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The new disintegration of finance

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As we approach the second anniversary of **Lehman Brothers' collapse**, is global finance on a more sustainable track? Many jurisdictions have taken unprecedented initiatives. The US has adopted the sweeping **Dodd-Frank Act**. The European Union is creating the world's first **supranational financial supervisory** authorities. Britain and others have introduced special resolution regimes, and are reforming banking legislation.

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At the global level, however, progress has been difficult. A sequence of **G20** summits raised expectations with a grand agenda of financial reform, meant to be consistently implemented across the globe. But advances toward an international system to rescue troubled banks remain limited, while there has been no global or regional agreement on banking levies. The Basel III discussion on banking regulation and supervision, which is **expected to result in a compromise this weekend**, illustrates how difficult it is to reach global agreement, even on seemingly uncontroversial areas such as reinforcing weak capital requirements.

At a broader level, the once-strong trend towards global financial integration is also in reverse. For its adherents, a truly global market would allow providers and users of capital to find each other worldwide, boosting efficiency and growth. Most economists see such integration as a global public good. But careless policy choices could soon move us in the other direction, creating a new era of financial disintegration.

Two major shifts in the global financial landscape are now impeding previous moves towards regulatory harmonisation. First, we live in an age of financial re-regulation, at least in developed economies. Governments have lost trust in the financial industry, and are imposing new constraints to ensure stability. But as they do so they are guided by domestic political realities that make international consensus more elusive.

In previous decades, simply finding a low common denominator was normally sufficient for convergence. No longer. In the US, for instance, the "Volcker rule" now places limitations on the way banks invest. But this has given rise to misgivings in Europe and elsewhere that were absent when the US, back in 1999, abolished rules that similarly sought to constrain banks' behaviour.

This change is also significant for the EU more broadly. In the decade prior to the financial crisis, while other powers tended to focus primarily on domestic regulation, the EU used global convergence as a way to build up its own internal market. But current hiccups in the global agenda undermine this strategy of "harmonise globally to harmonise the EU".

The second shift is being driven by the world's new rising powers. Financial institutions from emerging countries are beginning to overtake their western peers. New financial centres are gaining market share, while emerging countries are asserting themselves in global financial rulemaking, and increasingly resist standards proposed by members of the old north Atlantic consensus. They express ever more vocal unease about the dominance of westerners in the Financial Stability Board and other bodies. Complaints that little attention is given to problems felt strongly in the developing word, such as vulnerability to exchange rate instability, are also increasingly common.

With these twin forces pushing back integration, global leaders must prioritise their efforts. A new principle of subsidiarity would help, in which only those policy aims that cannot be addressed locally should be tackled globally. This might seem like a step back from integration but, in truth, many reforms are not best pursued at the global level. Plans to create worldwide international financial reporting standards, for example, cannot feasibly be imposed on all listed firms everywhere in the short term. It is more realistic to seek their gradual voluntary adoption, a path Japan has recently undertaken. In the same way most retail banking activities can be supervised by individual jurisdictions – if at the price of requiring national or (in the EU) regional subsidiaries.

That said, other areas do badly need global reform, and these should become the new priorities. Take capital markets, which must have globally consistent policies to avoid regulatory arbitrage and fragmentation. Stronger global institutions are needed to enforce disclosure requirements, maintain a level playing field for cross-border trading and monitor market developments. Where suitable bodies are unavailable, policymakers should stand ready to

create them – as may be required for the oversight of credit rating agencies, global audit networks, or securities clearing houses.

It would be a tragedy if attempts to co-ordinate global financial regulation and supervision, triggered by the crisis, end in failure. Given the twin undercurrents of financial re-regulation and multipolarity, visions of a world in which all financial activities are seamlessly integrated at the global level look certain to remain a mirage. But the risk is that these same currents of financial disintegration will push other badly needed reforms into reverse too. And if that happens, we will all be left poorer.

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