The Initiative for Policy Dialogue's Task Force on Governance, Transparency and Accountability Meeting on Financial Institutions and Regulatory Bodies

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Meeting Summary

Prepared by Stefano Pagliari

*To see submissions and background documents for the this meeting, please visit www.policydialogue.org

While for a long time secrecy has been considered a prerequisite for the work of central banks and regulatory bodies, in more recent years academics and policymakers have started to acknowledge the relevance of transparency. As **Joseph Stiglitz** has argued in his introductory remarks, transparency in financial institutions and regulatory bodies is even more crucial in this historical moment. The financial crisis has brought domestic institutions to engage in massive and often opaque transfers of wealth to the private sector and central banks have made extensive use of their "emergency powers" for which accountability mechanisms are weaker (**Chris Rude**).

Moreover, issues of governance, transparency and accountability have become more important in the debates about international financial institutions such as the IMF, which has been assigned a new role and significant financial resources in the context of the global financial crisis. A group of academics, central bankers and policymakers have been convened by the Initiative for Policy Dialogue at Columbia University on April 27 and 28, 2009 for the meeting on "Governance, Transparency and Accountability in Financial Institutions and Regulatory Bodies".

This report sums up what are arguably the most relevant points from the presentations and discussion of the workshop. Where the summary points are taken from presentations, the participant's name is followed by the title of their presentation; otherwise, the point was taken from discussion periods. The different points and comments are not always reported in the order they were made at the workshop, but rather they are divided in eight thematic sections. Each section focuses on how issues of governance, transparency and accountability are related to the literature on central banking (*section 1*); the origins of the financial crisis (*section 2*) and the policy responses (*section 3*); developing countries (*section* 4); international regulatory bodies (*section 5*); the Bretton Woods institutions (*section 6*); the G's (*section 7*); the United Nations (*section* 8).

1. Insights and Policy Lessons from the Literature on Transparency and Accountability of Central Banks

The first part of the workshop analyzed the theoretical lessons coming from the economics literature on transparency, focusing in particular on its policy insights for central banking. Not only this is probably the area where issues of transparency have been discussed most extensively, but also where these theoretical insights have influenced a revolution in central banks policies in the last decade.

Joseph Stiglitz opened the workshop discussing some key findings from the literature on transparency in financial markets. Issues of transparency have been central to regulatory initiatives since the East Asian financial crisis of 1997-98. In that case, the US Treasury and other Western agencies identified the lack of transparency in the financial sectors of emerging countries as one of the main causes of the crisis. Contrary to this argument, **Stiglitz** has pointed out that in several cases the countries facing a financial crisis had become more transparent in the years preceding the crisis, as confirmed by a study from the World Bank. **Stiglitz** argued that in order to strengthen financial stability, what we need is comprehensive transparency instead of half-transparency. Increased transparency cannot be requested exclusively from developing countries, but also from private market actors such as hedge funds.

Reviewing the literature on transparency, **Stiglitz** concluded that the relation between information and volatility is ambiguous, and it is incorrect to argue that more information is necessarily for stabilization. However, while the theoretical arguments in favour of transparency remain ambiguous at best, transparency remains a democratic imperative. The burden of proof that transparency will be destabilizing remains on the side of those defending secrecy.

During the discussion, **Stephany Griffith-Jones** suggested that given the ambiguous economic effects of transparency, we need to re-think the reliance on transparency as a regulatory tool. Several participants remarked the distinction between the economic and political arguments for greater transparency, concurring that the latter seems to be more relevant than the former. **Jo Marie Griesgraber** also argued that if more accountability could have negative effects from an economic standpoint, debates about accountability cannot neglect the normative component.

In the course of the discussion, **Stiglitz** presented an additional note of caution about the implication of transparency in central bank policy. **Stiglitz** argued that the cost of too much transparency could be to force central banks to renounce in part to their discretion in conducting monetary policy. From this perspective, transparency is an attempt to hardwide in monetary policy certain priorities and world-views. Similarly, **Indira Rajaraman** argued that the word “transparency” has been subverted in the context of the financial sector. This term is associated with rigidity and predictability in central bank actions, denying the flexibility and discretionary action needed to respond to unforeseen events and to ensure financial stability.

Stiglitz also argued that debates about central banks and transparency should not be confined to interest rates and money supply, but they should be extended also to regulatory policies (e.g. should a central bank disclose what it accepts as collateral?). Along the same lines, **Jose Antonio Ocampo** has raised the question of how is it possible to manage information when central banks have multiple objectives that are not confined to the control of inflation.

Damon Silvers has argued that events such as the recent financial bailouts, the stress tests on American banks conducted by the US federal authorities, and the reform on accounting rules have highlighted the tensions existing between financial stability-oriented regulation and investors protection-oriented forms of regulation, since these forms of regulation often points towards different levels of disclosure.

Petra Geraats ("Trends in Monetary Policy Transparency") provided a framework to analyze theoretically the impact of transparency in central banking and the changes that occurred across the last two decades in central banks across the world. **Geraats** argued that increased transparency has both "information" effects (direct effects of information disclosure) and "incentive effects" (indirect structural changes in economic behavior resulting from different information structure). In an economy with only one information asymmetry but no other market failures, transparency is always welfare improving. However in the real world both the information and incentive effects of greater transparency could lead either to detrimental consequences, such as more volatility or a run on the bank, or positive effects, such as encouraging more prudent behavior. Also in the realm of monetary policy, while the publication of inflation targets and central bank forecasts is beneficial since it allows alignment of private sector expectations and signals central bank's intentions, noisy public information could induce greater economic volatility.

Geraats then documented a significant increase in monetary policy transparency that has taken place in the last decades across different aspects of the decision making process, drawing a distinction between *political transparency*, *economic transparency*, *procedural transparency*, *policy transparency*, and *operational transparency*.
While monetary policy transparency is often associated with inflation targeting, significant improvements in the last decade also can be traced in other monetary policy frameworks. Moreover, the trend towards greater transparency in monetary policy is quite universal and not confined to a small group of advanced countries. An increasing number of central banks now publish a formal statement of policy objectives and a quantification of the primary objective, numerical forecasts, an explicit monetary policy strategy. They often announce decisions to adjust the main policy operating instruments or targets, and they release regular evaluation of monetary policy outcomes.

Geerats has analyzed what institutional and macroeconomic factors have determined this change. The rise in monetary policy transparency is not strongly correlated with the increase in central bank independence (with the exception of political transparency), while it is positively correlated with GDP. The initial inflation seems to present a

significant positive correlation with the subsequent increase in political and operational transparency, while it is negatively correlated with the subsequent level of inflation.
On the basis of these findings, **Geerats** has concluded that the increase in monetary policy transparency appears to have been largely beneficial, and this success story seems to have been the result of the voluntary actions from the same central banks.

Carin van der Cruijsen (“**Central Bank Transparency: Three lessons to bear in mind”**) agreed with **Geraats**’s conclusion about the benefits brought by the increases in central bank transparency. However, **Van der Cruijsen** pointed out that the focus should not be exclusively on the amount of information disclosed (“quantity”) but also on the clarity it creates (“quality”). While at low levels of central bank transparency, additional public information improves the quality of private sector inflation forecasts, beyond a certain level additional information could become counterproductive.

In the context of the current financial crisis, while the lack of transparency of financial institutions and products has been a major determinants of the crisis and steps towards more transparency are desirable, it is important to realize that more information is not always optimal and it could result in an information overload. From this perspective, the challenge is to identify an optimal intermediate degree of information disclosure at which the quality of inflation forecasts is maximized. **Van der Cruijsen** argued that this optimal level is lower for non-OECD central banks.

In conclusion, **van der Cruijsen** distinguished between actual and perceived transparency. She argued that transparency perceptions matter since they influence trust, and thereby also the economic decisions that economic agents make. However a mismatch exists between the actual and perceived transparency because of insufficient and incorrect knowledge, as well as psychological factors. **van der Cruijsen** concluded that increasing the actual transparency could increase the transparency perceptions. However, the mismatch between the actual and perceived transparency has the effect of increasing the complexity of the task of correctly communicating for central banks.

Jon Faust (“Operational Guidance from Transparency Literature”) brought to the table a different perspective on what we know about transparency and how it matters. **Faust** expressed some strong reservations about the empirical literature on transparency in central banking, since causal inferences about transparency are devoid of merit, while causal inferences on inflation dynamics are hideously difficult. Moreover, the theoretical literature either in favour or against greater transparency seems to be missing the main point, that is, in a democratic regime the government has the obligation to facilitate meaningful transparency, while a mandate to the contrary is absent. The main historical justification for restricting transparency has been that of providing a cover to central banks when populist pressures for nominal redistribution are strongest.

According to **Faust** the literature on central bank transparency does not provide any clear operational advice, and it is not clear whether any central bank has the information required to select the optimal degree of information disclosure. The choice available is often not between optimal transparency and opacity, but rather between sharing the

information and having it leak out in a haphazard and uncontrolled way. As a consequence, according to **Faust**, the only robust advice that can be given is: “attempt to be honest and clear”.

Faust argued that central banks should attempt to enhance “meaningful” transparency. However, while economists have developed a significant knowledge about what information should be communicated, how best to communicate it remains outside the their domain. Central banks should seek the help of experts in public communication to design a robust communication framework based on realistic benchmarks.

The discussion following these presentations addressed some methodological issues about how it is possible to analyze transparency and gather empirical evidence. **Geerats** argued that despite the limitations and difficulty in measuring transparency raised by **Faust**, this task remains worth pursuing, while **James Vreeland** questioned the analytical clarity in the existing indexes about transparency. **Tom Palley** presented a more radical critique, arguing that analysts need to consider that information is always processed through a mental framework, and there is no objective piece of information.

2. Governance, Transparency and Accountability in Central Banks and the Origin of the Financial Crisis

The workshop then discussed in what ways did problems of governance, transparency and accountability in central banks and other national institutions contributed to the inadequacy of efforts to prevent the current financial crisis, and what reforms could be implemented to make these institutions more effective.

This issue is particularly crucial because, as **Willene Johnson** showed in her presentation (“**What went right?**”)**,** the costs of central banks’ support of their financial institutions and the expected costs of the guarantees provided have been unprecedented. **Willene Johnson**’s presentation focused not on the more obvious question of “what has failed”, but instead of “what has gone right”. The success-story presented by **Johnson** is a set of regulatory policies implemented by the Spanish central bank in the years preceding the crisis: the dynamic provisioning and the consolidation of Special Investment Vehicles on the bank’s balance sheet. Dynamic provisioning was introduced in 2000, when in order to reduce the pro-cyclicality of the credit cycle, the Bank of Spain requested financial institutions to assign provisions for expected losses from the minute they made a loan. In the discussion that followed the presentation, the Spanish dynamic provisioning described by **Johnson** was criticized on the ground that it could not curb the property boom (**Griffith-Jones**) and for being simply not pro-cyclical rather than truly counter-cyclical (**Truman**).

The second set of policies introduced by the Bank of Spain attempted to consolidate the parameters of banking regulation and supervision by clearly defining the conditions under which SIVs pertain to a bank’s balance sheet.

Johnson argued that these policies represent a model for other countries and demonstrate the importance of introducing two guiding principles in regulatory policies. First, regulatory policy should have a countercyclical effect. Second, regulatory policy should be comprehensive, covering all institutions that serve a banking or credit function.
In her conclusion she suggested some policy prescriptions for developing countries, which should reinforce their macroprudential regulation, develop national regulation within the context of regional and global coordination, and encourage appropriate accountability and transparency of the national regulator and the central bank.

Thomas Palley ("**Monetary Policy and the great recession, what went wrong and what should be done?**") has identified in the failure of monetary policy in addressing asset bubbles another aspect of how the action of central banks contributed to the global financial crisis. In the years preceding the outbreak of the financial crisis, key protagonists such as Alan Greenspan and Ben Bernanke had argued that targeting asset bubbles was neither feasible nor desirable. **Palley** has contested this argument, pointing out that it is both possible and desirable to target asset price bubbles, so central banks should actively intervene given the damages to the real economy that asset-bubbles cause when they burst.

The policy tool **Palley** suggested is a system of Asset-Based Reserve Requirements (ABRR) to complement the existing regulation. This mechanism would force all financial institutions to hold reserves against assets, while the reserve requirement ratio would be adjusted at the discretion of the monetary authorities. **Palley** argued that this approach would present several important advantages vis-à-vis traditional risk-based capital requirements, such as its counter-cyclical properties, as well as the fact that it would allow monetary authorities to direct funds to socially deserving areas.

However, the failure of monetary policy in addressing asset bubbles has been just one part of a broader failure of central banking and economic policy. **Palley** argued that central banks were responsible also for other micro-economic failures, such as embracing the paradigm of de-regulation and non-regulation, and macro-economic failures, such as abandoning their commitment to full employment. From his perspective the crisis invites a broader and deeper conversation about what went wrong and the responsibilities of the dominant economic paradigm that has dominated central banking and economic policies since the 1980s. **Palley** concluded that the crisis shows the danger of having a central bank that is intellectually undiversified and closed-minded, and he made the case for breaking this intellectual monopoly which excludes alternative points of view and support the interests of Wall Street.

Similarly to **Palley**, **Roman Frydman** ("**Excess Countering Versus Countercyclical Policies**") acknowledged that asset bubbles need to be counteracted since they bring significant distortions to the economy.

While the economic literature has largely focused on traditional market failures such as asymmetric information and agency problems, these conceptions have neglected a different kind of market failure: market fluctuations. Crucial factors behind the current

financial crisis have been the excessive upswings in house and equity prices, which had devastating effects on the real economy once the downturn arrived. **Frydman** suggested that regulatory policies should go beyond transparency and address the connection between financial risks, the business cycle, and price swings in asset markets. Since the capital requirements defined by Pillar 1 of the Basel II Agreement are inherently procyclical, this problem should be corrected by building up capital buffers during upswings to protect banks against inevitable downturns. The approach adopted by the Bank of Spain and described by **Johnson** is often cited as a model of how this can be done. **Frydman** pointed out that although this system had certainly helped to protect the banking system and the regulators from underestimating risks inherent in the rapid expansion of banks' loan portfolio, it ignored the economic importance of swings in the real economy and it failed to require the Spanish banks to set aside sufficient provisions against mortgage loans issued during the sharp upswing in housing prices.

Frydman has cautioned against similar types of countercyclical policies, since they could have the effect of slowing down the issuance of loans and the volume real activity even in the early expansionary phase of the cycle that involves the financing of potentially the most beneficial new products and processes. Since financial markets are still vastly superior to regulators in setting values and allocating scarce capital, an important question for policymakers then becomes: what is the appropriate scope of re-regulation? **Frydman** suggested an alternative approach better able to reconcile regulatory intervention with the superior ability of markets to spur innovation and growth. His "excessive-countering" approach varies the degree of active state involvement and capital requirements depending on whether the levels of real activity and/or asset prices are within a "non-excessive" or "excessive range". Although the market eventually self-corrects, **Frydman**'s proposal aims at speeding this correction by announcing several measures aimed at counteracting, but not eliminating, movements further into the excessive range. In this way, the excess-countering approach aims to restore a balance between what should largely be left to the markets and what should instead be directly regulated by policymakers.

3. Governance, Transparency and Accountability and the Response to the Financial Crisis

How have deficiencies in Governance, Transparency and Accountability manifested themselves in responses of central banks and national policymakers to the crisis? In what ways may they have impeded the nature of the responses or their effectiveness?

Gerald Epstein ("**Central Bank Accountability for Financial Stability and Economic Reconstruction**") argued that in the current crisis independent central banks failed not only in stopping massive imbalances and bubbles from building up, but also in responding quickly enough to the crisis once it broke up. The relevant policy question becomes then whether greater central bank accountability would have prevented the crisis or helped in resolving the crisis. The answer given by **Epstein** is that central bank independence weakened the effectiveness of their response to the crisis.

Epstein argued that central bank independence (CBI) must be seen as part of a system of poor theory and poor practice. As central banks must cultivate political allies to preserve their political independence from governments, CBI has the perverse effect of giving an excessive influence to private financial interests. According to **Epstein** this process of "capture" has influenced the central bank policy in the financial bailouts. Reducing the norm of CBI would have then empowered a keener interest in more enforcement of regulation and empowered a more effective and quick response to the crisis.

Epstein also presented a strong critique of the role played by central banks as lenders of last resort during the crisis. According to **Epstein**, central banks focused for too long on liquidity and credit worrying about inflation, and failed to tackle decisively the problem until Lehman's collapse. Why did the lender of last resort fail? Epstein argued that the authorities were late to react sufficiently to the crisis because they had allowed financial institutions to become too big to fail but also too complex to be saved. Moreover, the obsession with "inflation and credibility" had the effect of delaying central banks' monetary responses.

Moreover, while the Federal Reserve under Alan Greenspan had often resisted the design of more stringent forms of financial regulation, more accountable central banks would have probably avoided the regulatory complacency and protected the economy from the financial bubbles and toxic assets that have ultimately brought the economy down. Greater accountability could also have increased the pressure on the Federal Reserve to take expansionary action earlier on and to be transparent in the initial bail-outs. In the current phase more accountability is necessary since the involvement of central banks with bank restructuring operations is placing billions of taxpayer dollars at risk.

From **Epstein**'s perspective, the question becomes then: how can we reform the Fed to enhance its accountability? **Epstein** suggested three proposals. First, while the commercial bank members currently own the Federal Reserve, their shares should be retired, and the Fed should be nationalized. Second, the Federal Reserve should be made more accountable to Congress, and its budget should be under normal Congressional approval. Third, the terms of the appointments to top Federal Reserve officials should be revised to make the institution more accountable to the executive branch.

The issue of regulatory capture raised by **Epstein** was further debated in the discussion. **Griffith-Jones** pointed out that the Spanish case invites academics to better understand why central banks are in the position to take certain unpopular decisions, and she suggested that this could be related to the relative strength of their financial sector. **Ted Truman** argued that the process of regulatory capture from the financial industry could have the effect of not only forcing regulators to relax regulation, but also of creating barriers to entry to protect the existing institutions against competition. According to **Damon Silvers,** the net effect of the US authority's intervention in the banking system in the context of the financial crisis has been exactly that of fortifying the largest US banks against the competition of other domestic and international banks.

Kevin Young has argued that bringing central banks and regulators closer to the political sphere would have the effect of increasing the risk of regulatory capture, as private sector interests could find new channels to influence the policymaking process. **Truman** discussed the recent reforms in international accounting standards and warned against the risk that the political process could override the technocratic standard-setting process.

Similarly to **Epstein**, **Damon Silvers** supported a change in the status of the Federal Reserve, which should become a public-owned institution in order to play the role of regulator and lender of last resort.

Silvers in his presentation warned that complexity could be used as a defense against transparency and this allows the hiding of significant wealth transfers, such as in the case of the complex allocation of risks and rewards in Public-Private Investment Partnership announced by the US Treasury. At the same time, information technology has increased the capacity to deal with complexity and to demystify the wealth transfers often hidden in the financial rescue programs from the US Treasury and Federal Reserve.

4. Governance, Transparency, and Accountability in Developing Countries

During the final part of the first day the discussion shifted from developed to developing countries. The presentations by **Juan Antonio Morales, Leonardo Villar Gomez,** and **Indira Rajaraman** explored the extent to which problems of governance, transparency and accountability have influenced the efforts of these countries to prevent and to manage the global financial crisis.

Morales (“**Governance, Transparency and Accountability in Latin America**”) provided an illustration of the challenges faced by central banks in Latin America and discussed the reforms these countries have undertaken in recent years. Most Latin American countries reformed their legislation in the 1990s in order to grant a greater independence to their central banks conduct monetary policy (Chile implemented these reforms in the 1980s).

Central banks in the region have increased the information published and they are requested to inform the government and the Congress on a regular basis. However, **Morales** warned against overstating the significance of transparency in central banking. Too much information could be counterproductive if people cannot process it, and while Latin American central banks have increased the documents published, they remain short on the specifics and they rarely publish the minutes of the board meetings.
At the same time, Latin American central banks have improved their regulatory and supervisory functions and they have been withstanding well the financial crisis significantly. Latin American banks are now better regulated, supervised, and capitalized than in the past. Part of this success is due to the fact that Latin American countries were plagued by severe financial crises (mainly banking crises) in the 1980s and 1990s, and they have learnt the lessons from these traumas.

Gomez ("**Governance, Transparency and Accountability in Colombian Central Bank and Financial Regulation**") has expanded the discussion on the evolution of central banking in Latin America by analyzing the Colombian case. As other central banks in the region, the Colombian central bank has gained formal independence and has moved from a policy of exchange-rate targeting to a policy of inflation targeting.
The recently gained independence has allowed the Colombian central bank to avoid mistakes made in the past. Contrary to what happened during previous crises, the central bank has been able to withstand widespread popular opposition to delink monetary policy from short-term considerations. Monetary policy was managed in a counter-cyclical way, tightened during the boom period and loosened during the current crisis.

In contrast, in Colombia it has been more difficult to introduce countercyclical macro-prudential policies in financial regulation, since this area remains controlled by the Government. **Villar Gomez** argued that in this area much could be gained by introducing accountability schemes in which regulators and supervisors are not judged by the short-run results of the financial sector, but by the degree of financial stability measured through the full extent of a complete economic cycle.

In the discussion that followed these presentations, **Ocampo** questioned the significance of transparency in the context of developing countries' central banks. In order to be accountable, central banks should do more than simply send reports to the legislative bodies (such as in the case of some Latin American countries) but there should be also some costs to making mistakes.

Rajaraman ("Transparency and Accountability: Were the Prescriptive Standards for Developing Countries Correctly Set?") argued that the prescriptive standards beamed at developing countries for what constitutes transparent functioning and accountability, carry some components that are diagnostically flawed, and/or unsuited to the economic structures and/or political economy pressures found in these countries.

Rajaraman discussed the case of the Reserve Bank of India (RBI), using excerpts from the Dincer-Eichengreen, 2007, assessment of Central banks over the period 1998-2006 (based on the Geraats index), which gives the RBI among the lowest ratings for transparency. **Rajaraman** argued that this is because the term "transparency" has been subverted in the **Geraats** calibration to mean: rigidity in Central bank objectives, when flexibility is needed to respond to unforeseen eventualities as developing countries open up; adherence to a narrowly defined objective like price stability, when what developing countries need is financial stability, where the components of that objective are not possible to prioritise independently of context; and predictability in Central bank actions, which denies discretionary actions towards ensuring financial stability. She argued that the actions taken by the RBI, such as sterilized intervention in the face of the quadrupling of capital inflows over 2004-08, and enhancing risk weights and provisioning requirements to prevent the build-up of a real estate bubble in India over 2005-08, were entirely transparent, and that the choice of action or objective itself cannot be judged on a transparency dimension. Transparency correctly defined remains of paramount importance, but it should be correctly defined to mean full disclosure of sales and

purchases by the Central bank in securities and exchange markets, and full disclosure of policy decisions, with effective dates, and pre-announced finite (or indefinite) durations. It should permit the full range of supervisory discretion under Pillar 2 of Basel II, and should not require disclosure of internal forecasting models or votes in internal meetings. Other transparency messages beamed at developing countries, such as that state ownership of commercial banks is by itself an obstruction to transparent functioning, on the assumption that they have a poorer skill pool, and poorer incentives, and that this will make them less effective at pricing risk, has been effectively disproved by the performance of privately owned banks in precipitating the global financial crisis.

5. Governance, Transparency, and Accountability in the International Regulatory Bodies

On the second day, the focus of the workshop shifted from the national to the international level, discussing how problems of governance, transparency and accountability in international institutions and regulatory bodies contributed to the inadequacy of efforts to prevent the current financial crisis.

Stephany Griffith-Jones and **Kevin Young** ("**Institutional Incentives and Geopolitical Representation in Global Financial Governance**") argued that the geopolitical representation in the key international regulatory bodies had perverse effects on the way in which systemic risk was governed. Their presentation compared the case of the Bank for International Settlements and the Basel Committee for Banking Supervision. While in the decade before the outbreak of the current financial crisis the BIS had reformed its Board of Directors to improve its representativeness, until very recently no developing country was represented within the Basel Committee. **Griffith-Jones** and **Young** showed empirically how in the last decade the relative national shares of reserves and Tier 1 bank capital came to diverge significantly from the representation within the Basel Committee.

They argued that the lack of representation from developing countries affected the content of the regulatory policies designed by the Basel Committee. Concerns about the model-driven and fundamentally microeconomic approach to risk regulation and the pro-cyclicality or regulatory policies hardly reached the table, since the developing countries who had expressed these concerns were not represented in the Basel Committee. Instead, the Basel Committee was dominated by countries with a strong set of incentives to promote the financial services sector even more than managing risks within it, and the lack of developing country representation had the effect of reinforcing the dominant ideology and discourse within the Basel Committee.

Griffith-Jones and **Young** praised the recent reform of the Basel Committee, whose membership has been expanded to include also Brazil, China, India, Mexico, and Russia. While this reform ensures a greater representativeness in terms of bank capital, it does not solve the problem of the lack of representation of smaller countries. In order to address this issue, better governance schemes need to be conceived (e.g. creation of

constituencies, regional representation). At the same time, a tactical question for these countries is to what extent they should spend political capital to improve the representation in financial regulatory bodies, instead of focusing on other issues that affect them more directly (e.g. IMF, capital flows).

Griffith-Jones then suggested the creation of a global regulatory authority. While the creation of such an institution is hindered by the unwillingness of countries to give up their sovereignty in financial regulatory issues, sharing sovereignty would actually strengthen the capacity of governments to regulate markets, while at the same time prevent regulatory arbitrage. Moreover, **Griffith-Jones** argued that developing countries should support this move, as their interests are better defended in a rule-based system.

During the discussion, **Ocampo** argued that the rule-making at the international level should not eliminate the policy space for individual countries, and in particular more policy space should be given to the smaller countries. From this perspective, **Ocampo** criticized the proposal to create a global regulatory authority, since this would probably increase the constraints on developing countries while leaving more space to the major stakeholders. **Griffith-Jones** responded that a truly supranational solution is necessary given the truly global scope of financial markets. A global financial regulator would build upon an existing institution, such as a strengthened Financial Stability Board.

Truman argued that there is a tension between the creation of a global regulatory authority, as endorsed by **Griffith-Jones**, and the argument presented by many that the host-country should be given more responsibility over the regulation of international financial services firms. In this context, **Eric Helleiner** raised the issue of what would be the role of international regulation if we were effectively shifting towards a regime based upon host country regulation. **Griffith-Jones** argued that the idea of a global regulator would not be inconsistent with the idea of host country regulation, since the latter would be mainly a mechanism to implement rather than to design financial regulation.

Helleiner discussed how it is possible to increase the accountability of transnational networks of financial regulators ("**How can transnational networks of financial regulators be made more accountable?**", coauthored with Tony Porter). While these bodies have received much less attention than the Bretton Woods institutions because of their perceived powerlessness, they are particularly influential in determining how international financial markets are governed. Most importantly, they are likely to increase their influence in the regulation of financial markets in the future, since the creation of a World Financial Authority as advocated by **Griffith-Jones** remains extremely unlikely according to **Helleiner**.

Helleiner discussed three accountability problems that plague transnational networks of regulators: 1) the representation of countries, 2) the responsiveness of technocrats to the public interest, and 3) the capture from the private sector.

Firstly, the accountability of transnational networks of regulators has been weakened by the exclusion of developing countries, as discussed by **Griffith-Jones** and **Young**. Since

the G20 leaders met at the Washington Summit on November 15, several steps have been taken to address this gap. The Basel Committee, IOSCO Technical Committee, the International Accounting Standards Board, and the Financial Stability Forum have revised their membership in order to increase their representativeness. However, **Helleiner** noticed that these patterns of expansion have remained uneven. Only the largest systematically important countries have been included, while the smaller developing countries remain rule-takers. Different models of universal accountability could be explored to increase the accountability of transnational networks of regulators, from the expansion of international standard-setting bodies to a universal membership through the creation of constituencies, to the creation of links to make transnational networks of regulators accountable to universal bodies (e.g. to a UN-based Global Economic Council, or the International Monetary and Financial Committee). **Helleiner** also discussed alternative mechanisms to increase the accountability such as the creation of checks and balances (e.g. through a regional outreach process), or the establishment of independent secretariats.

Moreover, in order to ensure the responsiveness of unelected transnational networks of regulators to the public interest, **Helleiner** suggested the creation of countervailing public sector arrangements, such as the establishment of a peer-review process including broader societal interests, the creation of the equivalent of the IMF' Independent Evaluation Office, or the creation of networks of legislators. Similarly, **Leonardo Martinez-Diaz** advanced the idea of developing counter-networks.

In order to mitigate the risk that the regulatory process be captured by the private sector, **Helleiner** suggested the creation of mechanisms to mobilize those market actors that have a more direct interest in financial stability (e.g. the insurance sector, institutional investors, pension funds), as well as the creation of access points for other societal actors (e.g. through the creation of non-governmental shadow regulatory communities). Moreover, the creation of simpler rules that are more likely to be understood by all (such as non risk-weighted leverage ratio) could decrease the risk of capture.

Finally, **Helleiner** suggested that shifting to a system where the burden of regulating international financial services firms is not exclusively in the hands of the home-country but it is shared with the host-country could decrease the tendency of regulators to represent the interests of their own institutions in international negotiations.

In the discussion that followed these presentations, **Bhattacharya** agreed with Helleiner, arguing that in order to increase the accountability of transnational networks of regulators, it is not sufficient to create increase the number of people sitting in the room, but it's important to create mechanisms to increase the degree of contestation.

6. Reforming the Governance, Transparency and Accountability of the Bretton Woods Institutions

After having discussed deficiencies in the governance, transparency and accountability of

international regulatory bodies, the discussion moved to the role of the Bretton Woods institutions, in particular the IMF. How has the response of the Bretton Woods institutions to the crisis been influenced by the limitations in their governance, transparency and accountability? How could the Bretton Woods institutions be reformed to address these limitations?

Pablo Andres Pereira argued that the effectiveness of the Fund and the ability to meet the needs of its members during and before the financial crisis were hindered by its democratic deficit. According to **Pereira,** the limitations of the IMF surveillance exercise, both at the bilateral level and at the multilateral level, were a factor in its failure in identifying the financial crisis.

Nonetheless the position and resources of the IMF have been strengthened as a result of the financial crisis, as the G20 has committed a significant amount of new funding and new lending facilities have been created. At first glance it seems that the Fund has been very responsive to the needs of its members, but it is not clear yet how effective these mechanisms will be in addressing the crisis. Moreover, the Fund has received enormous resources, but this has happened in a contingent way, without a reform in the quota shares and without an effective change in the conditionalities that the majority of developing countries will face. Since the last realignment in the quota system was very modest, the IMF is still not perceived as a legitimate platform to discuss the response to the crisis, and it is difficult for developing countries to contribute fresh funding to the IMF without a quota review.

Pereira concluded his presentation suggesting a possible way forward. As the priority right now has become that of stabilizing capital markets while reviving domestic demands through fiscal stimulus, the Fund needs to be seen as a legitimate platform, capable of sending that message (especially to the surplus countries). However, in order to regain this legitimacy, the Fund needs to significantly change its governance structure, starting from a reduction in the over-representation of European countries.

James Vreeland ("**Governance at the IMF**") discussed the governance structure of the International Monetary Fund in comparison with the United Nations Security Council. Three proposals to reform the Fund emerged from this comparison.

Firstly, **Vreeland** suggested that the Executive Board of the IMF should increase its accountability by taking votes by open ballot. In both the United Nations Security Council and the IMF, negotiations take place behind closed doors. However, while at the UN Security Council votes on resolutions by open ballot, at the IMF Executive Board all decisions are taken without taking actual votes, relying instead on "consensus". **Vreeland** argued that it is appropriate that sensitive negotiations remain behind closed-doors, the IMF Executive Board should always make its decision through a formal vote. In order hold the members of the IMF executive board accountable, these votes should be released to the public in due time, with a delay for the most sensitive matters.

The second set of reforms focused instead on the representation of great powers within

the IMF. **Vreeland** has acknowledged that there is some legitimacy in assigning greater influence to the great powers. In the UN Security Council the great powers holding a veto power were determined at the end of World War II and have not changed since. On the contrary, the IMF has a more flexible governance structure, which allows for realignment in the definition of who are the dominant powers at the moment. However, while before 1971 China and India were among the five countries with most votes in the IMF, at the turn of the century these countries are highly under-represented, while European countries are largely over-represented. In order to reduce the divergence between the voting shares in the institution and the economic realties, **Vreeland** suggested that voting rights should be assigned according to a transparent process, and the measure of economic size should be determined by a disinterested party, on the basis of purchase-power-parity rather than through nominal GDP. Moreover, no single country should have the power to veto the most important decisions.

Thirdly, **Vreeland** suggested that the Fund should introduce stronger regional representation mechanisms. The IMF should continue to allow the reelection of the Executive Directors but they should be regional representatives selected by the regions themselves. This mechanism would introduce an element of regional accountability, since the representatives could only be reelected if they act as good neighbors and pursue the interests of the majority in the region. At the same time, this mechanism would allow regional powers like Brazil, India, Japan, and South Africa to serve with continuity and regularity.

In the discussion that followed this presentation, **Griesgraber** said the IMF should publish not only the votes but also the minutes. This reform would give developing countries a way to have their voices on record. **Vreeland** responded that if the Executive Board was publishing also the minutes, this would simply shift the deals and negotiations in the backdoor.

Geraats disagreed with **Vreeland**'s proposal to publish votes of the IMF Executive Board, since this could weaken collegiality and lead countries to represent more explicitly their national interest rather than seek win-win solutions. **Rajaraman** argued that transparency should be increased not in the voting patterns, but rather in the design of loan programs, and in the relation between countries and the IMF management.

In his discussion about the reform of the IMF, **Ted Truman** reminded that the Fund is first and foremost an "inter-governmental organization". This means not only that governments will never step back from trying to influence its operations, but also that bringing in "independent experts" (appointed or self-appointed) would heighten rather than mitigate the concerns about the democratic nature of the Fund.

Truman explored different aspects of the IMF governance structure that must be reformed. First, the selection of the IMF's managing director as well as the deputy managing directors should be conducted via an open, merit-based selection process. Second, the size of the Board should be optimized, starting with consolidation of European representation. Amending the IMF's Articles of Agreement to stipulate that

executive directors must be elected could further facilitate this outcome. Third, **Truman** expressed his disappointment with the quota formula adopted to allocate the voting rights, and he argued that this formula was driven by political decisions of governments. Fourth, he suggested that special majorities should be reduced from 85% to 80% in order to remove the capacity of the US acting along to veto any decision. Fifth, the reform of the International Monetary and Financial Committee and the decision to take votes could be helpful to force member governments to pay more attention to their responsibilities. At the same time, **Truman** argued that the enthusiasm surrounding this reform is probably exaggerated. Sixth, the Executive Board should be reformed to remove the executive directors from the day-to-day oversight in favor of a role that covers only broader strategic decisions. At the same time, the role of management should be enhanced by assigning it the responsibility for many decisions, subject to ex post review by the executive board. Seventh, **Truman** discussed the relation between the Fund and civil society groups. Civil society groups have imposed a variety of constraints on both the IMF and the World Bank that do not exist in most democratic countries. Therefore, Truman argued that the role of civil society groups in these institutions should be mediated by member governments.

At the end of his presentation, Truman discussed the decision by the G20 to increase the allocation of Special Drawing Rights, but he rejected the idea that these could replace the dollar as a global reserve currency.

Leonardo Martinez-Diaz contributed to the discussion on the reform of the IMF by examining the critical role that enhanced transparency could play in making the Fund more accountable. **Martinez-Diaz** distinguished between *internal* transparency and *external* transparency, arguing that there is some room to limit international transparency in order to enhance the operations of the Fund. In particular, if the Fund wants to be an honest truth-teller, internal transparency should be limited in order to protect the staff from political interference. Several arguments could also justify limitations to external transparency, especially when information could destabilize the market, to avoid problems of insider trading, and not to embarrass national authorities and the Fund itself. He reported that the Fund seems to have increased its external disclosure in several areas and board minutes older than ten years are now published. While this has been extremely helpful to demystify how the IMF operates, it still remains difficult to have access to many documents. **Martinez-Diaz** argued that some of the policies restricting external transparency should be changed and the 10 year period could be shrunk down. However, releasing documents is not enough. In order to keep the Fund accountable there is also the need to increase the clarity of these documents and to demystify the code used by the Fund.

During the discussion that followed the presentation, **Pereira** defended the existing limitations to the publication of documents, since countries often do not agree with the assessment made by the Fund. **Vreeland** argued that while there has been an explosion of transparency at the level of the staff, similar improvements have not occurred at the level of the Board where they key decisions remain opaque.

Jenkins argued that often in the case of the Bretton Woods institutions there is an assumption in favor of non-transparency in order to insulate the staff and to allow it to make hard choices. However, it is not always clear what needs to be insulated and from whom. **Jenkins** then suggested that the Fund should identify what documents are regarded as really sensitive, while everything else should be released.

7. The intersection between the G's and the International Financial Institutions: issues of Governance, Transparency and Accountability

After discussing the role of formal international institutions such as the IMF and the World Bank, the workshop addressed the role played in the governance of financial markets by more informal groups, the so-called "Gs".

Amar Bhattacharya ("**The role of G's in BWI Governance**") explored the relation between the Gs and the Bretton Woods institutions, arguing that it is not possible to look at the role of the former without taking into account the governance problems of the latter. **Bhattacharya** reviewed what he considers to be the key weaknesses in the governance of the Bretton Woods institutions, such as the insufficient ministerial engagement, the ambiguity of roles amongst the various constituent bodies, the unbalanced representation (voting power, board composition, decision rules, selection of Heads and Senior Management), the insufficient transparency, and the weak board management and staff accountability. These weaknesses have significantly impaired the operation of the Bretton Wood institutions. Nevertheless, **Bhattacharya** argued that important reforms in the governance of international institutions could be achieved only when Gs plays a leadership role and the tensions between the G7/G20 and the G192 were reduced. In particular, **Bhattacharya** stressed the role that the Gs could play as forum for direct and high level dialogue, to achieve mutual commitment among different states, and to set the agenda for future reforms. While these factors make the Gs' leadership extremely valuable, its agenda-setting role raises significant concerns. While until the 1990s, the agenda set by the G7 did not imply commitments for other countries, during the 1990s and especially after the East Asian crisis the focus of these commitments expanded to countries that were not part of the G7.

Bhattacharya also argued that civil society groups have played an important role in influencing the reform of the Bretton Woods institutions and their policies (such as in the case of the Debt Relief initiatives and Governance reforms). Therefore, he stressed the need to find space for inclusion and contestability in order not to leave the agenda-setting entirely in the hands of the G20. The response to the financial crisis and the increase in the IMF resources point instead to the importance of the US leadership in moving the agenda forward.

Roy Culpeper ("**Governance, Transparency and Accountability in the G's**") argued that the Gs collectively represent a form of "asymmetric global governance". While the groups representing industrial or emerging market countries (e.g. G7/8 and G20) have played an active agenda-setting role and determined the direction of the IMF and World

Bank, the groups representing developing countries (such as the G24 and G77) have been confined to a permanent opposition role. **Culpeper** questioned what is the real position of the developing countries that are members of the G20. Are they influential or simply validating the position advanced by the G7 countries? Is the G20 simply a cooptation process?

This question generated an intense debate during the discussion that followed the presentation. **Leonardo Martinez-Diaz** argued that when emerging countries reach the negotiating table, in the initial phase their impact over the agenda is very limited. Similarly, **Palley** argued that increasing the representation of developing countries in the Basel Committee and similar bodies would not make a lot of difference, since these countries are focused on issues of national sovereignty and capital flows. Moreover, their inclusion could be detrimental, as these countries could have pushed for lower rather than higher standards. **Griffith-Jones** and **Bhattacharya** expressed a different view. **Griffith-Jones** responded that some developing countries (e.g. China) have developed an alternative regulatory framework and a different approach to risk. **Bhattacharya** argued that while the interests of developed countries in regulatory issues are mainly on micro-prudential regulation, developing countries could move the agenda of the FSB more towards macro-prudential issues.

Caliari warned against confusing developing countries' representation with influence. He argued that the influence that these countries can exercise in financial governance bodies is lower when they are divided than when they are able to speak as a group. **Bhattacharya** argued that the larger emerging countries and the other the non-G7 members of the G20 should speak with a single voice.

Secondly, **Culpeper** in his presentation raised the question of whether there is an optimal "G"? Do collective action problems render bodies with a universal membership (what **Culpeper** defined as the G-192) dysfunctional? **Culpeper** reviewed the "Collective Action" literature, in particular the work of Mancur Olson. While this literature suggests that a G-192 is too large to exercise a leadership function in the governance of the global economy, some global public goods cannot be provided without a more universal membership. If the literature seems to point towards variable geometries depending on the problem at stake, more universal bodies such as the "G-192" should play a greater role in coordinating the different groups.

Amar Bhattacharya commented that since universal bodies are not viable solutions in many areas, the design of regulatory standards should develop along variable geometries. **Didier Jacobs** asked whether an overarching body like the Financial Stability Board can coexist with relatively autonomous standard-setting bodies.

8. The Role of the United Nations

As **Griesgraber** noticed during the discussion, only very few presentations during the workshop mentioned the United Nations and what role it should play in a reformed

international financial system. This issue was brought to the table more directly in the concluding part of the workshop by **Jose Antonio Ocampo** and **Joseph Stiglitz**, respectively member and chair of the "Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System".

Jose Antonio Ocampo ("**Relation between Bretton Woods Institutions and the UN"**) discussed how the relation between the IMF and World Bank, and the United Nations could be structured. **Ocampo** discussed the proposal contained in the report on IMF Governance Reform of the Committee chaired by Manuel Trevor to reform the International Monetary and Financial Committee by creating Council. **Ocampo** questioned how this governance reform would affect those countries that are not part of the Council. **Ocampo** expressed his concerns for what he calls "minority shareholders", countries not represented in the G20 or in any other G's. The use of constituencies could be an important governance mechanism to ensure that the interests of these minorities are represented in the system.

Ocampo also discussed the proposal contained in the Manuel report to extend significantly the IMF mandate to areas such as financial stability and capital account, cautioning against the risk that this expansion could restrict the policy space of developing countries.

Ocampo argued that the UN's role should be similar to the role played by civil society in influencing the agenda, broadening the scope of the debate, and bringing diversity to the table. The G20 should move closer to the UN system (not the UN organization), and this would be useful to increase the coherence of those organizations that never report to the UN secretary general (such the Bretton Woods institutions and the WTO).

The desirability of moving the G20 within the UN framework in order to enhance its political legitimacy has also been reaffirmed by **Joseph Stiglitz,** who closed the workshop by presenting the work of the "Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System". The UN commission has analyzed the causes of the crisis both at the macro-level (e.g. lack of global aggregate demand based in part on greater inequality and in part on accumulating reserves) and at the micro-level (e.g. weakening of regulation), and, building upon this analysis, it has recommended several short-term and long-term policies.

A coordinated global stimulus is the first and most urgent short-term policy. **Stiglitz** warned that every stimulus that maximizes the domestic impact has strong negative externalities for other countries and he called for greater international coordination to avoid any protectionist backlash. Unfortunately, there are already visible signs of this trend, as 17 out of 20 G20 countries have engaged in protectionist measures since the Washington Summit on November 15.

Since many developing countries do not have the resources to contribute to such stimulus but are experiencing dangerous financing gaps, the Commission has discussed what are

the most appropriate instruments, facilities, and conditionalities to help these countries. An important point made is that there should be competition between different institutions in disbursing this money.

The Commission has also discussed governance issues, advocating a more extensive use of double-majorities, and financial regulation. International financial regulation needs to be comprehensive, countercyclical, and it should focus on large countries rather than small countries, because it is only what the former do that has systemic effects. Moreover, since individual firms do not take into account the externalities that they pose on other firms, regulatory reforms should not rely on self-regulatory mechanisms. The Commission has discussed a wide range of regulatory issues, such as corporate governance reforms, the role of off-shore centers, the break-up of institutions that are "too big to fail", and the separation of investment and commercial banks. Both behaviors and financial products should be regulated, for instance through a Financial Products Safety Commission, and naked derivatives should be restricted.

While many thought that a global regulatory authority would be a desirable goal, there was within the Commission a consensus around the desirability of greater reliance on home-country regulation. The presumptions on the benefits of unfettered capital market liberalization should be revised and the reintroduction some forms of capital control could be beneficial to strengthen international financial stability.

The UN Commission discussed some more long-term policies, such as the proposal to create a global reserve currency system, and possible alternative solutions at the global but also at the regional level if this proposal proved to be politically unfeasible. In order to foster global economic coordination, the UN Commission has suggested the creation of an expert body, which should be independent and would help to identify problems. The Commission has also addressed other long-term issues such as debt reduction, global risk management and new mechanisms to finance development (e.g. use of new global currencies to finance development, use of carbon credits).

List of participants:

Bhattacharya, Amar	*Director,* G24 Secretariat
Burke, Sara	*Policy Analyst,* Center of Concern
Caliari, Aldo	*Director, Rethinking Bretton Woods Project,* Center of Concern
Culpeper, Roy	*President,* The North-South Institute
Dobson, Chad	*Executive Director,* Bank Information Center
Epstein, Gerald	*Professor of Economics,* University of Massachusetts
Faust, Jon	*Professor,* Johns Hopkins University
Frydman, Roman	*Professor,* New York University
Geraats, Petra	*University Lecturer in Economics,* University of Cambridge

Green, Sarah	*Program Manager,* Initiative for Policy Dialogue, Columbia University
Griesgraber, Jo Marie	*Executive Director,* New Rules for Global Finance Coalition
Griffith-Jones, Stephany	*Financial Markets Program Director,* Initiative for Policy Dialogue, Columbia University
Helleiner, Eric	*CIGI Chair in International Political Economy,* University of Waterloo
Henseler, Joana	*Economic Development and Employment Project Manager* GTZ
Herman, Barry	*Visiting Fellow*, The New School
Jacobs, Didier	*Special Advisor to the President at Oxfam,* Oxfam
Jenkins, Bruce	*Director, Policy Program*, Bank Information Center
Johnson, Willene	*President,* Komaza, Inc.
Martinez-Diaz, Leonardo	*Political Economy Fellow,* Brookings
Morales, Juan Antonio	*Visiting Professor,* Columbia University
Ocampo, Jose Antonio	*Co-president,* Initiative for Policy Dialogue, Columbia
Pagliari, Stefano	*Ph.D. Candidate*, University of Waterloo
Palley, Thomas	*Economist*, Economics for Democratic & Open Societies Project
Pereira, Pablo	*Argentina Executive Director*, IMF
Puschra, Werner	*Executive Director*, Friedrich Ebert Stiftung New York
Rajaraman, Indira	*Professor of Economics and Senior Fellow*, National Institute of Public Finance and Policy, India
Rude, Christopher	*Instructor*, Graduate Program in International Affairs, New School
Silvers, Damon A.	*Associate General Counsel*, American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)
Stiglitz, Joseph	*Co-President*, Initiative for Policy Dialogue, Columbia University
Truman, Edwin	*Senior Fellow*, Peterson Institute
van der Cruijsen, Carin	*Economist*, Bank of the Netherlands
Villar Gomez, Leonardo	*Vice President, Financial Systems,* Corporacion Andina de Fomento
Vreeland, James	*Associate Professor of Int'l Relations,* Edmund A. Walsh School of Foreign Service, Georgetown University
Young, Kevin	*Fellow in Global Politics,* London School of Economics