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LASTING LEGACY ON FINANCIAL REGULATORY REFORM

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KEY POINTS

- The G20 finance ministers have set the stage for emerging market economies to finally make their mark on international regulatory policy.
- Cross-border capital flows is on the G20 macro-prudential regulatory agenda, a clear demonstration of the new international legitimacy of this issue.

Going into the Seoul summit, the G20 agenda for financial regulatory reform is both depressingly familiar and surprisingly new. The G20 leaders are unlikely to reach any dramatic breakthroughs on the familiar items, but they could leave a lasting legacy by prioritizing the new.

At their meeting on October 23, the G20 finance ministers and central bank governors prioritized a number of regulatory issues for discussion at the leader's summit. The familiar items included a ritualistic commitment to implement all reforms endorsed already by the G20 in an internationally consistent and non-discriminatory manner, such as those relating to over-the-counter derivatives, compensation practices, accounting standards and credit rating agencies.

The G20 finance officials also endorsed initiatives that follow-up on past summit commitments such as the Basel Committee's new bank capital and liquidity framework and the Financial Stability Board's (FSB) new recommendations to improve supervision. In addition, they backed the FSB's ongoing work to try to mitigate risks posed by "systemically important financial institutions" (SIFIs).

The Seoul summit is unlikely to produce any dramatic new developments relating to any of this familiar terrain. Not so long ago, some hoped the G20 leaders might use the Korean summit to hammer out an agreement on the all-important issue of how to regulate SIFIs, but the prospect seems distant now. We are still quite far away from an international consensus on this issue — a few days before the G20 finance officials meeting, the chair of the Basel Committee reported that the Committee's work in this area would not be complete until mid-2011. If any agreements are reached in Seoul on SIFIs, they will likely be pitched only in terms of very general principles.

While the Seoul summit may say little dramatically new on these conventional issues, the G20 finance ministers have placed some new topics on the summit's regulatory agenda on which progress is more possible. Particularly important is the decision to prioritize "the reflection of the perspective of emerging market economies in financial regulatory reforms."

Despite the new prominence of emerging market countries in international regulatory policy making through the G20, the FSB and other bodies, their distinctive

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contribution to regulatory debates has not been very noticeable. The Seoul summit may be remembered as the moment when they finally made their mark.

As if to reinforce this prospect, the G20 finance ministers urged "further work on macro-prudential policy frameworks, including tools to help mitigate the impact of excessive capital flows." The focus on macro-prudential policy is familiar; one of the accomplishments of the G20 summits has been to encourage regulators to look beyond merely the stability of individual firms to wider systemic risks. Until now, however, the G20 had not discussed cross-border capital flows within its macro-prudential regulatory agenda.

This neglect has been criticized by analysts who see the management of capital flows as a key macro-prudential regulatory tool for developing countries. They note that many financial crises in the developing world have been preceded by excessive capital inflows that have exacerbated domestic financial bubbles (also recently experienced by the US). In this context, efforts to discourage capital inflows in boom times — either by controls or more market-friendly measures — can play a useful counter-cyclical macro-prudential role. Since financial crises have also often been made worse by large-scale capital flight, restrictions on capital outflows have been seen in a similar light.

Large inflows of capital to developing countries over the past year have raised the political profile of this issue. To avoid an overheating of their domestic financial systems and exchange rate appreciation, many developing countries have introduced or strengthened measures to discourage capital inflows, including G20 members such as Argentina, Brazil, China, Indonesia, Russia and South Korea.

The International Monetary Fund (IMF) leadership has chosen to view these measures in a much more sympathetic way than they did only a few years ago. The decision of the G20 finance officials to prioritize cross-border capital flows on the Korean summit regulatory agenda provides further evidence of the new international legitimacy of discussions about this issue. If the G20 leaders were to instruct the IMF and other international bodies to take a more proactive stance in helping countries strengthen their counter-cyclical capital account management, this would mark an important turning point in international economic policy making.

The G20 finance ministers have also prioritized the discussion of two other issues of concern to developing countries. One is the regulation of commodity derivatives markets. These markets have been blamed for recent commodity price volatility, including that which contributed to the global food crisis of 2008. The other is the need for "increased outreach" to include more perspectives of "emerging market economies" in international regulatory discussions. This advice applies particularly to the FSB and some of the other international standard-setting bodies whose country membership remains quite narrowly constituted.

There are still other "development" issues that could receive more attention within international regulatory policy making. The G20 leaders could encourage greater international efforts to help regulate illicit capital outflows from low-income countries. They could also support more orderly sovereign debt-restructuring mechanisms at the global level — particularly since the Europeans are considering the establishment of such a mechanism regionally.

The Seoul meeting looks set to become the first G20 leaders' summit to add significant "development" content to the international regulatory reform agenda. If this result is realized, the Korean hosts will have met their goal of acting as a bridge between North and South. We will finally be able to say that the inclusion of more developing countries within the core of global economic governance is beginning to have an impact on the content of international financial regulation.