



The North-South Institute • L'Institut Nord-Sud

Policy Responses to Unfettered Finance

Project Launch Event Report

Report on discussions at the launch of
The North South Institute's project on the global financial crisis

**The North South Institute
December 16th, 2008**

Introduction*

The North-South Institute (NSI) launched a new research project on the global financial crisis on December 11th, 2008. The event took place in Ottawa at the NSI Boardroom. This report provides a summary of the discussion that took place at the launch event.

The event was attended by about 35 people. Participants from various government departments including Finance, Foreign Affairs and International Trade, Canadian International Development Agency (CIDA) and the Bank of Canada attended the event. Academics from the two main universities in the region (Carleton and University of Ottawa) were also in attendance. CEO's of the major civil society and non-governmental organization in the region, including Oxfam Canada, Care Canada, InterPares and the Aga Khan Foundation Canada attended the meeting. Other guests included representatives from the Canadian Labor Congress, the Library of Parliament and Embassies of select G20 countries.

Summary of Panel Presentations

Roy Culpeper (President and CEO, The North-South Institute) opened the meeting with a welcome address and situated the project in the context of the ongoing financial crisis. He outlined the purpose of the launch event as an opportunity to share views on the crisis, and to invite input into the NSI research project. Roy Culpeper introduced the three panelists who made presentations following his opening remarks. These presentations and meeting agenda can be found on the NSI website, adjacent to this report. Key points are summarized below.

Tim Lane from the Bank of Canada made the first presentation. The presentation focused on the broad contextual and macroeconomic outlines of the crisis and developments in the global economy leading up to the crisis. Tim noted that this crisis emerged from a remarkable period of growth and stability in the world economy, driven in part by enormous capital flows. The presenter situated the crisis within the context of persistent global macroeconomic imbalances.

However, deeper flaws in the financial system have now become evident. These include very weak regulation and governance of the financial sector, excessive short-term bias, pro-cyclicality of the regulatory framework which exacerbated the crisis, and disproportionately high rewards for risk takers while sidelining prudence and risk aversion.

The corrosive effect of boom time lending has been that market operatives forgot what risk looks like. Markets essentially lost a sense of what risk is, thanks in large part to the development of new risk transfer instruments and a benign global economic climate for much of this decade. The level of uncertainty is still very high and is compounded by the lack of transparency in the financial sector. The "queen of spades" problem continues to afflict markets; there is little clarity about where the next vulnerability will emerge and how it will be passed on to unrelated segments. The presenter noted two important feedback loops that need to be watched closely: the first between asset prices and capital positions of major financial institutions and the second between financial system performance and the real economy.

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As this is a multifaceted crisis, a case was made that reforms will need to be multifaceted, done in the spirit of global cooperation and minimize regulatory arbitrage, improve information sharing, and involve steps both at the national and international level.

Prof. Jacqueline Best of the University of Ottawa made the second presentation. The focus of the presentation was on governance related aspects of financial reform. The presenter drew lessons from past crises (primarily the Asian financial crisis of the late 90s), reviewed current reform proposals within the context of proposals for reforms that emerged out of the Asian crisis, challenged the efficacy of these proposals and outlined future challenges.

Part of the reason why this crisis has emerged and is proving problematic in terms of suitable policy responses is that policymakers and regulators have drawn the wrong conclusions and lessons from past crises. The presenter made the case with the example of the Asian crisis.

The dominant mainstream response to the Asian financial crisis was that it was the Asian model – recall ‘crony capitalism’ argument – that was largely at fault. However, critics have made a more persuasive case that too rapid and excessive liberalization and de-regulation was a more important source of the vulnerability.

Differing diagnoses are extremely important as they influence the type and scale of responses that are undertaken. Three reform pillars emerged from the Asian crisis. These are: common global financial standards; transparency; and self-regulation as the central locus of risk management. The key take-away from the Asian financial crisis was a sense that ‘it is their problem, not ours’, that ‘governments are to blame, not markets’ and the emphasis on standards, transparency and self-regulation bears this out. The present crisis is clearly demonstrating the limits of each of these.

As the presenter argued, this crisis has proven it is indeed ‘our’ problem too (i.e. financial crises are not the unique preserve emerging markets or developing countries), markets are less transparent than we would like and need them to be, and governments can be part of the solution. Therefore there is a need to go beyond the minimalist approach that emphasizes standards, transparency and self-regulation.

The desirability of common global standards needs to be weighed against the need for diversity and diversification. There are limits to how much can be achieved with greater transparency alone and these limits need to be considered seriously. Moreover there is a pressing need for comprehensive and global public regulation, balanced against national autonomy and responsibility. Reform proposals need to think holistically and address the question of who ultimately governs and puts proposals into action, and what their incentive is for doing so. The final calculus regarding which proposals receive how much attention is inevitably a political one.

Pablo Heidrich of The North-South Institute delivered the final presentation. The presentation laid out the objective of the NSI project, the central research questions and the approach and methodology the project would follow.

The presentation outlined the context and venues for influencing the discourse and reform agenda. These include (but are not limited to): the G20 process, the Financing for Development process, the next G8 (in Canada) and the UN Commission on the Financial Crisis, amongst others.

The presentation also outlined the three focus areas of the project: systemic reform, new actors and trade linkages, and regulatory implications of financial innovation. The presentation concluded by commenting on civil society preparedness in terms of articulating reform proposals and influencing the reform process on various levels. A number of discussion questions were proposed which animated the floor discussion and panel responses.

Summary of Floor Discussion and Q&A

An hour long floor discussion and Q&A took place after the three presentations. The discussion was lively and engaged a number of audience members. The discussion and Q&A revolved around the following key issues: the need for thinking more broadly, including consideration of the domestic contexts within different countries; governance related issues; the tensions created by the legacy of bailouts beyond moral hazard (in the financial sense) to hazardous morality if you will; assumptions about ascendant (and descendant) financial powers; and various project specific queries. These are summarized below.

A number of audience members highlighted the importance of better *linking this 'global' crisis to domestic socio-political and economic contexts*. A concern was raised that finance is being unnecessarily segmented from economic issues broadly and the economic roots of the crisis. One speaker pointed out that macroeconomic imbalances are reflected in imbalances in the domestic economy. About a decade ago a trend began to take root where the corporate sector began accumulating massive surpluses (and scaling back reinvestment) while households built up massive debts. The genesis of this trend lies in broader economic issues (such as labour and tax policies) and these connections are important to draw out.

Another audience member made a similar reference to domestic and international linkages, from a slightly different perspective. A suggestion for the project was made that one of the helpful ways of drawing linkages with respect to developing and emerging economies would be tracing the progress from the Monterey Consensus (2002) to the Doha review conference on development finance (2008). The commentator argued that a deeper understanding of the domestic context, especially in developing countries, is central to understanding transmission channels. The overall aim should be to assess how international finance can help stimulate domestic finance. This would also be in the broader interest of the global economy as we respond to the present crisis and economic downturn.

Panelists and members of the PRUF project team in the audience responded to these suggestions and comments. John W. Foster (NSI Principle Researcher) attended both the Monterrey (2002) conference on development finance and the recent Doha (2008) review meeting and shared his insights on the evolution of the debates. According to Dr. Foster accountability and legitimacy issues are still front and center in the debates as evinced from a virtual stand-off between the G-1 (US) and the G-192 (rest of the world) at the recent Doha conference particularly with regards to economic governance. Aniket

Bhushan (NSI Researcher) made reference to another active project titled 'Domestic Resource Mobilization in Sub Saharan Africa' which focuses explicitly on enhancing the ability of developing countries to mobilize and utilize domestic finance, as outlined in the Monterrey agenda.

A series of comments and questions from the floor focused on *governance and legitimacy*. An audience member made the case that the Washington Consensus agenda, while it has been shown to be grossly inadequate, is still the dominant paradigm for IFIs. It has been one of the main policy drivers of the current paradigm we have in the North, while the South has been consistent in its criticism of the same. The commentator posed the question what is likely to happen now (since the failings of limited regulation are apparent even in the North)? Would we necessarily need to change the governance of IFIs (who sits on the table) before we look to changing the reform agenda?

An audience member raised a question regarding the *moral and political legitimacy of the legacy of bailouts*. The member pointed out that several trillions have been mobilized in remarkably short time frame to meet the urgent needs of the financial sector, however of the miniscule \$22billion commitment on food aid made a few months ago a mere \$2billion has been delivered. How will the emerging context affect aid and other resources required to address truly urgent crises across the poorest countries?

In response to one of the presenters an audience member raised an issue regarding what assumptions were being made in the project about *ascendant and descendant financial powers*? The member pointed out that there is a possibility of more 'queen of spades', possibly emerging from the relatively less developed, but increasingly globally significant, financial sector in China.

Panelists responded to these questions in turn. On the issue of thinking more broadly panelists noted that the sub-prime mortgage crisis is in fact a clear example of a broader socio-economic crisis as it is linked to social policy goals of extending access to housing and housing finance.

On governance and the dominant paradigm, the set of rules that promoted limited and unobtrusive government ascendant in the 80s and 90s seems to have been shown to be completely bankrupt. Governments will likely emerge from the crisis playing a greater and more active role in the financial sector. As far as reform of IFIs is concerned the issue is deeper than reform of voting rights and board membership. *A shift in institutional culture is required at the IFIs* and this tends to take time (one of the panelists made reference to the introduction of poverty related issues in the work of the IMF and the amount of time required to shift attitudes in these areas).

On governance, one of the panelists argued that the *sequencing of reform measures is central to outcomes*. There is some indication of broadening governance structures (evinced by realization of insufficiency of G8 and the need to address at least G20). Emerging countries are indeed becoming significant global actors in their own right with vital stakes in a stable global economy. Therefore it is important to acknowledge their priorities and accommodate their interests in the ensuing reforms. Governments would need to act far more strategically as far as regulatory issues are concerned, by *setting clear objectives and articulating a comprehensive and holistic approach* to financial sector oversight. This is crucial in order to build confidence in a broken financial system that has revealed failures on multiple levels.

Another panelist noted that the *political context of reforms* was equally important to acknowledge and build into the project. Decisions regarding whether funds go to bailouts or aid flows are ultimately political in nature. Massive bailouts will create even greater moral hazard and lack of confidence in the system unless institutional cultures and practices are changed commensurately. The direction of policy thus far has been undesirable. We have gone from talking about 'welfare states' to 'workfare states' to now what amounts to 'credit-fare'.

Project team members from the floor extended these responses and talked further about reform proposals such as the need for an 'Economic Security Council'. The need to *bridge IFI mandates and accountability* was also pointed out.

The floor exchange provided valuable suggestions about questions the project could focus on, how we might engage with ongoing initiatives and what forms of publication and dissemination materials would be useful.

Concluding remarks

Roy Culpeper brought the meeting to a close with some concluding observations. He noted that one of the central issues in the financial sector is lack of transparency. In the last few decades we have let the financial sector explode with little regard for accountability of the players involved. The key question for us now is how to arrive at a system that brings equitable and sustainable development? How to ensure that the financial sector operates to serve the needs of society rather than the other way round, as has been the case lately? Addressing these issues requires accepting some ground realities. We are unlikely to end up with a world without debt or leverage, but how much debt is too much is a question that we need to pose. Are we equipped with the right tools to confront the type and scale of financial leverage we confront? Similarly, speculation is another financial market reality we need to accept. However speculation can be both desirable and undesirable. What we need is a sense of how much speculation is too much? Finally, there are more jokers than 'queen of spades' in the pack, what is required now is to remove these in order to ensure a stable financial sector that works in the interest of equitable and sustainable development.