COMMENT
OPINION

Regulation should be international

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In their expansive communiqué on the global financial crisis last weekend, the Group of 20 leaders bemoaned the pro-cylicality of financial regulation caused by lax regulators, inattentive rating agencies and greedy financial institutions. Curiously absent, however, is a candid acknowledgement of politicians' central contribution to the mix. That is most unfortunate. Finding ways to insulate financial regulation from political meddling is critical to creating a more robust global financial system in the future.

Indeed, the need for greater regulatory independence is a compelling reason for establishing an international financial regulator, another topic the G20 conspicuously avoided. We recognise that international financial institutions are far from perfect. Nevertheless, a well-endowed, professionally staffed international financial regulator – operating without layers of political hacks – would offer a badly needed counterweight to the powerful domestic financial service sector lobbies. The independence argument is in addition to the well-recognised need for better mechanisms for co-ordinating regulation to reduce regulatory arbitrage in a world of global capital markets.

We do not mean to imply that the political system alone is responsible for the lax discipline that has led to our current predicament. Overly optimistic assessments by rating agencies and negligence by investors, as well as malfeasance in the financial sector, certainly did play a role.

But politicians had a big hand in fanning the excessive leverage that lies at the root of the current crisis. Start with a tax system, particularly in the US, that favours debt finance. Add the favourable treatment given to partnerships, including hedge funds and private equity, that are largely taxed at very low capital gains rates instead of much higher income tax rates. Important regulatory appointments are, of course, largely political, and governments determine the extent and power of the regulatory agencies. During the boom, many regulators throughout much of the world were put under pressure by leading politicians to lighten up. The lack of transparency, which the G20 leaders complain of so vehemently, also served as a convenient shield to keep politicians' interference out of public view.

With asset prices soaring and rating agencies giving their usual overly optimistic boom-time assessments, regulators had few available weapons. This was no accident. Look at the list of leading contributors to the presidential and congressional candidates in the US election (including the primaries). Financial companies dominate. Thus it is no surprise that, during the boom, all the supposed market watchdogs were neutered. This is an international problem, not just a US one.

Establishing more independent national regulators, alongside the independent central banks, would help but would not solve the problem. The fact that financial regulatory policy deals with specific companies and markets makes it difficult for a domestic regulator to stand up to focused political lobbying and interference.

Also, national regulators lack the power to resist the "national champions" arguments that are so often used to justify favouritism to the financial sector. Banks and other financial firms love to play the "offshore" card. They tell their politicians and regulators that higher taxes or capital requirements will put them at a disadvantage relative to foreign rivals. An international regulator is better positioned to resist these often specious arguments.

In principle, international co-ordination and monitoring could be achieved through a recurrent series of agreements, in analogy to the World Trade Organisation. The Basel agreements on bank regulation have succeeded to some extent in achieving this, but they take too long to negotiate. The Basel II agreement is already dead on arrival. Arrangements for modifications and decision-making are too inflexible to deal with the pace of change in modern financial systems.

The principal activities of an international regulator should be to monitor agreements and promote free capital flows in a market-based system, not to re-regulate the global economy as it was 40 years ago. It is folly to imagine that the genie of free capital flows can, or should, be put back in the bottle. That said, both domestic and international regulators should look for ways to make policy less cyclical. In addition to imposing stricter capital requirements than envisioned by Basel II, they should dig up other rusty tools to combat leverage, such as margin requirements and reserve requirements.

The root problem of excessive leverage, and the political dynamics that produce it, are hardly new. In our study of more than 200 years of banking crises we find rapid leverage build-up and sharp asset price inflation are often harbingers of financial crisis that politicians discount or ignore. The G20 leaders were right to argue that containing leverage has to be a focus of any revamp of the global financial system. But they failed to recognise that any practical solution to the problem of domestic political interference will require stronger international agreements and regulation. These agreements are not only to help deal with large multinational banks and protect against cross-border regulatory arbitrage. An international regulator with teeth is needed to protect against national political interests that, left unchecked, will again push the global system to excessive leverage and risk.

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