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Redesigning global finance

Government leaders cannot rewrite the rules this weekend. But they can still do some useful things

IT IS tempting to dismiss the upcoming G20 meeting as a piece of political theatre. Presidents and prime ministers from a score of rich and emerging economies will descend on Washington, DC, ostensibly to remake the rules of global finance. Several have talked grandly of a sequel to the 1944 Bretton Woods conference, which created the post-war system of fixed exchange rates and established the International Monetary Fund and World Bank. That is nonsense. The original Bretton Woods lasted three weeks and was preceded by more than two years of technical preparation. Today's crisis may be the gravest since the Depression, but global finance will not be remade in a five-hour powwow hosted by a lame-duck president after less preparation than many corporate board meetings. Yet for three reasons it is still a meeting worth having.

The first is that this could mark the beginning of a better multilateral economic system. The G20, created after the emerging-market crises a decade ago, is not perfect for today's problems. It excludes a big economy with an admired system of financial regulation (Spain) but includes a mid-sized country that has become irrelevant to global finance because of its own mismanagement (Argentina). Still, the G20 includes most of the key parts of the rich and emerging world, making it a better forum for global economic co-operation than the G7 group of rich countries, which has until now held the stage.

Don't just stand there

In the short term that co-operation, and this weekend's meeting, should focus on the second good reason for the Washington summit: crisis management. Although the panic in the credit markets shows signs of abating, the economic news gets ever grimmer. Global demand is slumping as rich economies plunge into what, collectively, could be their deepest recession since the 1930s. Pernicious deflation, though still unlikely, is no longer an idle risk (see article). Emerging economies are being hit hard by weakening exports and the collapse of private capital flows. The G20 summiteers cannot prevent this, but they can stave off a slump with zealous and co-ordinated action to prop up domestic demand and provide resources to cash-strapped emerging economies.

Some countries understand the urgency. China's stimulus plan, even if it is a little less dramatic than first trumpeted, is an important step (see article). Others, such as Germany, are being woefully timid (see article). A collective commitment by those who can afford it will pack more punch than individual initiatives. Useful too, would be a pledge to cushion the slump in private capital flows to emerging economies, through both central-bank swap lines and the IMF. Countries with ample reserves, particularly China, Japan and the oil exporters, should promise now, and without preconditions, that they will lend to the IMF if it needs cash in the coming months. The G20 should also pledge its unequivocal support for free trade—a pledge that would gain credence if the leaders made a commitment to complete the Doha round of trade talks.

But what of the larger ambitions of "fixing" global finance? Here the temptation for hollow promises is greatest of all (see article). The summiteers can make progress, but only if they temper their hyperbole with realism and humility.

International finance cannot just be "fixed", because the system is a tug-of-war between the global capital markets and national sovereignty. As cross-border financial flows have expanded and big financial institutions have far outgrown their domestic markets, finance has become one of the most globalised parts of the world economy. At the same time, finance is inherently unstable, so the state has to play a big role in making it safer by lending in a crisis in return for regulation and oversight. Governments broadly welcome the benefits of global finance, yet they are not prepared to set up either a global financial regulator, which would interfere deep inside their markets, or a global lender of last resort. Instead, regulated financial firms are overseen by disparate national supervisors (in America they are sometimes state-based). The IMF helps cash-strapped countries, but the fund was conceived in an era when capital flows were restrained. It is puny relative to the size of global markets today.

This tug-of-war helped create today's mess. Disparate rules led to loopholes and "regulatory arbitrage". Many emerging economies sought to protect themselves against sudden outflows of foreign capital by building up vast foreign-exchange reserves. That fuelled the global credit bubble. Given today's crisis, the incentives to amass reserves have only grown.

The contradictory desires for national sovereignty and global capital markets limit the room for an overhaul. For all the grand rhetoric, no politician is proposing to cede sovereignty to a global regulator, let alone create a true global lender of last resort. Nor is anyone proposing a wholesale effort to curb capital flows (which is just as well). With no great design on the drawing board, it is better to concentrate on the more modest goal of improving the current muddled contraption through a series of politically feasible enhancements that together could amount to a third justification for this meeting.

Refit the existing engine

One example is Gordon Brown's idea of a "college of supervisors" to oversee the biggest financial firms. Another is a global set of norms on what should be regulated and how: from hedge funds to leverage limits, national regulators would do a better job if they acted in concert. By all means start to look at schemes to revamp the IMF by scaling back Europe's presence and enhancing emerging economies' clout. But it would be a mistake to rely only on the IMF. The Fed's new swap lines with other central banks are an important reassurance for countries that face a liquidity squeeze; those swap lines deserve to be systematised and broadened.

Modest as they sound, such repairs will be difficult and time-consuming. This summit should get them off to a start. It won't earn anyone a place in the history books alongside John Maynard Keynes and Harry Dexter White. But it would be a lot more useful than more gusts of grandiose rhetoric.