InterAction Council

High-Level Expert Group Meeting

Chairman's Report on the High-level Expert Group Meeting

Managing International Financial Markets

Chaired by Jean Chrétien

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Hotel Atlantic Kempinski
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President Horst Koeler of Germany has said, "The global financial market has become a monster, responsible for massive destruction of assets". The current crisis of the international financial markets is also affecting real economic activity, and faith in the system has been eroded. Huge disequilibria in the international balance of payments could lead to more disorderly adjustments, including an ever-weakening US dollar. The currency instability was a factor leading to manifold global speculation, and the rising speculation was accompanied by some practices with questionable decency. Only few experts can perceive correlations and interdependence in the opaque globalised financial markets.

Global financial crises are a daunting legacy since the 1970s. But the most significant feature of the current crisis is that it has been so long in coming, so foreseeable and predictable. In fact, it has been predicted repeatedly by the Council's Honorary Chairman, Helmut Schmidt. This has raised the question of what the regulators and supervisors could and should have done to prevent the latest crisis triggered by sub-prime loans. Some other challenging questions asked to the high-level experts gathering in Hamburg were; is a restructuring of regulatory frameworks necessary in the US, the UK, and globally? Should central banks get a mandate for pre-emptive action on asset bubbles in the making to prevent broad dislocations?

Disequilibrium in the International Balance of Payments

The enormous U.S. budget deficit has been accumulating since the beginning of the new century. Since private households are saving almost nothing, high deficits continue in the U.S. trade balance. These deficits are financed by foreign trade partners, making the U.S. the largest debtor in the order of $8 trillion, which amounts to about two thirds of the U.S. GDP grosswise and about a quarter netwise. Americans live from foreign capital import in the order of $5 to $6 billion dollars every year. How long will the U.S. be able to afford this level of debt? How long will the American foreign partners be able and willing to afford their capital exports to the U.S.?

Disequilibria, housing bubbles in the U.S., the sinking U.S. dollar and the rising energy prices have, to a large extent, all been fuelled by the enormous deficits, low interest rate policies and the opening of the liquidity floodgates at every difficult turn of the economy. Is the sinking dollar pushing the oil price up and thereby creating inflation in the consumer countries? Is there a fundamental disequilibrium between demand and supply? Or is it the hedge funds and other speculators that are pushing the oil price up? And how do we deal with the oil price-related explosive growth of the Sovereign Wealth Funds? Is this the beginning of a "rebalancing"? Or, are we just entering a period of increased volatility?

The gravity is shifting increasingly to the Euro from the U.S. dollar. In the long-run, the Euro will play a more active role, but nobody wants a sharp decline of the dollar.

The "best selling commodity" of the U.S. has been the "almighty dollar". But this is predicated on the dollar maintaining sound financial markets in the U.S., good rates of return, and keeping the currency value over time. Structural reform, thus, is inevitable in the U.S. The U.S. government officials keep insisting on a stronger dollar, since depreciation has led to a negative influx of dollars.

High and rapidly rising energy and food prices create a major challenge. They result in an income transfer from consuming to producing countries. If prices remain high, negative effects on world wealth distribution will be inevitable. At the moment there are only two countries with current account surplus in the case of Asia. A common cause is abundant liquidity created all over the world. This "moneterization" may not be sustainable in the future, as it fuels both increasing price pressure and widening disequilibrium.

The daily transaction volume in foreign exchange markets today aggregate approximately $3.2 trillion dollars. But this enormous figure is only a part of the problem we face. What is its implication for the practicality of credible and sustainable currency interventions to impact global imbalances? For one, no real solution can be brought by foreign exchange adjustments any longer.

Risks Inherent in Newly Created Derivatives and Hedge Funds

Today, there are more than 9000 unregulated, risk-taking hedge funds, managing nearly $2 trillion in assets. Many of these funds tend to register their headquarters in tax havens where functioning supervisory authorities are absent. Most of them aim to maximize returns on their assets with repeated borrowing. Although hedge funds claim to give liquidity to the market, they could also rapidly deplete liquidity. Large financial institutions also manage funds off-balance and, when losses are incurred, these are channeled back to them. The extraordinary projections of profits for hedge funds fuel greed, which has an enormous negative impact upon the regulated market.

However, politicians as well as ordinary investors lack both an overview and specific knowledge. As evidenced during the sub-prime crisis it is very difficult, if not impossible, to get information on what is going on out of your own jurisdiction.
Only a few highly specialized experts can perceive private financial correlations and interdependencies in the opaque globalized financial markets. It is largely because there is no supervision of hedge funds and their related institutions, unlike banks and insurance companies which are supervised by governments, nor are there any internationally effective rules. Despite the potential global risks inherent in these funds, very few financial authorities have the power to even judge and restrain these financial risks that could affect their own national economies.

Presumably, financial instruments are devised to diversify risks which, market players argue, help stabilize the financial market and therefore the economy as a whole. But the very instrument to diversify risks often becomes a new risk, as manifested in the recent

U.S. sub-prime loan case. By enlarging pricing fluctuations, these funds could destabilize the market as well. Short-term investment of these funds cannot align with the long-term efficiency of corporations.

There is also a problem in dealing with the derivatives industry. The systemic importance of Bear Sterns was so eminent. According to the Bank for International Settlement, about 85% of derivative trading volumes are over-the-counter (OTC) and therefore more complex, risky, profitable and less liquid than exchange traded derivatives and not transparent at all. Settlement is notoriously slow and inefficient. Pushed by the regulators and lately by a declaration from the G7 finance ministers, the leading investment banks have undertaken to build a central clearing operation for $62.2 trillion Credit/Debt Swaps by September 2008. This could theoretically take a lot of complexity and systemic risk out of this huge volume business. But by implication it would also reduce profitability, and therefore induce the risk of migration of business and people to the unregulated industry.

Increasing attention is being paid to Sovereign Wealth Funds, as many countries, including China and Russia, are creating or expanding new ones. Already some 30 SWFs exist with the estimated total investment exceeding $3 trillion. Countries with massive natural resources or trade and current account surpluses manage these SWFs. Unlike the foreign exchange reserve investment, the objective is to maximize returns by investing in a wide array of financial instruments and real assets. Concerns have been raised and international consultations are going on related to transparency and investment strategies of publicly owned sovereign wealth entities.

Supervising International Markets and Ensuring More Transparency

Regulators and market participants are playing the game with dynamite. There is a broad consensus that something should be done about aligning managers' incentives and compensation with investors' interests, risks and rewards. The question is one of supervising the financial markets with some urgency. Politicians are recognizing and responding to public sentiment that has a growing potential for social tensions – at a time when the income divide between the rich and the rest keeps growing and has become an issue of public debate, which is fueling a growing resentment towards market economics.

Excesses in the financial industry may produce a broader and damaging political and social backlash against the principle of free markets. Already some proposals have been made to curb the global flow of capital. Proposals for tougher financial regulation abound. The difficulty is to ensure that damage done by past excesses is not followed by damage to the markets' functioning and the economies they serve with new regulation that aims to control past excesses.

If, consequently, U.S. investment banks should come under the jurisdiction of the Federal Reserve System, their enormous leveraging might be reduced to the level of commercial banks. That would strongly reduce their lending to hedge funds and private equity funds as well as the leveraging capacities of those funds. This could be more effective than any efforts to regulate these funds directly. At the same time, regulators are working on additional strict capital adequacy rules for banks, including their trading books and off-balance sheet holdings of structured credit products. This would reduce not only their own leverage, but also that of their key leveraging customers, the hedge funds and private equity funds.

The redrafting of rules by the Basel Committee at Bank for International Settlements intentionally encompasses liquidity management – rightly so, given the ingenuity with which the derivatives sector has developed not only AAA products out of junk, but also for a large scale reverse maturity transformation.

The following observations were made during the High-Level Expert Group Meeting in Hamburg:

(Disequilibrium)

- American households should start making ends meet by borrowing less and by saving more and thus take responsibility for their financial soundness.

- While criticizing the U.S. consumption style, it is strongly encouraged that the developing and emerging countries take measures to enhance their national consumption, including establishment of adequate safety nets, in order to avoid the excess supply of the funds into the global capital market.

- Emerging market countries should increase consumption in order to reduce their surplus.

- It should be determined whether speculation in oil markets drives up commodities prices. Investors should follow prices and not the other way around.

(Trade-off)

- Political leaders must be clear with their electorates that there is a choice between long term financial stability and cheap money.

- Spell out clearly to the population the trade-off between stability and high cost of capital and cheap cost of capital and instability.

(Regulation, supervision & transparency)

- A more integrated financial regulatory system in the U.S. could go a long way in raising the private saving rate through the discouragement of excessive leveraging and debt.

- There is a need for a redirection of the global financial system to make it more robust and resilient. There may be a short-term price to pay but it is worth taking in order to bring long-term prosperity and avoid serious crisis.

- The steps to be taken should not stifle innovation of markets. Rather, they should strengthen shock absorbers and capital cushions in good times, to increase the resiliency of the financial system to stress and severe shocks.

- A holistic approach should be taken in view of regulation. International cooperation should be developed and all on and off balance sheet entities should be treated equally in regulatory terms.

- The overall leverage has to be reduced progressively. Stronger buffers and cushions, both in terms of capital and liquidity, have to be introduced and maintained in all circumstances, including in good times. This new endeavor should be undertaken worldwide with no loopholes. An international body, preferably the IMF, should be empowered to implement those recommendations.

- Central banks that have no supervisory task should be given direct access to supervisory information, including on-site inspections in order to sustain their role and mandate to ensure the stability of the financial system.

- Transparency of non-regulated entities should be increased by giving supervision authorities and central banks the right to get information in times of stress or when financial stability is at risk.

- Public authorities should be given prompt and continuous access to all relevant information by all market participants, whatever their legal status, both in normal and crisis times, so as to minimize moral hazard in their interventions and increase their efficiency.

- Political leaders should consider ways to regulate the risk-taking, unregulated hedge funds in order to increase transparency of financial operations and grant supervisory authorities the possibility of intervening against misuse.

- There should be no off-balance sheet, but rather, higher capital requirements and/or maximum leverage should be allowed.

- Ratings agencies must be regulated. Their knowledge must be improved and there must be transparency with respect to the models they base their ratings on.

Increased competition within the industry by more agencies being present could improve standards.

(The role of IMF)

- It is recommended that the IMF is given an oversight and signaling role on global financial standards and measures. The independence of the IMF Board should be strengthened; the Board should adhere to the articles instead of the capitals.

- The IMF should enhance symmetrical surveillance of financial systems in member countries.

- The G8 should request the IMF to propose recommendations for guidelines of the surveillance and direction of international financial markets. These should be equitable and loaded against developing and emerging markets, whose rather special needs should be catered to.

- The IMF should be tasked, as part of its formal mandate, to monitor, analyze and provide guidance to international financial markets, survey the conduct of market participants and their regulators and supervisors, benchmark this conduct against internationally accepted standards and best practices and make its assessments public. Where such standards and best practices do not exist, the IMF should convene the relevant parties to facilitate their formulation in a cooperative manner. For the IMF to fulfill this task effectively, its governance structure should be reformed.

- The Heads of State and Government of the G8 should take the lead in launching such a reform of the IMF by calling for a new "Bretton Woods"-type conference while at the same time signaling their readiness to reform IMF quotas and voting rights in such a manner that no individual member country retains a blocking minority.

(Risks inherent in new instruments)

- It would be highly desirable to abolish the current financial set-up in the tax-exempt and control-free islands in the Caribbean, Europe and elsewhere. National and international actions should be taken in order to close down the tax havens. As a short-term goal, governments of OECD countries could prohibit their banks from lending to private financial institutions registered in tax havens.

- This calls for, among other things, stronger norms on accountability, governance and ethical conduct by managers of financial intermediaries and funds, as well as the closing of information gaps through improved disclosure by both regulated and non-regulated entities.

- Incentives problems in the financial industry must be addressed as a matter of urgency. Solutions should be strictly enforced. As a general principle, market participants should fully share the consequences of their decisions on risk taking (both origin and transfer). Compensation practices for management should be designed so as to be consistent with the long term interests and risk preferences of investors and savers.

(Sovereign Wealth Funds)

- Sovereign Wealth Funds have played a positive role in the global financial system. It would not be helpful to the system to act on hypothetical possibilities of wrong-doing in the future. Hedge funds and rating agencies present a more pressing priority for attention and supervision than the SWFs.

- A set of standards or best practices should be developed on the management of SWFs. There should be better access to information on them. The EU initiative to work with the IMF and OECD to develop standards and best practices to gain more knowledge on SWFs as potentially important future market players is very welcome and should be supported.

(Professionalism & moral responsibility)

- The Council members should pay close attention to the specific needs and problems of the emerging markets. The "failure" of the Doha round is an indication of the abandonment of the moral leadership in the financial world.

- Political leaders should be explicit about the working personal integrity and trust in the foundations of the financial systems, especially in the credit banking world. Where these standards are ignored today they should be condemned.

- Professional responsibility of bankers must be emphasized. They cannot rely blindly on the ratings of ratings agencies. They must remember their duties and prepare due diligence.

- Remuneration system in banking sector should be addressed. Beef up regulators: more money, more training, better standing in industry so that the best can be attracted.

- Bring incentive structures of firms within supervision, compensation should be balanced by time and risk taking (e.g. by having multi-year horizons for bonus schemes).

- A call for global initiative on financial education should be made. As demographic challenges in an increasing number of countries make greater long-term savings and investment efforts by individuals and households inevitable, people need to better understand the relationship between risk and return in financial markets. People should know what kind of rates of return can be sustainable over longer periods of time without severe risk of loss. Governments and the private financial sector should work together to launch a comprehensive educational effort to explain to people the financial challenges they face due to aging populations, and raise their financial literacy in order to help them to better understand the financial risks and guide them towards safer savings/investment strategies.

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List of Participants

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List of Participants

InterAction Council Members

1. H. E. Mr. Helmut **Schmidt**, Honorary Chairman (Former Chancellor of Germany)
2. H. E. Mr. Malcolm **Fraser**, Honorary Chairman (Former Prime Minister of Australia)
3. H. E. Mr. Ingvar **Carlsson**, Chairman (Former Prime Minister of Sweden)
4. H. E. Mr. Jean **Chrétien** (Former Prime Minister of Canada)
5. H. E. Mr. Olusegun **Obasanjo** (Former President of Nigeria)

Associate Members

6. Baroness **Jay**, Chairperson of the Overseas Development Institute, London (U. K.)
7. Mr. Seiken **Sugiura** (Former Justice Minister of Japan)

High-level Experts

8. Dr. Muhammad **Al-Jasser**, Vice Governor, Saudi Arabian Monetary Agency
9. Mr. Axel **Bertuch-Samuels**, Deputy Director of the Monetary and Capital Market Department, IMF
10. Dr. Ulrich **Cartellieri**, Former member of the International Advisory Committee of the Federal Reserve Bank of New York (Germany)
11. Prof. Jose Manuel **Gonzàlez-Pàramo**, Member of the Executive Board, European Central Bank (EU)
12. Mr. Hans-Helmut **Kotz**, Member of the Executive Board of the Deutsche Bundesbank (Germany)
13. Mr. Jean-Pierre **Landau**, Deputy Governor of the Banque de France
14. Dr. Vincenzo **La Via**, Chief Financial Officer, World Bank
15. Dr. Marc **Roovers**, De Nederlandsche Bank
16. Dr. Jochen **Sanio**, President, The German Federal Financial Supervisory Authority
17. Dr. Susanne **Schmidt**, Bloomberg (Germany)
18. Dr. Gillian **Tett**, Capital Markets Editor, Financial Times
19. Mr. Hiroshi **Watanabe**, Former Vice Minister of Finance for International Affairs (Japan)