any economic forum that excludes rising economic powers, like China.

The G-20—composed of well more than 20 international actors—brings together major industrialized and developing countries in an attempt to address the legitimacy and effectiveness deficits faced by the G-7, but instead compounds the problems of too many people in the room and too weak of a mandate from the political authorities that the G-7 faces. The October 2008 G-20 Summit, the first heads-of-government level meeting for the group, was a step toward addressing the political legitimacy problem. Unfortunately, it also amply demonstrated the limitations of having more than 20 sovereigns represented as it produced little more than a commit-
ment to meet again. When the G-20 did meet again in April 2009, the communiqué was more substantive, producing a list of goals for national regulators and other international groups. While there has been some progress on key action items – for example the initiation of regulatory colleges for the 30 largest financial services firms – by all appearances the majority of the regulatory system (domestic and international) continues to plod along at the pre-crisis pace. It will require vigilance on the part of the U.S. to turn the vague promises of the G-20 into actions.

The International Monetary Fund has sought a role in this area, but its weighted voting structure and troubled history with many of the fastest growing economies has created a legitimacy problem that is in many ways as severe as that faced by the G-7. As an international organization with its own leadership and permanent staff, the IMF also frequently lacks insight on what can be realistically accomplished given the domestic political constraints faced by each country.

Each of these bodies also potentially brings together the wrong people, in that the representatives are generally the finance ministries and central banks, while in many countries (including the U.S. as noted above) the regulatory authority is much more widely dispersed. There are international bodies that bring together these other regulators, including the International Organization of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision, but their work is focused on technical issues rather than broader issues of fundamental policy. Given this fragmentation it is no wonder that the international response to the current financial crisis has been disjointed with officials from multiple countries expressing surprise at the actions of their counterparts.

Encouragingly, Treasury Secretary Geithner has recognized the international coordination problem. One promising organization that offers a strong base on which to build is the Financial Stability Board (FSB), which the G-20 renamed and expanded at the London Summit. The FSB, which was created by the G-7 as the Financial Stability Forum in 1999, brings together finance ministries, central banks, and regulators from the G-7 countries, Switzerland, the Netherlands, Australia, Hong Kong, and Singapore, and representatives of the key standard setting bodies like IOSCO and the Basel Committee. To make the FSB more effective, the G-20 has appropriately broadened the FSB’s mandate to provide oversight for cooperative, cross-border supervision of financial markets and institutions and expanded the membership to include the new key financial players, like China and a representative of the Persian Gulf States. Unfortunately, rather
than just extending membership to states that play a central role in the international financial system, the FSB opened its door to every member of the G-20, regardless of the international importance or integration of the country’s financial markets and institutions. Extending membership to the entire G-20 undermines a key element of the FSB’s promise – its basis as a coalition of like-minded countries with significant international financial sectors. Unquestionably, expanding the FSB to some group less than the full G-20 would have been difficult in the context of the G-20 summit, but that simply points back to the inherent shortcoming of using the G-20 as the primary forum for international economic policy coordination. Instead of universal G-20 membership, the U.S. should have taken the lead in advocating objective membership criteria that included commitments by all applicants to core principles prior to admission. The over-expansion is likely to seriously impede the ability of the FSB to address the difficult issues of cross-border financial regulation.

The history of international economic coordination is one of ever evolving international institutions, mandates, and memberships. Thus, the over-expansion of the FSB may not be an irretrievable mistake. Trying again, either within the framework of the FSB or through an ad hoc parallel institution is worth the effort because achieving better cross-border policy coordination can assist in the recovery from the current crisis and can help prepare for the inevitability of another financial crisis, be it ten months or ten years down the road.

NOTES


2 The G-20 is composed of Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States. The European Union is also a member, represented by the rotating Council presidency and the European Central Bank. The Managing Director of the International Monetary Fund, the President of the World Bank, and the chairs of the International Monetary and Financial Committee and Development Committee of the IMF and World Bank, also participate in G-20 meetings on an ex-officio basis.