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Think globally on financial regulation

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While it is not possible to know how today's financial crisis will unfold, the one certainty is that there will be a wave of new financial regulation in the US. The US Treasury has just released its "blueprint" and both Houses of Congress are preparing their own legislative proposals. Nevertheless, both efforts are bound to fall short of what will be required. Certainly the overwhelming focus for the US Treasury in its recommendations is organisational reform and not the content of regulation. As such, it must be considered no more than an opening gambit. As for Congress, its preoccupation with the immediate housing crisis, which is soon to be embodied in a law easing pressure on homeowners, will also have to be enlarged.

Here is just a sampling of the important issues that eventually need to be discussed in Washington and on Wall Street, besides the consolidation of the fragmentary regulatory structure and housing foreclosures. They include: new standards for future mortgage financing; enhanced protection for investors and homeowners; constraints on complex securitised financing, including global standards for valuation and disclosure; deeper capital cushions and enhanced supervision of investment banks and other "non banking" institutions; changes in the operations of credit-rating agencies; and internationally co-ordinated scrutiny of global banks and brokerages.

In tackling this daunting agenda, Washington ought to keep three critical considerations in mind.

First, the longer-term remedies for today's crisis will require far more perspective than anyone currently has, in the middle of today's epic battle to stabilise markets. After all, there is no way of telling where the crisis will spread to next or whether another big financial institution will collapse. No one knows whether the Federal Reserve will break more new ground in expanding its reach. It is impossible to predict how close we are to a dollar crisis, how deep and long the recession will be, or how the effects of the crisis will be transmitted abroad.

Second, the US should jettison its habit of making financial policy as if it were cocksure of what it is doing. Indeed, it should be humbled by the magnitude of its ineptitude in overseeing financial markets. After sitting on the sidelines while opaque financial instruments mushroomed, US officials should be deeply embarrassed by their own hypocrisy in preaching the mantra of transparency to governments around the world.

Wall Street's crowing about how financial innovation distributes risk to the benefit of all is also laughable in the light of how that very risk became concentrated and toxic. America's highly litigious culture has failed miserably to prevent extensive fraud among lenders and borrowers in the housing market. Never mind that Washington's laisser-faire attitude toward the debasement of its currency – with the damaging impact at home and abroad – ought to raise serious questions about its claim to any global leadership.

The implication is that America should be willing to examine other financial systems for ideas from which it might benefit and engage in extensive collaboration with its partners. For example, US officials should seek to understand how Europe has managed to avoid the extremes that have affected the US. There could be some lessons from the consolidated UK regulator, the Financial Services Authority. It would not hurt to confer with Sweden or Japan, both of which have experienced severe crises of their own in recent years and at least learnt from their mistakes.

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A willingness of the US to reduce its traditional arrogance in financial matters means it should not just concentrate on patching up the financial system with a blizzard of out-of-date legislation, but also consider a wholesale restructuring of the financial system in all its global dimensions.

In the late 1990s, the Asian financial catastrophe showed how quickly a crisis could spread across borders. In the current debacle, contagion has spread among financial products – from sub-prime mortgages to credit default insurance and to municipal bonds. Both in the 1990s and now, deep problems in financial markets have devastated the lives of millions of people.

We are therefore faced with a challenge of massive proportions that will require the re-examination of everything from how financial institutions of all kinds are overseen globally, to the stability of the international currency regime, to the role of central banks and their relations to one another and to the strengthening of social safety nets.

The Bretton Woods system arose out of the ashes of a world war. What has been unfolding over these past two decades is no less significant as markets globalise and become more intertwined with one another; as highly complex financial instruments outstrip regulators' ability to understand them, let alone exercise any meaningful supervision of them; and as new financial powers in Asia and the Gulf join the main financial decision-makers.

It is not yet time to act to reform the global financial system. However, it is time for the US to figure out how to lead by building a consensus, rather than moving unilaterally or trying to shove its own discredited biases down other people's throats. Most of all, it is time to ensure that the full dimensions of the challenges ahead are appropriately understood before new regulations are enacted.

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