The US as A GLOBAL RISK GENERATOR

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The US economy continues to have a hard time recovering from the biggest financial crisis since the Great Depression. So, the last thing one would expect the US government to do is to engage in policies that open the floodgates to severe risks in financial markets once again. And yet, that is precisely what's going on.

For all the attention that is paid to the Federal Reserve's "tapering", what Washington has in its crosshairs is something quite different. It is putting massive pressure on the Commodity Futures Trading Commission (CFTC) and the Security and Exchange Commission (SEC). Unless concerned policymakers act quickly to counter that pressure, the disastrous past — a financial industry running amok — may well be not just the United States' national, but our common global future.

How is this even possible? Even though the US Congress passed the Dodd-Frank financial reform law a few years ago as a bulwark against reoccurring financial crises, the legislation actually left most of the key decisions — the actual detailed rule-making to rein in the financial industry — for later.

At the center of this entire issue is Gary Gensler, a former Goldman Sachs partner, who is now the Commodity Futures Trading Commission Chairman. Gensler is one of the few officials who can credibly say that, having worked in the lion's den for many years, he is committed to rectifying what he knows is truly troublesome in the boiler rooms of the American financial industry.

And yet, the deck is stacked against him. The fundamental imbalance at the heart of this issue is not just very irritating, but also profoundly undemocratic. Just look at the numbers. The Sunlight Foundation found in a study released last year, that Wall Street has met 1,298 times with government officials to influence the new rules. In sharp contrast, public interest groups have only been able to get 242 such meetings. Talking about being outgunned — by a factor of 5:1.

But this unsettling imbalance in the US political process has consequences way beyond US borders. Not only is the US financial industry still in a dominant position globally, setting many of the standards and practices for "what goes". The G-20 and the Financial Stability Board also pledged that powerful nations like the United States would see to it that the global impacts of their national rule-making would be taken into account.

But now the United States may blow a hole in the Dodd-Frank law that would allow many of the key global operations of US banks to be entirely exempted from regulation.

The first blow came late last year. Very quietly, when the US Congress was on its Thanksgiving holiday, the US Treasury Department exempted foreign exchange (FX) swaps and forwards from the regulations.

Why should the American and global public care about this? After all, when US banks operating offshore, and in places like South Korea, sell FX derivatives to exporters, it allows them to hedge against foreign exchange risk. That sounds innocuous enough.

However, when the last financial crisis hit there was such a flight of capital out of emerging markets and back to the United States that many of those positions were rapidly unwound. Such are the massive transmission effects of today's tightly integrated financial markets.

Never relenting, these same FX derivatives market operators got very busy again right in the wake of the global financial crisis. Hedge funds and big banks engaged in the carry trade. They borrowed in dollars at very low interest rates and then invested in foreign currencies in a broad range of countries, from South Korea, Brazil, Chile, Colombia, Mexico, South Africa, Indonesia, to Thailand. Financial pros that as they are, they then built FX derivatives that shorted the dollar and went long on those currencies.

This fueled exchange rate appreciation and asset bubbles that are part of the reason for the slowdown in emerging markets. Now that the Federal Reserve looking to wind down its easing policies, capital is fleeing emerging markets, causing exchange rates to depreciate and debt burdens to rise.

By now, it is a familiar story. Financial engineers, largely by US-owned firms, generate serious blowback in the real economy. And get hurt themselves. Citigroup, a too big to fail bank, may lose US$7 billion in FX derivatives markets if the US dollar appreciates as capital flies back to the United States.

The next regulatory blow may hit any day. The CFTC and the SEC are now considering exempting those same foreign subsidiaries and branches of hedge funds and big banks headquartered or with stakes in the United States that have been packaging derivatives overseas.

This would be disastrous for emerging market and developing countries attempting to maintain financial stability for development. To their credit, South Korea and Brazil both have put in place their own regulations on FX derivatives, but emerging markets alone cannot carry the burden of regulating a $4 trillion per day market.

CFTC chair Gary Gensler has said that, if these regulations are swapped out of the rule-making, hedge funds can evade the rules "by setting up shop in an offshore locale, even if it's not much more than a tropical island P.O. Box". Gensler needs a majority of commissioners to help him close this loophole by July 12. Time is running out. The world cannot afford to create major loopholes that could threaten the global financial system yet again.

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VIEWPOINT

Mea culpa: SORRY SEEMS TO BE THE HARDEST WORD

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Jay Rayner's amusing 2005 novel, *The Apologist*, tells the fictional story of Marc Basset who is so good at apologizing that he is appointed the UN's chief apologist. But the façade of hypocrisy unravels as Basset must ultimately apologize for his apologizing.

Apologies are as common a vernacular in daily life as expressions of gratitude. But while "thank yous" are usually a more genuine heartfelt expression, "apologies" are laced with nuance and double meaning without necessarily being contrite.

Every girl in history has questioned the sincerity of a boyfriend's apology with a thought of words that do not match the deed.

Bring in the specter of diplomacy, politics and law; then, apologies become a complex double entendre of negotiated meanings where regret may not concede the offense, let alone remorse.

At the extreme end, there are individuals like Islam Defenders Front (FPI) spokesman Munarman, whose definition of decency is to fling water at panelists during a televised debate.

But we shouldn't be surprised at the conduct of someone who speaks for thugs and has been convicted for inciting violence.

Even Germany apologized for Nazi era crimes. So, if the FPI spokesman refused to apologize for his abhorrent behavior — distant and recent — then should we be blamed for thinking in terms of facist behavior?

Such insolence is not the monopoly of facists and fanatics. At times, the greater the democracy, the greater the conceitedness, even at the expense of life and destruction.

The United States purports high moral standards for its own people, but apparently not others whom they consider a threat. It expressed regret when its navy shot down an Iranian commercial airliner, killing 290 people in 1988, and accidently bombed the Chinese Embassy in Belgrade in 1999. But no formal apology was forthcoming.

Sometimes, such statements need to be coerced.

Israeli President Benjamin Netanyahu apologized for a raid on a Turkish ship in 2010 that killed nine, only after some arm twisting from US President Barack Obama.

In 2001, a US reconnaissance plane collided with a Chinese jetfighter. The fighter crashed and the US plane made an emergency landing on Hainan Island. After holding the American crew for 11 days, Beijing was able to extract a letter in which president George W. Bush and secretary of state Colin Powell expressed "sincere regret".

France apologized a year after its agents sank the Greenpeace ship, Rainbow Warrior, docked in New Zealand in 1985, following a political deal brokered by the UN.

So, why did President Susilo Bambang Yudhoyono apologize to Singapore and Malaysia for the recent haze? His initiative was received with as much shock at home as it was deference in the two neighboring capitals.

There are several reasons why a state would make an apology, apart from it being a binding judgment as in the Rainbow Warrior case or being coerced like Netanyahu.

It is improbable that Yudhoyono faced the same exigency as either France or Israel last week.

Apologies help restore international reputation, as with Washington's outward contrition about the Abu Ghraib prison abuses.

It can also be part of a low-cost tool to avoid conflagration by defusing troublesome incidents, hence a way of avoiding legal consequences while promoting the perception that the state should not be perceived as a threat to its neighbors.

On the surface, it was certainly a "gracious" act on the part of Yudhoyono, as described by Singapore Prime Minister Lee Hsien Loong.

Yet, history has also taught us that leaders must be wise even more than they are gracious.

The apology, said Indonesian Bishops Conference (KWI) secretary Benny Susetyo, "is a symbol of a government that cannot resolve its own problems".

Muhammadiyah chairman Din Syamsuddin probably put it best when he questioned why the President did not convey an equal apology to the people of Riau who suffered more than anyone in Singapore or Malaysia.

It becomes even more striking when we recount that the incumbent has been one of the most hesitant to issue "apologies" to his own people compared to his predecessors.

BJ Habibie apologized to victims of Aceh's Military Operation Zone (DOM) and those of the May 1998 tragedy, while Abdurrahman "Gus Dur" Wahid apologized for the violence in Papua.

Megawati Soekarnoputri set up two human rights tribunals: one to address the violence in East Timor (Timor Leste) in 1999 and the other to address the 1984 Tanjung Priok massacre.

Given these considerations, we can only advise our Singaporean and Malaysian friends to take the apology as more rhetorical and ritualistic than genuine, as is the case with many other of the President's statements.

Even Yudhoyono's own Cabinet was either coy or dismissive of his apology.

Coordinating People's Welfare Minister Agung Laksono described the apology as merely a personal one, while Foreign Minister Marty Natalegawa tried not to answer reporters' questions by saying what the President had said was "clear".

It is a bit like the Japanese. Despite their repeated "apologies" about World War II, there remains more than a hint of doubt over their sincerity given the continued glorification of the war effort in history books and the Yasukuni Shrine.

Sincerity begins at home.

Both Canada and the United States apologized for the internment of its Japanese citizens during World War II. The late pope, John Paul II, issued an apology in 2000 for historic wrongs committed by the Catholic church.

Australia, Canada, New Zealand and the United States all apologized to their indigenous populations. Even president Bill Clinton signed in 1993 a resolution apologizing for the overthrow of the Kingdom of Hawaii.

Perhaps Yudhoyono may not have time to ponder the lessons of *The Apologist*, but he can still digest Bernie Taupin's lyrics in Elton's John's classic "Sorry seems to be the hardest word": "It's a sad, sad situation/And it's getting more and more absurd!"

Getting infrastructure of property prices right

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PROJECT SYNDICATE/HONG KONG

Building and maintaining the infrastructure of property rights — the rules, laws, registers and administrative and judicial structures that define, protect and enforce such rights and regulate economic transactions — has traditionally been the responsibility of national governments. But, as the world economy has become increasingly interconnected, a global property-rights infrastructure (PRI) has emerged — further raising the stakes of developing effective national PRIs and accurate price-discovery mechanisms.

The global PRI has arisen through countries' widespread accession to the World Trade Organization (WTO), international accounting and regulatory criteria like the Basel Accords, standards established by the International Organization of Securities Commissions, and some aspects of international law. As national economies and multinational companies compete for market share, global standards of market behavior become increasingly important.

Consider the smart-phone industry, in which corporations like Apple, Samsung, Sony, Nokia and Huawei compete fiercely to secure their global market shares. Given that companies cannot compete effectively in global markets without a sound domestic PRI, such firm-level competition has driven countries to improve the national PRI over the longer term.

Furthermore, establishing accurate asset-price levels is essential to a well-functioning market. The state affects asset prices indirectly through its influence on inflation, interest rates and the strength of the currency. Governments can directly influence the prices of key resources like energy, money, and public goods and services through taxation, customs duties, production quotas and natural-resource ownership.

Government intervention in benchmark prices can be justified in the name of macroeconomic management or regulatory action to improve the provision of public goods and services.

After all, the state determines the supply of fiat money and is responsible for energy and natural-resource conservation. But there is a risk that the state can get important prices seriously wrong.

This is particularly true of money, which has two prices. The government (the visible hand) sets the benchmark price for risk-free financial assets through monetary policy and control over fiscal deficits, while the market (the invisible hand) sets the risk premia of risky assets above the benchmark rate.

The distinction between the two prices is the foundation of modern finance theory.

But the system rests on the assumption that the government will set accurate benchmark interest rates for risk-free assets. As the recent crises in advanced countries demonstrated, this is not a safe assumption: Unsustainable public debt and fiscal deficits forced central banks to expand their balance sheets massively, causing benchmark rates to turn negative in real (inflation-adjusted) terms.

In fact, lowering the benchmark rates for risk-free assets changes the distribution of the risk premia on risky assets, making it too low when asset bubbles are forming and too high when they burst. This pattern was evident in the 1997-1998 Asian financial crisis, the 2008 global financial crisis, and the eurozone crisis that erupted in 2010.

The logic and the mechanism that the government uses to set benchmark prices are very different from those that the market uses to set risk premia. The former implements policy decisions, based on economic, social, and political considerations, while profit-maximizing behavior — anchored by the state-determined price and requiring a robust PRI — determines the latter.

> Even in advanced countries, the influence of vested interests can lead to collective-action failures and, in turn, to incorrect benchmark rates.

Thus, the role of the market in price discovery is inextricable from that of the government. Indeed, there is a complex, non-linear feedback relationship between the two, so developing an accurate capital-pricing system depends on both actors.

Until recently, advanced-country markets predominated in setting risk premia, owing to their mature and well-functioning PRIs, which include clear rules and a high level of transparency in price formation.

But, even in advanced countries, the influence of vested interests can lead to collective-action failures and, in turn, to incorrect benchmark rates. Last year's LIBOR scandal, in which banks were found to be reporting inaccurate interest rates in order to manipulate the prices of financial instruments, epitomized this risk.

Meanwhile, given that many emerging economies have incomplete or immature PRIs, their influence over market-price discovery is relatively weak. In state-dominated systems like China's, developing an effective PRI — delineating market participants' rights and responsibilities, ensuring the exchange platform's transparency, and creating a fair and equitable process of dispute resolution — is particularly challenging, because the state acts as a regulator, asset owner, enterprise operator and competitor in the market.

In such systems, the government directly controls the benchmark interest rates. But setting the correct rate for risk-free assets is difficult when capital flows easily across borders, enabling market participants to exploit discrepancies between countries' rates.

Herein lies the dilemma (one that China currently faces) of market-oriented reforms.

While cross-border capital flows and interest and exchange rates must be liberalized to maintain economic development, such reforms raise the risk of asset bubbles if implemented under distorted benchmark prices.

Emerging economies have watched the leveraged power of investors distort the price-formation process in crisis-stricken advanced economies. Preventing this from occurring in emerging economies requires that these countries' leaders balance monetary, fiscal, and macro-prudential policies in a way that enables correct pricing of risk-free assets.

Striking this balance is made even more complicated by the influence of advanced-country policies on emerging economies. Exceptionally low interest rates and quantitative easing may be appropriate for advanced economies experiencing slow growth, but they can be problematic for emerging economies struggling to promote market-oriented price-discovery mechanisms. In this environment, it may be appropriate to strengthen the global PRI further.

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