GENERAL DISCUSSION
Reforming the Global Financial Architecture

Chair: Rakesh Mohan

Mr. Crockett: I'm well aware that I'm standing between now and whatever activities are in play this afternoon, but Janet says I may answer some questions.

Mr. Sato: Thank you very much indeed for this very insightful presentation covering both historic developments and the global agenda worldwide. In thinking about the future architecture of financial regulation, I think one of the bridges between the idea of trust in the market mechanism and actively avoiding systemic instability is to get the incentive structure right. For instance, compensation schemes which put too much emphasis on short-term profit maximization drove bank managers into reckless activities. In credit derivative transactions, profits coming from the transactions were recorded immediately, while the risk that was taken at that time materialized much, much later. To make the best use of the market mechanism and to be effective in our regulatory system, the incentive mechanism for financial market participants is very important. Could you give any recommendation or advice about the incentive structure?

Mr. Crockett: Well, we're all economists and we know the importance of incentives, and it's key to get the incentives right such that they are stabilizing for the system as a whole. In that sense, I think you're right to point to a host of different incentives. Compensation is obviously a key element, and it is, of course, a very public and high-profile element. I do think that some of the actions that have been taken are going to be beneficial in that regard.

I would make just two points. First, we should be careful to think that if we fix compensation we've solved the problem of instability; that was a contributory element, but I don't believe it was by any means the only contributory element. Second, I think it's going to be very important when we try to harmonize incentives to do so equivalently across countries. If individual countries pursue their own policies, regulatory arbitrage or, in this case, physical arbitrage of traders across tax jurisdictions will come into play.

Mr. Bery: As you know, there's been a lot of momentum regionally within Asia after 1997, basically around the ASEAN plus three countries. Do you have a view on how Asian initiatives would interact with the G-20? To draw an analogy from trade negotiations, there has been a lot of exegeses on the relationship between regional arrangements and global arrangements; do you have a view on how the two might mesh and how the leading Asian countries should concentrate their firepower between the regional and the global?

Mr. Crockett: This is not a subject on which I'm an expert. I think that regional arrangements can be in some circumstances positive if they are open regional arrangements and if the purpose is to build a fully multilateral system. Of course they often deteriorate into inward-looking and barrier-erecting kinds of arrangements. I'm a little bit afraid about the new architecture of the G-20. I think one of the big risks will be that within the G-20 there may develop blocks of emerging markets on the one hand and industrial countries on the other, or Asian countries versus other countries. I think it is very important for the participants to approach the discussions within regulatory bodies and within the Financial Stability Board as being an attempt to reach common agreements, and to make sacrifices in order to achieve agreement, rather than as being a platform for parading different points of view. There's obviously a risk of doing that when you've got a crisis such as the one that has come that's perceived by different people to be blamable on different entities. So, I think it's important that it is done in the spirit of promoting common agreement rather than in self-justification of any particular subgroup.

Mr. Liesman: I just wonder about the idea that what we really need is more global coordination. You began your speech talking about the idea that, in fact, a consensus about regulation had emerged, and I wonder the extent to which you're suggesting the best way to handle the next crisis is we should all adopt the same immune system, the danger being that if the right flu comes along, we all get wiped out. And I also wonder about the extent to which if we looked at countries where there were no banking crises—Canada, Australia, Singapore, and Hong Kong come to mind—to what extent were their regulatory systems different and better able to serve as backstops to what happened elsewhere in the globe?

Mr. Crockett: It's certainly a good point and what I wanted to say was not that there should be an identity of regulatory requirements, but there needs to be a harmonization such that you don't generate incentives for regulatory arbitrage between jurisdictions. I think in the case of Canada and Australia, they had strong domestic regulatory systems and I think there are a lot of lessons to be learned from them, but those were not regulatory systems that were fundamentally based on the desire to prevent global capital flows. Of course they saw advantages in not having too much foreign capital. Each of them has limitations on foreign involvement in their banking systems and we need to ask questions about why that is the case, but they didn't have major barriers to capital flows across national boundaries. I'm really looking for a system in which it's possible to preserve the advantages that come from global capital markets and global competition while achieving the protections that obviously some countries were much more successful in doing.

Mr. Liesman: Andrew, if you don't mind another question from the press. You said that unfettered market forces had not prevented a financial meltdown. What do you say to those, such as John Taylor, who say that government policies and incentives, not unfettered market forces, had a major hand in causing the crisis by, for example, the role that government-sponsored enterprises played in enabling imprudent lending through the securitization process?

Mr. Crockett: Yes, that's a good point too. There's plenty of blame to go round, but I think even had government policies been perfect, one does need to ask the question, when you look at what's happened, whether we can be as confident. And let's face it, we have to build financial protections against, I'm paraphrasing Donald Rumsfeld here, against the world that we have rather than the world that we would like to have, and the world that we have has government policies that aren't always exactly what we want them to be. I think the structure of financial regulation and the management of financial markets have to be as robust as possible against shocks, whether they're wholly exogenous shocks or shocks generated by government policies.

Mr. Bullard: You've talked about bank resolution authority and one of the issues there is how credible would the resolution regime really be? There's enough difficulty just thinking about how to do it, but beyond that, it has to be completely credible. Otherwise these big firms, when they got into trouble, would be able to appeal to their national governments and be bailed out so that the effect of the resolution regime would be zero at the end of the day at the next crisis. So, I think it's important to somehow design a system where everyone knows what will happen if you get into another crisis.

Mr. Crockett: Well, this is, of course, as I think I tried to say, the most difficult of the issues I addressed, and I restricted myself to saying what the desirable properties were; perhaps I could have added credibility to the other four properties. It's not easy to do. First of all, I want to say that we really ought to aim for a system in which no institution was regarded by virtue of its size or complexity as being too big to fail. I think there's something to be said—but I'm not wholly in agreement with it—for the "living will" proposal, whereby the regulators have got a clear idea about what they do to an institution that gets into life-threatening difficulties in a way that imposes losses on all of those that are stakeholders, so that nobody is pricing the credit they extend to a large institution on the assumption that they're going to get bailed out; so, those losses have to be there.

Clearly I think you're alluding to this point: If you have a global systemic meltdown, governments are going to have a role in the resolution, but I think the aim of what we do should make the system as little as possible dependent upon the ultimate power of governments, and as much as possible dependent on the power of market forces. And I think there are ways, it may not be totally credible, but there are ways of making credible the threat that those who lend, whether it's equity holders or debt holders, or counterparties, take adequate care in the extension of credit.