Not a New Bretton Woods but a New Bretton Woods Process

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Now that the quashing of excessive expectations is complete, it is time to ask what can realistically be accomplished by heads of state meeting in New York on November 15th.

Basic orientations should be obvious. Leaders should focus on financial stability. They should commit to a series of meetings. They should strive for a process rather than a quick, hollow agreement. They should acknowledge that consensus, like Rome, is not built in a day.

Their central challenge is how to ensure comprehensive and consistent supervision and regulation of all systemically significant financial institutions. The crisis is a reminder that inadequate supervision at the national level can have global repercussions. Addressing this problem is the single most important step they can take to make the world a safer financial place.

There will be calls for a global regulator, echoing proposals for a World Financial Authority by John Eatwell and Lance Taylor a decade ago. But it is unrealistic to imagine that the United States and for that matter any country will turn over the conduct of national financial regulation to an international body. Regulation of financial markets is a valued national prerogative. Not even EU member states have been willing to agree to a single regulator. In any case there is the particularity of national financial structures, which places effective oversight beyond the grasp of any global body.

The European proposal for squaring this circle by creating a College of Regulators is weak soup. We need more than more information sharing and discussions. Better would be to strive to create a World Financial Organization analogous to the World Trade Organization. Countries seeking access to foreign markets for their financial institutions would have to become members of the WFO. They would have to meet the obligations for supervision and regulation set out in its charter and supplementary agreements. But how they did so would be up to them. This would permit regulation to be tailored to the structure of individual financial markets.

An independent body of experts, not unlike the WTO's dispute settlement panel, would then decide whether countries have met their obligations. A finding of lax implementation would have consequences. Specifically, other countries could prohibit banks from countries found to be in violation from operating in their markets. This would protect them from destructive spillovers poor regulation.

It would also foster a political economy of compliance. Governments seeking to secure market access for their banks would have an incentive to upgrade supervisory practice. Resident financial institutions desirous of operating abroad would be among those lobbying for the requisite reforms.

Skeptics will question whether countries like the United States would ever accept having an independent panel of experts declaring the U.S. regulatory regime to be inadequate and authorizing the application of sanctions. But this is just what the WTO's independent dispute settlement panel does in the case of the trade regime. Why should finance be different?

Creation of a WFO is not a be-all and end-all. It should be supplemented by other measures. Trading in derivative securities should be moved onto an organized exchange to limit counterparty risk. Basel II should be urgently reformed to raise accepted measures of capital adequacy, reduce reliance on commercial credit ratings and banks' models of value at risk, and add a simple leverage ratio. These further initiatives can proceed in parallel and be completed quickly. But commencing negotiations on a World Financial Authority would be the most important single step.

It would be preferable to create the WFO as a new entity rather than building it on the platform of an existing institution like the IMF. The IMF's past efforts at capital-market surveillance have not exactly covered it in glory. The Fund continues to be regarded with suspicion in Asia and Latin America. Countries there would be reluctant to sign up to a World Financial Authority that was a wholly owned and operated subsidiary of the IMF. This reality is also evident in the reluctance of governments like China's to deploy their reserves in support of other countries by channeling them through the Fund.

This brings us to the other key challenge that must be met to make the world a safer financial place: mobilizing the resources, both financial and political, of emerging markets. The IMF desperately needs additional funding to aid crisis economies, and governments like China's are the logical contributors. The question is what to give them in return.

We cannot afford another inconclusive multi-year negotiation of new IMF quotas. More effective would be for the U.S., Europe and Japan to agree to abandon the G7/8, which is no longer a suitable steering committee for the world economy, in favor of a new G7 composed of the U.S., the EU, Japan, China, Saudi Arabia, India and Brazil. This would not require negotiations among hundreds of countries stretching over a period of years – time which is not available given the urgency of the task. It would give China and the others a seat at a table that really matters. It would give them ownership and the sense that they have a stake in the stability of the global economy. This would not be a club of democracies, but then the club-of-democracies man did not win the U.S. election. In any case it is not clear that democracies are necessarily better stewards of the global economy.

Again, other useful things could also be done. Europe could agree to a single executive director on the IMF board, freeing up directorships for emerging markets. Who better than a far-sighted European leader like Dominique Strauss-Kahn to announce that leadership of the Fund should be thrown open to the most qualified candidate regardless of nationality? But while this would be helpful, creating a new G7 would be the most important single step.

Starting on November 15th, everyone will roll out their pet ideas, from a substantial revaluation of the renminbi to a global system of target zones to a single world currency. (You know who you are!) But it is important to avoid nonstarters and superfluous initiatives. Creating a G7 now and committing to establish a World Financial Organization soon are the practical and effective ways forward.

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