PROJECT SYNDICATE
AN ASSOCIATION OF NEWSPAPERS AROUND THE WORLD

Brave New Financial World

by Kenneth Rogoff

CAMBRIDGE – A huge struggle is brewing within the G-20 over the future of the global financial system. The outcome could impact the world – and not only the esoteric world of international finance – for decades to come.

Finance shapes power, ideas, and influence. Cynics may say that nothing will happen to the fundamentals of the global financial system, but they are wrong. In all likelihood, we will see huge changes in the next few years, quite possibly in the form of an international financial regulator or treaty. Indeed, it is virtually impossible to resolve the current mess without some kind of compass pointing to where the future system lies.

The United States and Britain naturally want a system conducive to extending their hegemony. US Treasury Secretary Timothy Geithner has recently advanced the broad outlines of a more conservative financial regulatory regime. Even critics of past US profligacy must admit that the Geithner proposal contains some good ideas.

Above all, regulators would force financiers to hold more cash on hand to cover their own bets, and not rely so much on taxpayers as a backstop. Geithner also aims to make financial deals simpler and easier to evaluate, so that boards, regulators, and investors can better assess the risks they face.

While the rest of the world is sympathetic to Geithner's ideas, other countries would like to see more fundamental reform. Russia and China are questioning the dollar as the pillar of the international system. In a thoughtful speech, the head of China's Central Bank, Zhou Xiaochuan, argued the merits of a global super-currency, perhaps issued by the International Monetary Fund.

These are the calmer critics. The current president of the European Union's Council of Ministers, Czech Prime Minister Mirek Topolanek, openly voiced the angry mood of many European leaders when he described America's profligate approach to fiscal policy as "the road to hell." He could just as well have said the same thing about European views on US financial leadership.

The stakes in the debate over international financial reform are huge. The dollar's role at the center of the global financial system gives the US the ability to raise vast sums of capital without unduly perturbing its economy. Indeed, former US President George W. Bush cut taxes at the same time that he invaded Iraq. However dubious Bush's actions may have been on both counts, interest rates on US public debt actually fell.

More fundamentally, the US role at the center of the global financial system gives tremendous power to US courts, regulators, and politicians over global investment throughout the world. That is why ongoing dysfunction in the US financial system has helped to fuel such a deep global recession.

On the other hand, what is the alternative to Geithner's vision? Is there another paradigm for the global financial system?

China's approach represents a huge disguised tax on savers, who are paid only a pittance in interest on their deposits. This allows state-controlled banks to lend at subsidized interest rates to favored firms and sectors.

In India, financial repression is used as a means to marshal captive savings to help finance massive government debts at far lower interest rates than would prevail in a liberalized market.

A big part of Russia's current problems stems from its ill-functioning banking system. Many borrowers, unable to get funding on reasonable terms domestically, were forced to take hard-currency loans from abroad, creating disastrous burdens when the ruble collapsed.

Europe wants to preserve its universal banking model, with banks that serve a broad range of functions, ranging from taking deposits to making small commercial loans to high-level investment-banking activities. The US proposals, on the other hand, would make universal banking far harder, in part because they aim to ring-fence depository institutions that pose a "systemic risk" to the financial system. Such changes put pressure on universal banks to abandon riskier investment-bank activities in order to operate more freely.

Of course, US behemoths such as Citigroup, Bank of America, and JP Morgan will also be affected. But the universal banking model is far less central to the US financial system than it is in Europe and parts of Asia and Latin America.

Aside from its implications for different national systems, the future shape of banking is critical to the broader financial system, including venture capital, private equity, and hedge funds. The Geithner proposal aims to rein in all of them to some degree. Fear of crises is understandable, yet without these new, creative approaches to financing, Silicon Valley might never have been born. Where does the balance between risk and creativity lie?

Although much of the G-20 debate has concerned issues such as global fiscal stimulus, the real high-stakes poker involves choosing a new philosophy for the international financial system and its regulation. If our leaders cannot find a new approach, there is every chance that financial globalization will shift quickly into reverse, making it all the more difficult to escape the current morass.

Kenneth Rogoff is Professor of Economics and Public Policy at Harvard University, and was formerly chief economist at the IMF.