We Need a New Road Map

Don’t assume that the sum of national crisis-management activities will create a desirable framework for the longer term.

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NEWSWEEK
From the magazine issue dated Oct 20, 2008

Despite officials' best efforts to fight raging financial fires, it is a good bet that the capital markets will remain in crisis mode for many months to come. Unfortunately, there is a gaping hole in policymaking—that is, the need to look ahead a few years and to sketch out what the global financial and economic landscape should look like.

Of course, any attempt to mandate a definitive architecture for finance would be impossible in such a fast-moving situation. But a worse alternative is to assume that national governments in the heat of battle, frantically plugging one hole after another, can think beyond the next day, or that the sum of national crisis-management activities, all frantically established in ad hoc fashion, would constitute a desirable global framework for the longer term. Without some planning, we are likely to see a series of jerry-built systems that will produce a global marketplace rife with trouble spots and opportunities for regulatory arbitrage.

That's why a group of high-level experts who are not in the fray ought to be convened to vent ideas and come up with a few visions of where global finance should be headed. There is no perfect convener for such a group, but perhaps the Bank for International Settlements in Basel, the so-called central bank for central banks, could undertake the task. The members ought to be a mix of former officials with extensive financial experience and a number of highly reputable thinkers who might be able to bring fresher ideas to the table. Paul Volcker could serve as chair. From the United States, for example, people such as Warren Buffett, Robert Rubin and my Yale colleague Robert Shiller could be tapped. People of similar caliber from outside the United States could be induced to serve, too. The BIS would supply the research staff.

The group would make its recommendations to the G7 and governments from China, India, Brazil, Saudi Arabia and others within three months. The goal would not be to present a final blueprint, but to provide some guideposts and raise some critical questions that governments should not ignore. Here are a few examples:

What should new financial regulation look like?
We will undoubtedly emerge with a great appetite for tighter regulation of financial institutions. But the right balance between regulation and laissez faire is critical, and it is not now clear what the underlying regulatory principles should be. The path to all this is difficult enough, but even more problematic is getting all countries to sing from the same sheet—soon.

How should financial institutions set aside reserves?
Many experts have discussed the need for countercyclical-reserving on the part of banks. In good times they will have to set aside more reserves than they used to, so that in bad times they have the cushion they need. Just how this new process will work, what would be its metrics and who will enforce the new rules are essential questions.

What should be done about trading in complex derivatives?
The explosive growth of complex and nontransparent securities created a time bomb that has now blown up. Outlawing these kinds of securities, even if that were possible, would be far less preferable than making them easier to understand, standardizing their form and mandating their registration on a regulated exchange. The path from getting here to there will require a thoughtful but highly technically feasible road map that does not yet exist.

How should demand deposits in commercial banks, or various money-market funds, be insured?
In the heat of the crisis, different countries are taking different approaches. Washington has stepped in and guaranteed money-market mutual finds without limit, and banking deposits up to $250,000. Aside from the potential
for sucking money out of banks, the U.S. approach is different from the one that Ireland, Greece and Germany have just instituted, where all bank deposits are insured. Eventually common standards would be better.

There are many other global issues that need thinking through. What exactly is the role of a central bank? Does being both an investor and regulator constitute too much responsibility and lead to conflicts of interest? How should credit agencies be reformed? How should "mark to market" accounting be handled? When is short selling appropriate? What are the right incentives for executive compensation? What procedures should be followed for reorganizing global institutions that fail?

Improving communication among key governments is a start, but on its own is woefully inadequate. There is a pressing need for more common rules and institutions within the global financial industry. Without a vision of what that environment might look like, officials could be setting up the world for another disaster down the road.

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URL: http://www.newsweek.com/id/163585
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