Stabilizing Global Financial Markets
The Case Against Global Standardization

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I. Introduction

Proponents of global governance presume a strong complementarity between the location of a governance problem and its solutions. Local problems are said to require local solutions; it follows that global problems need global solutions. In this short paper I argue that this complementarity presumption does not hold in finance and that, therefore, attempts to deepen global standardization of financial regulation and adjacent fields are counterproductive. Instead, disruption and fragmentation of regulation is more likely to enhance financial stability than legal harmonization.

II. Governing Inherently Instable Financial Markets

The argument presented here builds on Hyman Minsky's insight that financial markets are *inherently* instable.[2] The basic premise of the Financial Instability Hypothesis (FIH) is that investing is core to the capitalist enterprise, yet that investing is undertaken under conditions of uncertainty and imperfect knowledge.[3] This implies that bets are made about future outcomes that are impossible to predict at the outset. Financing takes place nonetheless, if and when intermediaries are willing to carry the liquidity risk – that is, the risk that it may be impossible to refinance a given project irrespective of its long-term prospects because of unrelated adverse economic or financial conditions.[4] If and when liquidity risk materializes, financial systems in which many companies rely on re-financing rather than current income to pay their debt as it becomes due are prone to collapse.

To guard against financial destabilization it is critical to promote diverse financing strategies and to take precaution against competitive pressures that may drive the entire

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[2] For an early statement of the FIH see HYMAN P. MINSKY, *The Financial Instability Hypothesis: An Interpretation of Keynes and an Alternative to "Standard Theory"*, *in* Can "It" Happen Again? Essays on Instability and Finance (Hyman P. Minsky ed. 1977 (1982)). For a comprehensive restatement see HYMAN P. MINSKY, Stabilizing an Unstable Economy (Yale University Press. 1986).

[3] FRANK H. KNIGHT, Risk, Uncertainty and Profit (Houghton Mifflin. 1921); see also more recently ROMAN FRYDMAN & MICHAEL D. GOLDBERG, Beyond Mechanical Markets: Asset Price Swings, Risk, and the Role of the State (Princeton University Press. 2011).

[4] PERRY MEHRLING, The New Lombard Street: How the Fed Became the Dealer of Last Resort (Princeton University Press. 2011), building on Minksy's insight that liquidity management is critical for dealing with inherent financial instability.

financial system towards speculative or Ponzi financing schemes.[5] Viewed in this light, the notion that the best way to safeguard the global financial system is the standardization of rules is deeply flawed. In fact, regulatory harmonization handcuffs regulators around the globe with legally enshrined commitments to a single, pre-determined, global regulatory strategy whose effectiveness is unknown ex ante.[6] It contributes to financial instability by creating a highway for regulatory arbitrage. And it unduly focuses regulators on complex rule implementation schemes rather than enabling them to develop innovative regulatory responses to actual market developments.

Today's financial markets are complex, rapidly evolving, and highly instable systems populated by profit-seeking strategic actors. Such systems are better governed by a fragmented regime that allows for multiple sites of regulatory experimentation, one that is flexible and responsive to how rules affect market developments and market developments affect rules.

Experience with financial markets and financial market governance in the recent past bears out this analysis. A decade into the launching of the "international financial architecture" in response to the East Asian financial crisis, the global financial crisis broke out in the very countries that had served as models for the best practice standards that had been globalized. This suggests that there is no such thing as 'best practice standards' that can withstand the test of rapid financial market development and strategic regulatory arbitrage. Neither did the harmonization of financial regulation prevent unilateral, country-level rescue efforts in the midst of the crisis with little regard to how this might affect other parts of the interdependent global financial system. This demonstrates that the adoption of common regulatory standards is not sufficient to ensure a common response in times of crisis. What is needed instead is a system of coordinated regulatory diversification.

III. Governing Interdependent Financial Systems

The global financial system is not one system, but consists of multiple, interdependent financial systems. Our global financial system has several important centers and many peripheries. Those at the center expand financial services to the periphery in boom times and retract in bad times. Those at the periphery benefit from financial expansion in good times, but suffer from retraction in bad times – irrespective of whether they have actually contributed to the crisis. The effects of the crisis tend to be markedly different between the center and the periphery.[7] Countries that host global financial centers tend to have the wherewithal to rescue themselves in times of crises – even if this entails a major redistribution of resources in favor of the financial system internally. Countries on the periphery typically lack similar resources. They therefore depend on bilateral or

[5] Note that Minsky (supra) uses the term "speculative" financing to denote financing strategies that expect that some refinancing will be necessary in the future; in contrast, Ponzi financing relies on refinancing as investors know ex ante that future income streams are unlikely to suffice to pay debt as it becomes due.
[6] See also KATHARINA PISTOR & CHENGGANG XU, *Incomplete Law*, 35 Journal of International Law and Politics 931-1013 (2003) on the notion that law is incomplete.
[7] See Eichengreen's illuminating comparative analysis of the Barings crisis in the late 19th century and Mexico's Tequila crisis of 1994. BARRY EICHENGREEN, *The Baring Crisis in a Mexican Mirror*, 20 International Political Science Review 249-270 (1999).

multilateral help to get back on their feet.[8] It follows that the global financial system is hierarchical.[9]

The difference between financial centers and financial peripheries is crucial for understanding the dynamics of rule-making in interdependent financial systems. It is well known that developing countries and emerging markets have had little say in the governance of finance in the past and that their influence has not grown much by shifting responsibility for financial matters from the G7 to the G20.[10] Given the inherent hierarchical structure of global finance, a single regulatory strategy is more likely to represent the interests of the center than the periphery. Moreover, because the costs of crises have disparate effects in countries at the center and those on the periphery, the interests of these groups of countries are not aligned.

Destabilizing financing practices benefit disproportionately whomever has the resources to weather a liquidity crunch. It boosts their competitive advantage at the expense of more conservative financing practices. This works as long as the costs of these practices can be externalized to the periphery. As the US sub-prime crisis suggests, the periphery can be the center's own backyard. More generally, in an interdependent system destabilization anywhere may spread throughout the system. Yet, because the location and timing of future crises is impossible to predict, rule-makers at the center have little incentive to incorporate these costs.

Instability paired with hierarchy and misaligned interests between the center and the periphery of the global financial system speak for plurality, not uniformity of governance regimes. The more jurisdictions use 'trip wires' or 'speed bumps',[11] the greater the chances that financing practices will remain diverse rather than converge on the most destabilizing model.

IV. Flexible Coordination of Multiple Orders

Promoting the decentralization of global financial governance faces two dangers: A race to the bottom as countries seek to attract foreign capital and therefore lower their entry requirements and regulatory oversight; and the fragmentation of the global financial market. Both problems can be addressed by creating mechanisms of flexible coordination at the global level. This would require the reorganization of the global governance regime for finance. Specifically, it calls for a *global anchor* that should

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[8] For the distributional effects of transnational financial markets when countries lack an effective domestic guardian of their system, see KATHARINA PISTOR, *Into the Void: The Governance of Finance in Central and Eastern Europe*, in Reflections on Transition: Twenty Years after the Fall of the Berlin Wall (Gerard Roland ed. 2012).

[9] See PERRY MEHRLING, *Three Principles for Market-based Credit Regulation*, American Economic Review (forthcoming) (2012).

[10] STIJN CLAESSENS et al., *The political economy of Basle II: The costs for poor countries?*, 31 The World Economy 313-344 (2008) and WALTER MATTLI & NGAIRE WOODS, *In Whose Benefit? Explaining Regulatory Change in Global Politics*, in The Politics of Global Regulation (Walter Mattli & Ngaire Woods eds., 2009).

[11] GRETA A. KRIPPNER, Capitalizing on Crisis (Harvard University Press. 2011).

- Coordinate diverse micro and macroeconomic approaches to financial stability.[12]

- Endorse only minimum regulatory standards and not promote regulatory standardization with the goal of creating a single 'level playing field'.

- Encourage countries to develop regulatory standards over and above the global minimum standards and/or promote functional equivalents that may be more compatible with local institutions and the ideal of self-governance.

- Support limits on capital inflows in light of a country's risk absorption capacity or risk preferences.

- Monitor financial markets globally and alert international and domestic standard setters and implementers about how their regulations affect the cumulative costs of regulation, regulatory arbitrage, financial fragility, and financial contagion.

- Have free access to information that is relevant for carrying out its mandate from regulators in all participating markets.

- Publish Financial Fragility Reports that point out emergent vulnerabilities of the financial system, the buildup of financial booms in specific market segments, and the risks posed to the system by specific financial intermediaries and/or their practices.

- Hold regular meetings with regulators and financial intermediaries in different market segments to discuss market developments and assess their impact on the stability of domestic, regional or global financial systems.

- Collect information about regulatory strategies developed by different regulators to counter financial instability and make this information available to other regulators who seek to stabilize their financial system.

- Develop a rapid response system to emergent vulnerabilities and/or crises, loosely modeled on those that exist between NYSE and the Fed, or similar arrangements in other countries.

- Have the authority to blacklist countries and intermediaries that do not cooperate with the global anchor, whether by sharing information or taking actions to stem instability.

- Last but not least, the global anchor will need an internal governance structure suitable to these tasks that should combine elements of continuity and change. It needs to maintain relations with key stakeholders, which requires continuity. However, routinized bureaucratic structures are prone to capture; they are also unlikely to spot non-routine events.

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[12] For the need to overcome the conceptual separation of micro and macro in the area of finance, see JEAN TIROLE, *Liquidity and All its Friends*, 49 Journal of Economic Literature 287-325 (2011).