

# WebMemo



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## Gordon Brown's Financial Folly: The Global Economy Does Not Need More Regulation

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Prime Minister Gordon Brown of the United Kingdom asserted earlier this week that the financial crisis revealed the need to “rebuild our fractured financial system.” The European Union echoed this sentiment in a call for “a genuine and complete reform” of the world’s financial architecture.<sup>1</sup> The heart of Brown’s proposal is to enhance the power and authority of the International Monetary Fund (IMF) and the World Bank (known collectively as the Bretton Woods organizations)<sup>2</sup> to create an unprecedented level of global governance to supervise financial institutions, impose universal standards for accounting and regulation, and serve as an early warning system for future crises.

The financial crisis certainly is serious, but Mr. Brown’s suggested solutions would, for the most part, do little to prevent future crises; on the contrary, they could do great harm.

Brown’s proposal coincides with ongoing meetings between the Bush Administration and European officials and the announcement of a special G-8 summit as early as next month to focus on the global financial crisis. The Bush Administration should not make the creation of a powerful new international regulatory authority a part of its legacy.

**A New Financial Architecture?** Prime Minister Gordon Brown authored an op-ed in *The Washington Post*<sup>3</sup> on October 17 suggesting that the current international financial crisis requires a radical expansion of global governance over international financial institutions and transactions.

Brown’s op-ed is a study of internal contradictions and confusion and should not be taken as a serious proposal.

Brown opens his argument with the false statement that “We are living through the first financial crisis of this new global age.” The numerous banking and financial crises in Latin America over the past few decades, the Asian financial crisis in the late 1990s, and the Russian financial crisis in 1998 were all international in scope and precipitated calls for massive interventions. Indeed, the crises resulted in substantial lending from the IMF and World Bank to ward off fears they would spread to the U.S., Europe, and other parts of the world. Perhaps Brown means that this is the first financial crisis to arise in the U.S. and Europe in the new global age? If so, he should state it.

Brown’s criticism of an alleged deficit of international cooperation in addressing the financial crisis is undermined several times in his own piece. A good example is his statement that “The global problems we face require global solutions.... There are no Britain-only or Europe-only or America-only solutions to today’s problems. We are all in this together, and we can only resolve this crisis

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together.” Yet Brown acknowledges that this cooperation is already ongoing and robust. Several examples laid out in his op-ed include the following:

- “French President Nicolas Sarkozy and European Commission President José Manuel Barroso will meet with President Bush to discuss the urgent reforms of the international financial system that are crucial both to preventing another crisis and to restoring confidence.”
- “When President Bush met with the Group of Seven finance ministers last weekend, they agreed that we all had to deal with not only the issue of liquidity in the banking system but also the capitalization and funding of banks. It was clear that national action alone would not have been sufficient. We knew we had to send a clear and unambiguous message to the markets that governments across the world were prepared to act in a coordinated manner and do whatever was necessary to stabilize the system and address the fundamental problems.”
- “Over the past week, we have shown that with political will it is possible to agree on a global multibillion-dollar package to recapitalize our banks across many continents.”

Indeed, international coordination in financial regulation has a long history, including the Basle I and Basle II international agreements on bank capital standards. The recent crisis demonstrates the importance of internationally consistent regulation of financial markets. But any international effort should be consultative and advisory, engaged in such matters as the development of best practices standards, rather than bent on establishing new international regulatory authorities possessed of dictatorial or coercive powers over such matters.

Brown’s problem seems less that cooperation is not occurring than that it is occurring in a way that is led by national governments rather than being

directed by an international authority. He specifically notes that:

At the end of World War II, American and European visionaries built a new international economic order and formed the International Monetary Fund, the World Bank and a world trade body. They acted because they knew that peace and prosperity were indivisible. They knew that for prosperity to be sustained, it had to be shared.... The old postwar international financial institutions are out of date. They have to be rebuilt for a wholly new era in which there is global, not national, competition and open, not closed, economies.

The problem is that the Bretton Woods institutions have been struggling for years to find a role precisely because the world has been increasingly open and globalized. For instance:

- **IMF.** Under the rules established for the Bretton Woods system, each currency was assigned a value in gold that was to be maintained within a narrow range. The IMF was the mechanism that kept this system running smoothly and, for the first quarter century of its existence, the IMF had a clear mandate. However, in the late 1960s and early 1970s, the system of fixed exchange rates that the IMF was set up to oversee began to break down and ended entirely when the U.S. abandoned the gold standard. This rendered irrelevant the primary function of the IMF. Instead of reducing its activities, the IMF sought out new missions to justify its continued existence. As successive crises erupted, the IMF reoriented its focus to deal with them to greater and lesser degrees of success.
- **World Bank.** The World Bank was originally established to rebuild Europe after World War II. Once that need passed, it shifted to providing financing and economic advice to poor countries with the purpose of catalyzing development.

1. Tony Barber, “Brown Calls for Global ‘Early Warning System,’” *Financial Times*, October 15 2008, at <http://www.ft.com/cms/s/0/b2d37338-9aae-11dd-bfd8-000077b07658.html> (October 17, 2008).
2. Bretton Woods is the New Hampshire location where leaders met to establish these institutions in 1944.
3. Gordon Brown, “Out of the Ashes: The Financial Crisis Is Also an Opportunity to Create New Rules for Our Global Economy,” *The Washington Post*, October 17, 2008, p. A25, at <http://www.washingtonpost.com/wp-dyn/content/article/2008/10/16/AR2008101603179.html> (October 17, 2008).

Despite the best of intentions, many World Bank recipients today remain just as poor—if not poorer—than they were before receiving hundreds of billions of dollars in World Bank loans and grants.

Brown is offering a false hope by pointing to the IMF and the World Bank as the saviors of the international financial system. They simply do not have enough money to resolve serious financial crises in the U.S. or the EU. Global markets facilitate the flow of trillions of dollars in private capital. In 2006, international net capital flows totaled more than \$4 trillion. Global trade of goods and commercial services exceeded \$14 trillion in 2006. The U.S. and the EU countries have allotted well over a trillion dollars to address their financial crises.

By contrast, the IMF and World Bank each control roughly \$300 billion in resources. Moreover, their readily available resources are far less than this amount because much of their resources are tied up in existing loans and grants. Solving serious financial crises through the IMF and World Bank is simply not possible unless these institutions are granted substantially greater resources—an increasingly unlikely scenario considering the financial constraints in which countries currently find themselves.

Moreover, Mr. Brown assumes that additional resources will not be made available through other outlets. In response to growing panic over the tightening of trade finance—the credit, insurance, and trade guarantees used to keep the wheels of international trade turning—the WTO has called for a meeting of World Bank, IMF, regional development banks, commercial banks, and trade insurance agencies to lay out a plan for improving the avail-

ability of trade finance to developing countries.<sup>4</sup> Of the five commercial banks invited, Citigroup, JP Morgan, and the Royal Bank of Scotland are receiving government support and Britain's HSBC and Germany's Commerzbank may accept public bailouts in the future.<sup>5</sup> With these and other commercial banks increasingly holding hands with interventionist governments, a successful “public-private” solution to tightening trade finance could drive momentum for a misguided approach to bailing out global financial markets—at significant expense and risk to taxpayers everywhere.

Mr. Brown's proposal to have the World Bank or IMF serve this function is also naïve and ill-informed. These institutions are cumbersome, slow, and lack the expertise and standing to fulfill this role effectively. They should not be granted the sweeping authority proposed by Brown, especially when other organizations such as the Organisation for Economic Co-operation and Development and the Bank for International Settlements arguably have more experience and expertise with central bank supervisory issues.

Nor do Brown's proposed solutions seem on target. For example, he calls for

root[ing] out the irresponsible and often undisclosed lending at the heart of our problems. To do this, we need cross-border supervision of financial institutions; shared global standards for accounting and regulation; a more responsible approach to executive remuneration that rewards hard work, effort and enterprise but not irresponsible risk-taking; and the renewal of our international institutions to make them effective early-warning systems for the world economy.

4. “Lamy Convenes Meeting to Ensure Developing-Country Access to Trade Finance,” WTO 2008 News Item at [http://www.wto.org/english/news\\_e/news08\\_e/tnc\\_dg\\_stat\\_oct08\\_e.htm](http://www.wto.org/english/news_e/news08_e/tnc_dg_stat_oct08_e.htm) (October 17, 2008) and “Lamy Calls for Summit on Trade Finance Amid Global Credit Crisis,” Bridges Weekly Trade News Digest, Vol. 12, Number 34, October 15, 2008.
5. “U.S. bank bailout comes at steep price,” Reuters UK, October 14, 2008, at <http://uk.reuters.com/article/stocksAndSharesNews/idUKLNE49E01E20081015?feedType=RSS&feedName=stocksAndSharesNews> (October 17, 2008); “Royal Bank of Scotland Chiefs to be Forced Out Under Bailout Deal,” *Telegraph*, October 8, 2008, at <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3155667/Royal-Bank-of-Scotland-chiefs-to-be-forced-out-under-bailout-deal.html> (October 17, 2008); “HSBC has ‘No Plans’ to Use Government Funds,” *Telegraph*, October 13, 2008, at <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/3190698/HSBC-has-no-plans-to-use-Government-funds.html> (October 17, 2008); “European banks in no rush for bailouts,” *International Herald Tribune*, October 17, 2008, at <http://www.ihf.com/articles/2008/10/17/europe/banks.php> (October 17, 2008).

At the base of Brown's proposal is an assumption that national and regional financial regulators were inadequate and the rules governing accounting and transparency of private and non-private financial institutions need to be strengthened by an international regulatory authority. This is far from clear.

In the U.S., both the Federal Reserve and the U.S. Treasury warned repeatedly of pervasive risks posed to the U.S. financial system by unsound lending practices at Fannie Mae and Freddie Mac. Congress rejected measures proposed by the Bush Administration and some members of Congress to rectify or constrain these practices. It is this situation—a political failure rather than a regulatory failure—that triggered the financial crisis in the U.S.

Few can dispute the need for increased transparency in financial markets. But there is no such thing as perfect information and risk cannot be eliminated. That said, improving standards and the amount of information available to the market would not only make them more efficient, but would also improve accountability and reduce the risk of future crises. However, there is no need for such standards to be imposed through an international regulatory authority lacking the intimate knowledge of national financial markets that national regulators possess—and which failed to deter the current crisis.

Accounting standards are increasingly congruent internationally and can be tweaked on the national level to best fit domestic markets. Moreover, to a great extent, the World Bank and the IMF already provide sound advice to countries in improving transparency and accountability. Indeed, it was a key condition for their assistance during the Asian Financial Crisis. Unfortunately, countries do not always adopt sound advice. Few lawmakers are—or even should be—willing to blithely yield their authority to set policy at the urging of the IMF or the Bank and that is unlikely to change in the future. Similarly, the IMF and the Bank already provide frequent warnings and assessments of financial conditions internationally and in individual countries. These early warnings are accurate as often as they are wrong—an inevitable condition given the nature of imperfect information. It is hard to see

that they would be more “effective” simply by granting the institutions more authority.

As to Mr. Brown's notion that pay for CEOs be set by international financial regulators in a “more responsible” manner “that rewards hard work, effort and enterprise but not irresponsible risk-taking,” it is simply beyond comprehension why remuneration in private companies should be determined by governments or supranational institutions rather than the companies' stockholders or the board of directors, both of which are more likely to have the best interests of the company in mind when making such decisions.

**Preventing A Future Crisis.** Gordon Brown's proposal to create a new Bretton Woods system with greatly enhanced powers over international financial markets may be aimed at boosting his flagging popularity in Britain, but it will not make global financial markets more sound or a future crisis less likely. On the contrary, to the extent that it promises to remove risk by backstopping financial crises, his proposal could arguably increase market volatility and the likelihood of crisis by creating a moral hazard that encourages imprudent risk-taking.

There are undoubtedly steps that can and should be taken to make future crises less likely or severe that President Bush should entertain and suggest during his meeting with French President Nicolas Sarkozy and European Commission President José Manuel Barroso or at the upcoming G-8 meeting. But creating an additional layer of international regulation and oversight with unprecedented authority and power—especially one charged with “ensuring that globalization works not just for some but for all hard-pressed families and businesses in all our communities” as suggested by Mr. Brown—will more likely retard international investment, financial transactions, and other economic aspects of globalization that contribute to long-term economic growth in the developed and developing world.

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