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Summary: Today's news is full of beggar-thy-neighbor currency wars. Outcomes to date are mixed on the initial G20 goals and commitments and their application across members of the G20. The general divisions are reflected in the financial regulatory reform process, and they are substantial enough to risk breakdowns at the forthcoming G20 Seoul meetings. Member countries are currently working hard to square the circle of their domestic objectives and goals of international regulatory convergence. After explaining the reasons for discord, this article puts forth some constructive suggestions for objectively monitored compliance, including a broader use of proposed protocols for regulatory principles.

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# G20 Financial Regulatory Reforms: Navigating the Clash of National Interests

*by Barbara Ridpath*

In the past two years, the G20 has issued calls for coordinating financial regulations and their reforms across multiple issues, such as capital requirements, derivative instruments, and orderly resolution of failing banks. However, the G20 process is facing increasing dissention among the members on these and other measures, for three main reasons.

The first reason is the rise of domestic political pressures both in the North Atlantic states and in the key emerging country member states. At the height of any crisis, and never more so than in the financial crisis of 2007-09, it is relatively easy to get consensus because the stakes appear so high and the alternatives so unattractive. As the level of crisis diminishes, consensus always becomes much more difficult. Attention moves to other issues perceived to be more pressing. The details of agreements and implementation are hard work, but make far less compelling domestic headlines. In many negotiations, as in those among the G20, states tend to agree to what is easiest first, leaving the most contentious issues to be resolved later.

Domestic political issues come to the fore as the crisis diminishes. Some issues become politicized, such as deficit reduction, and others get disproportionate attention in terms of their relevance to preventing a future crisis, such as bankers' bonuses. In low-growth economies, including most of Europe and the United States, the search for scapegoats begins, with attacks on misaligned exchange rates or immigration instead of the necessary hard work of structural reforms.

The second explanation is that some of the initial proposals of the G20 do not stand up well to scrutiny. There has been more than a year of discussions, negotiations, private sector responses, and academic studies. Some of the recommendations fail to pass practical academic testing, or even if they are theoretically sound, it is difficult to find measurement techniques that permit monitoring. For example, the relationship between credit expansion and growth, while intuitively sound, is very difficult to measure accurately, making pro-cyclical provisioning difficult. Similarly, while the G20 calls for macroprudential supervision of financial stability, the definition of financial stability is open to interpretation and no one knows how to measure it. Moreover, few, if any, proven tools exist for action in the event of perceived macroprudential problems.

The third and most important explanation is that some of the G20's proposed reforms and commitments are genuinely inappropriate for the underlying domestic economic and financial market conditions in many G20 members. The hard task is sorting the wheat of the genuine underlying economic and financial issues from the chaff of political pressure and protectionism.

### One Person's Domestic Policy is Another Person's Protectionism

Economics is not a science, and certainly not an exact one. There are significant differences of opinion on the impact of deficit reduction on future growth and unemployment and the effects of changes in bank capital on domestic credit expansion. Critically and legitimately, each country has differences in economic and financial structures. Identical fiscal, monetary, and regulatory tools will affect each nation to a different degree. Notably, the financial infrastructures of countries are at relatively different stages of development, as are their depth and supervision. An economy's relative openness will have a significant impact on the repercussions of policy changes.

Each of these issues has led to genuinely and legitimately different views of the impact of domestic implementation of identical rules both among developed and emerging markets and across the Atlantic between the United States and Europe. There have also been clashes within Europe, including between Britain, France, and Germany, over the continental efforts to coordinate financial regulations and supervision.

Structural differences and lower degrees of interconnectedness with global financial markets meant that emerging markets were less affected by the crisis than the United States and Europe, and have recovered more rapidly. Such structural differences have strong implications for macroeconomic policy, monetary policy, and also for whether and which of the G20 objectives are relevant to the emerging nations.

However, the border between policies that are genuinely inappropriate and those that carry more than a hint of seeking competitive advantage or domestic political favor is often very porous. One way forward is to consider the G20 objectives by their relevance to member economies and the necessity of international coordination for their successful implementation.[1]

Some objectives are obviously less relevant than others, and issues can be classed into three main categories accordingly. The first category is "Not Yet Relevant." For some countries, this category would include issues such as executive compensation. While appropriate alignment of incentives is valid, the extremes of compensation and incentivization in the United States and Europe are rarely relevant outside of these markets, with the exception of a small number of offshore centers.

The second category is "In Process." This category would include issues such as corporate governance and risk management. Both of these issues are extremely relevant to emerging markets, but need to be developed from a much more basic level, and adapted to the structures in those markets and countries. A leap from their current position to some international norm would be neither feasible nor desirable.

"Requires Adaptation" is the third category. A key but controversial example of this is capital requirements. In order to ensure a level playing field, equivalent capital requirements across all countries make sense. However, in G20 countries with small equity and bond markets and high growth rates, such as India or Indonesia, changes in capital could have a considerably greater negative impact on growth than countries in North America, Europe, or Japan, which have well-developed alternative sources of capital. Such differences complicate the implementation of the Basel III capital requirements issued in September 2010. In addition, the ability of banks in some emerging markets to issue new instruments such as contingent capital, which are currently being contemplated, is considerably more limited than it is in advanced nations, and could put them at a significant disadvantage.

[1] Rottier, Stéphane and Véron, Nicolas, "Not all Financial Regulation is Global," Bruegel Policy Brief, Issue 2010/07, August 2010.

An additional fourth category of "Instant Agreement" could also exist, but it would be limited to global issues, such as fortifying the Financial Stability Board (FSB) established by the G20 more than a year ago to coordinate financial regulatory reforms, and all relevant G20 nations' participation in colleges of supervisors for major financial services firms.

These categories only focus on the direct relevance of G20 recommendations to a country's domestic economy. Two other lenses should be used as well. The first is that the success of some international initiatives may require a coordinated response. The second is that repercussions of domestic policies can have serious consequences to other states. How the linkages between domestic policies and international repercussions are managed is critical.

Domestic stimulus through quantitative easing is a prime example of the latter lens. Many high-growth economies such as China are struggling to manage unusually high levels of capital inflows as a result of projected growth differentials. Such flows are exacerbated by the quantitative easing policies of low-growth economies designed to stimulate growth through consumption and investment. The funds from these operations appear to be flowing rapidly to the high-growth markets in search of investment opportunities and creating, as a consequence, exchange rate and inflationary implications for the recipients. Countering inflationary pressures with increased interest rates only exacerbates the issue. As a result, many countries have chosen to either sterilize the monetary impact or impose capital flow taxes or controls.

An example of where international initiatives require a coordinated response is the failure of a multinational bank, or so-called cross-border crisis resolution. Coordinated responses are required to prevent a Lehman Brothers-like chaotic worldwide unwinding of assets and liabilities. States need to have similar tools and processes for addressing the potential failure of an ailing bank operating on their soil.

### Focus on the Feasible

Under discussion for cross-border crisis resolution is a protocol that spells out conditions that member countries are to meet at the time of a bank failure. Countries that are capable of meeting the conditions join the protocol. This provides one extremely effective mechanism for gradual domestic adherence to international norms. Application of such protocols may be the way forward in areas where international coordination needs to be a primary objective.

Such a system has significant advantages. The first is that it permits members to take the time necessary to complete the conditions. As more countries are able to meet the conditions, more countries join. Such a system provides both a demonstration effect and an investor effect, as investors may ultimately become wary of institutions active in countries where resolution mechanisms are either unclear or haphazard.

There are a number of possible steps to deal with the implications of domestic variations in the application of various economic and regulatory actions. Already, the FSB is publishing thematic and country-specific peer reviews. While this is an important step forward, what is written in terms of objectives and outcomes is often sufficiently vague at the G20 level that almost any application can be considered compliant. Rather, what is necessary is a more specific comparison by country and theme of what has been done. This would provide a significant demonstration effect, and an absolutely critical roadmap for institutions operating in multiple jurisdictions.

Similar exercises are needed within domestic markets. For each objective and recommendation, countries should analyze their domestic relevance, the incentives they create for global regulatory arbitrage, and any protectionist implications of a divergence in rules across nations.

To avoid a race to the bottom, such domestic analyses should be made available and reviewable by others. One person's domestic exception is another person's regulatory arbitrage. Such has been the case for years in the "national exceptions" clause under Basel II. To some degree, this is unavoidable. There have been some calls for a structure akin to the dispute settlement mechanism of the World Trade Organization (WTO) to address such breaches. A more feasible alternative would be a clear diagnostic on where these differences exist. This would permit early recognition of potential for regulatory arbitrage.

Yet some of these differences will always be legitimate unless and until countries have identical economic and financial structures, tax structures, and growth rates — an unforeseeable scenario. Diversity should be seen as a strength, much like biodiversity is a strength against the spread of disease. Some differences in economic systems, financial institutions, and supervision are vital so that everyone is not wrong at the same time. Such differences would also permit lessons from successful development stories to be shared, and allow countries to recognize that there is more than one model for successful development. At the same time, greater efforts must be made to search out local academics and experts to learn the applicability of these lessons to other markets.

The G20 should not strive for one-size-fits-all rules. For many elements on the G20 agenda, the focus should be on regulatory convergence rather than on homogeneous rules. Without an obvious enforcement mechanism, the best way forward seems to be in three steps:

1. An evaluation of the relevance of each of the G20 recommendations for each member country;
2. Protocols where international cooperation is critical to the success of a proposed recommendation; and
3. Analyses on each country's progress or divergence on each recommendation, together with an economic assessment of the impact of divergence on the global effectiveness of the measure, the incentives for regulatory arbitrage, and any protectionist implications of global rule divergence.

Wide usage and availability of each of these three tools would provide a strong demonstration effect and a possible "comply-or-explain" enforcement approach among G20 members, while also providing a valuable guide for financial institutions, investors, and regulatory colleges.

Policymakers should accommodate national differences in the implementation of the G20 recommendations that touch on domestic structural issues in order to secure consistency and cooperation on issues where they matter most, like cross-border crisis resolution. The United States and key European states need to use a negotiating approach that offers this compromise in return for cooperation on core international issues in the next G20 round.

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