Redesigning Financial Governance for the New Global Economy of the 21st Century

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The mission and mandate of economic governance and its accompanying institutional architecture requires realignment in order to conform to the realities of the new global economy of the 21st century. Two recent economic events, the emergence of the new economy and the aftermath of the financial crisis of 2008, have become the defining milestones which precipitated the need for a new vision and a new direction for the financial governance. The new global economy of the 21st century is composed of a trilogy of interactive forces that include globalization, trade liberalization and the information technology and communications revolution. The aftermath of the financial crisis has precipitated a more interventionist role for government and has laid the foundations for new institutional and regulatory structures that will impact on the financial landscape of the 21st century. This paper explores the future architectural governance landscape for the financial industry and the scope and substance of regulatory initiatives and mechanisms that should be designed in order to avert a future financial crisis.

1. Introduction

Globalization has melted national borders and redefined economic policy. Free trade has enhanced economic integration and extended the economic architecture. The information and communications revolution has made geography and time irrelevant and enhanced the reach of economic parameters. In consequence, the institutional architecture of economic governance requires modernization as well as transitional and transformational change. This is particularly true since the existing economic governance architecture was designed for the old economy and has proven ineffective and inadequate for the new economy. Furthermore, the new economy is built on a culture of innovation. Indeed, the signature mark of the new global economy is new ideas, new technologies and new initiatives (Passaris, 2006).

The global financial crisis of 2008 took everybody by surprise. Furthermore, the financial crisis had a more devastating effect than simply creating the most significant global economic crisis since the Great Depression of the 1930’s. The crisis revealed the structural fault lines on the contemporary economic landscape.

2. Global Economy

The new global economy of the 21st century has transformed the economic, social, educational and political landscape in a profound and indelible manner. The new economy is composed of a trilogy of interactive forces that include globalization, trade liberalization and the information technology and communications revolution.

The advent of the new economy has resulted in the fundamental restructuring of economic society. The role of innovation as a catalyst drives the engine of economic growth and has become a fundamental postulate of the new global economy. Furthermore, the pivotal role of a country’s human resources and the unique economic value of its human capital endowment, which is reflected in the educational attainment and technical skills of its population, is an essential prerequisite for empowering the new economy and facilitating the integration of labour in the knowledge based industries. The knowledge based economy is fuelled by technology, human capital and research and development. In short, the fuel of the new economy is technology and its currency is human capital. The product of the new economy is knowledge and its market is the virtual marketplace of the Internet (Passaris, 2011).
2.1 Economic Globalization

Economic globalization is not simply a theoretical, qualitative or conceptual construct, it is determined by the growth of foreign direct investment (FDI), the increase in international trade and the volume of transactions in international financial markets. Also the global outreach and economic integration beyond national borders impacts on numerous economic activities such as the statistical data on the increase in yearly flows of FDI and merchandise trade in relation to gross domestic product, the rate of growth in the stock of FDI, the increase in international financial flows and the international mobility of labour (United Nations, 2000).

Multinational and transnational private sector corporations have emerged as a catalyst for globalization. There are also significant qualitative aspects to globalization that should be noted as well. The transformation of the composition of trade from finished products to intermediate and sub-components is a case in point. Another example is the global reach of new financial products of derivatives and hedge funds. Indeed, the full impact of economic globalization should be considered in the context of its quantitative and qualitative dimensions. There is no denying that the observed acceleration in the pace of economic globalization can be attributed to technological advances and innovations in information technologies and communications, trade liberalization, the growth in incomes and consumption and productivity growth.

The advent of economic globalization requires a new perspective and a renewal of governance principles. Furthermore, the institutional governance architecture and a country’s economic policies should be adapted in order to conform to the realities of contemporary globalization. This is especially true of the economic landscape in the aftermath of the financial crisis of 2008. Globalization impacts on a country’s domestic economic landscape and a global mindset must permeate a country’s outward reach in terms of the formulation of its economic policies. In a sense, global economic integration results in diminished national and domestic autonomy. This is further accentuated by the existence of multinational and transnational corporations in the private sector that have embraced the benefits of economic globalization for a very long time.

Globalization has enhanced the fluidity and mobility of financial capital and foreign direct investment. The same is true for immigrant receiving countries with respect to the international mobility of labour, especially highly educated and skilled labour. Economic globalization accompanied by trade liberalization has accentuated the global competition for export markets. Clearly national economic policies have been influenced by both of those domestic and international forces and events.

The modern rules of economic engagement require the adoption of governance principles of fiscal propriety, enhancing competitive advantage, renewing the economic infrastructure, achieving full employment, embracing the tools of the information and communications technology revolution, reformatting tax policies, revising the regulatory mechanism and promoting a stable economic environment for foreign investment. All of this requires new governance structures and directions and the formulation of the domestic and international economic policies which would enhance competition on a global scale.

All of the above suggests that the contemporary economic landscape is redefining the scope and substance of economic governance. In some cases it has increased the responsibilities of national governments; in other cases it has modified or renewed them. In some cases the existing economic governance institutions and architectures require a refit and renewal and in other cases a modern economic governance institutional architecture needs to be built from the ground up. The management of these new or renewed governance institutions should also reflect the forces of economic globalization as well as economic integration and interdependence. This should allow governments to confront the modern economic challenges and take advantage of the contemporary economic opportunities.

2.2 Global Markets

The combination of trade liberalization and economic globalization has created global markets with the full significance of that concept. The international integration of production and distribution, enhanced trade activity, global investment and capital flows have defined the modern economic landscape and impacted on the scope and substance of economic governance. In the absence of a truly global framework for economic governance, countries have formed regional economic governance frameworks, associations and trading blocks that are defined by geographical proximity.
Globalization has created limitations and reduced the degrees of freedom for governments with respect to economic governance domestically as well as the operational features of the domestic market mechanism. This is especially true in the context of the financial quagmire faced by several countries including some European Union countries such as Greece, Portugal and Ireland. There is no denying that the formulation and implementation of domestic and international economic policies requires renewal and realignment with respect to the contemporary realities of the new global economy. The increase in economic interdependence or conversely the multilateral economic dependence of countries is the wave of the future. No doubt this generates a new environment where national governments are required to manage their respective economies with a diminished level of economic autonomy and sovereignty. One of the most challenging features of the new globalized economic system is the degree of asymmetry that was introduced as a result of economic globalization.

It is worth noting that the process of economic outreach in the context of the new global economy can create tensions for the domestic governance system. The scope of international influences diminishes the economic autonomy of the national governance system and creates the momentum for establishing a multilateral forum or a global governance regime, institution and protocol for international engagement. Global governance institutions can resolve problems and disputes in a multilateral context. There is no denying that the contemporary forces of economic globalization require governance institutions that are more inclusive, resilient, focused, rules based and serve as a neutral referee of national economic policies. In short, global economic governance regimes are an essential requirement in the modern economic environment of globalization. A more arduous next step is the development of global public policies and providing global public goods.

2.3 Financial Crisis

The financial crisis of 2008 unfolded with record speed into a devastating economic crisis of global proportions. The recent financial meltdown took everybody by surprise. This was especially true of economists. Indeed, the recent financial crisis had a more devastating effect than simply creating the most significant economic crisis since the Great Depression of the 1930’s. It rocked the very epicenter of the economics profession. More specifically it revealed the fault lines on the economic landscape and particularly with respect to financial governance.

In Chinese, the word crisis is composed of two characters - one represents danger and the other opportunity. Furthermore, a Chinese proverb reads “a crisis is an opportunity riding the dangerous wind.” There is no denying that the global financial crisis of 2008 has precipitated an awakening for the deficiencies in economics. Indeed, the recent cataclysmic financial and economic crisis may turn out to be the catalyst for redesigning our economic mission, realigning the scope and substance of economic governance and creating an institutional architecture that is congruent with the new global economy of the 21st century.

3. Keynesian Economics

The advent of Keynesian economics during the second half of the 20th century was aimed at preventing the Great Depression of the 1930’s from ever happening again. It would do so by empowering government with a supportive role in economic decision making. More precisely, government along with the private sector would collectively and collaboratively fulfill the fundamental macroeconomic objectives of price stability, employment creation and a high rate of economic growth. This new formula of a mixed economy would create the fundamentals for financial stability, sustained economic prosperity and full employment. The raison d’etre of government in this scenario would provide a supportive role for the private sector and allow for the introduction of macroeconomic policy that served to stabilize the extreme fluctuations of the business cycle. Furthermore, government would rely on monetary and fiscal policy in order to accomplish its economic mission and mandate (Passaris, 2008).

With the benefit of hindsight, the most significant inconsistency in the Keynesian model was the emergence of a confrontation between political expediency and economic rationale. By that I mean, that governments are elected with a political mandate and develop an opportunistic time frame, usually around four years, in order to confirm their political and economic success that would result in their re-election. On the other hand, achieving the desired macroeconomic
objectives requires a longer time frame, certainly in excess of the four year electoral cycle. In consequence, the structural foundations for the tenets of political economy that emerged along with Keynesian economics were unrealistic and lacking in pragmatism. The short term political cycle prevailed at the expense of the longer term economic time frame (Passaris, 2008).

In consequence, Keynesian economics enhanced the rift between political ambitions and the long term economic agenda. Almost invariably government decisions that promoted political success and political expediency were favoured at the expense of economic policy that created the conditions for economic success on the longer term horizon. In short, the addition of an economic mandate to a government’s pre-existing political mandate created the preconditions for tension between those two mandates. Furthermore, the short term political cycle required significant economic accomplishments that were unrealistic within the longer term time frame for influencing corrective changes to economic variables and achieving significant targets of success in economic growth and development.

4. Good Governance

Good governance has become the gold standard for measuring a government’s competence and accomplishments on the economic, democratic and political landscape in the 21st century. However, what exactly is good governance? Since good governance does not have a simple and straightforward definition, the concept is in many respects multilayered and multidimensional. In fact, we could say that good governance has many different faces. When these faces are combined in an appropriate manner they form the portrait of good governance. There is no denying that contemporary civil society is placing a higher premium on ethical, efficient and effective governance than at any time in the past. In my view, good governance includes ten interactive and complementary characteristics: leadership, vision, strategy, accountability, transparency, inclusiveness, participation, equality, consensus building and efficiency.

Leadership is the art of providing direction towards achieving predetermined objectives. It is not finding out which way the crowd is going and moving to the front to lead it. Leadership is about making the right choices for the common good that are in the best long-term interest of the citizenry. Vision requires a thoughtful, purposeful and articulate expression of what can be rather than what is. Strategy is the road map of how to get there. Accountability is perhaps the most important ingredient of good governance. It is both a mindset and a goal. The spirit and practice of accountability involves a commitment to announce and defend the actions, policies and legislation of the government so that they can be held up to public scrutiny. In many respects accountability is the very essence of a country’s democratic institutions.

Transparency in governance does not mean denying privacy and confidentiality. It does mean however, that the process of decision-making is clear, widely known and has earned the public trust. Furthermore, transparency requires that the decisions taken and their implementation are done in a manner that is consistent, predictable and follows established rules, regulations and guidelines. All of this underlines the importance for governments to practice openness and accessibility.

The inclusiveness characteristic of good governance acknowledges that political, social and economic success is contingent upon all the stakeholders in civil society feeling a part of the mainstream without having to contend with overt or covert barriers of exclusion. This requires a governance mindset and an institutional framework that will promote inclusiveness in every aspect of our daily lives. Participation is the cornerstone for the successful operation of democratic institutions and good governance. The eminent Greek philosopher Aristotle pointed this out in the fourth century B.C. by saying, "If liberty and equality, as is thought by some are chiefly to be found in democracy, they will be best attained when all persons alike share in the government to the utmost"(Barnes, 1984, IV.1291b34). Furthermore, a prerequisite for participatory democracy is an institutional framework, an impartial legal system and an inspiring human rights code.

Equality of opportunity is a fundamental condition of good governance. This is essential in any society, which is characterized by diversity. It is reflected in our collective commitment to pursue gender equality between men and women, promote the acceptance of religious diversity, and celebrate multicultural population profile. All of this should be implemented without disenfranchising persons with disabilities, the aboriginal population, visible minorities and those who are marginalized because of their social condition.
Good governance promotes consensus building. This process allows different ideas and varied perspectives to formulate future objectives. Consensus building encourages all citizens to work in harmony rather than in collusion with each other. An efficient, effective and responsive government contributes to good governance; a form of government where waste, mismanagement and inefficiency are not tolerated.

On the economic and political landscape, the pursuit of good governance has become the signature mark of the 21st century. It empowers our democratic institutions to respond to the direction set by civil society. It also ensures that our economic, environmental, cultural and social resources are protected and passed on to future generations. There is no denying the significant impact of the technology enabled social media on the modern parameters of good governance. In consequence, the modern institutional architecture must conform to the contemporary standards set by civil society for good governance. In effect, they must embrace and reflect the modern principles of good governance.

4.1 Economic Governance

There is no denying that civil society has raised the bar and placed higher standards and expectations on the performance of economic governance. In the past, economic governance was shrouded in mystery, mystique and secrecy. These were the traditional operational features for the conduct of economic governance. The preparation and public disclosure of government budgets was a case in point. In the contemporary phase there is a tendency to consult with the public and become increasingly more transparent in the process and performance of a government’s economic responsibilities. Furthermore, the formulation and dissemination of public policy has been structurally altered in its scope and outreach as a result of the advent of the technology enabled social media.

The future evolution of economic governance in the 21st century will be shaped by two recent economic events. First, the emergence of the new global economy and second the consequences of the financial crisis of 2008. At the outset, the scope and substance of public policy should be re-examined for the purpose of modernizing its reach and effectiveness. The forces shaping the direction of economic governance in the 21st century will also require a forensic evaluation of the accompanying institutional architecture. This new economic environment will require the renewal of existing economic institutions as well as the birth of new institutions. The modern version of our economic institutions should be adept, nimble and equipped with the tools to deal with contemporary issues that are multifaceted in their genetic composition inasmuch as they intertwine economic, social and environmental issues simultaneously. In consequence, the economic governance institutions of the 21st century should have the capacity to develop public policy and implement informed solutions in a manner that is holistic and comprehensive.

Economic governance can take different forms and shapes. A simple, direct and operational definition of economic governance is the multidimensional aspects of direction and policy that impact on the economy including the machinery and institutional architecture for the delivery of economic governance initiatives. In this regard, a conventional approach to economic governance includes the traditional private and public sectors, household, financial institutions and labour organizations. More specifically, it is directed to all aspects of economic engagement including production, distribution, consumption and investment of resources. In short, economic governance refers to the formulation and implementation of policies, the institutional economic architecture and the administration and management of the economic landscape.

Economic governance is an area of study that analyses how economic governance institutions affect the decisions of economic agents, the design and implementation of public policies and the interaction between the public and private economic spheres. One strand examines the ways in which institutions (understood as formal and informal rules, norms and values), affect economic outcomes through their effects on market structures, collective action outcomes, principal-agent problems, credibility and accountability of public policy and quality of regulation. The other tends to examine bottom-up processes leading to emergence of norms, rules and social networks that function as privately-ordered economic governance institutions (Dixit, 2008).

It should be underlined that economic governance impacts upon individual and collective behaviour and standards. In consequence, the organizational structure must promote the principles of effective and efficient economic governance in compliance with the legal, statutory and regulatory frameworks. Governance institutions including the machinery of government, the economic and financial markets as well as government agencies, boards and commissions
form the institutional landscape. They are mandated to formulate and implement principles, norms, rules and decision-making protocols that impact upon the economic behaviour of individuals and groups. It goes without saying that the critical analysis of economic governance as well as the design of new organizational structures must include both the governance institutions as well as the institutional environment. Clearly, the specific nature and scope of government intervention in the economy should be aligned with the desired public policy objectives, the formulation of enlightened public policy initiatives and the creation of the most effective and efficient governance institutions.

Good economic governance is not a static concept. It should evolve in order to accommodate the structural changes on the economic landscape. Clearly it is a concept that is not only time sensitive but also responsive to societal permeations. In this regard Dixit points out that ‘different governance institutions are optimal for different societies, for different kinds of economic activity, and at different times. Changes in the underlying technologies of production, exchange of goods and services and communication change the relative merits of different methods of governance (Dixit, 2008: 673).

4.2 Governance Dilemma

A couple of decades prior to the financial crisis of 2008, economic governance had developed a marked tendency to rely on the free market mechanism. This translated into a diminished presence for government in the economy. Some examples of this devolution included enhanced privatization, strategies for deregulation and an emphasis on marketization. There was a discernable trend towards privatizing public sector activities, the exploration of different forms of contractual arrangements for public sector activities and generally the extension of market instruments within the public sector. Indeed, the public sector became more entrepreneurial in its mission and mandate. This retraction was especially discernible in the regulatory enforcement by government in the financial industry. It meant a retraction from an influential presence in the organizing and the controlling of production activities to a more peripheral role in the form of a facilitator and catalyst for private sector activities and initiatives. In some cases it evolved to take the form of private and public partnerships.

There are several reasons for the retreat of the public sector from its previous level of economic engagement and involvement. These include, declining tax revenues, an increase in the public debt, public displeasure with the government’s management of the economic agenda, the restructuring of government organizations, a decentralization of government operations, the belt tightening and reduction in government expenditures particularly with respect to social programs and the privatization of government activities. It is worth noting that along with the downsizing and downloading of government economic initiatives and an increased reliance on the market mechanism, the public sector institutional architecture has been neglected and allowed to atrophy to the point that it has reached a minimalistic existence. There is no denying that this weakness in the structural foundation for the formulation and implementation of economic public policy has had a deleterious effect on economic governance. The redirection of influence and leadership on the economic landscape has favoured the market mechanism and the private sector. All of this has generated an adverse effect on macroeconomic stabilization efforts and the role of the public sector in economic governance.

The application of Keynesian economics during the second half of the 20th century promoted the complementary role of the private and public sector in economic governance. The entry point for government influence and involvement in economic decision making is the acknowledgement that the free enterprise system does not result, in all instances, in achieving the desired economic objectives. In consequence, government is required to provide a supportive role to the private sector. It should be noted that both the public and private sectors do not stand alone but in reality will complement and reinforce each other. In other words, they provide a complementary mission for economic governance. For example, the advent of globalization was accompanied by the removal of many government restrictions regarding international financial flows and the international ownership of financial institutions and assets. Regrettably, this was achieved without the introduction of the necessary government regulatory architecture and mechanism. In large measure, this resulted in the financial crisis of 2008. In short, it is not a matter of simply shifting responsibilities for economic actions from government to the market and vice versa. There is an additional pre-requisite for installing an adequate supporting structure and architecture.
In the modern context, the economic role of government within the framework of a mixed economy has evolved to embrace the following economic functions: a legislated, legal and regulatory framework that is conducive to the protection of property rights, intellectual property and the enforcement of contracts; an agent for investing in physical and human capital infrastructure that permits the private sector to accomplish its mission and contribute to economic growth and development; the role of an overseer and referee with respect to the private sector through economic regulations that promote fair competition and that prevent concentration of economic power with the social addendum of a regulatory outreach in the form of human rights codes that protect the rights of individuals and groups; to provide all those public goods that are not produced by the private sector; to provide collective social security systems that cover basic risks; to promote macroeconomic policies such as monetary and fiscal policies that support a vibrant private sector and contribute to the long term economic goals of sustainable economic growth; and to intervene in order to correct market outcomes that contradict social goals such as the redistribution of wealth.

The pursuit of an effective economic governance model in the contemporary context requires a re-examination of the scope and substance of public policy for the purpose of modernizing its thrust and effectiveness. Public policy has a long tradition of separating and compartmentalizing between two foundational arms of public policy; economic policy and social policy. This has resulted in a vacuum with regard to the development of synergies and the creation of a cohesive and holistic approach for good governance. The traditional approach was to formulate economic policy and social policy on two different tracks. However, the financial constraints faced by governments in the 1990 have resulted in prioritizing economic policy above social policy.

Public policy can no longer be segmented and compartmentalized in this manner. We need to recognize the interdependent nature of those two policy variables. In addition, the modern construct of public policy requires the incorporation of a third dimension which has considerable contemporary currency; that of environmental policy. Furthermore, the modern context requires elevating the mission of public policy to a completely different formulaic structure as well as embracing a three dimensional context for formulating public policy. One that embraces a more holistic and comprehensive mission than anything we have inherited in the recent past. By that I mean the recognition of the complementarily and inter-independence between economic policy, social policy and environmental policy in the 21st century.

Increasingly we will need to build the new economic institutions with the purpose of becoming more proactive and incorporating a longer term horizon in their decision making mandate. This in contrast to the previous genre that was propelled by the electoral cycle which was more suited to a short term and reactive mode. This may take the form of restructuring existing institutions through renewal or institutional innovation or building new ones from the ground up. In addition, technological advances in information and communications have provided a degree of public scrutiny that is unprecedented. They have raised the bar on the interchange between civil society and public institutions. There is no denying that public expectations of government performance are at a higher standard than at any time in the past. The invasive nature of modern technology has resulted in a public demand for government disclosure regarding their vision, policies, strategies, performance and actions.

Furthermore, the modern institutional architecture of economic governance should have a global mindset for the reasons that the dividing line between the national domestic context and the international linkages is blurred at best and fluid on most economic issues. This does not negate the need for domestic institutions but simply recognizes and acknowledges that their efficacy in responding to national issues can be constrained. In addition, a global mindset embraces the prevailing axiom of internationalization and creates a positive environment for taking advantage of international opportunities. Global economic interdependence is a fact of life in the 21st century and our institutions need to adapt and evolve to embrace it rather than ignore its existence. The economic linkages associated with internationalization in the context of the new global economy can emerge as contentious and controversial. More specifically, countries may endorse the process of trade liberalization while at the same time recognizing the existence of irritants such as the linkages between an enhanced trade outreach and labour regulations, environmental standards, or direct and hidden subsidies. In this regard, there is a need to invent a modern mechanism, an effective framework and a purposeful capacity for resolving trade disputes.

All of this requires redefining the role, functions and modern economic mission of government. Clearly, business as usual is not an option. There is a need for conceptualizing a new structural framework along with a modern institutional architecture. The structural changes on the economic landscape require a transformational mandate for government.
Furthermore, the institutional architecture should be modernized in order to ensure the formulation of enlightened public policy, its strategic implementation as well as effective and efficient machinery for economic governance that is congruent with the realities of the 21st century.

4.3 Crisis Anatomy

A prescription to reform the financial sector must necessarily commence with an incisive examination and analysis of the economic fault lines that triggered the financial crisis of 2008. Indeed, it was the financial crisis which in turn fuelled the prolonged economic recession that followed. At the outset, it should be stated that the financial crisis of 2008 was a made in America financial crisis. The epicentre of the recent financial crisis was the sub-prime mortgage crisis that unfolded during 2007 and 2008. Despite the fact that the eye of the financial storm was the asset backed securities collateralized with sub-prime mortgages, it was the US housing market that influenced in a profound and indelible manner the economic outcome and should take the blame as being the principal cause of the financial crisis. Indeed, the contextual narrative for the 2008 financial crisis starts with the abrupt collapse of the US housing market that started in 2006.

The perfect financial storm was created by the adverse alignment of a combination of political, economic and financial factors. These factors included political pressure in the US to increase home ownership for low and medium income earners, the advent of economic globalization and the global contagion effect, the introduction of new financial products such as derivatives and hedge funds that carried a significant level of risk, the process of de-regulation that allowed large investment banks to carry excessive leverage and the existence of a large global supply of investment funds seeking investment grade bonds. All of this created unsustainable mortgage lending practices and a vulnerable financial governance institutional architecture. In short, the financial crisis reflected a systemic failure of the US housing market in particular and the global financial industry in general. More precisely, the recent financial crisis created an implosion of the financial industry with global consequences (Schwartz, 2009).

A more meticulous analytical examination of the financial crisis of 2008 will set the stage for correcting the economic fault lines that have developed. The contextual narrative starts with the abrupt collapse in 2006 of the housing boom which had started in the 1990’s. Clearly a contributing factor to the recent financial crisis was the creeping de-regulation that took place during the two decades prior to the financial crisis. The derivative market was allowed to self-regulate starting in 1998. This in turn created an enhanced use of credit default swaps in order to hedge against credit risk. In 2004, the US Securities and Exchange Commission relaxed the net capital rule which opened a window of economic opportunity for investment banks and other non-bank financial institutions to increase their level of debt. By way of maximizing this financial opportunity some commercial banks shifted a major portion of their assets and liabilities off the balance sheet to a more leveraged position. In effect, as a direct consequence of this de-regulation, large investment banks significantly increased their leverage ratio.

It is worth noting that there is a disconnect between the economic intent and the purpose in a dysfunctional relationship between mortgage holders on the one hand and mortgage brokers on the other. Indeed, the financial incentives for mortgage brokers and mortgage holders are divergent rather than compatible. More specifically, mortgage brokers are the beneficiaries of a commission for issuing the mortgage. On the other hand, mortgage holders receive interest payments directly from the homeowner. In consequence, the mortgage broker has a vested interest to make the terms of the mortgage as easy and attractive to the prospective homeowner without due diligence to the homeowner’s ability to meet their financial obligations in the future.

The increase in the supply of credit during the period immediately preceding the financial crisis facilitated the promotion of less stringent financial requirements associated with new mortgages. Indeed, this is the context for the emergence of sub-prime mortgages which are defined as mortgages issued to a homeowner without a strong credit worthiness and consequently carry a greater risk of default in comparison to holders of prime mortgages.

Another emerging economic fault line prior to the financial crisis was reflected in the fact that the pricing of complex derivatives was not congruent with the systematic risk associated with them. In consequence, the financial markets did not accurately measure the risk contained in financial products such as collateralized debt obligations and mortgage backed securities. Finally, the period prior to the financial crisis witnessed political pressure in the US to increase the supply of mortgages to low and moderate households. The abrupt collapse of the housing boom in 2007
Passaris created a high default rate and an increase in foreclosures which in turn generated serious liquidity challenges not only for major banks but for several large financial firms that had a significant investment in mortgage backed securities and other forms of collateralized debt obligations.

By 2008, the serious economic challenges of the US housing market had contaminated the global financial market. In addition, many financial institutions attempted to safeguard their liquidity by recalling outstanding loans and raising the bar with respect to new loans. All in all, a full-fledged and worldwide decrease in the supply of credit developed. The economic impact of the failure of several major US financial institutions with a large exposure to subprime mortgages confronted the financial markets around the world.

Greenspan put it more succinctly during his testimony before the Committee of Government Oversight and Reform of the U.S. Congress: “The evidence strongly suggests that without the excess demand from securitizers, subprime mortgage originations (undeniably the original source of crisis) would have been far smaller and defaults accordingly far fewer. But subprime mortgages pooled and sold as securities became subject to explosive demand from investors around the world. These mortgage backed securities being “subprime” were originally offered at what appeared to be exceptionally high risk-adjusted market interest rates. But with U.S. home prices still rising, delinquency and foreclosure rates were deceptively modest. Losses were minima. The consequent surge in global demand for U.S. subprime securities by banks, hedge, and pension funds supported by unrealistically positive rating designations by credit agencies was, in my judgment, the core of the problem. Demand became so aggressive that too many securitizers and lenders believed they were able to create and sell mortgage backed securities so quickly that they never put their shareholders’ capital at risk and hence did not have the incentive to evaluate the credit quality of what they were selling, etc. It was the failure to properly price such risky assets that precipitated the crisis” (Greenspan, 2008: 2-3).

The capital markets were in a downward tailspin. By 2009, the exporting of problematic securitized financial instruments, conveniently but most certainly in appropriately rated triple A by the credit rating agencies, brought about a freeze in global markets with global repercussions. The mechanics of the operation involved packaging mortgage products that financial institutions would not want on their own books and selling them globally at prices that were significantly higher than what would have been recorded in their books by carrying the mortgages in the traditional banking manner. This process gave birth to the global demand for sub-prime mortgages.

During the course of the better part of 2008 and in the early months of 2009 stock markets around the world incurred significant losses which were driven by fears of bank insolvency, a sharp decline in credit availability and a plummeting investor confidence. Countries around the world were confronted with a weak level of economic activity, international trade declined and credit shrank. The blame for all of this was pointed at credit rating agencies and investors that failed to account for the risk involved with mortgage related financial products.

The financial crisis of 2008 has precipitated the need to redesign the financial architecture in a manner that is congruent with the structural and transformational change that was brought about as a result of the emergence of the new global economy of the 21st century. The magnitude of the economic devastation was recorded in the collapse of some leading financial institutions, the bailout of banks by national governments, the significant spike in unemployment, the creation of stimulus packages by national governments to spur economic growth despite considerable public debt and the downward spiral of the stock markets. The financial crisis led to business bankruptcies, the loss of personal wealth and a prolonged downturn in economic activity. All of this created a resonance and a déjà vu of the Great Depression of the 1930’s.

5. The Great Recession

The advent of what has become known as the Great Recession resulted in the resurgence of the economic presence and involvement of governments in the economy and particularly in the financial sector. The corrective action that was taken by governments and central banks can be summarized as three pronged: First, a massive fiscal stimulus; second, a purposeful expansionary monetary policy, and the third, institutional bailouts that supported economic activity and helped maintain existing jobs.
The emergence of shadow banks on the financial landscape during the latter part of the 20th century consisting of investment banks and hedge funds precipitated a two-tiered financial infrastructure for governments and policy makers. This was particularly the case as shadow banks began to play an increasingly important role in financial transactions. Despite the fact that they assumed commercial banking roles, nevertheless, they escaped the supervisory and regulatory role of commercial banks. They became a major source of credit in the US economy. Furthermore, the period preceding the financial crisis witnessed a deviation from the norm of prudent credit management. In consequence, shadow banks as well as commercial banks amassed huge debt burdens without an appropriate financial cushion that could have absorbed the potential risk of large loan defaults or risky mortgage-backed securities. In short, the decades preceding the recent financial crisis witnessed the elevation of the shadow banking system to rival the traditional commercial banking sector and assume an equally important role on the financial landscape. In consequence the implosion of the shadow banking system resulted in significant and widespread economic damage.

There is no denying that the financial crisis of 2008 precipitated an urgent need for greater government involvement and the introduction of enhanced regulation in the financial sector. Prior to that there was a minimalistic overview of the financial sector. This had started in the USA during the Reagan administration with the process of a gradual relaxation of regulations. This redesigned laissez-faire approach culminated with the endorsement by the former Federal Reserve chairman’s prediction that the markets would self-regulate because it was in their best interest to do so. In this regard, it is worth noting the remarks of Greenspan during his testimony before the Committee of Government Oversight and Reform of the U.S. Congress, when he stated “We are in the midst of a once-in-a century credit tsunami. Central banks and governments are being required to take unprecedented measures... those of us who have looked to the self-interest of lending institutions to protect shareholder’s equity, myself included, are in a state of shocked disbelief” (Greenspan, 2008: 1).

All of this set the stage for the harshest repudiation of the modern laissez-faire system that had been re-introduced during the two decades prior to the recent financial crisis. In consequence, the financial sector can no longer take for granted the governments’ passive non-interference as the future norm. On the contrary, governments have already taken the first steps towards a more pronounced presence in economic decision making and the formulation of economic policy. On the contemporary landscape, governments have assumed a leadership role, providing direction and have embraced a more provocative role as an economic referee and regulator. More specifically, this will take form and substance as governments assume a direct role in the financial sector and influence the process of structural change through enhanced regulation. Governments are no longer prepared to sit on the bleachers and watch the spectator sport of the economy unfold. There is no denying that the financial crisis has ushered in a new era of government intervention. Indeed, the presence of government in the economy and its role as an enforcer and referee on the financial playing field is likely to accentuate rather than abate. The rules of the game have changed and governments are in the process of unveiling a new set of rules for the financial sector in the foreseeable future. This will also require a new institutional architecture for financial governance to implement the new guidelines and regulations in an effective and efficient manner. In addition, we can anticipate a long list of new guidelines and regulations to be implemented that will curtail the degrees of freedom previously enjoyed by the financial sector. In short, the process for financial reform and cleansing will be long and arduous.

6. Financial Innovation

The process of de-regulation that swept through the US economy immediately prior to the financial crisis of 2008, precipitated the global financial tsunami and the economic crisis that engulfed the international community of nations. The economic fault lines that were revealed were primarily due to an economic governance structure and the accompanying regulatory framework that was designed for the old economy and was not subjected to the required recalibration and renewal dictated by the structural changes that accompanied the emergence of the new global economy of the 21st century. More specifically, it fell short of the financial innovation, the emergence and the growing importance of the shadow banking system, the development of new financial products, derivatives and off balance sheet financing. Furthermore, the legislative infrastructure remained unchanged and the machinery for enforcing existing regulation was weakened for certain segments of the financial system.
On the financial landscape a two-tiered institutional system emerged. On the one hand, financial institutions that formed the shadow banking system were not subjected to the same regulations as the commercial depository banks, allowing them to carry larger debt obligations in comparison to their capital base or financial cushion. On the other hand, the financial innovation that took place consisted of the development of financial products that were designed to meet specific client objectives. Some specific examples of innovative financial instruments linked to the 2008 financial crisis are: the adjustable-rate mortgage; the packaging of sub-prime mortgages into mortgage backed securities or collateralized debt obligations for scale to investors, a type of securitization; and a form of credit insurance that has become known as credit default swaps. The financial sector made extensive use of these innovative financial instruments during the years leading up to the recent financial crisis. It goes without saying that these financial vehicles differ in terms of the degree of complexity and the level of ease with which they can be valued on the books of financial institutions. All of these instruments – off balance sheet instruments, the derivatives and the shadow banking system that emerged – were clearly designed to circumvent the existing set of rules and regulations.

The development of new and innovative financial products facilitated the process of circumventing regulations. For example, the practice of off-balance-sheet financing that impacts on the leverage or capital cushion reported by the banks. Furthermore, the new financial products were more complex and more difficult to value. Investors were guided by the re-assurance of the international bond rating agencies and the bank regulators that used complicated mathematical models to conclude that these financial products carried a lower risk than what the financial crisis determined was their real level of risk. In short, the financial gatekeepers including the auditors, analysts, boards of directors and politicians failed to do their duty and exercise due diligence. All in all and in hindsight, it turned out to be a major abdication of integrity and responsibility.

6.1 Financial Reforms

The two decades prior to the financial crisis of 2008 were marked by extending the parameters of laissez faire and the introduction of a steady stream of de-regulation initiatives directed towards the financial sector. The aftermath of the recent financial crisis has led to the rediscovery of Keynesian economics and a more influential role for government in the economy. Already there are signs of a significantly different perspective and orientation in the management of the financial industry. More specifically, we have started to witness a more pervasive and pronounced role for government intervention in the financial sector. The next two decades will witness the re-engineering of the financial governance architecture, the re-calibration of the financial governance machinery, the introduction of more stringent regulations, guidelines, systems and directives and a host of structural reforms aimed at ensuring the stability of the financial sector and promoting economic growth.

There is no denying that in the aftermath of the financial crisis, the prolonged economic downturn and the jobless recovery the financial landscape can anticipate a profound shake up. The scope and substance of the changing structural landscape on a national scale will be directly related to the magnitude of the economic adversity experienced by individual countries subsequent to the global financial crisis. Furthermore, the financial crisis has underlined that in the context of the new economy with its global outreach, globalization has meant that future financial crises and economic recessions can no longer be neatly confined to an individual country or even region. Henceforth, they are going to be most pronouncedly global in scope and impact. We are therefore on the cusp of defining a new relationship and a new modus operandi between the government and the financial sector and the international community of nations. In one respect the structural changes to the financial governance infrastructure that are required are going to be symmetrical to the fault lines that have emerged as a consequence of the financial crisis.

The new global economy of the 21st century has been empowered by the electronic capacity and connectivity of the digital age. This is especially true of the electronic capacity that has served as a catalyst for the speed and outreach of economic transactions in the contemporary financial landscape. It is worth noting that the advantages of the modern financial transmission process have also created distinct disadvantages. Foremost among the adverse effects of the digital connectivity is the capacity for fraud, the blurring of the jurisdictional boundaries and national borders as well as diluting the effectiveness of domestic regulatory agencies. Indeed, this is one area where international financial governance architecture is urgently needed to serve as a regulatory, monitoring and overseeing institution with a mandate to promote global financial stability.
In the ensuing decades, the most pronounced change for the financial sector will be the influential and pervasive presence of government as a regulator, supervisor, referee and decision maker. It is anticipated that a slew of stringent regulations will emerge in the next few decades. The list of new regulatory initiatives will contain proposals for enhancing consumer protection from unfair, abusive or deceptive financial practices, creating adequate bank financial cushions and capital requirements, introducing expanded regulations for the shadow banking system, regulating institutions that perform similar functions as banks with the same rules and regulations that are applied to banks, setting limits and ceilings for executive pay, restricting the leverage that financial institutions can assume, ensuring that all institutions engaged in financial transactions have the necessary capital to support their financial commitment, containing the spread of exotic financial products, regulating credit derivatives and require that they are traded within the parameters of well-capitalized exchanges in order to contain and limit exposure and risk.

In my view, the re-engineering and the re-calibration of the financial sector should take place at two distinct levels. At the micro level or the business operational level the emphasis should be on drafting stringent financial regulations with the purpose of enhancing consumer protection and advancing the financial stability of individual firms. This will also simultaneously strengthen the financial system in general. More specifically, the micro level regulations will require a higher standard of accountability with respect to the quality and transparency of each financial corporation’s capital base. This may also take the form of introducing specific leverage ratios. On the other hand, the macro level or at the national scope of engagement, new initiatives will trigger economic policies that will enhance the financial stability and minimize the costs to the overall economic system. These will also require designing new financial governance architecture in order to implement the new financial directives.

The post financial crisis reforms should have as their principal and foremost macro focus to enhance the role of national regulatory supervision. In consequence, a new set of institutional architecture, tools and systems will have to be designed and built. Keeping in mind the lessons of the recent financial crisis and how large financial corporations can adversely affect the stability of the entire global financial landscape. Regulations aimed at these financial institutions will be directed at preventing the contagion effect of insolvency in the global financial system and closing the window of opportunity for financial products that carry an excessive amount of risk such as hedge funds, private equity funds or other types of toxic financial products. In the first instance, the introduction of stringent regulations is directed at preventing the insolvency of individual financial corporations and at the same time serving as a buffer to immunize individual financial institutions from contaminating the entire financial system.

At the present time, most governments’ are faced with a substantial deficit and a burdensome public debt as a consequence of the financial crisis and the prolonged economic recession that followed. The current financial restructuring efforts are contemplating the introduction of a bank levy. The purpose of the bank levy is designed to recover the bailout funds that were dispensed to support individual financial institutions during the recent financial crisis. They can also serve to create a capital reservoir and a financial safety net that will be earmarked for bailout funds for future financial crises. In effect, with the precarious condition of government finances at the present time and the significant burden of the public debt, governments are interested in having financial institutions contributing to a nest egg that can serve as a capital endowment fund in the event of a future financial crisis. Another proposal that is currently under consideration is a global tax on financial transactions in the form of a “Tobin tax” for the purpose of enhancing capital market stability. The theoretical intent of the proposed global tax is to raise the opportunity cost for high risk financial transactions and reduce the flow of speculative capital (McCulloch and Pacillo, 2011).

The concept of a bank levy has resulted in polarizing the debate into two opposing camps on an international scale. It is not coincidental that the most ardent proponents of a bank levy are those countries that have suffered the most economic damage from the recent financial crisis and were forced to allocate a significant amount of public funds in the form of bailouts to individual financial firms. These countries include the U.K., US, France, Italy and Germany. On the other hand, Canada, escaped relatively unscathed the economic consequences of the financial crisis and is the most vociferous opponent to the bank levy. Furthermore, Canada is joined in its opposition chorus against a bank levy with such countries as Australia, Japan, China, Russia, Brazil and India.

In the contemporary globally interconnected new economy, individual countries are reluctant to impose additional costs to their financial institutions that will adversely affect their international competitiveness and profitability. In the final analysis, and in the absence of an omnibus global financial governance architecture, every country should select its institutional architecture and regulatory protocols that are responsive to domestic needs and economic priorities.
Undoubtedly, this will include structural reforms that will correct for the systemic failure of the financial system. In short, every country should set up its own regulatory institutional framework and guidelines that will correct the contemporary financial fault lines and promote the stability of their respective financial sector.

6.2 Financial Commission

The pursuit of good economic governance will require the creation of a new agency whose principal mission and mandate would be to promote the integrity and the stability of the national financial system. There is no denying that the emergence of the contemporary economic governance fault lines requires an urgent and purposeful effort to redesign the domestic financial governance skyline. A new economic governance institution will enhance and complement the existing financial architecture. Indeed, the pursuit of good economic governance in light of the recent financial crisis will require the creation of a new national institution whose singular mission will be to promote the integrity, stability and economic potential of the financial sector. This institution will have as an overarching mandate to promote an economic and financial environment that is conducive to promoting full employment and sustaining economic growth and development within the parameters of the new global economy.

I am proposing the creation of a national Financial Commission that will serve as an early warning system in effect alerting us to the impending economic crises on the financial landscape. This Commission should create a financial firewall that will significantly reduce the probability of any future financial crises. The Commission should also be empowered to detect the vulnerable facade of the financial system and take appropriate action in order to correct and sustain the integrity of the financial industry and its accompanying governance infrastructure. The Commission should also develop a protocol for proactive interventions in order to arrest the convergence of systemic risk. The broad purpose of this institution would be to serve as an economic intelligence gathering and financial forecasting agency.

There is no denying that the mission and mandate of a Financial Commission is a daunting task. Nevertheless, it is an imperative machinery of institutional engineering that we need to put in place in order to come to grips with a new financial governance protocol that is congruent with the challenges and opportunities of the new global economy of the 21st century. I believe that if more stringent financial oversight and regulations were in place, over exposure to risky investments of the genre of sub-prime mortgages by large investment banks might have been prevented. This new institution must earn the respect and confidence of the financial industry as well as the general public.

The new national Financial Commission should be accountable, transparent and embrace the highest standards of efficiency and effectiveness. This new institution should be independent and at the arms length from government. The Commission should report to the national parliament and be governed by a board of directors that will include representatives of government, the private sector, professional experts as well as representatives from the public and private sector unions. The national Financial Commission should be capable of making long-term economic and financial decisions rather than focusing on the short-term electoral cycle. The undeniable benefit of a financial Commission would be to protect and promote the integrity and stability of the financial sector in the decades ahead.

7. Conclusions and Recommendations

The mission and mandate of economic governance and its accompanying institutional architecture requires realignment in order to conform to the realities of the new global economy of the 21st century. Two recent economic events, one foundational and the other cataclysmic, have precipitated the need for a new vision and a new direction for economic governance. They are: the emergence of the new global economy and the financial crisis of 2008.

Economic globalization has precipitated the need for a renewal of our governance principles, the institutional architecture and a country’s economic policies in order to conform to the realities of the contemporary landscape. The modern rules of economic engagement require the adoption of governance principles of fiscal propriety, enhancing competitive advantage, renewing the economic infrastructure, achieving full employment, embracing the tools of the
information and communications technology revolution, reformatting tax policies, revising the regulatory mechanism and promoting a stable economic and financial environment.

Good governance has become the gold standard on the economic and political landscape in the 21st century. My list of what constitutes the contemporary principles of good governance includes ten interactive and complementary characteristics: leadership, vision, strategy, accountability, transparency, inclusiveness, participation, equality, consensus building and efficiency.

An operational definition of economic governance is the multidimensional aspects of direction and policy that impact on the economy including the machinery and institutional architecture for the delivery of economic governance initiatives. The modern institutional architecture of economic governance should have a global mindset. It should reflect the complementarily and inter-independence between economic policy, social policy and environmental policy. Indeed, there is room for new economic institutions that are proactive and incorporate a longer term horizon in their decision making mandate.

The realities of the new global economy and the pursuit of financial stability require the re-engineering of our inherited economic institutions and the introduction of a new set of economic architecture that is more conducive to meeting the challenges and taking advantage of the opportunities of the 21st century.

The pursuit of good economic governance will require the creation of a new institution whose singular mission is to promote the integrity and stability of the financial sector. I propose the creation of a national Financial Commission that is at arm’s length from government influence and direction and serves as a catalyst for sustaining financial stability.

References


