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“More Heat than Light”: On the Regulation of International Finance

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“Right now there is huge uncertainty as to where risk resides” noted an anonymous international economic official as the credit crisis started in August 2007 (Guha and Tett 2007). “We are in a minefield”, commented Drew Matus, economist at Lehman Brothers, “no one knows where the mines are planted and we are just trying to stumble through it” (ibid.). By summer 2008, international organizations acknowledged the severity of the crisis. “The current market turmoil in the world’s main financial centres is without precedent in the post-war period”, said the Bank of International Settlements (BIS 2008: 137). Now, in early 2009, even optimistic observers acknowledge that what was first a credit crunch confined to the US has evolved into a global recession, which is likely to last for at least a year or two, with severe social consequences throughout the world. Yet, one of the most remarkable features of the debate on the global financial crisis is the absence of in-depth analysis and discussion of the regulatory crisis implied.

The current crisis has occurred despite efforts over the past decade to ‘strengthen the international financial architecture’ (SIFA). The SIFA approach to international financial regulation emphasised measures to enhance ‘transparency’ and promoted the global adoption of standards of ‘best practice’ in areas such as banking supervision, corporate governance and financial accounting. Given the emphasis on enhancing ‘transparency’, it is ironic that financial market participants have been bewildered, at best, with regard to the whereabouts of financial risk since the crisis started unfolding. More generally, there is reason to believe that the SIFA initiative was ineffective, if not counter-productive, with regard to its objective of enhancing the stability and resilience of the international financial system. Yet, current debates proceed without much interest, it seems, in understanding the underlying reasons of the spectacular failure of this regulatory regime.

Policy debates continue to focus on the recapitalisation of banks and on fiscal stimulus packages. Indeed, increased ‘oversight’ and a revision of capital adequacy requirements are likely to become the ‘catch-all’ regulatory response (FT 2008, 15 September), along with a renewed emphasis on ‘transparency’ (see also Kessler, this issue). Such responses grossly underestimate the regulation crisis underlying the current global predicament. Analysing codes and standards of ‘proper economy’ propagated by the SIFA initiative since the late 1990s, this essay seeks to identify the key presumptions of the current approach to international financial regulation, and subjects it to critical scrutiny.

The ‘Proper Economy’ programme

The SIFA initiative was launched in the wake of the financial crisis in Asia in the late 1990s. The Asian crisis was widely believed to be caused by ‘excessive borrowing’ on the part of Asian banks and companies. There was some acknowledgement that ‘excessive borrowing’ on the part of Asian actors could not have taken place without ‘excessive lending’ on the part of Western financial institutions and investors; “it takes two to tango” (Eichengreen 1999). At the end of the day, however, Western financial institutions and investors were acquitted of responsibility for they had been “misled”, it was argued, by “poor data”. The SIFA initiative therefore endeavoured to enhance ‘transparency’. The true state of economies was to be made visible to financial market participants in terms of their deviances from a set of standards of ‘best practice’. And the standards themselves were to guide countries toward a ‘proper’ organization and regulation of their economies. In the words of James Wolfensohn, director of the World Bank at the time, “the proper governance of companies” is becoming “as crucial to the world economy as the proper governing of economies” (Singh 2003: 377).

This new form of ‘visibilization’ (Foucault 1991, 1997; Miller and Rose 2008) and restructuring of economies was meant to contribute to making the international financial system more stable and resilient. Complying with standards of best practice was to help ensure “that economies function properly at the national level, which is a key pre-
requisite for a well-functioning international [financial] system” (IMF 2000: 3). Moreover, by making the degree of compliance visible to financial market participants, important effects were expected by means of a mechanism of ‘market discipline’: On the basis of data on countries’ compliance with standards, financial markets would reward or punish economies according to their degree of compliance. Countries with a high degree of compliance would receive larger amounts of foreign capital, at a lower price (interest rate), as compared to countries with a lower degree of compliance. By creating strong economic incentives in this manner, ‘market discipline’ was to help enforce the global adoption of ‘proper economy’ standards (Vestergaard 2009). Further, a whole “new body of economic statistics” was developed around the notion of “financial soundness” (IMF 2005). Financial soundness indicators (FSIs) were to make the relative financial soundness of financial institutions visible to themselves, as well as to regulatory authorities and financial market participants. The financial soundness of a financial system was then to be assessed by aggregating measures of financial soundness from each individual financial institution.

The effectiveness of the SIFA initiative hinged upon three key presumptions: the presumption that a mechanism was in operation by which financial markets rewarded or punished economies according to their degree of compliance with ‘best practice’; the presumption that more ‘market-sensitive’ modes of financial accounting and risk management would increase the resilience of the international financial system; and the presumption that the vulnerability of financial systems could be assessed by aggregating measures of financial soundness from individual financial institutions. Each of these three presumptions were and are at odds, however, with the actual dynamics of financial markets. First, evidence suggests that financial markets do not reward and punish economies according to their degree of compliance with standards of ‘best practice’. Second, there is reason to believe that the promotion of ‘market sensitive’ risk management practices undermines rather than increases the stability and resilience of the international financial system. And finally, evidence suggests that the current approach to detecting financial vulnerability, whether at the level of the individual financial institution or in national or international terms, is deficient and sometimes perhaps even misleading.

The illusion of ‘market discipline’

Argentina for many years followed IMF’s macro-economic policy recommendations and was one of the first emerging market economies to make considerable efforts to comply with standards. Yet, in 2001 international investors withdrew capital at large-scale, causing deep financial crisis in Argentina. Malaysia, on the other hand, when afflicted by the Asian crisis in 1997, did the opposite of what the IMF had advised (imposing capital controls, etc.), and made little effort to comply with standards. Nevertheless, soon after the onset of the Asian crisis, foreign capital flowed plentifully into Malaysia again. Argentina, which strove to comply with standards, was punished by financial markets, whereas Malaysia, which did nothing to comply, was rewarded (Bluestein 2003, 2005; Rodrik 2003).

This absence of a positive link between foreign capital inflows and domestic policies is not a recent phenomenon. When Chile achieved huge capital inflows in the 1850s and 1860s, it was attributed to ‘free market reforms’, but similar capital inflows were received simultaneously in Russia, the Ottoman Empire, Egypt, Colombia, Tunisia, Spain, Austria-Hungary, Peru, Romania and the Confederate States of America. “It is hard to argue”, Michael Pettis stresses, that these countries “followed a common set of policies”, rewarded by foreign investors (Pettis 2001: 191). On a more recent note, if capital flows did indeed reward domestic policy, one would have expected post-WW2 capital flows to Mexico, Chile, Brazil, and Argentina to be correlated with reform implementation. Yet, “in spite of the huge timing differences in the reform process”, Pettis observes, “the timing of capital flows … was virtually identical: the massive capital inflows of the 1970s were wholly cut off in 1982-83 and resumed again in 1989-91 to reach their apogee in 1995-1997” (Pettis 2001: 50).

In other words, with respect to foreign capital inflows, there is little reason to believe that compliance with standards of ‘best practice’ has been or will be rewarded by financial markets. The same seems to hold for the case of foreign capital outflows. When a financial crisis occurs, fund managers tend to sell off assets not just in the afflicted country but in countries that “resemble in any way the trigger spot” (Williams 2006: 162). Hence contagion, the phenomenon by which a financial crisis spreads, is likely to occur irrespective of the degree of compliance in other countries. On this background, it is unsurprising that quantitative studies examining the impact of compliance on the cost of foreign capital have failed to demonstrate
the presumed positive link. In brief, the evidence in support of the existence of an effectively operating mechanism rewarding or punishing countries according to their degree of compliance with standards is not overwhelming.

‘Market-sensitive’ governance is procyclical

A key aspect of the SIFA initiative was to encourage the adoption of risk management models that were highly ‘sensitive’ to shifts in market valuations. This reflected a growing fashion in risk management to “move away from discretionary judgements about risk” toward “more quantitative and market-sensitive approaches” (Persaud 2001: 60). The problem is, however, that this approach failed to take adequate account of herding, one of the most salient features of globally integrated financial markets. In a herding environment standardized, quantitative, market-sensitive risk-management models tend to destabilise markets, making them less rather than more resilient.

By promoting a homogenization of risk management practices, the SIFA effectively encourages investors to identify and select very similar investment portfolios. When all financial market participants pursue highly similar investment portfolios, these will automatically lose the attractions that made investors choose them. When everyone searches out investment positions which had high returns, low volatility, and correlation in the past, these will inevitably “become overvalued assets, incapable of outperforming others in the long run” (Persaud 2004a: 98). They will no longer be “high-return, low-volatility and low-correlation assets, but the precise opposite” (Persaud 2004b: 181). By promoting the adoption of standardized, market-sensitive risk management models, the SIFA initiative entailed procyclical and destabilising effects, which undermined rather than increased the resilience of the international financial system.

But market-sensitive modes of economic governance are not confined to risk management. To briefly mention one other example, standards of accounting promoted in and through the SIFA initiative have made ‘market-sensitive’ accounting, commonly known as fair value accounting (FVA), the norm to be strived for. Fair value accounting (FVA) replaces valuation anchored in historical values (acquisition prices) with valuation tied to current market values. Capital markets use financial accounting data to assess the likely future income streams of companies, and for this purpose FVA provides much more suitable data than does historical cost accounting (HCA), the contention goes. Whereas HCA is believed to ‘distort’ economic reality by ‘under-reporting’ asset values, “there is nothing more real than the value of an asset today”, in the words of the vice-chairman of the IASB (cited from Perry and Nölke 2006: 564). In the course of the current financial crisis, FVA became the subject of increasing criticism, on account of its procyclical effects – which had been debated by scholars for a while already (see e.g. Plantin et al. 2005). Proponents of FVA argue that it is not the role of accounting to ensure financial stability. Critics protest that surely it is not the role of financial accounting to exacerbate financial instability either. Accounting too often is regarded as merely a mode of representing economic value, disregarding that accounting shapes economic reality as much as it represents it. In any case, it is important to stress that FVA reinforces the business cycle, both in the boom and the burst, and hence reduces rather than increases the stability and resilience of the international financial system.

Financial risk is not a ‘national aggregate’

In terms of financial risk analysis by authorities, the key tool of the SIFA initiative consisted in various forms of stress-testing. In the Financial Sector Assessment Program (FSAP), operated jointly by the IMF and the World Bank, stress tests have focused exclusively on banks, in the vast majority of cases. The relative neglect of non-bank financial institutions – such as insurance companies, hedge funds and pension funds – is only one of a number of severe limitations of the current approach to stress-testing.

According to the IMF (2003: 16), most stress-testing has relied “almost exclusively on balance sheet data” and therefore has “serious shortcomings” with regard to assessing risk exposures of “complex institutions with substantial derivatives positions”. When stress tests fail to “take account of the effect of derivatives positions”, even the “direction of exposures to financial shocks … can be misleading” (ibid.). Further, stress tests have tended to focus on individual institutions, rather than on the financial sector as such, or the economy as a whole. This constrains the usefulness of the tests, for one must distinguish between the role of an individual bank supervisor (such as FSA in the UK) and the role of a central bank. For the former, so-called macro/micro stress tests, which focus on the impact that a macroeconomic shock of some sort can have
on an individual financial institution, are in principle satisfactory. But for a central bank, responsible for systemic stability, macro/micro stress tests are of limited value. A macro/micro stress test is usually a single factor exercise, assessing the impact of, say, a rise in interest rates, on a single financial institution. Dynamic effects in and among financial institutions and the wider economy are not assessed in macro/micro stress tests (Goodhart 2006: 3417). Yet, “actions that may appear compelling and fully rational from the perspective of individual market participants” may very well lead to “undesirable aggregate outcomes for the market as a whole” (Borio 2004: 234). Although much work has been done to “address market distress by improving the market infrastructure and the risk management at individual financial institutions”, Borio concludes that the “link between collective actions of individual market participants and market dynamics” remains largely unexplored (Borio 2004: 237).

Finally, there has been a somewhat surprising tendency for stress testing to neglect the relation between domestic and international risk. FSAPs “have generally been limited to the segments and risks of the financial system that have domestic implications” and they have “made limited inroad into the broader global and regional dimensions” of financial risks (IEO 2006: 35). It is not without irony that in the current era of promoting global financial integration, the predominant modes of financial risk analysis remain firmly wedded to nation states, both conceptually and in terms of the quantitative methodologies deployed.

Concluding remarks

The SIFA initiative has institutionalised a particular gaze on financial risk which overlooks some of the most important dimensions of global financial risk and rests upon some misguiding assumptions about the dynamics of financial markets. First, the effectiveness of the SIFA initiative was predicated upon the presumption that a mechanism of ‘market discipline’ was in operation, which would reward and punish economics according to their degree of compliance with standards. ‘Market discipline’, conceived in this manner, is an utopia, in discordance with the realities of financial market behaviour. Second, stress-testing, the key tool for financial risk analysis in the SIFA initiative, neglected a number of crucial issues (non-bank financial institutions; off-balance sheet operations; systemic risk; etc.) and hence was curiously ‘out-of-sync’ with the realities and dynamics of modern finance. Generally, the SIFA initiative has been firmly confined to nation states, conceptually as well as methodologically, despite the increasingly global and interconnected nature of financial risk. Finally, the promotion of ‘market-sensitive’ financial accounting and risk management practices has had profound procyclical effects. Indeed, the general thrust of the approach to financial regulation launched in and through the SIFA initiative is to promote homogenization and ‘market sensitivity’ which tends to exacerbate economic cycles by reducing the diversity of investor behaviour and by creating a ‘spiral’ relation between market valuation and risk management.

What can be concluded from this? First, with regard to ‘market discipline’, a new approach to financial regulation should be careful not to depend on any such mechanism for its effectiveness. Second, in terms of financial risk analysis, tools and methodologies need to be developed which address financial risk as a genuinely systemic phenomenon. Indeed, any form of ‘methodological atomism’ – whether in terms of focusing on the financial soundness of individual financial institutions, or in terms of addressing systemic risk as a national phenomenon – is inadequate with respect to today’s highly interconnected global financial markets. Third, with regard to the relation between risk management and financial regulation, it is important to realise that universal standards of best practice are not the solution, but a key part of the problem. A more effective regulation of international finance must emphasise diversity and segmentation of risk instead of homogenization. A key element in achieving this could consist in assessing and approving a set of varied risk-management approaches rather than promoting the same model for all types of financial institutions. In such diversified financial regulation lies, as Persaud argues, a “potential for a virtuous cycle” (Persaud 2004a: 102). “The more short-run and long-term investors behave differently”, he argues, “the shorter market disruptions will be and the more this different behaviour would be profitable for long-run investors” (ibid.). Finally, ‘market-sensitive’ modes of economic governance do not appear to be particularly conducive to financial stability. Regulatory measures which are counter-cyclical rather than procyclical need to be developed and deployed, if the international financial system is to become more stable and resilient in the future.

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Endnotes

*Philip Mirowski (1989) first used the title More heat than light, for his book on economics as the physics of the social.

1 The International Accounting Standards Board (IASB) defines FVA as “the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm’s length transaction” (cited from Perry and Nölke 2006: 562). In many instances, however, fair value accounting is complicated by the absence of knowledge of market values because the asset in question is not traded. In such cases, recourse must be taken to various forms of model-based estimations of market value.

References