Group of Twenty

Research Report
The Question of:
Regulating and monitoring global financial markets

Introduction

The only constant of financial markets is that they fluctuate, which is increasingly dependent on the excessive risk taking by financial intermediaries. For a long time, it was believed that if central banks guaranteed price stability, the financial infrastructure would also remain stable, and financial markets could be deregulated safely. This view is no longer widely supported. Therefore, the regulation of banking and financial markets has become a major challenge for public authorities again. The clear borders between financial institutions are fading and internationalisation makes control by national authorities nearly impossible.

In 2007-09 a global financial crisis occurred because of a combination of the above-mentioned problems. It started in the United States, when interest rates started rising again after the historical lows following the 2001-02 crisis caused by the crash of the dot-com bubble. Many subprime borrowers could not afford the higher interest rates and started to default on their loans. However, because the rising interest rates also caused a sharp drop in home prices, the collateral for the loans on which the homeowners defaulted could not cover the remaining outstanding debt. This caused more than 25 subprime lenders to file for bankruptcy within two months. More importantly, however, these subprime mortgages had been sold by the subprime lenders to larger investment banks as ostensibly low-risk products. The value of these products dropped dramatically, and they no longer generated any income. As a result, large banks which had invested in these problems suddenly experienced acute liquidity shortages. Because of this shortage of liquid assets, the interbank market froze completely, and many banks started to become unstable.

Hereafter, national banks worldwide resorted to rate cuts to aid the world economy. However, rate cuts and liquidity support weren't enough to stop the world-wide spread financial meltdown. This shows us that the confidence in the financial market, once lost, cannot be quickly restored. In a globalised world, a liquidity crisis can quickly turn into a solvency crisis for financial institution, a balance payment crisis for sovereign countries and an extreme crisis of confidence for the entire world.

More recently, the world economy has more or less restored to a stable market. However, many nations have taken preventative measures to ensure the well-being of the global financial market. Some have expressed their opinion that the right measures lay in the monitoring and regulating of the global financial market.

The Committee

The Group of Twenty is an international forum consisting of the world-leading industrialised nations. In total the Group accounts for 85% of the world GDP and Two-thirds of its population. Much of the important discussions are held on the side-lines and in informal meetings.

The Group of Twenty was established in December 1999 in Berlin, Germany as a meeting between financial ministers and central bank governors hosted by the German and Canadian ministers. Originally the G20 meetings were solely for finance ministers, however afters an inaugural meeting between G20 leaders in Washington DC as reaction on the collapse of the Lehman Brothers in 2008, leader's summits became an annual event.

The chairmanship rotates annually between the party states; the country that holds the presidency gets to invite additional nations who are not a party state. There are no formal votes or power differences, however the informal influence is almost equal to that of major power politics.

Definition of Key Terms

Free Market

A Free Market is defined by its independent characteristics; its prices are not ruled by governments or other price-setting monopolies. It is a market solely based on the ancient term of supply and demand.

Liquidity

Liquidity is described as the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price. Cash is considered the most liquid asset, while real estate fine art and collectible are all relatively illiquid.

Prime Rate

The prime rate is defined as the interest rate that commercial banks charge their most credit-worthy costumers, who are the least likely to default on their loan. Generally, a bank's best costumers consist of large corporations. The prime interest rate is largely determined by the national decided rate. It has a direct influence on the individual borrowers, seeing that it directly affects the lending rates available for individual loans.

Solvency

Solvency is the ability of a company to meet its long-term financial obligations. Solvency is essential to any company in order to stay in business as it asserts a company's ability to continue operations into the foreseeable future. Therefore, a company that is insolvent must often file for bankruptcy.

Stock Market Bubble

A Stock Market Bubble is defined as an increase in prices above their real value. This usually originates from the main-stream investing, which is people solely reacting to prices going up without further researching the intrinsic of the share. These bubbles create dangerous situations, seeing that when they collapse stock prices plummet into the ground and whole corporations could go bankrupt.

Subprime Loan

A subprime loan is defined as a type of loan with a higher interest rate offered at a rate above the prime to individuals who do not qualify for prime rate loans, usually due to their low credit ratings or other factors that suggest they have a reasonable chance of defaulting on the debt payment.

General Overview

Financial crises are not things of the modern world; they have occurred throughout history with of course the most infamous one being the Great Depression. This is also the main example of how far the global economy can decline, caused by a stock market crash. Since then, the regulatory and monitoring approach has been considered unnecessary and even counterproductive. However, this free-market approach is being reconsidered.

Regulated Market

Firstly, the need for the regulation of the market lies in its fiduciary nature. The word credit originates from the Latin word 'credere', which translates to 'to trust'. With the essence of the financial market being unavoidably characterised by its risky and uncertain nature, in order for costumers to trust the financial markets, they have to be able to trust their representatives, who have to ensure their protection from opportunist or predatory behaviour by the market.

Secondly, regulation ensures that the government takes all steps necessary to protect the consumer. This creates opportunities for individual participants rather than big corporate investors. However, this does create a more unstable market, due to the fact that many of these individuals are unaware of the exact system of the market. Therefore, this creates a more main-stream investing that solely looks towards the rising and falling of the stocks.

Finally, regulation allows governments to provide aid to financial systems that have become unstable, through legislative and monetary means. The government has the power to ensure the greater stability of the market. However, seeing that the market is solely based on social factors, it will always fluctuate.

Free Market

In a completely free market, there are no intervening authorities. Hence, prices are not regulated by either the government or other price-setting monopolies. This gives a less powerless identity to the individual investors, who not much like big corporations have little investing funds.

Secondly, a free market ensures that the market is totally adapted to the supply and demand. It encourages the improvement of some economies, seeing that import and export are not regulated through tariffs. Conjointly, in this free market big corporations do not have price-setting authorities, making the whole stock market a main-stream phenomenon, causing it to have very extreme highs and low.

Lastly, the government will not be able to protect the economy through legislative means; this leaves the economy unprotected, seeing that corporations will always opt for the cheaper option which will take away business from the national companies causing their stocks to decline.

Stock Market Crash

The stock market is constantly fluctuating due to inconstant information supply to the financial intermediaries. It is mostly a social phenomenon, caused by external economic events in conjunction

with crowd behaviour. Examples of such events are wars, large-corporation hacks, changes in laws and natural disasters, which could have a significant decline in stock value. However, these drops could result in the rise of stock prices for the competitor corporations.

These drops could turn into crashes: abrupt, dramatic, above double-digit percentage stock price declines. When such price declines occur, all stockbrokers tend to dump the shares of the affected company, causing the prices to plummet into the ground. This would cause these corporations to go bankrupt.

Furthermore, said crashes could be caused by stock market bubbles, that will eventually grow to the point of unsustainability. It is the process of overpaying for certain stock, which drives the prices up to the point where they cost much more than their 'actual' of 'intrinsic' value. The generation of stock market bubbles is accelerated by positive feedback, a process where rising prices attract the interest of investors. Not all people participating in the stock market study the intrinsic value of shares, and therefore, the rising prices alone are reason enough for such people to invest.

The price increases that lead to such a bubble are often followed by a rapid price correction, better known as a crash. During a crash, the prices fall from the inflated value to one that is closer to the 'intrinsic' or 'actual' value. Depending on the type of bubble, a crash can have many different causes.

Major Parties Involved

European Union (EU)

The European Union (EU) is one of the major economic powers in the world, due to the important stock markets situated in the member states. The EU is a single market which holds free trade as one of its principles, allowing member states to profit from free trade. The EU is a firm believer that trade can be used to develop less economically developed countries economies through allowing lower tariffs to support small businesses and create jobs. Despite this, the EU still has substantially high agricultural tariffs, which is especially damaging towards less economically developed countries as agriculture is generally their largest export. This approach ensures for a strong and stable financial market due to the large connected footprint.

United States of America (USA)

The United States of America play a key role in the global financial market, due to the fact that the biggest and most important stock market, the New York Stock Exchange (NYSE), is situated there. The NYSE plays an important role in the global economy, which is provable by the fact that the Great Depression first started in the NYSE. Furthermore, the USA have the biggest and most powerful economy, which makes them indispensable in any conversation about the global economy.

World Bank

The World Bank was founded on the intention to provide temporary loans to low-income countries, which are unable to obtain commercial loans. Furthermore, it promotes foreign investment, international trade and to the facilitation of capital investment. It gives nations an independent

platform to discuss the world economy and their concern, with that it provides economic investigation.

Timeline of Events

Date	Description of Event
Early 1600s	Establishment of the first stock exchange by the Dutch East India Company.
1930s	The Great Depression started
1944	The World Bank is established.
1946	The Bretton Woods system is introduced between 44 nations to liberalise world trade.
1957	Treaty of Rome established a common market between European countries, a step towards the current single market and liberalization of the European economy.
1999	First G20 summit, between financial representatives.
2002	The EU currency is launched, establishing the single market.
2007-08	The global financial crisis occurred
2016	The UK votes to step out of the EU, which might mean that they will withdraw from its the single market, which could have grave consequences for the financial system.

Previous attempts to solve the issue

There have been many attempts to solve the issue ranging from extreme monitoring to creating a free market. The first of its kind was the Bretton Woods Conference which had the biggest impact of them all and laid down massive ground work for the future. It established the World Bank Group and created a regulation for the international monetary and financial order for after World War II. This conference encouraged open markets, what intended to remove the road block in investing and put an end to economic nationalism. However, it encouraged countries to maintain their national interest, which would mean some form of regulation without totally blocking outside partaking. This initiative has had the greatest impact on the shape of the world economy as we know it today.

Many nations have taken their own approach to the 2008 global financial crisis. A good example of regulation as a reaction on this crisis is the Dodd-Frank act signed by US president Barack Obama in 2010. This act was instigated to streamline the regulatory institutions in the US, which would increase oversight of certain financial institutions and enhance overall transparency. In Europe a similar reaction took place. The EU created the European Securities and Markets Authority (ESMA), which supervised financial institutions registered in the EU. It was tasked to reduce overreliance in credit ratings, improve transparency and improve the quality of the credit rating process.

Possible Solutions

There are many possible approaches to this issue that could be taken by single countries but would be most effective if taken by many nations together. With this in mind the G20 could take many important steps seeing that they consist of 85% of the world GDP. Therefore, a good approach would be establishing G20 outlines, that would guide the financial market in such a way that it will become interesting for individual investors and big corporations, in conjunction with making the market more stable to inhibit the chances of global financial crises.

Additionally, the G20 could serve as a platform to build trust between governments, which would ensure the better communication and together regulation and monitoring of global financial markets, ensuring a more stable global economy.

A more extreme measure would be breaking up banks that are “too big to fail”: banks that have become so large and influential that their bankruptcy would destabilise the whole financial system of a State, or even the entire world (such as was the case with Lehman Brothers in 2008). Breaking up these banks is an extreme measure, but it would reduce the relative impact of bankruptcies in the financial system and it would reduce the likelihood of taxpayers having to pay for bank bailouts.

One could also look at less radical solutions, such as providing the market with an oversight organisation that would monitor financial institutions internationally. It would have to be able to collect and disseminate data, predict market trends to be able to identify a global crisis “in-the-making”, and might take on similar roles to current credit rating agencies.

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