



FOUNDATION FOR EUROPEAN
PROGRESSIVE STUDIES
FONDATION EUROPÉENNE
D'ÉTUDES PROGRESSISTES

Queries

N°01 (4) / 2011

THE NEXT GLOBAL DEAL

Magazine by FEPS - Foundation for European Progressive Studies

www.feps-europe.eu/queries

About **Queries**

Isaac Newton's famous book *Opticks* concludes with a set of "Queries".

These Queries are not questions in the ordinary sense,
but rather rhetorical questions intended to stimulate thinking.

This was Newton's mode of explaining "**by query**".

Queries

N°01 (4) / 2011

FOUNDATION FOR EUROPEAN
PROGRESSIVE STUDIES
FONDATION EUROPÉENNE
D'ÉTUDES PROGRESSISTES



Inside

INTRODUCTION

- 7** **The NEXT Global Deal:
The need for a balanced, equal and
social growth**
Ernst STETTER
- 10** **Preface**
Joseph E. STIGLITZ

REGULATING AND TAXING THE SYSTEM

- 16** **Turning the financial sector
from a bad master to a good servant;
the role of regulation and taxation**
Stephany GRIFFITH-JONES,
Damon A. SILVERS and Matthias THIEMANN
- 39** **Macro-governance**
Marcus MILLER
- 47** **Reforms in regulation
of financial sector: outlook**
Yaga Venugopal REDDY

THE NEW GLOBAL DEAL

61 **Global economic governance, a European perspective**

Poul Nyrup RASMUSSEN

68 **The unsettled Global Trade Architecture**

Martin KHOR and
José Antonio OCAMPO

89 **Towards a Progressive Trade Agenda**

Pascal LAMY

A NEW POLITICAL ECONOMIC RESPONSE

96 **Global Economic Governance for Balanced Growth. Institutional Issues**

Massimo D'ALEMA

101 **Global Economic Governance: an audacious rebuilding from a European perspective**

Pervenche BERÈS

108 **Global Economic Governance: In search of a New Policy framework**

Roy CULPEPER

CONFERENCE REPORT

122 **Global Economic Governance Conference**

Ariane ORTIZ MARRUFO



“**Queries**” is the scientific magazine of the Foundation for European Progressive Studies.

The Foundation for European Progressive Studies is a European progressive political foundation, close to the Party of European Socialists (PES). As a platform for ideas, FEPS works in a close collaboration with social democratic organizations, and in particular national foundations and think tanks, to tackle the challenges that Europe faces today.

Publisher: FEPS – Foundation for European Progressive Studies

First published in Belgium 2011

Publishing supervisor: **Dr. Ernst Stetter** (Secretary General – FEPS)

Managing Editor of **Queries**: **Dr. Ania Skrzypek** (Policy Advisor – FEPS)

Editorial support: **Dr. Matthieu Méaulle** and **Stijn Van Hummelen** (Economic Advisors – FEPS)

With the financial support of the European Parliament.

FEPS Team

Massimo D'Alema
President

Dr. Ernst Stetter
Secretary General

Dr. Ania Skrzypek
Policy Advisor

Dr. Matthieu Méaulle
Economic Advisor

Charlotte Billingham
Executive Secretary

Judit Tánczos
Junior Policy Advisor

Yolanda Fernandez-Romero
Junior Policy Advisor

Stijn Van Hummelen
Junior Policy Advisor in Economics

David Kitching
Junior Policy Advisor

Gaston Simon
Financial Advisor

Alain Bloëdt
Communication Advisor

Designed by: Ogilvy Belgium

Copyright © FEPS – Foundation for European Progressive Studies
ISSN 2032-9113

This magazine is published subject to the condition that it shall not by way of trade or otherwise be lent, resold, hired out, or otherwise circulated without the publishers' prior consent in writing in any form of binding or cover other than that in which it is published and without a similar condition being imposed on the subsequent purchaser.

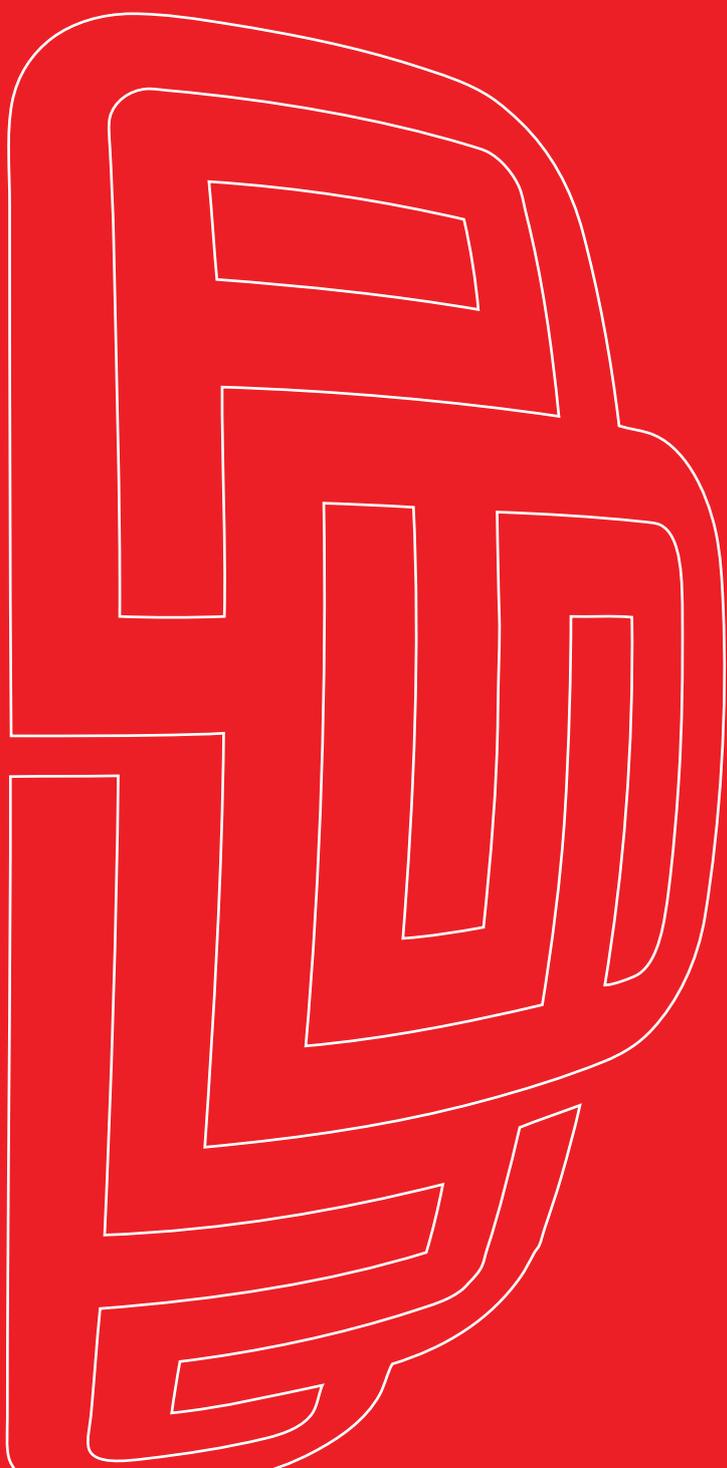
The articles collected in the magazine reflect only the individual observations of the respective authors.

FEPS

Rue Montoyer 40, 1000 Brussels, Belgium
Phone + 32 2 234 69 00, Fax + 32 2 280 03 83
info@feps-europe.eu
www.feps-europe.eu

Queries

Foreword



The **Next Global Deal:** The need for a balanced, equal and social growth!



Dr. Ernst STETTER
FEPS Secretary General

The crisis made it clear: The Washington Consensus is no longer the format for the globalised economy of the 21st century.

The main characteristics of the “NEXT Global Deal” is the change from the current “no-system” of global economic governance to a balanced growth model, and ensuring social justice and the viability of our welfare systems. Such a structure needs to integrate geographical, sectoral and social dimensions.

The world economy and its constituent parts are experiencing significant imbalances and this is a consequence of the lack of an efficient mechanism of collective responsibility to manage such crises. The attempts of the last two years from the international institutions (IMF and World Bank) to cope with the ineffectiveness of the current system are not enough and repeatedly miss the purpose. The system still lacks an effective new mechanism in order to properly cope with the globalised economy. This puts sustainable recovery after the financial and economic crisis at high risk.

Clearly, global governance suffers from important weaknesses and needs a real fundamental restructuring. Without any doubts, this requires more coordinated economic policies with more balanced representation of world economic actors. This is the overall challenge of a revised and more efficient global governance system.

A careful analysis of the institutional settings, as well as of the world productive and financial structures is needed in order to provide adequate institutional settings with efficient production and trade mechanisms.

It should to be recognised that we are living in a new multipolar world as a result of the rise of emerging economies such as China, India, Brazil and others. For example Asian’s GDP in the next decade will probably come close to that of the United States and the Euro area together!

We are now all aware that deregulation has led to the creation of major economic and social imbalances. This was definitely at the root of the crisis, and this also raises the question of a new institutional framework. Such a framework has to enable a sustainable and progressive strategy and refers to effective management of transnational challenges in the absence of a world government.

Unfortunately for a long time now, the framework of global economic governance is carried out by an informal set of actors, the Gs'. It promoted the agenda of economic liberalisation and narrowed the scope for aggregate demand management in a counter-cyclical way. It seems that the underlying ideological motivation of the Gs' is only efficient allocation of capital for the economy far away from what economists call optimal allocation of resources. The economic governance mechanism is therefore understood as an end in itself more than a means for increasing the level of employment or improving living conditions through income distribution rules.

Globalisation as we know it has also produced increased volatility in incomes and has increased income inequality. This was visible within and between economic areas should they be developed, emerging or developing. When associated with deregulated financial markets, this growth in inequality has significant consequences for the evolution and resolution of the crisis. This magnifies the extent of the failure, intellectual and practical, of the neo-liberal non-agenda.

Macroeconomic policies should ensure a system which will finance growth much more effectively in order to ensure not only growth output but first and foremost job creation.

Industrial policy on national, regional and international scales should be part of the *"Next Global Deal"* especially concerning global public goods management. Incentives are needed to ensure public provision to guarantee the kinds of investments which are needed in a number of areas. As suggested by the Commission of Experts of the President of the United Nations General Assembly headed by Joseph Stiglitz, a new consensus is needed in terms of job creation, green in terms of addressing environmental and sustainable concerns, and global in the sense that there will be international collaboration.

However, such investments and public incentives require funds and call for fiscal policies progressively taxing higher incomes and capital flows. This will also necessitate a high level of financial regulation and taxation for ensuring that the financial system is closely linked to the real economy, as a "good servant".

A much more intense collaboration should be implemented in order to avoid tax evasion and to raise inclusive regional taxes. Such policy proposals, given the degree of interconnection in the global production system, could only be implemented on a global scale. Therefore the current call for global fiscal consolidation through austerity plans, by definition, cannot be a success.

However, the challenge for such a *Next Global Deal* is for European member states to be more integrated and to speak with one voice. It goes without saying that the European Union has to be

represented in the new International set-up with one voice. Hence the paradox is: *Europe needs less representation for being more representative!*

The FEPS-IPD conference in Washington in October 2010 intended to address these issues, and to suggest ways to prepare an alternative and more coherent framework for world development. This intellectual gathering right before the autumn meetings of IMF and World Bank was highly welcomed. FEPS is honoured to publish the papers with the outcome of this conference in its scientific magazine QUERIES.

I would like to express my sincere gratitude for the effective cooperation with Professor Stephany Griffith-Jones from the Initiative for Policy Dialogue (IPD). She and her team, especially Mildred Brehm, did the utmost for the success of the conference.

Last but not least, I would like to thank FEPS Economic Advisers Matthieu Méaulle and Stijn Van Hummelen for their academic and logistical assistance.

Biography notes

Ernst STETTER was nominated as Secretary General of the newly created Foundation for European Progressive Studies (FEPS) on January 30th 2008. Ernst STETTER worked for the Friedrich Ebert Stiftung from 1980 to 2008 in various positions, which included amongst others, the offices in Dakar, Paris and Brussels. Ernst STETTER is an economist and political scientist. He obtained his Ph.D in political science in 1980. In 2003 he received the Chevalier de l'ordre national du Mérite.

Preface



By **Joseph E. STIGLITZ**

It is a pleasure to write a Preface to this special issue of the Journal, which gathers the papers presented at a joint conference of IPD (the Initiative for Policy Dialogue, at Columbia University) and FEPS (the Foundation for European Progressive Studies) at Brookings in Washington DC. The key issue addressed is how to reshape global governance to make it both more progressive and supportive of development. We explored both institutional issues and governance of the macro-economy, finance and trade.

For many years, the debate around the question of redesigning global economic governance had mainly been theoretical. The financial and economic crisis radically changed this. As Massimo D'Alema points out clearly in this issue: *"Nowadays, the reconstruction of global economic governance is no longer a question of choice. It is a question of necessity."*

This addresses the first of three major issues related to global governance. First, why do we need global economic governance and, in particular, how do we think about it for the purposes of development? Second, what should the agenda be? And third, what should the institutional framework be?

The global financial crisis made it clearer than ever that the world needs some system of global economic governance. Globalization and the closer integration of countries around the world has meant that countries are more interdependent. There are more externalities. Actions by one country have effects on others, as the current economic crisis made so obvious: bad government policy and reckless behavior in the United States has affected people all over the world. With financial contagion, a crisis in one country can give rise to crises elsewhere.

Global problems require global action. The existence of externalities and the need to provide global public goods make international collective action essential. We have a national government to deal with

national problems requiring collective action at the national level. But we have no global government to address these issues requiring global collective action. We have a system of global governance without global government: a complex set of institutions, institutional arrangements, treaties and rules. The subject of this journal special number TK is to analyse how we can improve those sets of rules and institutions to achieve more progressive outcomes: How do we make global economic governance work better, particularly for developing countries and for development?

The agenda has to be broad, because almost every aspect of the economy today is affected by what happens globally – and by the rules that are set globally. Thus, global economic governance really has to extend to almost every area, in a way that has parallels with what has happened within individual countries.

Governments such as the United States, for instance, have national economic policies that touch upon every aspect of the economy because there are interdependencies, externalities, and national public goods. One can't simply leave economic governance to the states and localities. Similarly, as the EU has worked to create a common market, it has realized that there needs to be a comprehensive set of economic regulations at the European level. The same principle applies globally.

The issues that need to be addressed, among others, are finance and banking, macroeconomic coordination, technology and knowledge, trade, competition, corporate governance, and the environment.

Finance is the area in which the deficit of global governance seems greatest. While financial markets are powerful and inherently globalized, regulation is predominantly national, weak and incomplete.

There is a need for a more stable global financial system that supports development. Clearly a comprehensive and global regulatory system is an important part of the answer, but there are many unanswered questions about what such a system might look like and how this can best be achieved. Most importantly, it is unclear whether governments will be able to overcome powerful vested interests to ensure sufficient and appropriate financial regulation – nationally and globally – to achieve financial stability.

Further, developing countries need a reliable, stable source of finance for development, which highly unstable private capital markets clearly do not provide. The private financial system has forced the developing countries to bear the brunt of exchange rate and interest rate fluctuations. Indeed, both risk and money have been flowing the wrong way: while the rich countries should be bearing risk, it is the poor; and while money should go from the rich to the poor, it has actually been going in the opposite direction.

Recent financial crises have reminded us of the absence of global arrangements for restructuring sovereign and private debt. In the aftermath of the Argentinean crisis, there was much talk of a new sovereign debt restructuring mechanism, but nothing came of it; just as in the aftermath of the East Asian crisis there was much talk of a “new global financial and economic architecture” – but little came of that.

And a global reserve system so dependent on the currency of a single country seems an anachronism in the twenty-first century – and especially in a world where the value of the dollar is so unstable. Additionally, the international reserve system is antiquated and dysfunctional. There is a global system that is overly dependent on the currency of one country – which contributes to unsustainable global macroeconomic imbalances – and is inequitable, especially for developing economies.

This leads us to the second area where global governance is crucial: macroeconomic coordination for sustained growth. In the short term, the international community (and especially the developed economies)

face the major challenge of restoring rapid and sustainable growth, which is also crucial for the developing world. Though the US and European economies show some positive signs, a major constraint is the continuing high level of unemployment. US unemployment – which is high in general, but especially for African-Americans and the young – is a major constraint on growth. So are mortgage foreclosures, which transform homes from major assets to liabilities for American families.

The European sovereign debt crisis and the incorrect response to it have excessively curbed growth in a number of countries. Even some countries, such as the United Kingdom, which have no sovereign debt crisis are pursuing damaging policies of fiscal austerity. And even countries with favourable fiscal and trade situations, such as Germany, have been overly cautious in their fiscal policies. There is clearly a need, both in the US and in Europe, to give higher priority to growth in policy design. This inevitably implies more expansionary fiscal policies than are being pursued in both the US and Europe. Monetary policy on its own cannot lead to economic recovery. Contrary to what many argue, more expansionary fiscal policy will crowd in private investment, rather than crowd it out. More broadly sufficient assistance should be provided to countries that cannot otherwise implement fiscal expansion (both in the developed and developing countries), and countries that can implement fiscal expansion should be encouraged to do so.

As Jomo Kwame Sundaram and Justin Yifu Lin pointed out at the IPD-FEPS Conference, another source of global growth could be a global green New Deal, which would rely mainly on increasing demand for long-term investment in climate change mitigation and adaptation. Innovative mechanisms, possibly including a financial transactions tax and/or SDR issues, as well as more traditional cooperation, should be creatively deployed to finance investment, especially in poorer developing countries.

A third area that is very important for better global governance is technology and knowledge. What separates developed from developing countries is not just a gap in resources but a gap in knowledge. There is the TRIPS framework in the WTO; there is also WIPO, the World Intellectual Property Organization. However, there are very big deficiencies in the existing frameworks, both for protecting intellectual property and for the promotion of knowledge, which is a public good. There is a great deal of concern about access to knowledge, particularly dramatic in the case of access to medicine. The developing countries are asking for a development-oriented intellectual property rights regime, and so far they have not succeeded in getting it.

A fourth crucial area is trade. In terms of development, many had hoped for a development-oriented round of WTO negotiations. What has emerged so far does not deserve that description. Maybe the Doha Development Round has been better than nothing, though this is a question for debate. But certainly, it has not really been fully addressing the concerns of developing countries on issues like non-tariff barriers, migration-escalating tariffs, and agricultural subsidies. In fact, the recent crisis highlights a new dimension of unfairness. The advanced industrial countries have provided massive subsidies to their banks and their auto companies, and would do it again; the rules of the game have been changed in a fundamental way. Those firms who know they have suffered losses know that they can call upon their governments for massive subsidies when the time comes. Knowledge that there might be subsidies is also an unfair trade advantage.

More broadly, as Pascal Lamy points out, the governance of international trade – whatever its many limitations – has relatively stronger institutional apparatuses than other areas, including enforcement mechanisms, which may offer useful lessons for the global governance of finance. This trade governance may have helped curb protectionist pressures during the crisis.

A fifth crucial global issue is the environment, including especially global warming. Developing countries need to be compensated for their environmental services, the rainforests that they provide. The issue of climate justice is central, given the fact that developing countries are amongst those that bear most of the cost of global warming.

There are of course many other areas in what is a broad agenda.

Finally, let me address the institutional framework. There are several things wrong with the current set-up. First, many of the things that have been brought within the ambit of global economic governance – such as attempts at standardization, for which no compelling case has been made – should not be there. And many of the things that should be there are not. This is partly because special interests have, to a large extent, taken over global economic governance. It is an extreme case of what we all know about domestic political economy – that there are special interests that press for policies with gains for a few and costs shared by society. Globally, the gains are even more concentrated and the costs are more dispersed and less understood. So the special interests are very large and influential. I saw this in the U.S. government very clearly, but it is more marked globally. The silo nature of global governance is one of the reasons special interests have a broader sway.

So what is the answer in terms of the institutional framework? The G20 is a big step up from the G8 but lacks representativeness – 172 countries (i.e. most of them) are not represented. Thus, it lacks political legitimacy. The solution – and the view that was taken by the UN Commission on Reforms of the International Monetary and Financial System that I chaired--is the creation of some sort of a global economic coordinating council, which could be based on a constituency principle. Such a body would be small enough that one could get meaningful discussion, but also representative enough and with far more political legitimacy, so that it could be more effective than the G20.

Biography notes

Joseph E. STIGLITZ is co-founder and Executive Director of the Initiative for Policy Dialogue at Columbia University. He is also a University Professor and Chair of Columbia's Committee on Global Thought. In 2001, he was awarded the Nobel Prize in economics for his analyses of markets with asymmetric information, and he was a lead author of the 1995 Report of the Intergovernmental Panel on Climate Change, which shared the 2007 Nobel Peace Prize. Stiglitz was a member of the Council of Economic Advisers from 1993-95, during the Clinton administration, and served as CEA chairman from 1995-97. He then became Chief Economist and Senior Vice-President of the World Bank from 1997-2000. In 2008 he was asked by the French President Nicolas Sarkozy to chair the Commission on the Measurement of Economic Performance and Social Progress, which released its final report in September 2009. In 2009 he was appointed by the President of the United Nations General Assembly as chair of the Commission of Experts on Reform of the International Financial and Monetary System, which also released its report in September 2009. Stiglitz helped create a new branch of economics, "The Economics of Information," and his work has helped explain the circumstances in which markets do not work well, and how selective government intervention can improve their performance.

Queries

01

Regulating and taxing **the system**

The recent financial, economic and social crisis exposed the inadequacy of the contemporary set up of the world's financial sector. The lack of appropriate and binding regulations, deficiency of any forms of its supervision and its disastrous detachment from the economic reality, as experienced by ordinary people every day leads to a conclusion that a profound change is required. But what should be its guiding principles? In this opening Chapter of *Queries*, Stephany GRIFFITH-JONES together with Damon SILVERS and Matthias THIEMANN search for an answer how to *turn the financial sector from a bad master to a good servant*. Their article provides a theory on what makes a financial system efficient and safe from collapsing, as also they empower readers with a detailed glossary of terms connected with regulations – thanks to which the differences between what exists and what is desired can easily be detected. Marcus MILLER, complements their analyses, bringing in the global governance aspects, while elaborating on emergence of G20 and the possible alternatives to the dollar-based system. Last, but not least, Yaga Venugopal REDDY, makes a pioneering critical assessment of the existing regorm proposals, focusing especially on the potential impacts of so called *Basel III*.

Turning the financial sector from a **bad master** to a **good servant**. The role of regulation and taxation.



Stephany GRIFFITH-JONES, Damon A. SILVERS and Matthias THIEMANN

The world experienced in 2008 the destructive power of an unregulated financial system. There has been much discussion in the aftermath of the financial crisis about how to protect the world economy from another such panic and its negative effects on the real economy. But there has been much less discussion about whether the financial system is actually serving the functions for which it was created, and whether the various proposals for reforming the regulation of the financial system are likely to lead to the financial system being more effective at achieving its core purposes.

In this paper, we intend to discuss the actual purpose of the financial system—the combination of financial institutions, financial markets, and governments as both regulator, market participant, and sponsor of financial institutions. Then we intend to review the course of post-crisis financial regulatory reform both in the United States and Europe, as well as the recent Basel 3 proposals to regulate banks internationally. We then pose the question, is the course of reform likely to leave us with a global financial system that is more or less effective at its core purposes? We finish by examining the issue of taxing the financial sector. We discuss financial sector taxation as a source of revenue and possibly as an additional way to mitigate negative externalities the financial system generates. The revenues generated by taxes on the financial system are one way of addressing that same system's failure to generate job-creating investment in the developed countries and to finance global public goods, such as financing development in poorer countries and mitigating climate change.

The financial system is mainly supposed to allocate resources in the form of savings to productive purposes in the form of investments. Some examples of recipients of investment are entrepreneurs with new projects, businesses needing working capital or seeking to expand, governments issuing public debt, and families needing to finance housing or education. The financial system should in doing so screen projects that seek capital, and invest only in those which are likely to be profitable on a risk adjusted basis. In a modern economy, financial markets also help investors manage both liquidity needs and insure against a variety of risks, both of which

should facilitate investors being willing to invest in long term projects that entail a variety of risks. (see IDEAS,2010)

This is the main purpose of the financial system. The financial system should not be treated as an end in itself, nor should the desire of participants in the financial system to enrich themselves be confused with the function of the financial system in the world's economy.

The financial system is efficient when it performs all these functions satisfactorily without collapsing into crisis on a regular basis. Its primary role of channeling resources from savers to real investors is a necessary condition for any economy to work, but modern financial sectors have evolved to offer more sophisticated financing and insurance products for agents who no longer operate with a regional/national perspective, but in globalized markets.

There are complicating factors in this simple description of the goals of a financial system. Among them are the problem of externalities, both positive and negative, including the need to finance public goods – investments that will generate large benefits that cannot be captured by the owners of the investment. And finally investors are not indifferent to both risk and return, time horizons and liquidity – some investors will be rationally risk averse, and some will seek returns even at the expense of incurring excessive risk. Then finally there are large problems associated with the fact that information is not cost-free and is asymmetric (Stiglitz and Weiss, 1981), as well as the fact that much information about the future is unavailable.

The problems inherent in financial markets manifested themselves in the real world in events like financial panics and prolonged difficulties in achieving adequate levels of investment in public goods like rural electrification. In response, modern societies actually allocate capital by a combination of capital markets, financial institutions, operating companies themselves, and governments both directly and indirectly through tax policy.

But in the runup to the financial crisis of 2008, there was a long period during which the role both of governments and of financial institutions in capital allocation shrank, and the role of private finance and specifically capital markets grew. Public policy in much of the developed world and the policies of the International Monetary Fund and the World Bank consciously encouraged this trend. Of course, the result was a world economy more vulnerable to a financial market panic, and an ensuing recession, than at any time since the Second World War. And of course, that was the moment when the panic came.

Much of the recent debate about financial reform has treated the financial system as an end in itself – so that the goal of financial reform is to stabilize and preserve the financial system. Naturally this is important, but it is clearly not enough. Ironically, some discussions have been focused on minimizing the threat the financial system poses to the real economy, as if minimizing systemic risk was the best we could do. Of course, returning to the post-WWII environment where financial busts did not pose a meaningful threat to economic growth is certainly a worthy goal, but it is not a sufficient one.

One of the reasons why the financial system is so hard to regulate is its extreme complexity and large size, especially in the Anglo Saxon world. A highly relevant, but not often asked, question is whether all this scale and complexity is necessary for satisfying the needs of the real economy. In fact, there have been simpler and smaller financial systems in the US and elsewhere in the past; even today, in the so called under developed world, certain aspects of the financial system may work better to channel efficiently resources from savings to productive investment.

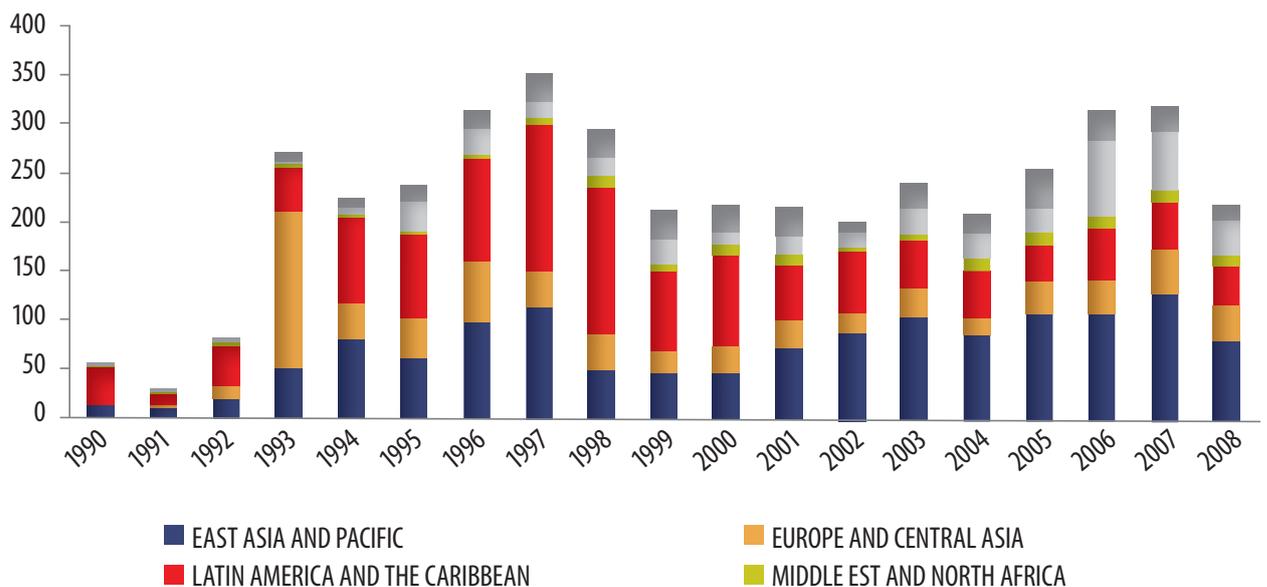
There is a wide consensus that some aspects of the increasing complexity of the world's financial system have been welfare-increasing. But critics rightly point out that the oversized financial sector that we have witnessed during the last decade - with financial activity, and their profits, growing at rates enormously bigger than those of real economies - is a signal that some parts of the financial system may be generating activities that are only marginally productive. Moreover, the destabilizing potential effects of some forms of financial trading for real economies need to be considered. As a result, the net effect of parts of the financial sector may be socially negative. As we have seen with the recent crisis, when the financial sector becomes a "threat to the sovereign" in making huge demands on public resources that then has knock-on effects for the state's capacity to provide welfare, we can talk about imbalanced priorities and raise the question of how to tax finance.

In particular, can we think of how to simplify and possibly even reduce (in some aspects, where there are large negative externalities) financial systems, to make them also easier to regulate, and less prone to financial crises, whilst more focussed on their real purposes, like providing sustainable credit for firms and households?

Consider the case of infrastructure on a global basis. Infrastructure plays a key role in promoting and sustaining economic growth and intraregional trade, especially but not only in developing countries. However, despite the significant progress in the development of infrastructure in most developing countries in recent years, investment has not kept pace with the demands placed on it by economic growth. This is particularly the case in East Asia. Recent estimates suggest that on average, Asia needs to invest about US\$ 750 billion per year in infrastructure during the period 2010 - 2020 to meet the strong growth of populations and economies. Approximately two-third of this amount will be earmarked as new investments, with the remaining third used for the maintenance of existing infrastructure assets.

As we can see in the Figure below, the private public investment in East Asia, at around \$70 billion in 2008 is well below the needed amounts. Also highly problematic is the fact that private public (PPI) investment in East Asia, and in the rest of the developing world fall after crises; as can be seen in the Figure above, PPI fell sharply in the wake of the East Asian crisis, and was very slow to recover previous levels; similarly we can see

Private public investment in developing countries, by region (US \$ billions)



Source: World Bank

how PPI has fallen for all developing regions since the 2007 crisis.

This latter fall is particularly sharp for low income countries, as we can see in the Table below, where PPI

Private Public Investment in Low Income Countries (\$ US billion)

Low income	2006	2007	2008	2009
	\$ 8.9	\$12.0	\$10.1	\$0.6

– according to World Bank data –, fell from \$12 billion in 2007 to \$ 0.6 billion in 2009.

These trends show that firstly private investment in developing countries is insufficient, in relation to needs; secondly it is highly procyclical, in relation to crises.

In the United States, in the aftermath of the economic crisis and the rescue of the large financial institutions through the Troubled Asset Relief Program, there are continuing problems not just with infrastructure finance, but with the provision of commercial credit through the banking system generally. As can be seen in Table below, commercial and industrial bank credit is 18% below in June 2010 than it was in mid 2009; the fall for the

U.S. Bank Commercial and Industrial Loans Outstanding Balances by Month

(\$ in 000s)	2008 Dec	2009 Mar	2009 Jun	2009 Sep	2009 Dec
All US Commercial Banks	\$ 1,618,600,000	\$1,563,500,000	\$ 1,503,700,000	\$1,561,800,000	\$1,316,000,000
% Change From June 09		97%	93%	104%	88%
Bank of America	\$ 188,845,918	\$ 193,463,760	\$ 191,710,309	\$ 171,587,276	\$ 165,589,221
JP Morgan	\$ 151,237,000	\$ 141,695,000	\$ 130,760,000	\$ 123,258,000	\$ 112,816,000
Citigroup	\$ 151,178,000	\$ 145,034,000	\$ 137,095,000	\$ 126,242,000	\$ 117,792,000
Wells Fargo	\$ 184,957,000	\$ 174,844,000	\$ 163,176,000	\$ 152,627,000	\$ 142,755,000
Total of 4 banks	\$ 676,217,918	\$ 655,036,760	\$ 622,741,309	\$ 573,714,276	\$ 538,952,221
% Change From Dec 08		97%	92%	85%	80%
% of Big Banks/Total	42%	42%	41%	37%	41%

Federal Reserve National Information Center.¹

largest US banks is even higher, as it declined by 25% from December 2008.

The real measure of a successful financial system is, does it efficiently allocate capital to useful, wealth creating purposes? It is hard not to look at the record of the world's financial system over the last fifteen years and conclude anything other than that it failed this test. This is true whether the results are measured by simple returns to investors – who have suffered long term negative returns in some of the world's largest markets, or by the obvious waste of the trillions of dollars pumped into the developed world's housing bubble. But it is most true when one considers the investments not made – in the replacement of the developed

¹ The Federal Reserve System, Bank Hold Company Performance Reports, Federal Reserve National Information Center available at <http://www.ffiec.gov/nicpubweb/nicweb/SearchForm.aspx>.

world's aging infrastructure, in basic infrastructure for the world's poor, and perhaps most tragically of all, in the energy technologies necessary to stop climate change,

In the remainder of this paper, we survey financial reform in the United States and Europe and measure it against both standards – has it addressed the causes of our continuing crisis, and are the reform measures that have been adopted or are under consideration likely to result in systems of capital allocation that are more likely to pass the more fundamental test of whether or not they allocate resources to productive purposes. We then examine in some detail the new Basel bank regulations proposed recently, as they will play an important role in shaping behaviour of banks in the future. In the final section we turn to financial transactions taxes, and especially the currency transactions levy.

Regulation

a. The United States and the Passage of the Dodd Frank Act

The one clear step toward re-regulation of global financial markets following the events of 2008 was the passage in the United States of the Dodd-Frank Act. This comprehensive legislation took a year to move through Congress, but, much to the surprise of many observers and lobbyists, it passed in a more robust form than it began, quite the reverse of the usual outcome of Washington's legislative process.

Several factors seem to explain greater strength of the US legislation compared to what has been accomplished in Europe, where the public discourse has been more aggressive than in the United States. Firstly, there was particularly strong coordinated lobbying effort on behalf of strong financial reform in the United States by trade unions, consumer and civil rights advocates, and a wide range of civil society organizations. This lobbying built on popular anger against the financial sector that was reflected for example in demonstrations and polling data. Much of the liberal media also backed the financial regulatory process. The trade union interest in systemic risk issues, arising out of the employment consequences of the financial crisis, had a particularly strong influence in ensuring regulatory and transparency progress on derivatives, on the establishment and nature of the systemic regulator and on the establishment and stronger features than would have been otherwise been achieved of the resolution authority.

In terms of the broader background, more progressive forces in U.S. politics were encouraged and became more assertive by the success of passing the U.S. health reform bill just as Congress took up financial reform.

Finally, there was the element of political structure and political leadership. The leadership provided by Senator Dodd and Congressman Frank at critical moments ensured that strong versions of the reform measures made it to the floors of Congress. Finally, and perhaps most importantly, the strong unitary executive structure of the U.S. system of government combined with President Obama's personal commitment to robust reform in a politically significant manner, particularly on aspects such as consumer protection.

The Dodd Frank bill that resulted had the following key features:

Consumer protection – the bill created an independent consumer financial protection bureau with a dedicated budget and close to universal jurisdiction over firms that sell consumer financial services. Recently,



President Obama appointed Harvard Law School Professor Elizabeth Warren to launch the new agency with the title of Assistant to the President for Consumer Affairs.

Private Equity and Hedge Funds – Dodd Frank requires that both private equity and hedge funds’ managers register with the SEC as investment advisors, subject to SEC issued rules for both disclosures and investor protection. In addition, Dodd-Frank creates the option that the Council of Regulators charged with overseeing systemic risk could find large hedge funds or private equity funds to be systemically risky, and require leverage limits or other systemic risk mitigation efforts be undertaken by the funds. Finally, the bill included a provision barring large banks from owning significant stakes in either leveraged buyout funds or in hedge funds

Derivatives – The Dodd-Frank bill ends the exemption from regulation granted to those who trade in derivatives in 2000. In its place are requirements to list over the counter derivatives with clearinghouses that will require parties post collateral to cover the risk of losses, and to list derivatives transactions with an exchange or exchange like entity that will provide pricing transparency. However, there are a number of exceptions to these requirements for commercial companies (end users) and others whose precise definition has been left up to the Commodities Futures Trading Commission.

Corporate Governance – The Dodd- Frank Act requires U.S. public companies to submit their executive pay packages for a shareholder advisory vote, as is also the case today in the United Kingdom. The Act also clearly grants the Securities and Exchange Commission the authority to require candidates for corporate boards nominated by significant long term shareholders to be included on management’s proxy card. Finally, and perhaps most surprisingly, the Act requires publically traded companies to disclose the ratio of the highest paid employee’s pay to that of the median worker at that company. The Securities and Exchange Commission has been left the task of deciding whether this ratio is company-wide or just with its U.S. workforce.

Systemic Risk and Resolution Authority – The Act created a Systemic Risk Council, tied to the Board of Governors of the Federal Reserve and chaired by the Secretary of the Treasury, with broad powers to regulate systemically significant institutions, including the power to set more stringent capital requirements, and bar systemically risky business activity. Under this system, the Federal Reserve is charged with doing annual stress tests of systemically significant institutions.

Resolution Authority – The Systemic Risk Council has the authority to place bank holding companies and other systemically significant financial institutions into a resolution process in which equity capital is eliminated, existing management is laid off, and there is a strong preference for haircutting bondholders. The resolution process would be run by the FDIC, who have the most experience in the US financial regulatory system in resolving weak financial institutions.

We summarize the main changes of this legislation in the matrix below, where we list why certain measures are desirable, which changes were initially envisioned by the administration (as reflected in their rhetoric) and what the final bill will actually do.

There is however a pattern that runs through the Dodd-Frank bill. The bill is the product of a struggle between two views of financial reform within the Democratic Party – first the view that the real problem was

that prudential regulators did not have broad enough powers to oversee and correct risky behavior. The second point of view was that there were structural problems within the financial system that had to be addressed – that simply giving prudential regulators universal jurisdiction was not going to for example resolve the problem of “too big to fail,” or that the big banks should not be allowed to own hedge funds no matter who was watching.

These tensions were ultimately addressed by Congress not addressing them, and instead asking regulators to involve the fundamental tensions in the bill. As a result, the real shape and force of Dodd-Frank remains unknown today, as the financial regulators begin the lengthy process of writing and adopting all the new rulemakings required by Dodd-Frank. The following table describes some of the key features of the Dodd-Frank bill that were left to the regulators to define.

Regulation of Wall Street	Desirable	Rhetoric of the administration	Reality
Proprietary Trading of Banks (<i>Volcker rule</i>)	Needed in order to reduce interconnectedness due to funding strategies (repos) that rely on borrowing from other financial institutions and to prohibit speculation in institutions where taxpayer guarantees to protect depositors lower its cost and increase the incentive for risky behavior.	<i>In recent years, too many financial firms have put taxpayer money at risk by operating hedge funds and private equity funds ... When banks benefit from the safety net that taxpayers provide ... it is not appropriate for them to turn around and use that cheap money to trade for profit</i> (Obama, January 21 st 2010)	Rule has been adopted and other provisions will limit borrowing among financial institutions. However, the bill will allow banks to hold on to hedge fund and private equity funds equal to 3% of their tier 1 capital. Furthermore, regulators must distinguish between proprietary trading and trading for clients, which could lead to loopholes.
Transparency and Margins in the Derivatives Market (<i>called Swaps market in the Legislation</i>)	Needed in order to increase systemic stability, as all sellers of derivatives (including nonbanks such as AIG) will have to hold capital in order to be able to cover their contractual obligations. Transparency is also needed to improve understanding of market activity by regulators and market participants.	<i>I will propose strong trading and mandatory clearing requirements, higher capital standards for systemically important market participants, real-time reporting of derivatives trades to regulators and the public and laws which will ensure that all loopholes are closed.</i> (Senator Blanche Lincoln, in a letter to Senator Cantwell et al.)	Transparency and margin requirements will be instituted for all derivatives which can be cleared through clearing houses. Those for which no clearing house can be established and those involving end-users will be exempted. Regulations covering who and what will fall under these categories will be established by rulemaking.

Swap Trading by Banks
(Lincoln amendment)

Should be banned, in order to prohibit speculation by federally protected institutions, reduce interconnectedness and thereby reduce systemic risk.

In my view, banks were never intended to perform these activities, which have been the single largest factor to these institutions growing so large that taxpayers had no choice but to bail them out in order to prevent total economic ruin. (Senator Lincoln, May 5th 2010, press report)

Banks will be allowed to continue to conduct the majority of their derivatives business (such as foreign exchange and interest rate swaps) and hedge their own activities but they will have to push out to subsidiaries trading of non-investment grade entities, commodities, and credit-default swaps.

Capital Ratios

Capital adequacy ratios need to be increased and definitions of capital tightened in order to make banks more stable in the face of unexpected shocks. The problem of capital adequacy needs to be addressed in the context of market perceptions that large institutions enjoy an implicit government guarantee, by regulators adopting size based capital requirements.

In Pittsburgh, G20 Leaders noted the unique risk posed by Systemically Important Financial Institutions (SIFIs) highlighting that in addition to proposals to increase capital adequacy, for banks in general, the FSB should *propose . . . possible measures including more intensive supervision and specific additional capital, liquidity, and other prudential requirements.* (White House Press Secretary, June 27th 2010)

Some forms of hybrid capital will be phased out except for bank holding companies under \$15 billion in assets. BHCs will have to consolidate their capital ratios for their structure as a whole. Final regulation on how much new capital banks need to raise is pending (awaiting international agreements) but US regulators must issue rules establishing requirements to address risks arising from significant activity in derivatives, securitized products, financial guarantees, securities borrowing and lending and repos, and from asset and market concentrations. Regulators have the option of imposing size-based capital requirements.

The problem of too big to fail

Banks should be reduced in size in order to stop cheaper borrowing for banks which are deemed too big to fail and thus to avoid the high fiscal costs of rescuing huge banks which are engaging in too risky businesses.

Never again will the American Taxpayer be held hostage by a bank that is *Too big to fail*. (Obama, January 21st 2010)

The legislation does not require the break-up of big banks but the Financial Stability Oversight Council may require a systemically important company to take remedial actions, including selling assets, if 2/3^{ds} of its members find that it poses a “grave threat” to financial stability. Further regulation regarding size might be imposed by regulators after impact studies. Mergers which result in holdings of more than 10% of financial assets by BHCs and financial holding companies will be prohibited after rulemaking by the Fed.

Even more fundamentally, the financial regulators and the Obama Administration face the challenge of whether or not to use the new resolution authority created by the Act to address the fate of a number of weak financial institutions kept alive by some combination of explicit government funds and implicit guarantees. While this question is most clearly posed by the state of Fannie Mae, Freddie Mac, and AIG, it is also relevant to the U.S.’s four largest banks, whose creditworthiness currently is in substantial part a function of their enjoying an implicit government guarantee.

Moody’s: Uplift in Ratings From External Support²

	Stand Alone Rating (Rating if no external support)	Actual Long Term Rating (adjusted due to external support)	Notches of Ratings Uplift Due to External Support
Bank of America NA	Baa2	Aa3	5
Citibank NA	Baa2	A1	4
JP Morgan Chase Bank NA	Aa3	Aa1	2
Wells Fargo Bank NA	A3	Aa2	4

² Moody’s.com - Moody’s provides BFSR and Long-Term Rating and how the BFSR scale maps to the Long-Term Rating scale. Notches uplift from external support can be figured out from this.

Fitch Ratings: Uplift in Ratings From External Support³

	Stand Alone Rating (Rating If no external support)	Minimum Rating For This Bank Due to External Support	Actual Long-Term Rating
Bank of America NA	C/D	A+	A+
Citibank NA	C/D	A+	A+
JP Morgan Chase NA	B	A+	AA-
Wells Fargo NA	B	A+	AA-

Because Dodd-Frank remains truly a work in progress, it is unclear whether it will ultimately lead to a U.S. financial system better able to transform savings into productive investment. That potential exists within the Act, but it may go unrealized. Ultimately, the effectiveness of Dodd-Frank may depend on the extent to which it is ultimately paired with other measures, such as changes to the tax codes, the restructuring of the housing finance system, and the creation of public or quasi-public investment vehicles in areas like infrastructure that will provide viable alternatives to a return to short term speculation, financial engineering, and yield chasing that have characterized U.S. financial markets over the last fifteen years.

b. Europe makes progress, but somewhat less than US

It seems more difficult to reach agreement in Europe on regulatory reform, as there is no federal state. Any regulation has to be negotiated by 27 member states, with different financial systems-both in their scale and in their characteristics. Above all, competition amongst EU member states to attract international investors and innovative financial products leads to national caveats in negotiations, which often create loopholes in prospective EU regulation (see also ETUC,2010).

In light of the limited progress made at the G20 on financial regulations, progress at the European level would be very important, as it is essential at least to have rigorous regulations at the supranational level of the European single market, to avoid a race to the bottom in the EU of looser financial regulations. European negotiations are more complicated because they take place in several levels:the more nationally oriented European Council, the very active more pro regulation European Parliament, and the European Commission. This makes the process slower and subject to bureaucratic delays, as well as to strong national and ideological contradictions; though lobbying by the financial sector seems less open and organized than in the US, it may in the end be more pervasive, as there are so many points of intervention where such lobbying can take place in Europe.

In Europe, valuable initiatives, such as that of the European parliament to regulate hedge funds and private equity - led by Poul Nyrup Rasmussen, President of the PES, gets not only diluted, but continuously postponed by the blocking tactics of the UK – where most of the European funds are hosted – the pressure from the US to avoid regulation for US funds in Europe and of course intense lobbying from hedge funds and private equity firms themselves.

³ Page 26, Fitch Ratings' "US Banking Quarterly 1010 - Financial Stability", June 2, 2010.

There are several areas where Europe seems well behind what the US is doing; one example is in relation to too big to fail, where Europe is largely silent, in contrast with the US, where the Volcker rule and the Kanjorski amendment gives federal regulators the power and responsibility to limit activities or even break up bigger banks if they pose a “grave risk” to the financial system. As ETUC suggests, caps on the size of the banks in relation to GDP, combined with a functional separation between investment banking and commercial banking seems very important also for Europe, as does forbidding deposit taking banks proprietary trading activities. It is to be seen to what extent the UK commission appointed for this purpose leads to meaningful changes in these areas.

However, there are important areas where the European Union seems to be making important progress, such as institutional issues, where a fairly ambitious pan-European financial regulatory architecture was approved. This architecture could become an important step forward that that would help develop common European rules for national regulators to implement. Three pan European Supervisory authorities for micro prudential supervision and regulation have been set up: one for banking, another for insurance and pensions and a third for securities and Markets. A European Systemic Risk Board has been set up for macro prudential regulation, which is due to start running in January 2011. The trade unions will be part of the Scientific Advisory Committee of the macro prudential regulator, thus providing diversity of stakeholders there, though they are no longer part of the Board, as was originally planned.

Another important development is that the European Parliament may request the European Council to declare an emergency for regulatory purposes. The legislation also contains elements such as the banning of certain financial products, consumer protection in financial markets, and binding mediation between national regulators in case of conflicts. Apparently the European regulators may in case of emergency – if national regulators do not act appropriately – impose binding decisions to national authorities. If national regulators do not comply, the European authorities can impose conditions directly on the financial institutions concerned. Finally, EU authorities will be equal partners in colleges of national supervisors.

c. Basel 3 proposals

While both the U.S. government and the EU have been addressing comprehensive financial reform, a parallel international process has been underway addressing the particular problem of capital standards for banks in light of the shortcomings of Basel II revealed by the financial crisis. In September 2010, the 27 countries of the Basel Committee on Bank Supervision agreed in principle rather major changes to bank regulations, the so called *Basel 3*. Their aim is to strengthen banks so that “never again” a crisis like the 2007-2008 happens. The *Basel 3* initiatives appear to be quite substantially influenced, amongst others, by the critique of *Basel 2* levelled by Daniel Tarullo in his book *Banking on Basel*. Mr. Tarullo now serves as President Obama’s appointee to the Board of Governors of the Federal Reserve System, with particular responsibility for bank regulatory matters.

These *Basel 3* proposals have a number of positive elements, such as increasing risk weighted capital requirements, (though questions are rightly asked whether this increase is large enough and soon enough, see below), introducing a leverage ratio for solvency, an additional capital buffer and a countercyclical buffer (through dynamic provisioning based on expected losses) and introducing liquidity provisions.

However, a fundamental issue looms over *Basel 3*. Many of the provisions of *Basel 3* have effective dates far into the future. The reason for this, sometimes stated openly, sometimes not, is that banks and governments

are fearful that sound capital requirements, if imposed in the current economic situation, would lead to a further pullback in bank lending, and acting as a further drag on an already weak global economy. This approach is founded on the earlier refusal of a number of bank regulators in advanced countries, particularly the United States and Germany, to take a hard look at the asset side of their banks' balance sheets. The implementation schedule for *Basel 3* is unquestionably part of a broader strategy of forbearance, a strategy with unfortunate antecedents in the Japanese lost decade of the 1990's. The alternative approach would be to impose appropriate capital requirements now, and restructure and force to raise capital for banks that are too weak to function in their role of credit provider.

In what follows we analyze *Basel 3* measures in some detail and provide a critique. Firstly, are the increases of capital requirements enough, and will they be implemented soon enough? Most observers, even fairly conservative ones, think the answer is no to these questions, especially for banks with very risky assets. A more radical critique, which we discuss below, is whether focusing on risk weighted assets is the best approach, or will this lead to new forms of arbitrage? Also are the liquidity buffers well designed and sufficient? Will the new regulation deal properly with the problems that caused the previous crisis and even more whether the rules are dynamic enough to avoid systemic risk building up? Finally will better regulation of banks not cause financial activity to move even more to the so called shadow banking system if other activities are not properly regulated? Below we describe the main changes being suggested, and in a preliminary way offer an evaluation.

1. Raising core capital requirements- is it enough?

2. What has been decided?

The **minimum common equity requirement** (the highest form of loss absorbing capital) is raised **from 2% to 4.5%**; **Tier 1 capital is raised from 4 to 6%**, while total tier 1 and 2 requirements will remain at 8%.

In addition, the definitions of Tier 1 and Tier 2 capital have been changed to raise the quality, consistency and transparency of the capital base. The goal is to make sure that banks have access to this capital at all times, and that the banks can stop paying any dividends on Tier 1 capital in case of crisis. Clearly, common equity and retained earnings most easily fit the definition of Tier 1 capital. The deduction of certain positions from core capital has also been made more restrictive. Banks will, for example, have to deduct good will and general intangibles from common equity rather than from tier 1 capital, as was the norm before *Basel 3*. This is effectively increasing the amount of common equity banks need to hold.

The cumulative effect of the two measures just described will mean that it will be significantly more expensive for banks to raise capital than it looks at first sight, i.e. that the mere numeric increases look far smaller than what *Basel 3* has actually done.

In addition, banks will need to hold a **capital conservation buffer of 2.5%**, designed to withstand future periods of stress. As a consequence, in calm times, banks should have 7% of common equity. **Banks are allowed to draw on the 2.5%**, buffer in times of crisis; however, the closer to the 4.5% core common equity they come, the smaller becomes their capacity for the distribution of dividends and bonuses among employees. The Basel Committee claims that in this way, regulators will effectively require retained earnings be used to increase common equity, rather than allowing banks to spend retained earnings on executive compensation.

The Basel agreement included in addition a number of less well detailed proposals, whose final shape remains to be resolved:

- **Countercyclical buffer of the range of 0 to 2.5% of common equity**, which will be implemented according to national circumstances, when there is excess credit growth in a country. Once introduced, it is above the 7% total equity requirement described above. The acceptance of the countercyclical buffer is a very positive step forward (see Griffith-Jones and Ocampo with Ortiz ,2009 for a discussion of the great need for countercyclical provisioning to help moderate booms and busts).One problem with implementation is that banks increasingly lend internationally, especially in countries in the EU. In order to prove more effective, such moves then would have to be accompanied by restraints for lending for foreign banks in these countries. This will be aided by the creation of EU wide regulatory institutions; also very important would be the adoption of greater emphasis on home country regulation, as advocated in the UN Stiglitz Commission Report (2009)
- **Non-risk based leverage ratio:** Behind the risk-based capital measures, there is a flat 3% Tier 1 capital requirement as a “back stop”, meaning a complement to the risk based approach. It implies a maximum leverage ratio of 1 to 33.33. The simple leverage ratio is based on high quality Tier 1 capital, with a 100% treatment of all exposures net of provisions, including some off balance sheet exposures. Test runs regarding this ratio will be starting from 2013, which will be evaluated in mid 2017 and put into pillar 1 requirement form (hopefully) by January 1st 2018.

Whilst introducing a leverage ratio, as a backstop to risk weighted exposures, (with the latter far more subject to regulatory arbitrage) is positive, given that excessive leverage was such a large part of the causes of the crisis, it could be asked why is the leverage ratio not the primary capital adequacy control tool ? Also very importantly, should leverage permitted not be lower as was initially proposed , proposal which was watered down due to the pressure of the banks ? And implemented sooner? In this respect, it is ironic to note that the Non-risk based leverage ratio in *Basel 3* of 3% is approximately the same leverage ratio that the U.S. Securities and Exchange Commission allowed the investment banks under its supervision to reach in 2005, a step for which the Commission has been intensely criticized. Three of those five firms failed, the other two converted themselves to bank holding companies so they could take advantage of Federal Reserve provided lending in the crisis.

The BIS and the Financial Stability Board are considering raising capital requirements for systemically important banks, where they are trying to determine the right size. For this reason, there is yet no number or a binding time plan.

Implementation:

One of the key critiques of the *Basel 3* proposal is that they will be implemented far too slowly, with some not being in effect until 2022. The schedule is detailed below. The main reasons why this has been done is lobbying by the banking industry itself, and the fear by regulators that increasing capital and other requirements sooner could further curb banks willingness to lend, thus further undermining growth and jobs recovery. The



problem is that this current strategy is too risky, especially as many banks are currently perhaps weaker than the numbers show due to accounting manipulations on the asset side of their balance sheets. The risk of more banking problems occurring before the new rules kick in seems unacceptable. Therefore an alternative could be for regulators to push banks, especially those that are clearly undercapitalized, to raise fresh capital; this could be enforced, as Sharfstein and Stein (2010) suggest, by regulators forbidding dividend payments or limiting compensation until they did so.



National implementation will begin by January 2013, by when these requirements will have to be implemented into national law. That day minimum core equity requirements will be raised to 3.5%, tier 1 from 4 to 4.5%. On 1st of January 2015, the banks will have to meet the 4.5% common equity and the 6% tier 1. Regulatory adjustments, which will further increase the capacity of core equity to absorb losses (by e.g. limiting investments in other financial companies to 15%) will be phased in in 2018.

The raising of the tier 1 capital from 4 to 6% will be phased in starting January 1st 2013 and will be reaching 6% by January 1st 2015.

The capital conservation buffer will be phased in from 2016 and reach 2.5% on January 1st 2019. The same holds for the countercyclical buffer, where countries are urged to shorten the transition phase in case excessive credit growth is experienced.

State capital injections will be phased out by 1st of January 2018. Instruments which will no longer qualify for tier 1 or tier 2 capital will be phased out through an annual 10% derecognition starting from January 2013 and ending December 2022.

Disqualification of riskier forms of tier 1 capital will be recognized immediately in 2013. However, if they are issued by non-joint stock companies, recognized under national accounting law and national banking law, they will be exempt from this provision. This seems to be a response to the problems of German public banks.

Liquidity requirements: what is done?

One of the most revolutionary aspects of *Basel 3* is its attempt to establish liquidity risk as an independent pillar of regulatory action and supervision, rather than treating it as a subsidiary problem to the risk of losses. *Basel 3* applies liquidity tests to internationally active banks on a consolidated basis. While their implementation is too slow and the measures themselves could be more robust, this direct approach to regulating liquidity is very positive. Problems of liquidity were central to the crisis, and in part were the result of previous regulation having practically abandoned liquidity regulation. Financial institutions, including banks, had extremely low liquidity ratios, which made them very vulnerable (see for example Darista and Griffith-Jones (2010) for the US).

A liquidity coverage ratio is introduced, which will come into force on January 1st 2015. The Net stable funding ratio will be introduced by January 2018. However, these standards might still be changed, in case unintended consequences occur over the observation period. Initially, implementation was planned earlier, but banks complained that the impact of these measures might be dramatic and therefore require more

intensive quantitative studies (s. e.g. Zentraler Kreditausschuss (2010)) justifying the delay. These two measures, if implemented, could have a very significant impact on large banks' business model, limiting the derivatives business of banks and their exposures to the wholesale funding market. In particular, this measure make make it difficult for banks to participate in the Asset-Backed Commercial Paper (ABCP) markets.

- **The liquidity coverage ratio** is defined as the sum of all liquid and high value assets a bank holds (weighted according to the quality and liquidity of assets) and the 30 day liquidity needs it might face, assuming a disaster scenario. This ratio has to be equal or bigger than 1. The rating of the quality and liquidity of assets will form part of the quantitative impact studies. Conservative approaches favor substantial discounts on corporate and covered bonds, letting only cash and state bonds have a 0% risk weighting. On the denominator side, credit and liquidity lines for small and medium sized enterprises and for banks and special purpose entities will be weighted with 100%. For Special Purpose Entities (SPEs), this proposal is intended to curb much of off-balance sheet activity, as it will not be profitable anymore for banks to engage in the credit arbitrage business by running SPE's and providing them with liquidity lines and other credit guarantees. On the other hand, the 100% risk weighting for credit lines for banks and SME's seems overly restrictive, and could damage lending to SMEs. Also, given that the current risk weighting measures are very restrictive for the more speculative and more profitable activities in the short term, there is the risk that after Quantitative Impact Studies, they will be severely watered down. If that occurred and yet the 100% weighting remained for credit for small and medium sized enterprises, the net result would tilt the financial system further away from financing the real economy.
- **The net stable funding ratio** is defined as a ratio of all available stable refinancing options over all the needed stable refinancing options over the course of one year. This ratio has to be equal to or bigger than one. This further seeks to minimize the liquidity mismatch in the banking sector, which proved so disastrous in the crisis. However, this might impact lending too much, so that recalibration will be needed. Liquidity lines are risk weighted, such that 10% of their value has to be available for the entire year. Other contractual commitments by the banks will have to be risk weighted by national regulators, which may reintroduce national regulatory competition.

Besides these two measures, *Basel 3* also provides 4 instruments to supervisors in order to measure the liquidity risks of banks. These are:

1. The contractual maturity mismatch
2. The concentration of funding- which aims at uncovering and potentially limiting the concentration of exposure to lenders,
3. The available unencumbered assets: how much can the bank refinance without trouble, and
4. Market related monitoring tools

With the help of these instruments, regulators hope they will be able to have a better understanding of the liquidity consequences if a bank is failing.

Criticism/ final evaluation

Like its predecessors, *Basel 3* may be vulnerable to strategic behavior by the banks. And despite the obvious efforts to make the *Basel 3* rules less vulnerable to the banks' own risk management models than *Basel 2* was, *Basel 3* remains dependent on risk management models that may not be able to easily model the consequences of the interaction between the behavior of different actors in the financial system in a crisis.

As Felix Salmon points out in his blog on *"The biggest weakness of Basel III"*, imposing risk weighted measures on assets is not only backward looking, but it induces a game in which banks increasingly take up risks which are not accounted for by the regulatory framework, *Since taking any additional measurable risk is now stigmatized, the game becomes how to increase returns without increasing measurable risk...*

This means that *Basel 3*, which is reacting to rampant regulatory arbitrage under *Basel 2*, which was a reaction to rampant regulatory arbitrage under *Basel 1* might again induce regulatory arbitrage (s. Blundell-Wignall and Atkinson 2010: 3). Banks may transform assets with high risk weighting into assets with low risk weighting, which, as in the case of AAA MBS can prove disastrous.

This issue is about promises in the financial system. If regulations treat promises differently in different sectors, then with complete markets in credit, the promises will be transformed into those with the lowest capital charges... There is a massive incentive in financial markets to use "complete market" techniques to reconfigure credits as capital market instruments to avoid capital charges and reduce tax burdens for clients, thereby maximising returns for themselves and their customers. This will continue despite the proposed reforms. (ibid: 5, 8)

This problem could be counteracted maybe, if the two measures of liquidity and capital ratios are actually supporting each other in order to stem excesses, i.e. if loading up on assets due to 0 risk weighting is actually limited by the liquidity requirements of banks, and in particular source of funding regulation. Also, as discussed above, if the leverage ratio were to be lower and more binding, as well as given a bigger regulatory role, this could help. How these factors will interact together thus has to be a focus for future research and study as well as monitoring by regulators, in order to determine how different elements can be adapted to each other to prevent excessive risk exposure due to regulatory arbitrage.

The two ratios, Liquidity Coverage and Net Stability Funding are particularly subject to modeling risk. The effectiveness of the two ratios at preventing crises will depend on the models used by regulators in order to determine liquidity behavior in these moments of crises. The ZKA has noted that the approach of penalizing illiquid investments will lead to more herding and concentration risks. This is so because these restrictions make certain business models unprofitable and thereby will lead to more intense competition in other segments. If these segments are impacted by a crisis, due to lower diversification, the whole banking sector will be affected.

Duttweiler (2010) also points out that the LCR and NSFR-approach well defines the period of one month (shock) and the period for one year (crisis). However, it is unclear how a bank will be able to renew its short term liquid assets if it is in a persistent liquidity crisis after the first 30 days.

Then there is the problem of off-balance sheet instruments. Many of the banks which looked well capitalized before the crisis suffered the biggest losses during the crisis. This was due to mispricing of securitized assets on balance sheets and due to off-balance sheet activities which were not sufficiently accounted for in core equity calculations. The historical impact of the crisis on core equity was substantial, and for several banks far above even what the new capital requirements could buffer. One approach to this problem is to instead of demanding impossible equity ratios, to reduce the sources of potential substantial sudden write downs in the system, by discouraging or forbidding more risky instruments. This is essentially the approach taken by the Dodd-Frank bill to a limited extent in barring large investments in proprietary trading by banks.

In this respect, *Basel 3* does go some way in the right direction. The liquidity coverage ratio and the net stability funding ratio, if enacted as such will limit the emission of ABCP-papers for credit arbitrage reasons and will thereby limit one of the most lethal instruments for banks before the crisis.

In general, *Basel 3* (like most regulation) is an ex-post regulation which cannot foresee future regulatory arbitrage. For this reason, stronger and especially faster mechanisms for responding to regulatory arbitrage need to be found (and are not part of *Basel 3*). Here we must recognize the irreducibly political nature of bank regulation. To the extent banks are allowed to become large enough to dominate the regulatory process itself, that process will never have the political independence to respond to regulatory arbitrage in anything other than a crisis environment.

During the run up to the financial crisis, regulatory arbitrage activities often involved the shadow banking sector. Thus, industry bodies, such as the ZKA for Germany, have rightly noted in response to Basel 3 that the new regulations will increase the incentives for regulatory arbitrage, as they are imposing severe limitations on banks, while leaving other financial sectors untouched (e.g. money market funds).

The appropriate response should be a more robust form of increasing regulatory coverage that included all financial intermediaries and all financial instruments in an equivalent way in the same core capital requirements regime in order to avoid such asset-shifting (Darista and Griffith-jones, op.cit.; for more recent analysis see Blundell-Wignall and Atkinson (2010): 16f). This is not an easy task, but is essential. Both US and EU regulation are moving in this direction, but too slowly and not comprehensively enough.

The step of creating a systemic regulator, both in the US and in Europe, is an important move forward; however, the question is if they will be sufficiently strong and comprehensive? The further question is how much more should in the medium term the international institutional regulatory structure be coordinated, with a view towards the creation of a global financial regulator, as discussed in the *UN Stiglitz report*? Naturally issues of governance, eg participation of developing countries, and autonomy from financial interests, would be crucial here.

A fair contribution from the financial sector; the case for a financial / currency transactions tax

The global financial crisis sparked a surge of interest in financial transactions taxes. Financial transaction taxes are a response to failures of the financial system to allocate resources productive in two ways – first by increasing resources for governments to invest in areas like infrastructure and education, and secondly, by creating incentives for financial markets and financial institutions to make productive investments rather than engaging in speculative market activity. Financial transaction taxes also are a way to discourage systemic risk and encourage financial stability, in the tradition of Keynes and Tobin. Finally, such taxes may, for example, improve transparency, which is good for financial stability, as was the case in Brazil during the bank transaction tax era.

For some time there have been various proposals for “innovative sources of financing” to meet the goal of official development assistance of the United Nations and help finance provision of global public goods. This received support in several UN summits since 2000. Some innovative sources have begun to be successfully adopted, such as a tax on airline tickets.

Proposals for financial taxes have received support in the UK – the world’s largest financial centre for foreign exchange transactions – from former Prime Minister Gordon Brown, and the head of financial regulation, Lord Adair Turner. Furthermore, the manifesto of the UK Liberal Democrats, now part of the Coalition Government, clearly endorsed such a tax, and its use for development and climate spending. The leaders of France and Germany have also given significant support to this idea, as has President Luiz Inácio Lula da Silva of Brazil. At

the recent UN Millenium Development Goals Summit, many leaders-and especially Heads of State José Luis Rodríguez Zapatero and Nicolas Sarkozy – gave clear support for such a tax. There has also been support in other European countries as well as Japan. In the US, the labor movement, led by the AFL CIO has given strong support to such taxes, as have prominent NGO's like Oxfam. In September, Ecofin (EU Finance Ministers) started discussion of a financial transactions tax.

The efforts to enact financial transaction taxes have received further support from recent expert reports. One such report was written by a group of experts at the request of a leading group of 60 nations sponsored by the United Nations, including the United Kingdom, France, Germany, Spain, Japan, Belgium, Brazil, and Chile, which concludes that a very small currency transactions tax, of 0.005% is the best option (TIFTD, 2010). The most recent paper of the IMF on the subject of financial transactions taxes, (IMF, (2010) recognizes that securities transactions taxes (STTs) exist in many countries and there is little evidence that they distort markets; it concludes that a low rate, less than 0.05%, broad based multilateral STT would raise considerable resources, whilst having modest impact on markets, beyond its impact on short term trading, especially linked to computer high frequency trading.

There are several important reasons for strong support for a tax on financial transactions. First, even a small tax (half a basis point, or 0.005%) applied only to foreign-exchange transactions of major currencies could generate a significant amount: more than \$30 billion annually (see Spratt, (2006); TIFTD, (2010), op cit). These resources are increasingly seen as critical at a time when the global crisis caused a significant increase in deficits and public debt levels in developed countries, and there is high unemployment in these countries. And this at a time when the crisis has also increased poverty in many developing countries, making it harder to meet the Millennium Development Goals (Ocampo, Griffith-Jones et al, (2010). In addition, governments around the world need additional resources to finance investments in developing countries to combat climate change, while the global financial crisis makes it less likely the private sector will finance such investments.

An added attraction of a tax on currency transactions is that a high proportion of such transactions are made by people of high income or by specialized financial agents, including hedge funds. Therefore the tax seems likely to be more progressive than other taxes. Possible disadvantages, argued by opponents of such a tax, like a reduction in liquidity, should not be relevant provided the tax is very small, as for example IMF reports have recognized. Indeed, such a tax would be far smaller than the commissions and spreads charged by financial institutions for such transactions.

A second reason is that, at the moment, political support for such a levy is relatively high, given the widespread perception that the behaviour of the financial sector has been one of the root causes of the crisis. The key question is whether the significant rhetorical and technical support will materialize into a political commitment. The recent financial regulatory reforms, especially in the US but increasingly in Europe, give ground for optimism that governments can be independent of financial interests, to act for the common good.

There is also a long tradition of taxing financial transactions nationally, including in the United Kingdom which has a stamp duty on all stock sales of 0.5%, or 100 times above the proposed tax to be applied to currency transactions. Not taxing currency markets, despite their large volume, is a real anomaly. (IDEAS, 2010).

It should be noted, moreover, that financial transaction taxes have a distinguished theoretical tradition. Since Pigou it has been recognized that there is a need to correct, through taxes, the difference between

public and private marginal benefits of economic activity generated by negative externalities. Keynes, in his General Theory, more specifically proposed a small tax on financial transactions to mitigate volatility generated by speculative excesses (Keynes, 1936). Nobel laureate James Tobin proposed in 1972 a tax on foreign-exchange transactions. Tobin (1996) explained that the proposal's aims were twofold: cause exchange rates to better reflect fundamental factors rather than short-term expectations, and expand autonomy of national macroeconomic policies. As such a tax could generate substantial resources, Tobin suggested they might be used for international purposes, such as development.

The *Tobin tax* as it came to be known, was supported by well-known economists of different persuasions (Jeffrey Frankel, Peter Kenen, Lawrence Summers, John Williamson and Nobel Prize winners Paul Krugman and Joseph Stiglitz, among others).

In recent years, proposals to create a tax on currency transactions (CTT) have varied, however, in relation to Tobin's initial suggestions (see, for example: Landau, (2004); I.F.T.D., op cit). **The CTT differs, therefore, from the Tobin tax, both in its purpose, which would be only to get additional resources, and in its amount, which would be much smaller to avoid distorting effects on the foreign exchange markets.**

Politicians in developed countries seemed more willing to support such a tax in the context of innovative financing for global public goods (GPGs) such as poverty reduction and mitigating, as well as adapting to, climate change. Overall, sectors of civil society switched to support for a lower tax to raise revenue for development and climate change. It was also assumed that ensuring financial stability should be achieved mainly by more precise instruments, such as financial regulation.

However, given the severity of the global financial crisis, and the central negative role the financial sector played in it, some studies (such as IDEAS, 2010) returned to the idea of currency or financial transactions taxes to help curb, together with regulation, massive negative externalities that the financial sector generates, as well as raising revenue for GPG.

Proposals to use taxes to help financial stability are especially influential in continental Europe (Schulmeister, (2009)) and progressive US circles (Baker et al, (2009)); they also tend to prefer a broader financial transactions tax on all financial activities.

Importantly, as a result of the collapse of Herstatt Bank in 1974 and its negative effects on international payments, regulators, central banks and private banks have taken measures to reduce risk in systems payments for foreign-exchange transactions. This has led to the establishment of the *Real Time Gross Settlements System*. This means that all transactions in foreign currencies are made in real time in a centralized manner. Supporting these activities, there are a number of institutions that have complete records of currency transactions. This makes it extremely easy and inexpensive to impose taxes on currency transactions. There is also a similar central global clearing system for derivatives transactions.

Ideally, such a tax would be done at the multilateral level (or, rather, for the major currencies), but studies show it could be applied to individual major currencies. Thus a coalition of the willing, eg the Leading Group of countries and/or the EU could move forward leading by example.

We will look at two recent reports on financial taxes, to illustrate different types of financial taxes, and their aims. The first was the mentioned report written by a Committee of Experts (including the coauthor of this article) at the request of a taskforce created by a leading group of governments (TIFTD, op cit). The second

report is written by IDEAS, a think tank close to the Spanish government and endorsed by Stiglitz, Sachs, Stern, Griffith-Jones and others. Whilst the first report focuses more on a small currency tax to finance development and climate change, the second focuses on larger and wider financial transactions taxes to both curb speculation and raise revenue.

a. The Taskforce on International Financial Transactions for Development Report

The aim of the TIFTD Report is to address the vast shortfall in finance required to meet international development and environmental commitments. The global financial crisis and resulting fiscal consolidations, seriously undermined governments' ability to meet existing commitments.

This Report links the funding crisis directly to the "global solidarity dilemma". The growth of the global economy has not been matched with effective means to levy global economic activity to pay for global public goods.

Given the scale of the funding gap, financing will need to be on a large scale. The financial sector is the most appropriate point to levy such an innovative financing mechanism. The sector is intertwined with the globalized economy, and is a primary beneficiary of its growth. It is the most appropriate channel to redistribute some of the wealth of globalization towards provision of global public goods, to help those benefiting least from globalization.

The option this Report chooses as most desirable is the global currency transaction levy (CTL) on foreign-exchange transactions on all major currency markets at points of global settlement. Given existing infrastructure, it would be easy and cheap to implement, practically immediately. It could serve as a pilot (to be applied for 4-5 years); then if it worked well, it could be extended both in time and/or to other financial transactions.

Global collection mechanisms avoid the domestic revenue problem, as funds would go directly into a Global Solidarity Fund for development and mitigating climate change. A global CTL has challenges. Principally, the levy would need to be scaled so it did not lead to avoidance of centralized settlement. However, the report concludes this would not be difficult. First, currency transactions not going through centralized settlements could be non-enforceable legally if problems arose. Second, higher capital (or margin) requirements could be placed on transactions not going through central settlement.

b. The IDEAS Report

The IDEAS Report argues that taxes, apart from being a source of revenue for the public sector, are an instrument for economic policies. The obligation to pay taxes provides governments with information about the volume of trade (large parts of financial transactions performed daily are completely unknown). Also, taxes are tools to create the right incentives to decrease the volume of transactions that generate more social costs than benefits.

The two main objectives for the suggested FTT are: promoting stability of the financial system; and obtain revenues to cover costs of the current economic crisis originated by financial causes, and/or provide funds for global public goods.

Three main objectives should be pursued in designing taxes on the financial sector, according to this report:

- 1. avoid negative externalities generated by the financial sector,**
- 2. put an end to the anomaly of having a large sector with no VAT; and**
- 3. obtain revenues.**

The IDEAS Report makes the important point that different taxes on the financial sector are not mutually exclusive: a combination of different types of taxes applied to the financial system could be used since they pursue different objectives, although the fiscal burden on the sector should be carefully considered.

Like the IFTD, the IDEAS Report argues that a global approach to financial taxes would be the right one: but, if this does not happen, it suggests the debate should continue at EU level.

c. Economic and political conclusions on taxing the financial sector

Both these approaches to financial sector taxation should ideally be implemented multilaterally, as markets are global. However, if this is not politically feasible, it is technically possible to have it implemented by a group of countries – or a so-called coalition of the willing; examples could be the EU or the Leading Group of countries for Innovative Financing. Ideally the US, given its importance, would join such an initiative, but it is not essential. The lead may be taken by countries where the lobbying powers of the financial industry are relatively weaker (or where the financial sector is more enlightened) or counteracted best by other political forces, linked more to the real economy.

There could be a two pronged strategy; a CTL on currency transactions could be used mainly to fund global public goods, such as helping finance development and poverty reduction in the poorest countries, as well as investment in climate change mitigation in the developing world. Taxation on other financial transactions, (mainly domestic, which ideally but not necessarily be coordinated) would be used for domestic purposes, such as deficit reduction, but above all job creation and long term investment.

d. Overall Conclusion

The financial crisis of 2008 and the global economic crisis that followed it led to a paradox. The rise of neo-liberal approaches to financial regulation over a generation had discredited mixed economy approaches to capital allocation, and led to a deep belief in policy makers in unregulated financial markets as efficient allocators of resources. A key consequence of this trend was skepticism about government intervention in the form either of subsidies, direct public investment or loans, or the use of tax policy to drive investments. It was thought that government was not efficient, and markets were.

In the crisis of 2008, governments intervened wholesale to prop up both financial institutions and financial markets that had demonstrably behaved in an astoundingly inefficient and destructive fashion. Instead of using the power of government to support investment for clear reasons related to the need to provide public goods, the power of government was used only to prop up financial markets and institutions largely because they were there. Clearly it was also the case that governments did not want to risk a repeat of the negative effects of financial sector collapse as occurred in the 1930s.

Financial reform and debates over financial sector taxation in the U.S., Europe, and on the international stage in processes like the *Basel 3* accord and the work of the Financial Stability Board represents an opportunity to ask, how can governments interact with private institutions and financial markets to lead to genuine wealth creation, so that financial markets are the helpful servants, and not the destructive masters of the world's real economies, and of democratic societies. In our survey of regulatory and tax initiatives, we have shown that a number of positive steps are either underway or being contemplated by governments, often under pressure from angry publics and mobilized labor movements and NGO's. But what is equally clear is that unless the

promise of the initial regulatory steps is realized and complimented with parallel tax reforms, it is likely that the financial system's capacity for regulatory arbitrage and political capture will set the stage for both continued failure on the part of the financial system to perform its proper role, and more crises to come. Though regulation and taxation are crucial, a more in-depth transformation of the financial sector to make it simpler and better suited to the needs of the real economy seems desirable

References

- Baker Dean, Pollin Robert, McArthur Trevis and Sherman Matt, (2009)** *"The potential revenue from Financial Transactions"*, CEPR and PERI Issue Brief, December
- Brassett James, (2010)** *"Cosmopolitanism and Global Financial Reform London"*, Routledge/RIPE Series in Global Political Economy
- IDEAS, (2010)** *"Taxing the financial sector: Proposals and Revenues for Spain"*. Available at http://www.fundacionideas.es/sites/default/files/pdf/Informe_version_ingles.pdf
- International Monetary Fund, (2010)** *"Taxing Financial Transactions: Issues and Evidence"*, Working paper, Washington D.C.
- Landau Jean-Pierre, (2004)** Report to Mr Jacques Chirac, President of the Republic
- Ocampo Jose Antonio and Griffith-Jones Stephany et al, (2010)** *"The Great Recession and the Developing World"*, Spanish Presidency of the EU, conference on development cooperation in times of crises and on achieving the MDG's available at www.policydialogue.org, June
- Schulmeister Stephan, (2009)** *"Tobin or not Tobin: Die Finanztransaktionssteuer - Konzept, Begründung, Effekte"*, in Informationsbrief Wirtschaft & Entwicklung, Dezember 2009
- Spahn Bernard, (1995)** *"International Financial Flows and transaction taxes"*, IMF WP /95/60
- Spratt Stephen, (2006)** *"The Tobin Tax in the 21st Century: Financing Development & Promoting International Financial Stability"*, Paper presented at the Tax, Poverty and Finance for Development Conference, Essex University, 6 / 7 July 2006
- TIFTD (2010)** *"Report of the Committee of Experts to the Task Force on International Financial Transactions and Development"*
- Stiglitz E. Joseph, (2009)** United Nations Stiglitz Report (2009) to President of General Assembly
- Seifert Markus, (2010)** *"Liquiditätsrisiko: Regulatorische Vorgaben in fundamentalem Umbruch"*, Deloitte
- Duttweiler Rudolf, (2010)** To the Basel Committee on Banking Supervision Comments on Consultative Document: International Framework for Liquidity risk measurement, standards and monitoring
- Zentraler Kreditausschuss, (April 2010)** *"International Framework for liquidity risk measurement, standards and monitoring"*, Stellungnahme des Zentralen Kreditausschusses zum Konsultationspapier des Baseler Ausschusses
- Deutsche Bundesbank, (2010)** Neue Liquiditätsstandards Presentation
- BIS, (12.09.2010)** Official Press Release regarding the new International Banking Regulation Agreement Basel 3
- Blundell-Wignall Adrian and Atkinson Paul, (2010)** *"Thinking Beyond Basel 3: Necessary Solutions for Capital and Liquidity"*, OECD Working Paper

Biography notes

Stephany GRIFFITH-JONES is an economist whose areas of expertise include macro-economic management of capital flows in Latin America, Eastern Europe and sub-Saharan Africa, and international financial reform with special emphasis on regulation (Basel II, hedge funds and derivatives). Prior to joining IPD, Professor Griffith-Jones was Professorial Fellow at the Institute of Development Studies at University of Sussex, United Kingdom and served as Senior Official at the United Nations Department of Economic and Social Affairs and the Economic Commission of Latin America (ECLAC), as well as Head of International Finance at the Commonwealth Secretariat (UK). She has acted as senior consultant to governments in Eastern Europe and Latin America and to many international agencies, including the World Bank, the Inter-American Development Bank and United Nations, especially UNDP and ECLAC. She began her career at the Central Bank of Chile.

Damon A. SILVERS is the Director of Policy and Special Counsel for the AFL-CIO. Mr. Silvers is the Deputy Chair of the Congressional Oversight Panel for TARP, as also a member of the Securities and Exchange Commission's Investor Advisory Committee, member of Public Company Accounting Oversight Board's Standing Advisory Group and Investor Advisory Group. Among the other function, he also held a mandate as a Chair of the Competition Subcommittee of the United States Treasury Department Advisory Committee on the Auditing Profession and a member of the United States Treasury Department Investor's Practice Committee of the President's Working Group on Financial Markets. Mr. Silvers is a graduate of Harvard College, a former Baker scholar and he also studied at King's College, Cambridge. He received his M.B.A. from Harvard Business School and his J.D. honors from Harvard Law School. He is an author of many books and articles, the most recent of them was *"Rebuilding Workers' Retirement Security: A Labour Perspective on Private Pension Reform"* (2010).

Matthias THIEMANN is a PhD candidate in Sociology at Columbia University. In his dissertation he is looking at the (non-) convergence of domestic accounting standards in European countries with IFRS on consolidation and its impact on the prudential regulation of special purpose entities in these countries. He holds an MA in economics from the New School in New York and a Diplom in Social Sciences from Humboldt-Universität. He is currently a visiting researcher at Sciences Po Paris.

Macro-governance



Marcus MILLER¹

千里之行始于足下，寸步不行说明了什么？

The longest journey begins with a single step: so what does standing still signify?

Introduction



It may be useful to distinguish three different levels of governance, starting at the top with the *political authority*; followed next by the *regulatory and administrative institutions* that the political authority chooses to establish (and the rules and regulations they come up with); and coming finally down to ground level with the *actors themselves* behaving in accordance with these rules, Scott (2009, p. 37, 8). In cricket, for example, these levels are represented by the International Cricket Council, which promulgates the Code of Conduct and appoints umpires and referees for international matches, at the top level; next are the umpires who specify the precise rules of play make sure these rules are followed; and finally the players, wielding bat and ball under the umpire's eagle eye!

In the sphere of international economic affairs, political authority ultimately resides in the participating sovereign states, who have decided to establish organisations like the IMF, the World Bank and WTO to achieve specified strategic objectives. In the case of the IMF, these are to promote international monetary cooperation and exchange rate stability so as to facilitate the balanced growth of international trade – so member countries, their companies and private citizens can go about their business according to the rules of the regime that has been established, subject to IMF surveillance and financial assistance where necessary.

Arrangements that may have been clear and acceptable when these institutions were first set up after WWII have come to be challenged, however. Over time, as output and trade have grown apace, Emerging

¹ Author would like to express his gratitude to John Drifill and Stephany Griffith-Jones for their respective comments, as also to Han Hao Li for research assistance and Chinese translation.



Market countries (EMs) have become much more prominent players in the world economy; but the IMF has not expanded in commensurate fashion. In their political-economic analysis of the IMF as a credit Union, Irwin et al. (2008) suggest one reason: that the Fund's existing lending framework is well suited to a world in which its members have homogeneous interests; but with heterogeneity, the Fund is increasingly unlikely to provide financing on a sufficient scale to meet the demand of higher-risk members, leading them to rely more heavily on self insurance.

Dissatisfaction with the operation of the IMF became acute with increased globalization and the onset of financial crisis in emerging markets. When the Sudden Stop in capital flows to South East Asia in 1997/8 led to severe economic instability, IMF policies of providing financial support subject to tough conditionality (of high interest rates and fiscal tightening) were widely seen as ill-designed for capital market crisis. (Significantly, India and China, who maintained controls on capital flows, escaped the crisis.) As a result, the IMF lost the trust of many EM countries, and *its big fee-paying clients such as Korea, Russia, Brazil and Argentina deserted it in droves, preferring to take more expensive loans elsewhere.* Woods (2010).

As Ngaire Woods goes on to note, *The old financing model of the IMF made the institution reliant on income from its emerging economy members which borrowed from it in a crisis. Yet this did not give borrowing members power.* Indeed, it seemed to provide a perverse incentive for the IMF – giving rewards for mission failure!

Exit from the IMF ambit is one response. Another is to co-operate only on condition of systemic reform. In the immediate aftermath of the recent global financial crisis for example, China, Brazil and India refused to join and participate in the New Arrangement to Borrow until more substantial reform were undertaken in the IMF's governance and arrangements. Later, at the Pittsburgh summit, the BRICs did agree to participate in the NAB but only in exchange for quota reform of the IMF - a shift of 5% of the voting power, in the quota review to be completed by January 2011.

Could something similar be happening with respect to reform of the International Monetary System (IMS) as a whole – with the persistence of issues like global imbalances reflecting unhappiness with the current rules of the game? If so, what are the alternatives? Before discussing this interpretation of the current state of play, we briefly outline the emergence of the G20 as an alternative to G7 for discussing reform of the international monetary system.

Emergence and achievements of G20.

As Ngaire Woods (2010) notes: *The amassing of foreign exchange reserves by emerging economies in the wake of East Asian crisis of 1997 began in large part to ensure 'financial independence' in the event of adverse developments in a country's external position. The fallout of IMF's engagement in Asia during the 1997 crisis was dramatic. It greatly magnified the 'stigma' associated with assistance from the IMF... (and) swept away the political acceptability of any assistance from the IMF should an external shock hit a country.*

Along with the accumulation of foreign exchange reserves came the setting up in 1999 of the G20 (a group of finance ministers and central bank governors consisting of 19 countries plus the EU) as a forum for debating the reform of the international monetary architecture in which the interests of EM countries would be more obviously taken into account than in the existing G7.

Ironically enough, the value of having such a broader-based group became most apparent after the storm-centre moved from the EM to the so-called Advanced Economies in 2007/8 – a trial by fire when the G20, with its balanced membership of developed and developing countries, helped the world deal effectively global financial and economic crisis.

At the first **summit in Washington DC in November 2008**, for example, the members *agreed a series of measures and a joint Action Plan for dealing with the crisis, including measures to reinvigorate their own economies (without damaging global trade), to regulate global finance, to assist the poorest countries affected by the crisis and to reform global institutions.* Ngaire Woods (2010).

This was only the first of several meetings for the G20 - initially twice a year, in the future, annually. Highlights are indicated in table 1 below, but it may be worth reporting some developments in more detail.

Summit meetings held in response to 2008-9 crisis: some highlights.

Summits	Date	Key items
Washington	Nov 2008	A joint Action Plan to deal with the crisis and to implement principles for reform of financial regulation
London	Apr 2009	Commitment to global monetary and fiscal policy coordination (including +5 trillion of fiscal expansion); \$1.1 trillion of additional resources for IFIs and trade finance; Financial Stability Board (to replaces FSF),
Pittsburgh	Sept 2009	BRICs promised a shift of +5% of voting power for EM
Toronto	Jun 2010	Framework for 'Strong sustainable and Balanced Growth'; Mutual Assessment Process to check collective consistency; +4 trillion
Seoul	Nov 2010	To complete quota reform, shifting at least 5% to EMs and DCs
France	2011	
Mexico	2012	

Memo items: global GDP 2010 (\$62 trillion),

The follow-up to the first summit in Washington was in **London in April 2009** – a critical time for the world economy suffering a heart attack. *A global crisis requires a global solution*, said the communiqué, noting that the actions taken by fiscal authorities and central bank *will constitute the largest fiscal and monetary stimulus and the most comprehensive support programme for the financial sector in modern times.* (It was forecast that the 'unprecedented and concerted fiscal expansion would amount to \$5 trillion', i.e. around 8% of global GDP.)

It was also agreed that over a trillion dollars of additional resources for the world economy were to be channelled through the IFIs. (This was made up of an extra \$500 billion of resources available to the IMF in the form of new arrangement to borrow, a new SDR allocation of \$250 billion, at least \$100 billion of additional lending by the MDBs, and \$250 billion of support for trade finance.) *Together with the measures we have each taken nationally, this constitutes a global plan for recovery on an unprecedented scale.*

Earlier this year, the **G20 at Toronto in June 2010** considered the results of the Mutual Assessment Process (MAP). In the absence of coordinated global response, it was noted, global output is likely to remain below its pre-crisis trend. But the IMF and World Bank estimated² that with improved policy response, global output could be raised by over 5%. As a *credible exit strategy* from action taken to support financial sector and global demand, principles for fiscal consolidation in Advanced Economies were also agreed, as were and steps to promote financial sector stability.

In what may be an indication of topics to be tackled at the **forthcoming G20 summit in Seoul**, Dominique Strauss-Kahn (2010) has identified two key issues: first, the *imperfections of the system of volatile capital flows*, where the balance of adjustment is asymmetric (falling more heavily on deficit, non-reserve-issuing countries) and there exists only a narrow range of reserve assets. The second issue is the *massive reserve accumulation* (tripling in a decade) that has occurred as a consequence of these imperfections – and the aggregate deflationary impact that may emerge as many countries aim at current account surpluses.

Much has been clearly achieved by the G20 summit meetings so far: by coordinating action and preventing protection, they may indeed have been instrumental in saving the world from sliding into a second Great Depression! In the assessment of Ngaire Woods (2010):

The creation of the leaders-level G20 means that a wider group of countries has engaged in shaping the agenda of global institutions. The new G20 has met and designed action plans with speed. The winner among multilateral institutions has been the IMF, thrust centre stage with approximately \$1 trillion resources for the purpose of dealing with the crisis. The IMF has been tasked with lending to emerging economies to prevent financial crisis, fostering cooperation that might prevent a future crisis and assisting poor countries affected by the crisis...

Not achieved is a transformation in relations with the major emerging economies such that the IMF would be positioned to address the global imbalances, to set new multilateral rules, to operate as an alternative to self-insurance or indeed to provide a more multilateral response to the development emergency. There is very little (beyond rhetoric) of a multilateral response to poorer countries affected by the crisis.'

This last maybe no co-incidence: after all, low income, small countries are not in the G20.

The game of reform

How to avoid global imbalances? The US policy response to excess savings in Asia was to engineer deflation. But other policy packages have been proposed as alternatives that would reduce global imbalances, e.g. *tighter fiscal policy and exchange rate depreciation of the US, and looser fiscal policy and exchange rate appreciation in the surplus countries*, Joshi (2010, pp 77). Coming up with technical solutions of this sort is all very well; but is their implementation incentive compatible? Will surplus countries be willing to cooperate if doing so is seen as accepting rules that failed to prevent crisis?

Maybe not. As Jim O'Neil (2010) – the man who coined the BRICs acronym – remarks, *it could be that China wants to sit back now, especially as a G20 member, and think afresh after the crisis about how the world monetary system might evolve better, with fewer unpredictable, chaotic financial movements occurring. Until then, China may not want fresh movement of their currency adding to their problems.*

² See IMF (2010)

In 2009 the Governor of the Central Bank of China, Zhou Xiaochuan, suggested a broader role for the Special Drawing Right (SDR), as an international reserve currency. In the paper cited, Jim O'Neill suggests that Governor Zhou may have been thinking of the SDR as part of system of managed exchange rates and IMF-created reserves - an alternative to current system of flexible exchange rate with national currencies as reserves (particularly the dollar). The motivation for this could be that the flexible exchange rate system has been associated with global financial crisis - with the biggest losses occurring in those countries like the US and UK, who had *been keen supporters of very flexible and free financial markets, including floating exchange rates*.

Could non-cooperation at the level of macro-economic policy and exchange rate adjustment under the current rules of the game be seen as a way of trying to secure a change in the rules themselves?

The Great Game

Consider a strategic game played between great powers – a game in which the EU as yet plays no significant part. In the Status Quo, China pegs its currency against the dollar and runs a low consumption economy (and seems deaf to US rhetoric calling for revaluation of RMB and rebalancing of domestic demand, even though this offers more consumption for its citizens); while the US, reluctant to give up the “exorbitant privilege” of printing the world’s money, dismisses any suggestion for an alternative reserve asset. Can this persist as an equilibrium? Assume each player has a choice of *two actions*, and chooses a best response to the other’s action. Thus China can either stay with the Status Quo; or Revalue its currency and Rebalance its aggregate demand (in favour of domestic consumption.) The US for its part can either choose to persist with the current floating rate IMS based on the dollar; or to participate in the development of a managed exchange rate system based on SDR, see Table 2.



What are the *pay-offs* to each party? Normalising pay-offs to zero for the Status Quo, assume that China would be happy to Revalue and Rebalance in the context of an SDR-based system (see column 2), but not when this involves perpetuating the dollar based system, (see column 1). The US, on the other hand, may indeed be reluctant to give up the dollar (a loss of 1 unit of welfare), but this could be more than compensated by China agreeing to Revalue and Rebalance demand.

Actions and notional payoffs in the Great Game		Is the US willing to be flexible on reserve regime?	
		Dollar as reserve currency	SDR as reserve currency
Will China co-operate on adjusting Global Imbalances?	Peg to dollar, Export surplus	0,0 ↑	+1, -1 ←
	Revaluation and Rebalancing	-1, +3 ←	+2, +2 ↓

Note: payoffs shown in each cell are for (China, US)

One might therefore hope that equilibrium will involve a shift from the current Status Quo in the top left hand corner to a reformed IMS without global imbalances in the bottom right corner. This will, after all, make

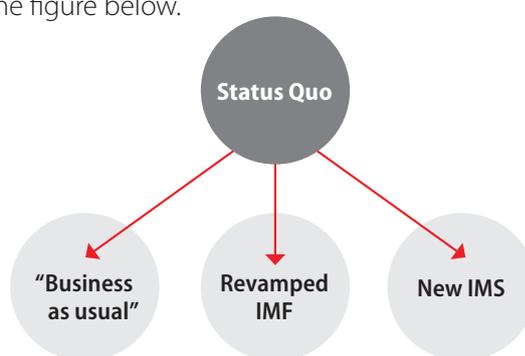
both parties will be better off. But without coordination and commitment, the Status Quo is the only Nash equilibrium. (This is indicated by the arrows, showing how each party will respond to the other's choice of action, which converge on the Status Quo).

What is the moral of the tale? It is that – despite the possibility of extra consumption, China will offer reciprocity and flexibility in policy adjustment only if the US and others are willing credibly to redesign the IMS. More broadly, in terms of the “levels of governance” discussed in the introduction, the BRICs will only agree to play ball if they have a role in drawing up the rules of the game.

Alternatives to the dollar based system

Where does one go from the Status Quo?

Consider three scenarios as in the figure below.



The first scenario, is a return to ‘Businesses as usual’, with floating exchange rates and relatively free capital movements, subject to whatever can be achieved through *Basel III*, and complementary efforts by individual countries (and the EU) to prevent financial crisis. So the dollar remains as the world’s reserve currency.

Second is revamping the IMF along lines suggested by Dominique Strauss-Kahn (2010). Insofar as reserve accumulation reflects the fear of capital flight and financial instability, he argues, the IMF could provide substitute for individual reserve holdings as follows: the IMF could provide better insurance facilities (e.g. improvements to the FCL, a Precautionary Credit Line); support regional financial arrangements; and develop a Multi-Country Swap/Credit Line instrument for systemic crises that liquidity quickly and simultaneously to several countries with strong underlying fundamentals and policies.

As for non-precautionary reserve demand, there could be a wider role of Special Drawing Rights:

With a value determined in terms of a basket, the SDR diversifies the currency and interest rate risks of its constituent parts. Thus, it has more stable store of value and unit of account attributes. Moving to a more SDR-based system would require:

1. increased supply,
2. greater liquidity, and
3. transparent, automatic rules for determination of the currency composition of the SDR basket, which are essential for wider private sector use.

For lively and informed discussion of these issues, see the contributions to IPD (2009).

The third scenario would embrace these changes but is a lot more ambitious. It could, for example, include a set of *reference rates* based on current account targets, as proposed by John Williamson (2007), where Countries’

authorities are forbidden from intervening in order to push the exchange rate too far from what is termed the “reference rate.” It could help a country’s authorities manage its exchange rate to avoid large misalignments, assist the private sector in forming more dependable expectations of future exchange rates and thus to manage their businesses more efficiently in a world of floating exchange rates, and aid the International Monetary Fund in designing and managing an effective system of multilateral surveillance.

In addition, as well as enjoying the liquidity insurance provided by a re-vamped IMF, countries may have recourse to *capital controls* as when necessary to preserve financial stability.

The case for *counter-cyclical prudential regulation* to manage the effects of boom-bust cycles – as opposed to the pro-cyclical provisions of earlier Basel Accords – has been made by Ocampo (2003) and Griffith-Jones et al. (2009). For *outflow controls*³ on capital, the Pigovian logic has been supplied by Anton Korinek (2010) as follows: *decentralized agents do not internalize that capital outflows are magnified through a systemic feedback cycle of depreciating exchange rates, tightening financial constraints, and declining aggregate demand, akin to Fisher’s process of debt deflation.* (See Ostry et al. (2010) for a recent IMF survey of capital controls.) In a wider discussion of how to stabilize the capital flows to emerging markets, Williamson (2005) discusses complementary changes to current practices in advanced economy capital markets, and the creation of *new financial instruments*, e.g. GDP-indexed bonds, which might help to limit foreign currency borrowing by emerging market governance. Rochet (2006) proposes *sovereign debt limits* for governments who always repay when they can but are myopic – so they always borrow as much as possible without paying attention to the burden of future repayments.

Finally, as Dominique Strauss-Kahn has indicated, *a new global currency might evolve out of the special drawing right.* A new global currency may be necessary to ‘make globalisation work’, Stiglitz (2006, Chapter 9).

Conclusion

The vast accumulation of international reserves by EM countries, both as a pre-cautionary cushion and as a side-effect of export-led policy, are symptoms of defects in the International Monetary System. The debate on policy adjustment to handle Global Imbalances must surely take into account the desire by BRIC and other emerging market countries to play a bigger part in the Great Game of resetting the rules.



³ Note that, insurance companies in London impose so called ‘value adjustments’ as exit taxes on withdrawals, and of course, many hedge funds ‘gated’ their depositors and stopped marking to market to keep afloat during the recent crisis: if this is what financial institutions do, why not sovereigns?

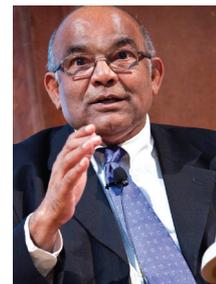
References

- Griffith-Jones Stephany, Ocampo José Antonio and Ortis Ariane (2009)** 'Building on the counter-cyclical consensus: A policy agenda', High-level Roundtable Towards *Basel III*? Regulating the Banking Sector after the Crisis,ussels on OctBrober 12.
- IMF (2010)** 'G20 Mutual Assessment Process--Alternative Policy Scenarios', a report by the IMF Staff.
- IPD (2009)** 'Towards A World Reserve System', Conference at Columbia University, New York, Nov 2009. http://policydialogue.org/events/meetings/towards_a_world_reserve_system_new_york_2009/
- Irwin Gregor, Penalver Adrian, Salmon Chris and Taylor Ashley (2008)** "Dealing with country diversity: challenges for the IMF credit union model," Bank of England working papers 349, Bank of England.Joshi,
- Vijay Joshi (2010)** 'Global imbalances and the current crisis'. In Robert Skidelsky (ed) *The Economic Crisis and The State of Economics*. London: Centre of Global studies.
- Korinek Anton (2010)** "Regulating Capital Flows to Emerging Markets: An Externality View", working paper
- O'Neil Jim (2010)** 'A Twenty-first century International Monetary System: Two Scenarios.' In P. Subacchi and J. Driffill (eds.), *Beyond the Dollar: Rethinking International System*, London: RIIA, pp. 43-45.
- Ostry et al (2010)** 'Capital inflows, the role of controls', SPN/10/04.
- Rochet Jean-Charles (2006)** "Optimal Sovereign Debt: An Analytical Approach," RES Working Papers 4477, Inter-American Development Bank, Research Department.
- Scott Bruce (2009)** *The Concept of Capitalism*. New York; Springer.
- Stiglitz Joseph (2006)** *Making Globalization Work*, London: Allen Lane (Penguin).
- Strauss-Khan Dominique (2010)** 'Concluding remarks', High-Level Conference on the International Monetary System, Zurich, May 11, 2010.
- Williamson John (2007)** *Reference Rates and the International Monetary System*. Policy Analyses in International Economics 82. Washington: Peterson Institute for International Economics.
- Williamson John (2005)** *Curbing the boom-bust cycle: Stablizing capital flows to emerging markets*, Policy Analyses in International Economics 75, Washington: Peterson Institute for International Economics.
- Woods Ngaire (2010)** 'Global Governance after the financial crisis: A New Multilateralism or the Last Grasp of the Great Powers', *Global Policy* 1 (1), pp 51-63.

Biography note

Marcus MILLER is a professor of economics at Warwick University. He has worked with the London School of Economics and Manchester University, and held visiting teaching positions at Chicago University's Business School and Princeton University. He has worked as an Economist at the Bank of England; acted as advisor to the Treasury Committee of the House of Commons; was Member and Chair of Academic Panel of the Treasury and joint director of International Macroeconomics Programme at CEPR from 1986 to 1991. Over the years he has been visiting fellow/economic consultant at the OECD, TACIS (Technical Assistance to the CIS, on Macroeconomic Policy in the Ukraine), IMF, World Bank, ECB; and recently at the Inter-American Development Bank.

Reforms in regulation of financial sector: outlook



By **Yaga Venugopal REDDY**¹

The global financial crisis has led to a reconsideration of the benefits and risks of liberalized financial sector. The first section describes the agenda for assessment and reform of the financial sector in response to the lessons learnt from the crisis. The second section lists the balancing of considerations that is critical for assessment and reform. The third section provides a summary of globally coordinated approach to the reform, and discusses the impact of *Basel III* proposals. The fourth section narrates the reforms undertaken or proposed (or under consideration) in select countries. The fifth section considers select issues, urges a development orientation to the reform, and makes a brief mention of the outlook for reform.

Agenda for Assessment and Reform

An assessment of regulatory system in financial sector should ideally take account of the purposes of financial system, in view of its facilitating role for economic well being and broader goals of economic policy. To serve that purpose, the regulatory system should be consistent with economic objectives and financial systems. The regulatory systems should have well understood objectives and a given perimeter or scope of operations. There would have to be a structure, a philosophy, and a set of tools for the regulators to operate. These are discernable from features both external to regulatory bodies such as legal framework and internal to it, such as governance approaches and skills. Financial system has three broad overlapping segments, namely, financial institutions, financial markets, and financial instruments. Regulatory system will have components directed at each of these segments but it is extremely complex to compartmentalize them, making coordination, formal and informal, critical. It is possible to argue that in pre-crisis years, some of the regulatory regimes had a somewhat over simplified view of achieving economic efficiency and stability through essentially market driven self regulatory regime, while financial systems were growing rapidly and adding to complexity. Experience with crisis, both in countries severely affected by financial crisis and those

¹ Thanks to John Driffill and Stephany Griffith-Jones for comments and to Han Hao Li for research assistance – and Chinese translation.



less affected, enables a list of general principles for assessment of adequacy of regulatory regimes in this background. In considering the general principles, it is necessary to recognize that the objectives of financial system and of regulatory systems could legitimately be country specific. **In view of the systemic risks generated by the individual and collective behavior of firms coming into sharp focus, the critical role of macro-prudential regulation in complementing micro-prudential regulation became evident.** Macro-prudential framework should be so designed that there is adequate capital with the financial institutions to absorb a variety of risks both in normal and abnormal times. Hence the regulators have to prescribe a quantity of capital that is adequate to absorb these risks. In computing the requirements of capital, an assessment and quantification of risk is critical. In assessing capital requirements of individual institutions, there is need for a countercyclical approach. In other words during good times capital should be set aside so that in bad times it will be able to take care of the risks. In aggregate, the bank's balance sheet should not be excessively leveraged, and hence the ratio between owned resources and borrowed resources in the conduct of the business should be reasonable. The quality of capital is also important. In other words, the practice of treating borrowed capital also as risk capital may have to be restrained. The regulatory framework should also take a view of systemic risks and not merely the risks of individual institutions. It is quite possible that individual institutions considered separately may be healthy, but as a part of the system they may become vulnerable in terms of capacity to take risks of interconnections in their operations. Hence the regulatory framework should take a view of systemic risks and in that context stricter norms for systemically important financial institutions (SIFIs) and an effective regulation mechanism for such institutions came into prominence.

The perimeter of financial sector regulation has to be well designed. If one segment, say banking, is subjected to rigorous regulation, and the non-banking segments are not subjected to such regulation, such institutions may find ways of performing prohibited banking functions through some innovative mechanisms taking advantage of the regulatory gaps. Further, the banks themselves may finance banking activities outside their own pools. In addition, private pools of capital such as hedge funds or private equity funds could be large and may have systemic implications. Such pools of capital may also have to be regulated, but the extent of regulation cannot be on par with banks. In brief, different segments of the financial sector will have to be subjected to different types of regulations, to ensure that regulatory arbitrage is minimized. In other words, the same type of activity undertaken by different types of financial institutions should be subjected to the same type of regulation. Furthermore, improving transparency and regulatory oversight of hedge funds, credit rating agencies and over-the-counter derivatives (OTC) became a priority in the light of the experience during the crisis.

The recent financial crisis witnessed the collapsing of large investment banks in the US, which rekindled a discussion of optimal banking models. There are three views about the structure of banking institutions. One view is that the economies of scope and efficiencies of scale can be captured by the financial sector if banks are able to perform a range of financial services of which retail banking is one. These are described as universal banks and are recommended on grounds of efficiency. A second view is that universal banking incorporates in itself significant conflicts of interests between different businesses within itself and they may tend to take excessive risks. Further, this institutional structure may neglect retail banking which is of interest for large sections of people. The traditional banking function includes the payments system, which is of considerable significance and therefore, should be treated as a public utility. Hence, some commend banks to devote exclusively to retail banking and this is sometimes described as narrow banking. An intermediate view is that

a bank should predominantly be carrying out traditional retail or commercial banking functions and the other riskier activities should be either prohibited or permitted only under stringent restrictions, depending on the nature of financial activities.

The financial intermediaries often have mismatches in regard to maturity between assets and liabilities. It is necessary to ensure that the mismatches are within limits, and the financial intermediaries are not excessively dependent on money markets, i.e., very short-term lending and borrowing. The regulation should, therefore, take into account the liquidity requirements also.

With the improvements in technology, financial service industry has brought about several innovations. These financial innovations, which are in the nature of complex instruments, are expected to spread the risk widely and help in efficient price discovery. In practice, however many of the innovations have tended to circumvent regulations and, in any case, they often inject complexity to financial products. It is, therefore, necessary to ensure that only good innovations are permitted by regulations and bad innovations are discouraged or even prohibited. No doubt, it is difficult to distinguish between what is good and what is bad in advance of their actual working in practice. Moreover, the complexity in regard to some of the innovations warrants protection of consumers of such products from undertaking excessive risks. Transparency by itself may not help if the complexities merely become transparent, but the innovations are not simple enough to understand. To the extent the innovations are new and uniquely designed, it is difficult to subject them to standard trading practices such as on exchanges. While over-the-counter (OTC) transactions enable innovations, they also have embedded risks. Hence, appropriate regulatory framework that ensures good innovations and sound trading practices should be considered.

Although accounting conventions were not the cause of the financial crisis, certain accounting measures, such as the use of fair value accounting for illiquid financial instruments and the important model for loans and debt securities, have been viewed as weak areas that exacerbated the problems. In order to operationalize the principles in a clear and nondiscriminatory manner, accounting standards should be of a quality that are sufficiently standardized, well understood and subject to common interpretation. The accounting standards to the extent they depend on market prices for valuation can be pro-cyclical thus adding to the problem. Hence, they should be stable as also be able to capture the impact of cycles on the financial intermediaries.

The incentive structures to the management and staff in each financial institution should be such that they are not encouraged to take excessive risks. In particular, the remuneration for senior executives when linked to the short-term profitability may have the potential to increase risk taking by the institutions. Mechanisms should, therefore, be found which provide incentives for good performance, but disincentives for excessive risk taking. A major area requiring regulatory intervention is the complex task of avoiding conflict of interests. The erection of firewalls within an organization between functions involving conflicts of interests may not necessarily serve the purpose, since fire-walls in financial transactions have a tendency to be porous and almost invisible.

The legal and institutional arrangements governing the regulatory framework should provide regulators are provided with adequate powers coupled with accountability. Where multiple regulators exist, arrangements are required for coordination, formal or informal, among the multiple regulators. Similarly, in the case of large or systemically important financial institutions, special coordinating arrangements would be required among the regulators. In addition to the structures, the regulators will have to have mechanisms for capacity building of the regulators, to keep pace with the innovations in financial markets.

The credit rating agencies play a vital role in financial sector since they are also used by regulators for specific purposes. However, the rating agencies also have inherent conflict of interests since they are hired by the rated, giving significant scope for conflict of interest. The rating agencies inadvertently contributed to the build-up of systemic risk during the recent times by issuing unrealistically high ratings (BIS, Annual Report, (2009)). It is therefore necessary to reduce the dependence of regulators on rating agencies and, at the same time, ensure that the quality of rating is appropriate.

Above all, it is the quality of supervision that is important since it has been found in practice that even though the regulations did exist, but the compliance was poor and supervision inadequate or ineffective. In brief, there is a realization about the criticality of equal emphasis on what may be termed as sound principles on regulating the financial sector and effectively supervising them. An assessment of the financial sector with reference to these sound principles is the first step towards the reform of financial sector in any country. However, in considering the general principles, each country has to take account of the objectives of regulation as part of broader public policy.

Balancing of Considerations:

There is a broad agreement on most of the general principles of regulation and supervision of financial sector, in the light of the crisis. However, conflicting considerations in the actual framing of the regulations and their implementation need to be explicitly assessed and balanced. It is extremely difficult to weigh the benefits and risks with regard to these conflicting considerations. Financial crisis has shown that in the past, in the absence of a good balance between conflicting considerations, private interests have prevailed over public interest, resulting in considerable gains for private interests at great social costs. First, it is generally assumed that market forces and competition will have a tendency to impart efficiency. In the financial sector, however, short-term efficiency may often threaten longer term stability. Second, the interests of shareholders who have to contribute to the capital of the financial intermediaries should be weighed against the benefits of giving higher priority to social goals such as development or stability. Third, assurances of support in times of difficulties would enable the financial intermediaries to assume risks that could add to overall efficiency in normal times, but there is a moral hazard since assurance of support may be encouraging excessive risk taking. Assurances of support should be minimal and only to the extent of not creating a moral hazard, but it is very difficult in practice to say what is an ex ante minimal support. Fourth, it is well known that higher the risks (measured in terms of price), higher the returns in a risk-return frontier. The accumulation of higher risk by several financial intermediaries in the system may threaten systemic stability, especially if the risk is being taken with borrowed resources. An issue is whether the consumer of the product is provided with full information to assess risks and returns. Fifth, there is need for market participants to be fully aware of the rules that they should follow. But, it is not possible to envisage all circumstances and lay down rigid rules in advance. However, giving excessive discretion to the regulations may add a premium for uncertainty, thus adding to the cost of intermediation. It is also possible that the regulators are captured by the regulated. One approach is to depend on rules in normal times while permitting discretion under extraordinary circumstances, though it may be difficult to define extraordinary circumstances in advance.

Sixth, an intrusive regulation may not be commensurate with the costs of regulation and the costs of compliance. On the other hand, soft regulation especially self regulation is less costly since the regulator can state principles that should be complied by the regulated, and leave details to the regulated. Experience

has shown that excessive reliance on self regulation has a tendency to be weak regulation, thus defeating the objectives of regulation. Where standards of governance are high, self regulation could be preferred to external regulation and hence the regulatory framework could focus on standards of governance more than external regulation. Defining appropriate governance standards and ensuring their implementation, however is a complex task and may involve subjectivity. Seventh, the regulators have a fiduciary responsibility in as much as the banks are licensed to conduct businesses that are highly leveraged and take deposits without colaterals. Hence, some regulatory prescriptions are essential, but beyond a point they restrain operation of markets that are essential for promoting efficiency, and constrain competition. Eighth, because of the changing circumstances, particularly fast changing technologies, the regulatory framework should be dynamic and be able to cope with changes in the market's products and practices. At the same time, some stability in the regulatory regime is essential for market participants to conduct their operations without imposing a high uncertainty premium. Ninth, consumers of financial services, in particular retail depositors, need to be protected from sale of low quality or toxic products. However, undermining basic principle that buyers should be vigilant about their products is not conducive to efficiency or choice. Finally, the regulatory framework will have to take into consideration the relevant trade-offs in the context of a particular country. However, to the extent, finance is increasingly globalised, these trade-offs will have to be built into a globally applicable framework for financial sector regulation. Financial sector may be increasingly globalised, but its regulation continues to be national since the regulatory system of a country should fit into the financial system prevalent in the country and subserve the objectives set for regulations in public policy. At the same time, regulation and supervision of cross border financial institutions and activities are inevitable and hence some arrangements for coordination among the national level regulations would be essential.

Coordinated Approaches to Reform

In the light of the crisis, there are attempts to design best practices in regulation of financial sector, encourage countries to adopt them and monitor the progress. A reform agenda for financial sector has been set by G20 for the medium term with a timetable for action. Accordingly, international norms of capital, leverage and liquidity are to be finalized by end of 2010 and phase in their implementation by 2012. Reforms in Over the Counter (OTC) derivatives, their exchange trading and clearance through central counter-parties (CCPs), and trade reporting requirements are to be completed by 2012. A single set of high quality accounting standards should be in place by end 2011. The compensation reforms and prudential rules for the systemically important financial institutions and finalization of architecture of cross border resolution are expected to be completed in 2010. In the meeting of G20 in November 2010, G20 is expected to review implementation of reforms in financial sector in the member countries and consider "*Basel III*" proposals, described later in the chapter. There is however no agreement in the G20 on levy of taxes on financial sector or banks to finance the public expenditure relating to crisis and on the regulation of pools of private capital such as hedge funds, though both are under consideration in several countries. G20 recognizes the need for some emerging economies to develop their financial sector to provide depth and breadth of financial services required to promote high rates of economic growth. Financial inclusion has been identified as a priority item for emerging markets.

It is clear that the financial sector reform will be based on individual country circumstances at the national level but broadly in the direction indicated by the deliberations in G20. The pace of reforms will also depend

on the assessment of the current situation in countries. A peer review put in place by G20 mechanism imposes some pressure on individual countries to honour the agreed global standards.

The Basel Committee on Banking Supervision (BCBS) in close association with the Bank for International Settlements (BIS) has developed what may be described as minimum standards or guidelines on capital of banks. The prevailing standards, described as Basel II, were exposed to several inadequacies in the light of the recent financial crisis. Hence BCBS decided to update their guidelines on capital and liquidity reform proposals. Collectively, the revised Basel II capital framework and the new global standards announced in July and September 2010 have come to be commonly referred as "*Basel III*". The *Basel III* guidelines includes tighter definition of Tier-I capital and Tier-II; minimum norms for common equity component and Tier I, the introduction of leverage ratio; a capital conservation buffer and a framework for counter cyclical capital buffers; enhanced measures of counter party credit risk; and short as well as medium term quantitative liquidity ratios. Some explanation of the improvements suggested, though somewhat technical, may be useful.

Basel III proposals emphasize that the capital base of the banks should be characterized by full loss absorption capacity. Base III has, therefore, proposed that Common equity to be a predominant form of capital. The minimum common equity ratio (as a percentage of risk weighted assets) would be increased from the current 2.0% to 4.5%. The Tier-I capital ratio would be increased from 4.0% to 6.0%. The total capital adequacy requirement will continue at the existing 8.0%. New criteria on certain capital elements would be introduced to make them stronger. There will be no sub-categories of Tier-2 capital such as upper Tier-2 and lower Tier-2. There will be only one form of Tier-2 capital with minimum maturity of five years. *Basel III* has also proposed measures to reckon counterparty credit risk for derivatives, repos, and securities financing along with capital. The Systemically Important Banks (SIBs) or Systemically Important Financial Institutions (SIFIs) will be subjected to additional capital and liquidity measures (the exact quantum yet to be decided), in addition to exposure limits and intensive supervision.

The Basel Committee is proposing to test a minimum Tier-1 leverage of 3% during the parallel run period covering January 2013 to January 2017. Specific steps have been proposed to ensure that the banking sector is able to maintain the flow of credit to the real economy during times of stress. A capital conservation buffer i.e. a buffer of 2.5% composed of common equity only and established above the common equity requirement is contemplated along with constraint on distribution of earnings as dividends and bonus payments when capital levels fall below this limit. Introduction of contingent capital in the regulatory capital framework is being explored for SIFIs. Contingent capital would be debt or debt like instruments, which would convert into capital on some pre-specified trigger events such as capital adequacy falling below the specified threshold or on the event of a catastrophe. The use of contingent capital in meeting countercyclical buffer requirements and additional surcharges for systemically important financial institutions and introduction of two ratios, namely liquidity coverage ratios and net stable funding ratios have also been proposed.



Impact of *Basel III*

There is a view that implementation of *Basel III* proposals may have some macro-economic impact on growth through the cost of capital channel and impact on lending. If banks have to retain more capital (a more costly source of finance), then that will have impact on the final lending rates which may have its impact on the growth of economy particularly at a time when slackness in credit growth is a matter of concern. The other channel could be the overall lending. Since the norms are ratios between capital and risk weighted assets, in the absence of raising of capital or inability to raise capital, the ratios can still be met by contracting the assets such as lending. This in turn could have adverse impact on economy when overall credit supply cannot grow to the requirements of the economy.

There is much agreement on the view that there are clear net long-term economic benefits derived out of the increased safety and soundness of the global system from higher minimum capital and liquidity requirements under *Basel III*. The benefits of higher capital and liquidity requirements accrue from reduction in the probability of financial crisis and the output losses associated with such crises. The benefits substantially outweigh the potential output costs for a range of higher capital and liquidity requirements. The transition to stronger capital and liquidity standards is likely to have a modest impact on aggregate output as higher requirements are phased in over a medium term time horizon (four years). Further, the burden of mobilizing additional capital will be on those who happen to be severely undercapitalized and sooner the de-leveraging is achieved the better it will be to regain trust in the financial sector.

In view of the criticality of the time-frame in implementing the *Basel III* norms, attempts have been made to compute the possible impact of adoption of *Basel III* on aggregate output depending on the pace of implementation of new standards. According to the BIS, if higher requirements are phased in over four years, each one percentage point increase in banks' actual ratio of tangible common equity to risk-weighted asset may lead to a decline in the level of GDP relative to its baseline path by about 0.20% after implementation is completed. In terms of growth rates, this means that the annual growth rates would be reduced by an average of 0.04 percentage points over a four and half year period, with a range of results around these point estimates. A 25% increase in liquid asset holdings is found to have an output effect of less than half that associated with a one percentage point increase in capital ratios. No doubt, there are differences between the official estimates of BCSB and that of banking industry lobby (the latter estimates higher costs in terms of loss of output).

There is hope for reducing the risks of instability in the financial sector since there is agreement on major issues such as leverage, liquidity, counter cyclicity and attention to systemically important financial institutions. Agreement on parameters of capital adequacy is also welcome. The fears of possible adverse impact on growth are possibly exaggerated. The real issue is therefore the challenge ahead of some of the advanced economies that have to deleverage and reach the standards prescribed by *Basel III*. Notably, many emerging markets already meet these norms. There are apprehensions that

Basel III in its present form may not meet the concerns of global community in view of time table that appears stretched till 2017 with scope for dilution as time passes and potential for instability in the interim. It is also feared that the principles set forth appear adequate, but they may be diluted in practice. More important, there is a widespread discomfort with the manner in which the “too big to fail” issue is being addressed by the reform proposals.

Reforms in Select Countries:

In U.S.A, a comprehensive legislation was enacted on July 21 2010. An independent consumer financial protection bureau with jurisdiction over firms that sell consumer financial services has been created at the Federal Reserve. The private pools of capital, namely private equity and fund managers have to register with Securities and Exchange Commission (SEC) as investment advisors, who may be required to observe disclosures and investor protection. Large hedge funds or private equity funds which are considered systematically important are subjected to the jurisdiction of a council of regulators. Large banks are barred from owning significant stakes in leveraged buyout funds, or hedge funds. In regard to derivatives, there is a requirement that over the counter derivatives be registered with clearing houses, who may put some safeguards, but there are several exceptions to these stipulations. The pay packages and remuneration for senior executives and directors under certain categories are subjected to regulation. A Systemic Risk Council has been created with broad powers to regulate systemically significant institutions. The Federal Reserve is charged with conducting annual stress tests of systemically significant institutions. The proposed Systemic Risk Council has authority to place bank holding companies and other systemically important institutions into a resolution process – a process whereby equity capital may be eliminated, bondholders may be forced to take cuts and management replaced.

In Europe, a Pan-European financial regulatory architecture has been approved to help develop common European rules for national regulators to follow. Three Pan-European supervisory authorities have been created for banking, insurance and pensions and for securities and markets. While the European Systemic Risk Council (ESRC) has been setup for macro-prudential regulation the European System of Financial Supervisors (ESFS) corresponds to a micro-prudential approach. Extraordinary regulatory processes have been acquired by the European Parliament when emergency is declared for regulatory purposes. In brief, the regulatory coordination in EU area has been the major focus of reform. However, in regard to several other areas, such as regulation of hedge funds, private equity funds and policy in regard to too big to fail, lack of progress is conspicuous. There are two factors for the reform-process to be different from that of USA, namely, the reluctance of UK in some matters which are critical for Euro Area; and the difficulties of negotiating agreement with member states since they have financial systems with different characteristics.

In U.K., an overhaul of the financial structure has been announced. The Financial Services Authority (FSA), the single regulator and supervisor for all financial services providers in the UK. will cease to exist. The tripartite structure consisting of the treasury, the Bank of England (BOE) and the FSA gets dismantled. The key role in financial structure is now assigned to BOE; which becomes institution in charge of monetary policy, lender of last resort, special resolution regime, macro prudential supervision, and oversight of micro prudential supervision. A new prudential regulatory authority as a subsidiary of the BOE and a financial policy committee within the BOE, have been proposed and both will be chaired by the Governor of BOE. There will also be a new Consumer Protection and Markets Authority and an Economic Crime Agency. An independent commission on competition in banking industry has also been announced. Switzerland which was also

severely affected by the crisis has a financial system dominated by very few very large entities. The reforms focused on several relatively stringent regulatory prescriptions to ensure stability. These relate to capital buffers, leverage ratios and safeguards in regard to their systemically important financial institutions.

Some generalizations on reforms in the financial sector in these select countries may be made. First, noticeable reforms have been implemented, in those countries which experienced excesses. That is a matter of comfort. Second, the underlying logic is essentially towards greater weight to stability than before. There is some discomfort about the time path given in some reforms which appears stretched. There could be pressures to dilute the standards over time and in detailing the measures for applications. Third, the design, content and pace of reform are clearly country-specific or Euro Area specific. Fourth, major areas of cross border regulation, and sources of contagion have not been addressed adequately, presumably on the assumption that strengthening regulation at national levels would serve the purpose for the present. Fifth, there have been no cognizable reform initiatives in other advanced economies like Australia, Canada and Japan. Almost all EMEs have not considered it appropriate to attempt reforms at this stage. However, many of them are addressing issues relating to volatility in capital flows by using regulation of financial sector as one of the instruments. Korea provides a good illustration of this approach.

Developing Country Perspectives:

In countries that experienced the financial crisis in acute form, some reforms took place, while in others, especially in developing countries where the impact was not as severe, they are still waiting to the overhaul of the international financial regulatory architecture, so they can consider adapting appropriately their national regulatory frameworks.

The developing countries may view the reform proposals in *Basel III* and G20 with a mixed feeling. Measures to strengthen the financial system in the advanced economies should be welcomed. Since many of the developing countries satisfy most of the stringent criteria on banks, there may not be additional regulatory burden on them. They are not over exposed to sophisticated financial products requiring actions stipulated by *Basel III* in this regard. Infact they may gain by better safeguards in the regulatory framework governing financial innovations. Lesser dependence on credit rating may also be to their advantage. The emphasis on financial inclusion in G20 is also appropriate though it is not clear how it is being operationalised in the reform-proposals. Further, financial inclusion should not be an excuse for pushing credit or irresponsible lending as it happened in sub-prime lending. It should not be an excuse for circumventing regulatory rigour. There is a recognition that regulatory intervention is desirable for stability but a similar dispensation to achieve objectives of growth with equity through influencing direction and price of credit is not observed. In particular, issues relating to long-term financing needs of development and significance of small and medium enterprises for employment are not recognized.

Adequate weight has not been given to the comfort of relationship lending and collateralized lending prevalent in developing economies.

Impact of *Basel III* proposals on emerging market economies may be illustrated with the Indian case. The effect of proposed *Basel III* is expected to be minimal on the capital requirements of Indian banks. For example Tier-I capital in banks at nine percent is above stipulation 6%. Deductions in capital proposed are already in force in India. Counter parity credit risk framework may impact a few private sector or foreign banks which

have significant exposures to trading book. The banks are not excessively leveraged and hence stipulations on leverage ratios will have little or no impact. On counter cyclical policies, India follows a sectoral approach. For a rapidly growing economy, credit to GDP ratio in the short run may be too aggregative to reflect building of systemic risks. Indian banks have not faced the type of stress that advanced financial markets did. Assessment of liquidity stress scenarios is a new task for Indian banks. The banks in India are strong for two important reasons namely dependence on more stable retail business and the regulatory requirements, that banks should hold a significant part of assets in the form of government securities.

Select Issues:

It is necessary to set-out the purpose of the developing the financial system in order to assess the appropriateness of the regulatory regimes and design suitable agenda for reforms. The objective is no doubt to maximize output, employment and broader social objectives. Financial sector should facilitate real economic activity, at a minimum cost and on an assured basis. To achieve these objectives, the financial sector has to match savings, investment and liquidity in an optimal manner. Further, in view of nature of externalities in financial sector regulation become inevitable. But, there is a need to look at expectations from the common person, particularly in developing countries, in setting out the objectives of financial system. These are:

- consumption smoothing, since income stream and expenditure stream may not converge;
- payment transfers in an efficient and economical manner;
- safe custody of deposits without serious loss of value of their earnings through enabling supply of at least one instrument of safety;
- and making available a choice of institutions and instruments for savings and investments and not merely enable lending or extending credit. Public policy should, therefore, address two sets of issues, namely
 - meeting common persons' needs and providing financial services with sensitivity to price and quality and
 - facilitating growth by enhancing efficiency, imparting stability taking account of externalities that characterize financial sector.

The financial sector reform debate now is essentially a response to the crisis and the focus is on correcting the excesses of the past; especially excessive deregulation which caused the crisis. Almost all proposals involve tradeoffs, at least in the short run. Tradeoffs are often contextual, to the society, to the economy and to the institutional needs. But minimum and common standards are necessary in view of linkages between financial sectors of different countries. Currently, there are two sets of reform-ideas under debate namely reforms in individual countries especially USA, UK and Europe and minimum standards as per G20 reform agenda and *Basel III* proposals. Some advanced economies have brought about changes in regulatory regimes in the light of their experience and these are of systemic importance to the global economy. Emphasis on stability in their reform agenda is inevitable since the reform is in reaction to crisis, but a development orientation is equally relevant for global economy since there is a paradigm shift in the role of regulation of the financial sector. If intervention of the State in markets is necessary for ensuring stability, there is a valid reason for intervention by the State to ensure economic development.

There is a case for development orientation to the design and policies of regulation of financial sector but the skeptics argue that regulation is not the best instrument and in any case it may be difficult to operationalise such a policy. First, the mandate for regulator should include utilizing the regulatory tools to achieve objectives

of not only stability but also development as allocation of credit to different uses prescribing differential margins. Second, where subsidies from government are warranted, as in the case of Development Financial Institutions, the regulations should also be aligned to achieve objectives of development. Similarly, a longer term view may be taken in regard to risks assigned to longer term direct financial of infrastructure. Third, the budget of regulators should be used for promoting use of technology or extending financial services to backward areas or remote areas or poorer sections which may not be profitable in the short to medium term. Fourth, in regard to policies such as licensing of branches of banks incentives and disincentives could be considered in favour of under-served areas. Fourth, access to payment and settlement facilities should be ensured at an affordable price and acceptable quality in favour of the poor. Exploitative practices in certain activities such as credit cards should be curbed. Fifth, financial and technological innovations that are likely to favour the poor should be encouraged and, if need be, subsidized by the regulators. Financial institutions devoted to retail operations and without serious systemic implications should be nurtured. Finally, the weight for financial stability should be higher in developing economies where social safety nets do not exist. For example, the practices and products that are innovative, whose risks are indeterminate, should ideally be tested in advanced economies before the regulators allow them to be used in developing economies unless the regulators are aware of and comfortable with implications of innovations.

The experience of China and India with public sector banks and financial institutions in successfully using them as instruments of public policy is relevant in this regard. The trust that people have placed in public ownership under stressful conditions in advanced economies is also relevant. In fact, the presence of some public sector units in financial sector along with private sector helps reduce information asymmetry between the regulator and the regulated since incentives in public sector are conducive to transparency. Further, as experience with crisis has shown, in times of stress on public policy, existence of some public sector enterprises improves effectiveness of public policy.

In the agenda for reform of financial sector consequent upon the crisis, taxation of financial sector has been prominent, although no agreement could be reached. As a broad generalization taxation of financial sector should be consistent with the regulatory objectives and burdens or benefits of both should be assessed in a comprehensive manner. Differences in tax burdens and regulatory burdens across countries may not be viewed in isolation. Financial sector taxation as debated in the context of the crisis, may have several objectives, namely to share the burden of bailout expense (which is indeterminate so far); to build a buffer for the future crisis (which should ideally be designed as an insurance fund); to raise resources for budget (similar to any other tax); to discourage excessive speculation or unnecessary multiplication of financial transactions (which exist in some advanced economies also like stamp duty or securities transaction); and to raise resources for global public goods. In the current context, the use of financial sector taxation has been advocated mainly by advanced economies to pay the bail-out costs and to build a buffer for future crisis.

In respect of developing economies, the bail out is not relevant and cost of funding of future crisis is not a priority. However taxation of financial sector for resource-raising, discouraging excessive financialisation and possible funding of global public goods are relevant objectives. The taxation of financial sector as compared to non-financial sector and different institutions or different instruments in the financial sector would have consequences for both development and regulation. The financial sector could potentially be an instrument of development policies and these may impose regulatory burdens, say on banks in the short run. Any view of on financial sector taxation should therefore include an assessment of regulatory burden due to development objectives also. Hence, taxation of financial sector

should remain as a national imperative. However, international agreement on levy of Tobin Tax would be in the interest of developing countries since it would moderate excess volatility in currency markets.

On the basis of Indian experience it can be argued that regulation of the financial sector could be used as a tool for macro-economic management. For example, in India the cost of sterilized intervention in forex markets is shared by the banking sector through the imposition of unremunerated cash reserve ratios, as needed. More important, the large borrowing programme of the Indian government is facilitated by a stipulation that deposit taking institutions in financial sector are required to invest stipulated amounts as a proportion of balance sheets in government securities. These stipulations provide reasonable stability to banks and assured support for the borrowing program of the government, as these securities are relatively less risky. The effect of such mechanisms is similar to domestic financial sector taxation.

Prudential regulation may also be used as an instrument of capital account management. For example, limits are set on foreign currency exposures of financial intermediaries, including a limit on their external debt. These stipulations have the effect of tax, but serve the purpose of moderating volatility in capital flows. Use of financial sector for macro-management has elements of tax burden.

Outlook:

The outlook for a globally coordinated and sustained regulatory reform appears to be uncertain. First, there is no clarity on what is a right model for regulation of financial sector though there is a recognition of general principles. Second, there are several tradeoffs involved which are more often than not country specific. Third, the immediate compulsions for urgent reform appear to be for a few countries which were significantly affected by the crisis as a result of excessive deregulation. Fourth, regulation of financial sector cannot be divorced from other aspects of macroeconomic policy, such as monetary and fiscal policies, especially in regard to countercyclical approaches. Fourth, the capacity of countries and societies to bear risks varies, with developing countries being at a disadvantage. Hence, several policies in the nature of self-insurance are inevitable, and such policies may include financial regulation. For example, prudential measures may be used for capital account management in developing countries. Fifth, experience has shown that regulatory capture in a comprehensive manner, and inadequate or ineffective supervision were often sources of fragility, and not necessarily the regulatory framework. Sixth, there may be merit in recognizing that regulation of the financial sector would be essentially at the national level. Search should therefore, be to identify regulatory standards and practices in each country that are likely to have negative externalities to the global economy.

A possible approach to reconcile the need for policy space for national authorities and the need for global coordination may consist of three sets of actions. They may consist of reaching agreement on

- basic principles of national regulations that could address national level activities of the financial sector
- standards of regulation for systemically important financial intermediaries at global level and
- minimum standards for systemically important financial centres for global economies. The basic principles of national regulation may have to identify the 'bad' practices and create mechanisms to persuade countries not to adopt them while continuing a search for the 'good' that is equally good for all countries in a global economy where only nation states are accountable to their people. The regulations at national level are most appropriate for institutions and markets that are predominantly national. To supplement these minimal national standards, focused globalised regulation should be evolved in respect of large financial intermediaries whose activities are predominantly cross-border. A distinction could be made

between national and multinational banks whose main activities are within a country's jurisdiction and international banks which are large institutions that operate across financial markets, regulatory jurisdictions and tax regimes. The international banks are the main sources of diluting policy autonomy including regulation at the national level. They need to be subjected to global stringent regulations.

These centers which are having the privilege of being international financial centers have a responsibility to subject themselves to globalised regulation. Such focused approach to regulation of the financial sector in financial centers and banks of international significance will be consistent with differentiated regulatory regimes that have been accepted now for systemically important financial institutions.

There are two views on the way forward in regard to sustained regulatory reforms in the financial sector. One view is that regulators have been excessively defensive in view of the crisis and political pressure has been brought on the proposed framework due to public outcry. This view questions the wisdom of many initiatives for enhanced role for external regulations. The alternate view is that the financial sector lobby continues to exercise influence over decision making processes and hence the framework is possibly weak and in any case will be diluted in practice. The developing economies have been innocent victims of the global financial crisis and they have every reason to guard against facing adversities in the post-crisis management of financial sector in the global economy. Much of the debate and action so far has bypassed concerns of developing economies despite their recently acquired importance in G20, FSB and BSCB. This is evident from the reforms that are missing in the agenda, namely, the basic purposes of financial system, the legitimate expectations of common persons, development orientation and finance as a possible supplement to macroeconomic management including capital account management and possibly in supporting the very large borrowing programmes of some governments.

Biography note

Yaga Venugopal REDDY (Dr. Y.V. Reddy) was Governor, Reserve Bank of India, from 2003 to 2008. Subsequently, he was Member of the UN Commission of Experts to the President of the UN General Assembly on Reforms of International Monetary and Financial System. Dr. Reddy is currently Professor Emeritus, University of Hyderabad. He is also Honorary Fellow of the London School of Economics and Political Science. Dr. Reddy is on the Advisory Board of Institute for New Economic Thinking (INET) and is also on International Advisory Board of the Columbia Program on Indian Economic Policies, Columbia University, New York. He is a Member of an informal international group of prominent persons on International Monetary Reforms, and is also on the Advisory Group of eminent persons to advise the Finance Minister of India on G20 issues. Prior to being the Governor, he was Executive Director for India, Sri Lanka, Bangladesh and Bhutan at the International Monetary Fund since August 2002. Prior to this, he was Deputy Governor, Reserve Bank of India, for six years. Formerly, he was Secretary, Ministry of Finance, and Additional Secretary, Ministry of Commerce in the Government of India. He served Government of Andhra Pradesh, India in several capacities including Principal Secretary and Secretary – Finance and Planning, Collector and District Magistrate etc. He was also advisor in World Bank. Dr. Reddy was honoured with the Padma Vibhushan Award in 2010. His book *India and the Global Financial Crisis: Managing Money and Finance* was among the best sellers in India (Orient Blackswan 2009). His most recent publication is titled *Global Crisis, Recession and Uneven Recovery* (Orient Blackswan, 2011).

Queries



02

The New Global Deal

Though the phrase *Never waste a good crisis* has been continuously repeated in all the parts of the globe, there is a great danger that nevertheless many wish to steer towards returning to *business as usual*. This is happening despite the obvious fact that it is no longer possible. The imbalances in economic developments among the respective countries and societies, extreme poverty of some versus incredible wealth of the others, exploitation of workers versus privileges of capital holders – as long as these exist there can be no hope for any global stability. The 21st century requires that the Next Global Deal will therefore be of a completely new generation. Poul Nyrup RASMUSSEN exemplifies, how Europe could lead the way towards a new pact, which should entail a new agenda towards policies of: trade, labour, finance and environment. He emphasizes the need for an adequate international architecture. His thesis are supported by Martin KHOR and José Antonio OCAMPO, who propose a new vision for trade and development, matching it with a proposal of a reform plan of WTO. The Chapter is concluded with an article by Pascal LAMY, who points out what kind of trade policy can be described as progressive and what role it can play in realizing the principles of social justice worldwide.

Global economic governance, a **European perspective**



By **Poul Nyrup RASMUSSEN**

Europe's inward looking is undermining its recovery

The crisis highlighted the failures of the economic and social system at global level. The problems at global level are not new but the crisis has considerably worsened them and highlighted the unacceptable gap between the regions in the world, the rich and the poor and the lack of coherent economic governance at global level. We need global economic governance that ensures a fair and sustainable world based on welfare for all. This is no small task and I will try and give some concrete ideas on Europe's role in working towards this goal.

After the steps forward at the G20 summits in London and Pittsburg, we are now facing a bleaker prospect with divisions clearly apparent on the right policies to pursue for recovery at global level, the currency war between the US and China, the devastating impact of the sovereign debt crisis in the European Union and the rise in commodity prices and notably foodstuffs that signals the daunting prospect of a repeat of the food crisis that triggered riots in developing countries in 2008.

Since the April 2009 G20 gathering in London, Europeans have experienced a psychological roller coaster ride that began with the euphoria of President Barack Obama's first visit to Europe and ended abruptly a year later with the political and economic onslaught of the European sovereign debt crisis. At global level, there is now a stark divide over how best to achieve economic growth while simultaneously implementing budget austerity. This divide is made all the more tangible because it is fueled by the eclipse of Europe's historical economic and political preeminence in the international monetary system and the rise of the emerging economies. The world is increasingly multipolar and Europe appears to be losing its position as a power house for growth, unable to address the challenges it faces such as aging population and the transition towards a greener economy as well as the need to ensure a strong European Union in the face of the Eurozone crisis.

The conservative majority across Europe is in the process of implementing the most right wing agenda since the Reagan-Thatcher era with the sole aim to dismantle the welfare state perceived as being crippling for public finances. Job creation and sustainable growth through investment comes second to the crusade

the conservatives are leading in the name of austerity. The consequences will be catastrophic for Europeans and inequality within the European Union will increase. Europe governed by the conservatives is inward looking and fails to look at what is happening across the world. At a time when our social model is being exported across the world with the US, Brasil, Australia implementing progressive bills, and even China studying our pension systems, the European Union and European leaders are attacking all sectors of the welfare state. The double sentence imposed on European citizens is crippling: not only are they having to pay for the crisis that was trigger by reckless behaviour on financial markets, they are seeing their mid term and long term prospects diminish with unemployment rising even as social safety nets disappear.

We progressives put job creation and growth and fiscal consolidation at the same level. One doesn't happen without the other. Ultimately, the only way to ensure a return to sound public finances is to ensure that growth returns. The focus on expenditure only is at the heart of the mistakes that are being made today. In particular, cuts in welfare systems, with its dire consequences on social cohesion and gender equality should be avoided. **What we need is an alternative way, in which a tax on financial transactions and a bank levy play a complementary and central part. In this context, a collective European debt mechanism, otherwise known as "Eurobonds", should also be put on the political agenda.**

Investment in infrastructure, education and sustainable industries must be at the heart of the recovery and the growth strategy. Creating a knowledge-based economy producing high added-value products would create jobs and trade and contribute to pulling Europe out the crisis.

And finally and most importantly, the most erroneous aspect of today's economic policies in the European Union is the massive underuse of human resources which is becoming structural with the ongoing lack of investment. The most alarming economic indicator in this respect is the high youth unemployment rates all over the European Union.

The Global New Deal for a fair globalized world

We have developed a model that is based on fairness and decent work, inherently outward looking and fuelled by a financial sector at the service of the real economy and sustainable modes of production and consumption: the Global New Deal. The design and implementation of a Global New Deal will require a revision of the relationship between the four normative pillars of the global economic order: trade, labour, finance and environment.

1. Trade

International trade is an area where the progressive movement should encourage increased international cooperation based on developing rules that ensure fairness and promote a holistic approach in order to mainstream social and environmental concerns. History has shown that the economic model on which trade is based and insufficient or partial regulation can lead to gross imbalances and injustices. Therefore, regulating trade properly at global level is necessary notably by taking into account development stages across the globe and national parameters as well as ensuring that fundamental values and human rights are not undermined through global trade. Trade opening and reducing trade barriers under the right conditions remains a vector to promote growth and development, to improve standards of living and to tackle poverty reduction. Nevertheless, one mustn't confuse trade opening with deregulation.

The welfare gains from efficiency gains with global trade are not true in anyplace and in any time and for every country. The poorest countries are extremely vulnerable in the framework of free trade. Therefore, **we must strive to develop rules at global level that ensure fairness is at the heart of the global trading structures and that all countries and regions get safe and fair deals within the global trading platform.** Furthermore, the relevance of regional level is also very important as far as shaping trade dynamics is concerned. Encouraging trade at regional level is a means to address environmental issues related to trade in the globalised world as well as to create a sustainable economic development. Trading between emerging regions of the globe, i.e. South-South exchanges, is also a major factor for development in so far that the dynamics are dictated differently than in a North-South relation.

Lastly, free trade isn't an end in itself. We believe that we must use the policy space at global level through the World Trade Organisation (WTO) to introduce trade rules that address the risk of undermining cultural diversity, antidumping, and the effects of adverse environmental and social effects. This issue is not only a matter for domestic policies. Global trade policies must internalize social and environmental externalities: regulation must ensure that environmental issues and social values are not the adjustment variable of global competition. In this respect, the European Union's must play a strong role in promoting the mainstreaming of social and environmental concerns into its trade agreements. At global level, the rules defining the relationship between trade, social rights and environmental protection must be rebalanced in favour of the latter two areas. The International Labour Organisation (ILO) must be put on an equal footing with the OMC and environmental protection must be mainstreamed into trade policies.

2. Labour

The increasing inequalities and household indebtedness in some developed countries are due to real wage stagnation. Over the last two decades, real wages have stagnated for the millions of workers in developed countries and increased too slowly for those in developing countries. This is a reflection of the reduction of labour income share of the added-value. Social dialogue is central to tackling the issue of real wages as well as the principle of collective bargaining. In Northern European states, the high working conditions are the result of collective bargaining and have fuelled strong economies. In a globalized world, the question of real wages is all the more crucial because of wage competition that leads to a race to the bottom. The International Labour Organisation (ILO) is central to voicing workers concerns across the globe. Nevertheless, the ILO still remains the "poor cousin" of the WTO and the International Monetary Fund (IMF).

Furthermore, on top of the economic issue of real wages, the implementation of the agenda for decent work is relevant in all countries in order to achieve a broadly-based equitable recovery from the crisis. It is also crucial to underpin the catch-up process in developing and emerging countries. It involves the key priorities to ensure the lift of working conditions and the focus on employment and social protection as the key interfaces between economic and social development. Hence, in the framework of comprehensive strategies for sustainable development, it is important to promote the priorities of the decent work agenda that includes four pillars: human rights at work; employment and incomes; social protection and promoting social dialogue.

All countries should ratify and implement the relevant ILO conventions while strengthening ILO supervisory role and capacity to provide technical assistance to the implementation of the decent work agenda.

At the September 2010 MDGs summit an important step was made. Representatives agreed on an outcome document calling for a series of important measures including job intensive and sustained, inclusive and equitable economic recovery and growth, increased investment in youth employment, active labour

market measures, full and productive employment and decent work for all, the promotion of a Global Jobs Pact and a strong focus on women in all employment policies.

3. International finance

We still live in a political and decisional world where the dominating paradigm is that markets are self correcting. After the financial crisis that was triggered with the abrupt deflation of the real estate bubble in 2007, a political consensus appeared to dominate: the will to make the financial markets the servants of the real economy by increasing transparency and curbing highly damaging behaviour. Three years after the crisis began, the old paradigm of self correcting markets is back in the public sphere.

The crisis highlighted to what extent the financial sector is interconnected with the banking and industrial sector as well as, in the light of the recent sovereign debt crisis' in Europe, with the public sector. Financial markets have turned out to present extremely high systemic risks. They present systemic risks in two aspects: their malfunctioning triggers downfalls all a long the economic chain, even as far as the households and they are pro-cyclical, creating bubbles that trigger bursts.

Deregulation in the past two decades put aside the lessons of the past and allowed for an accelerated development of financial markets and in an opaque way. The interconnectedness is not only the result of a proportional growth of relations between investors and creditors or lenders and borrowers, i.e in the dependence of other economic stakeholders including States to the financial markets, thereby the increase in dealings and transactions. It is also the consequence of new technological developments such as computerized finance.

Because of their exponential growth and the ever growing size of financial markets in the macroeconomic structures and because of an increasing interdependence and interconnectedness, regulation of financial markets is of the utmost importance. Two dimensions need to be tackled as exposed above: the interconnectedness and the pro-cyclicality. In both cases, transparency is the prerequisite.

In order to understand what needs to be done in terms of regulation of the financial markets, it is necessary to move back a bit from the actual financial markets and the time frame of recovery and look at a somewhat larger picture: the financial market is not an end in itself. Financial markets must no longer be comprehended in decision makers' minds as an entity on their own but as a component of a larger picture, a macroeconomic structure and must be measured against society's values. The question of fair burden sharing of the crisis as well as redistribution is crucial when tackling financial market regulation.

Though some work has been done in drawing up a regulatory framework for financial markets, notably with the new capital requirements, there still lacks commitment at global level. The shadow banking system has not been addressed globally through regulation and doesn't fall within the scope of the *Basel III* rules. This hampers regulators' work on ensuring more transparency on the financial markets and tackling asymmetric information. The high degree of concentration of financial establishments, the so called "too big to fail", has also not been tackled thereby increasing the systemic risk on the markets and the possibilities of conflict of interests to develop. Tax havens still operate with no constraints and contribute to creating an opaque and unfair banking and financial sector. An effective sanction regime should be applicable to non compliant territories. There is still no proper instrument that ensures the fair burden sharing of the crisis, such as a FTT. Fiscal policies reflect the basic values of a society. A general FTT is a truly progressive fiscal instrument and a strong alternative solution to austerity measures. It would raise substantial amounts of revenue that could be invested in public services, development

and environmental protection. Furthermore, transactions are at the heart of the way the financial markets function. By focusing on transactions, the FTT would weigh on unwholesome practices, such as High frequency trading,

4. Environment

Environmental issues are fundamental to tackling the global imbalances between developed and developing countries. The Global New Deal is also a Global Green Deal and ensures equal access to technologies and a global plan for development in a sustainable and fair way. The transition to a low-carbon economy will involve a major transformation in our patterns of production, consumption and mobility, requiring smart policy frameworks, large-scale investments, mechanisms to share the costs and policies to ensure social justice in this transition. While others support green growth mainly for economic and environmental reasons, we as social democrats and socialist fight for green growth that contributes to a good life for citizen, quality jobs and sustainable and fair growth. The European Union and other developed countries must be at the forefront of pushing for concrete targets and measures to ensure a just transition towards a carbon-free economy. They must take the lead due to their historic responsibilities, resources and technological capacities

Europe especially must play its role as a leader in this field for economic as well as political reasons: it is essential to ensure the EU's competitiveness and there is a larger political consensus in the EU to push for ambitious environmental targets. The EU should adopt ambitious greenhouse gas (GHG) reduction targets, such as increasing the unilateral EU emission reduction target from -20% to -30% for 2020. The obligatory percentage of renewable energy in the EU energy mix increased to 30% in 2020; 45% in 2030; 70% in 2040 and 95% in 2050. It should reduce waste by creating a generation of energy capacity close to 60% (today it is around 40%), refurbish building and increase sustainable mobility. Europe's final demand for energy should be reduced by 40% compared to today's demand by 2050.

Developing countries will also need to make substantial cuts, but should not be asked to take on binding national targets until developed countries provide the example of lower carbon growth and until the relevant institutions and frameworks provide financial and technological support for both mitigation and adaptation in the developed countries. And lastly, emerging economies should be able to define targets now, under the assumption they will get technological transfers to support for this transition.

This requires to define a tax system and/or a cap-and-trade system which will ensure not only effectiveness, by imposing an absolute limit on emissions and efficiency by reducing the costs of action, but also equity, by generating private sector flows to developing countries, which can then be used for low carbon growth.

Correcting power imbalances at international level

International institutions are severely lacking and this leaves room for a real progressive agenda. But problems of legitimacy and representation remain considerable at global level. Correcting global imbalances of power must be at the heart of the model. In this respect an equal representation of different regions of the globe and especially a fairer representation of developing countries within global governance structures is a priority. Not only does over-representation of Europe and the Western world in these structures appear anachronistic in today's world, but it also fuels structural imbalances. This requires addressing the central institutional problem which is re-weighting votes according to the actual relative power and resources of the involved countries and avoiding

particular veto powers. This is particularly evident regarding the IMF and the World Bank, where reforms such as an EU seat and more voting power for the emerging economies should no longer be delayed. The recent agreement reached on the quota system that determines who sits in the IMF's board of managers whereby the Europeans have given up two seats is a welcome development.

For a renewed multilateralism, it is crucial to strengthen the legitimacy and the effectiveness of several central bodies and agencies of the multilateral system. This revision can only be achieved by combining public political pressure with a stronger political drive in the multilateral system. This political drive should be given by a triangle composed by the United Nations bodies, by the international agencies (including WTO and BWs) and by the G20.

- **The relationship between UN bodies and these international agencies should be strengthened by the CEB, UN Chief Executives Board**
- **The relationship between the G20 and the international agencies should be strengthened by their involvement in the G20 process;**
- **And, finally, the relationship, between the UN bodies and the G20 should be strengthened by the concerted effort of G20 members in the UN bodies.**

On the longer term, the G20 should improve its composition with an appropriate representation of the different constituencies. A first step is to improve the involvement of the relevant UN Agencies and macro-regional structures. Later, it can evolve to become a UN Global Sustainable Development Council able to ensure, at the highest political level, the coordination of the relevant policies, the follow-up of the key-commitments and the response to new challenges.

The establishment of the Financial Stability Board and its effective cooperation with the IMF and the World Bank could be the first steps towards a charter for the New World Finance Organization that is called for by the Socialist International. All systemically important financial institutions, markets and instruments should be subject to a degree of regulation and oversight. One of the mechanisms of the welfare state – regulation – will be implemented on the global level as global regulation of emergent Global Welfare Statehood.

Biography note

Poul Nyrup RASMUSSEN is the President of the Party of European Socialists (PES), which brings together Europe's socialist, social democrat, progressive and labour parties. The President coordinates the overall political line and vision of the Party. He is also co-chair of the *Global Progressive Forum*. Mr. Rasmussen is one of the most prominent centre-left figures in European politics. He is internationally recognised for his advocacy work on financial regulation, European economic governance, wind energy initiatives and mental health promotion. He was born on the 15th of June 1943 in Esbjerg, Denmark, and studied economics before working in the Danish labour movement. Prior to his political career, he spent 14 years as economic advisor to the Danish trade unions. In 1988 he was elected a member of the Folketinget (Danish Parliament) for the Social Democratic Party and then went on to chair the party. From 1993 to 2001 Poul Nyrup Rasmussen was Prime Minister of Denmark. In 2004 he was elected President of the PES and led the Danish Social Democrats to victory in the European elections. During his term as a Member of the European Parliament (MEP), Mr. Rasmussen sat on both the Economic and Monetary Affairs Committee and the Foreign Affairs Committee. In 2009 he was re-elected as President of the PES.

The unsettled Global Trade Architecture



By **Martin KHOR** and **José Antonio OCAMPO**

Europe's inward looking is undermining its recovery

The World Trade Organization (WTO) was created in April 1994 by the Marrakesh Agreement, which concluded eight years of negotiations of the Uruguay Round. Since then, the WTO has been widely taken to be the embodiment of the multilateral trading system. In fact the WTO is only a part (though of course, a very significant part) of the global trade architecture. There are also other institutions (especially the United Nations Conference on Trade and Development, UNCTAD) and other agreements (in particular the regional and bilateral trade agreements) that are part of that architecture. Although the WTO covers many trade issues, it does not cover some crucial trade areas such as the issue of commodities and their related problems of instability of prices and demand, an issue that has been traditionally covered by UNCTAD and was subject in the past to a series of commodity agreements; those that continue to exist now have a narrow focus. Moreover, the mandate of the WTO also covers non-trade subjects such as intellectual property rights and the investment component of services. Thus, the WTO is less than the multilateral trade system, but also more than it.

The parts of the international trade architecture that come under the WTO are covered by the organization's principles and legally binding rules, as well as a strong enforcement mechanism through its dispute settlement system. The preamble to the Marrakesh Agreement establishing the WTO does contain the objective that *"trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand (...) in accordance with the objective of sustainable development"*. It equally recognizes the need for positive efforts to *"ensure that developing countries, and especially the least developed among them, secure a share in the growth of international trade commensurate with the needs of their economic development"*. The preamble also states the desire of *"contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the eliminations of discriminatory treatment in*

international trade relations". The principle of "non-discrimination" – reflected, in turn, in those of the Most-Favored Nation (MFN) and "national treatment" (that imported goods must not be accorded treatment less favorable than that accorded to like domestic products) – together with Special and Differential Treatment for developing countries (SDT), constitute two pillars of the architecture of rules upon which the multilateral trading system is supposed to be built up.

It can be argued that the main stated objectives of the WTO are therefore those of raising living standards, full employment and growth of real income, as well as ensuring that developing countries secure a fair share in global trade growth, whilst reduction of tariffs and non-tariff barriers and elimination of discriminatory treatment are instruments to achieve them. However, in practice the means have many times prevailed over the ends and, in particular, insufficient attention has been given to the "development dimensions" of the global trading system, in particular on what trading rules and complementary policies are necessary to maximize the trade-development link.

The principle of SDT – that is, asymmetrical treatment or non-reciprocity in international trading rules when they involve transactions between developed and developing countries – was adopted in the 1960s to underscore the trade-development link. This principle led to the drafting of Part IV of GATT, on trade and development, and the more comprehensive "Enabling Clause" approved in 1979 during the Tokyo Round. Article XXXVI provided a clear formulation of the principle: *"The developed contracting parties do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of less-developed contracting parties."* (. . .). The understanding of the meaning of this principle was clarified soon after and written into the fifth provision of the Enabling Clause: *"Developed contracting parties shall therefore not seek, neither shall less-developed contracting parties be required to make, concessions that are inconsistent with the latter's development, financial and trade needs."*¹

This principle is, of course, a major exception to that of non-discrimination, to allow for unequal treatment of unequal partners. However, SDT has been at best highly insufficient and at worst openly violated. It can be argued, furthermore, that this is even more clearly valid of the free trade agreements that have proliferated in recent years, which have also ended up radically eroding the principle of non-discrimination.

This paper analyzes major issues facing the world trading system. It is divided in four parts. The first looks at the development dimensions, as seen through the lens of the imbalances of the trading system. The second looks at the proliferation of free trade agreements. The third looks at the essential features of governance: dispute settlement and decision making. The last draws some conclusions.

The Imbalances of the Trading System

1. The Uruguay Round imbalances

Growing protectionism prior to the Uruguay Round was one of the major reasons why developing countries came to increasingly distrust the commitment of industrial countries to a more liberal multilateral trading order, and were willing to negotiate in an integral way the way the multilateral trading system was

¹ The main development of this principle was the creation of the General System of Preferences (GSP) in 1968, but it never became what it was expected to be, a generalized (as its name indicates) system of preferences subject to multilateral notification. Several studies soon indicated that its effects were rather frustrating. See, for example, Karensky and Laird (1987) and Whalley (1990).



organized. Major reasons were the exclusion of agriculture and textiles from multilateral trade disciplines, the high tariffs and extensive use of quantitative restrictions (QRs) that characterized those sectors, and tariff escalation according to the processing of raw materials, which generated constraints to industrialization based on forward linkages of traditional raw material exports. These issues have been at the center of the views of the international trading system since UNCTAD's first diagnosis in the 1960s which, with some variations, continue to be valid today.

Redressing this trend faced, however, a major problem: since it was accepted that the Uruguay Round agreement would be adopted as "a single undertaking", and developing countries had few prior disciplines in the context of GATT, the acceptance of a comprehensive agenda led to significant additional commitments. Most early evaluations of the Round (Agosin et al., (1995); Ocampo, (1992); Rodrik, (1995)) came indeed to the conclusion that the Round had led to a sharp increase in the range of obligations and responsibilities adopted by developing countries and a loss of what came to be later called the "policy space" they had enjoyed in the past, including to adopt the widely praised East Asian export-led strategies. Although not entirely eliminated, the SDT principle was significantly eroded, particularly for middle-income developing countries (those with a per-capita income above \$1000). In these cases, SDT was confined to longer transition periods, lower tariff cuts, and somewhat greater freedom to apply special provisions (e.g., in relation to subsidies).

Table 1: Major characteristics of tariff regimes

	Pre-UR	Post-UR
A. Percentage of tariff lines bound		
Developped countries	78	99
Developping countries	22	72
B. Percentage of imports under bound rates		
Developped countries	94	99
Developping countries	14	59
	Applied	Bound
C. Percentage of imports under bound rates		
Developped countries	4.0	4.7
Developping countries	13.1	20.8
Latin America and the Carribbean	10.1	18.6
East Asia and the Pacific	9.8	16.6
South Asia	27.7	56.1
Europe and Central Asia	9.6	14.9
Middle East and North Africa	14.4	26.8
Sub-Saharan Africa	16.5	19.8
D. Bound rates of industrial countries		
(all industrial products, excluding petroleum)		4.3
Raw material		0.8
Semi-manufactures		2.8
Finished products		6.2
Natural-resource based		5.9
Textiles and clothing		11.0

Source: A and B: Rodrik (1995), Table 4. C and D: Laird (2002), Tables 11.1 and 11.3

Gains for developing countries included the prohibition of gray area measures (Voluntary Export Restraints and Orderly Market Agreements) as well as the dismantling of the Multi-Fiber Agreement, though with a long transition (ten years, the longest transition agreed). There were also increased disciplines in the use of the instruments of contingency protection (antidumping and countervailing duties). Industrial country tariffs were further reduced, though from already low levels and maintaining the tariff peaks and escalation that had been criticized by developing countries since the 1960s (Table 1).

In the case of agriculture, negotiations had, in contrast, a deeply frustrating outcome. The only breakthrough was the formal inclusion of the issue in WTO, as the agreement allowed a large number of subsidies to be maintained, even on a permanent basis (what came to be known as the “Green” and “Blue Boxes” – see below), whereas commitments on the reduction of restricted subsidies (those classified under the “Amber Box”) did not represent an improvement over what countries, particularly European countries, had already done on an unilateral basis. Indeed, as the estimates by the World Bank (2008, Figure 4.3) for the post-war period now make clear, the reference period adopted was that with highest rate of agricultural subsidies in the industrial world. Also, it was agreed that non-tariff restrictions would be “tariffed”, but the method chosen, the so called “tariff rate quota”, was really a quota with the semblance of a tariff, as tariffs above minimums level of market access were in many cases prohibitive. The minimum level of imports as a proportion of domestic consumption that was agreed represented, therefore, the only real measure of increased market access. Indeed, deep frustration by many actors with this outcome, particularly by the Cairns Group, which had pushed for deep liberalization of agriculture, led to the only other meaningful decision that was adopted together with the inclusion of agriculture in WTO: that the agricultural agreement would have to be renegotiated after five years (in 2000).

The counterpart of these advances was a significant set of new commitments by developing countries. Most stringent according to all evaluations was, of course, the new disciplines in intellectual property rights, which generated a constraint that had not been present in prior development experiences, including those of industrial countries. QRs were forbidden, except as emergency measures during balance of payments crisis (under stricter disciplines, in any case) and tariff bindings increased substantially, indeed to cover the whole tariff schedule for many middle-income countries. In general, however, developing countries were able to keep bound tariffs at levels that were substantially higher than those effectively applied after their own unilateral liberalization processes. Another instrument that had been actively used by developing countries in the past, both as a protection device and as an export promotion instrument, the so-called TRIMS, was also prohibited.

Some of the greatest contrasts between the degrees of additional commitments made by industrial vs. developing countries lay in the area of subsidies. In practice, the major subsidy instrument used by developing countries, export subsidies, was prohibited for countries with a per capita GDP above \$1000, except in the case of agriculture, where industrial countries staunchly defended their traditional forms of state intervention. This exception was part of a broader acceptance at Marrakesh of all major instruments of intervention used by industrial countries, with some restrictions. This included export and production subsidies in agriculture, but also for research and development, regional development and environmental adaptation in the general agreement on subsidies. This asymmetry was also present in the case of QRs, which were generally prohibited and made more stringent in the case of balance of payments crises, the typical clause used by developing countries, but were given greater room in textiles (during the transition period), in the general safeguards agreement and, as we have seen, de facto in the case of agriculture. Both in relation to subsidies and QRs, as well as in the transitional provisions for textiles, the principle of special and differential treatment was not only ignored: it was actually turned upside down.

The new General Agreement on Trade in Services (GATS) represented basically a framework for future negotiations. It included the basic principles of GATT – gradual trade liberalization, reciprocity, MFN, fair trade and use of QRs only as an emergency tool – and added new ones, essential for this sector –the transparency of domestic regulations and the need to negotiate commercial presence. However, in practice, countries maintained significant discretion as to what to liberalize (or even totally exclude certain sectors or activities from liberalization) and what form (or “mode”, according to GATS terminology) it would take. They also maintained a significant degree of freedom to regulate and even to violate the principle of “national treatment” – such as establishing restrictions on maximum foreign ownership of firms in specific activities. It was agreed that either the “positive list” or the “negative list” approaches could be followed, but it was presumed that developing countries would follow the former, which provides greater discretion.

The sense that the outcome of the Uruguay Round negotiations had been imbalanced weighted heavily in the succeeding history of WTO. The call in recent years for a development oriented trade round could not be understood otherwise than as a recognition that the Uruguay Round had failed in that regard, and therefore that a new set of negotiations was essential to correct the imbalances that had been left by the Round. Whether a new “Round” was the best way to correct these imbalances is, of course, quite controversial. In this regard, it is useful to recall that the possibility of conducting regular negotiations in WTO rather than through the sequence of special rounds used by GATT was regarded as one of the major institutional innovations of the Marrakesh Agreement. For the purpose of correcting imbalances, it may have been better to negotiate first the pending issues (the so-called “built-in agenda”), particularly agriculture. Furthermore, the new round brought with it the emphasis on reciprocity, which indeed ended up dominating the Doha Round negotiations, to which we must add the additional reciprocity that was required under the free trade agreements that proliferated in the post-Marrakesh years.

The succeeding history of WTO was also plagued by attempts to further broaden the scope of the new organization. This was particularly true during the first Ministerial meeting held in Singapore in 1996, where a set of issues (investment, competition policy, transparency in government procurement and trade facilitation) were introduced into the WTO agenda. After a long controversy, in August 2004 the WTO’s General Council decided to drop three of these Singapore issues (with the exception of trade facilitation) from the Doha Work Programme.

2. The Pending Development Agenda

Developing countries had expected to benefit significantly from the Uruguay Round through increased access to the markets of developed countries for products. This was especially in agriculture and textiles, sectors in which developing countries have a comparative advantage. However, as Tables 1 and 2 indicate, these two sectors remained those subject to the highest levels of protection in industrial countries. Tariff peaks continued to be an embedded feature of the system, also in particular in these two sectors. Natural-resource intensive manufactures continued to be constrained by tariff escalation. Non-tariff barriers, particularly antidumping rules and technical standards have also continued to constrain exports from developing countries. In textiles, developed countries progressively phased out their quotas over ten years to January 2005, but they in fact retained protection in most sensitive areas up to very near the end of the transition period. After liberalization, some additional protections were put in place, which in some cases implied a temporary come back of the “grey areas” prohibited by the Marrakesh Agreement.

Table 2: Major characteristics of applied protection, 2006

Summits	Total trade	Agriculture	Manufacturing
A. Tariffs			
High-Income Countries	2.1	12.1	1.4
East Asia and Pacific	5.0	8.7	4.8
Europe and Central Asia	4.5	10.3	4.0
Latin America and the Caribbean	5.4	6.6	5.3
Middle East and North Africa	11.9	12.1	11.8
South Asia	14.0	31.4	13.2
Sub-Saharan Africa	8.4	13.8	7.6
B. Overall trade restrictiveness			
High-Income Countries	7.0	43.1	4.3
East Asia and Pacific	11.3	28.6	10.4
Europe and Central Asia	10.1	25.9	9.0
Latin America and the Caribbean	15.0	28.1	13.8
Middle East and North Africa	21.6	32.3	19.4
South Asia	19.5	46.4	18.2
Sub-Saharan Africa	14.4	24.9	12.9

Source: World Bank (2008), Tables 4.1 and 4.2

Agriculture remained the sector subject to both the highest level of tariff protection and, in particular, non-tariff protection in industrial countries –and this was also true of the developing world (Table 2). In the case of agriculture, and despite the 36% reduction in tariffs agreed to in the Uruguay Round, many tariffs remained high – even prohibitively so – in areas of interest of developing countries, beyond certain moderate level of access. Indeed, conscious that the so-called “tariffication” of non-tariff restrictions would lead to high levels of tariffs for several products, the Uruguay Round agreement on agriculture set minimum market access commitments. But, as already pointed out, this made the trade restriction effectively a quota.

The agreement divided subsidies in three categories. The first, which are classified under the so-called Amber Box, includes subsidies that are clearly trade distorting, as they generate incentives to produce specific commodities or subsidize the use of certain inputs. The second, classified under the *Blue Box*, includes direct payments under production-limiting programs, which include the “compensation payments” of the EU and the “deficiency payments” of the US. The third are the very long list of *Green Box* subsidies, which have to meet the criteria that “*have no, or at most minimal, trade-distorting effects or effects on production*”.² Only *Amber Box* subsidies are subject to reduction commitments.

The Agreement left therefore huge loopholes in the form of subsidies that are not subject to reduction commitments: the *Green* and *Blue boxes* as well as *de minimis* support for otherwise *Amber Box* subsidies³. This has allowed industrial countries to redistribute their support to agriculture, while actually increasing the amount of support in dollar terms in relation to the reference period in dollar terms (less so when valued in

2 They include general services (research, extension, pest/disease control, infrastructure and marketing services); public stockholding for food security and food aid; direct payment to producers and incomes support that are decoupled from production; government financial participation in income insurance and income safety net programs, crop insurance and relief from natural disasters; and structural adjustment programs.

3 The *de minimis* provision applies for subsidies that represent less than 5% of the value of production of the specific commodity involved (10% in the case of developing countries)

euros). This is reflected in Table 3, which summarizes the evolution of agricultural subsidies according to the OECD (2008) data. Whereas support based on commodity output (*Amber Box*) has declined, *Blue Box* (included as part of OECD estimates of product support) as well as *Green Box* subsidies have increased. Interestingly, whereas transfers from consumers have declined, as domestic prices paid to producers have gradually approached international prices, fiscal transfers have sharply increased. Furthermore, although as a proportion of farm gate income support has declined relative to the peak levels of the reference years, they have declined only minimally with respect to the levels of the late 1980s.

Table 3: OECD: Support to agriculture (US\$million)

OECE: Estimates							
	1986-88	1989-91	1991-94	1995-97	1998-00	2001-03	2004-06
Producer Support Estimate (PSE)	241,932	249,390	268,866	254,510	257,435	238,555	280,247
General Services Support Estimate (GSSE)	39,484	53,658	62,650	64,032	55,580	56,761	66,624
Total transfers to producers	281,416	303,049	331,515	318,542	313,014	295,316	346,871
Net transfers to consumers	17,258	19,617	25,343	28,169	25,938	27,555	33,903
Total Support Estimate (TSE)	298,674	322,666	356,858	346,712	338,952	322,871	380,774
Transfers from consumers	194,882	193,724	214,244	196,588	192,240	162,106	171,477
Transfers from taxpayers	129,856	156,365	178,977	180,439	172,540	182,959	230,651
Budget revenues	-22,272	-23,293	-33,352	-30,315	-25,829	-22,194	-21,354
Percentage PSE 2/	37.5%	32.8%	34.2%	29.9%	33.6%	30.6%	28.9%
TSE as % of value of production at farm gate	41.0%	35.6%	37.5%	33.2%	38.1%	34.9%	33.2%
TSE+GSSE as % of value of production at farm gate	47.7%	43.2%	46.2%	41.5%	46.3%	43.2%	41.1%

PSE: Producer Support Estimate. NPC: Nominal Protection Coefficient
 1/A (Area planted), An (animal numbers), R (receipts), I (income)
 2/Producer support as proportion of total income (market income plus producer support)

Source: OECD, PSE/CSE database

These conclusions are confirmed by alternative World Bank data, which indicates that subsidies have not only increased but have actually remained higher in relation to the value of production to the levels that were characteristic up to the mid-1980s (World Bank, 2008, Figure 4.3 and Table 4.4). In some cases, the redistribution has actually violated even the generous WTO rules. Thus, in a dispute settlement case on cotton, it was found that the US had been wrongly shielding some trade-distorting subsidies within the Green Box, and was asked to change its policies accordingly.

The debate that has taken place since the Uruguay Round indicates that the division between trade and non-trade distorting subsidies is artificial. Blue Box subsidies are now clearly recognized as trade distorting. As a result, they have been included in possible reduction commitments, together with Amber Box subsidies in proposals that are on the table as part of Doha Round discussions. But Green Box subsidies can also generate trade distortions. So, as the World Bank (2007, pp. 97-98) has argued, even decoupled payments can influence production by making farmers less averse to risk or reducing the variability of farm income and thus making banks more willing to lend to farmers. This is true if farmers are potentially credit constrained: in this case, reducing the

risk they face through income and crop insurance will allow them to access finance and expand production (Stiglitz and Charlton, 2005, p. 124). By allowing farmers to obtain parts of their income from different sources, even decoupled income support allow them to remain in business, which otherwise they might not. Furthermore, to the extent that farmers are located in areas with specific natural resources, the incentives to produce in these areas will necessarily have some commodity biases, and thus trade-distorting effects.

In the area of services, the General Agreement on Trade in Services (GATS) has a number of development flexibilities built into its provisions. In the present GATS architecture, a developing country can decide whether to enter any service sector in its schedules of commitments. Thus, sectors can be excluded. And if a sector is included in the schedule, the country can decide the extent of liberalization to commit in that sector, in each of the four modes of service delivery, including restrictions and limits on foreign equity ownership in Mode 3 on “commercial presence.”

Experience indicates that developing countries and, particularly, least developed countries have used the flexibility that GATS offers, and have made fewer commitments than industrial countries, but this is not true of acceding developing countries, which have had to accept substantial commitments in this area. Most liberalization has taken place in modes 1 (cross-border supply) and 2 (consumption abroad); in contrast, liberalization has been more limited under mode 3 (commercial presence) and, particularly, 4 (movement of natural persons) (Marchetti, (2004); World Bank, (2005), pp. 136-8).

A look at the WTO data base on service commitments indicates that out of 55 sectors, a majority of member countries participate only in eight: hotels and restaurants, travel agencies and tour operators, professional services, computer and related services, other business services, telecommunications, insurance and banking. Developing countries have gained as exporters from those associated with tourism and business services that have facilitated offshore supply of certain tasks, whereas liberalization in telecommunications and finance, as well as other forms of business services are mainly in the interest of industrial countries.

The major discussion in this area relates to Mode 4, where commitments have been minimal, and have been made largely to facilitate intra-corporate transfers and mobility of executives, managers and specialists (Marchetti, 2004, Chart 5). The opportunities for developing countries under Mode 4 are potentially very broad, and are closely interconnected with the benefits from partial liberalization of temporary migration, or migration in general. Indeed, according to general equilibrium estimates, the benefits in this area largely exceed those associated with the liberalization of trade in goods. Thus, for example, additional temporary access to foreign service providers equal to just 3% of the OECD labor force, would generate gains that exceed \$150 billion (Brown et al., (2002); World Bank, (2004), ch. 10; Stiglitz and Charlton, (2005), Appendix 1).

Another set of imbalances faced by developing countries are associated with implementing their own obligations under WTO. One of the most important issues is the constraints imposed on their policy space to implement development-oriented measures such as promotion of local industries or adoption of new technologies. There is a major concern in this regard that the Non-Agricultural Market Access (NAMA) negotiations is likely to exacerbate the de-industrialization that has already taken place because of rapid liberalization⁴. It must be recalled in this regard that today's developed countries made use of high tariffs to protect their industries during their industrialization phase, and successful East Asian economies of Taiwan, South Korea and Japan resorted to tariff measures to pursue their industrial development (Akyüz, (2005)).

⁴ See in this regard Buffie (2001) and Khor and Yen (2006).

As already pointed out, the subsidies that were more commonly used by developing countries (for export diversification) came under actionable disciplines, and thus potentially subject to countervailing duties. In turn, the TRIMS Agreement prohibited developing countries from making use of local-content policy (which developing countries had used to increase the use of local materials and improve linkages to the local economy) and some aspects of foreign exchange balancing (export targets aimed at correcting balance-of-payments problems).

The Agreement on Trade Related Intellectual Property Rights (TRIPS) for the first time set minimal standards for the whole range of intellectual property. Developing countries, which had previously enjoyed the ability to set their own IPR policies, are now constrained by having to adhere to IPR standards that are high compared not only to what they previously had, but also what the developed countries had when they were at their initial stages of industrialization. Prior to the TRIPS agreement, several developing countries had exempted pharmaceutical drugs and food from patentability, and had an active policy of promoting generic medicines. However, this policy of exemption can no longer be maintained, as the agreement prohibits exemptions on the basis of sectors. The implementation of the TRIPS agreement has therefore increased the costs for local firms in developing countries to access technology.

Furthermore, in contrast to the strict protection of the rights of the innovator, there is no comparable protection of the rights of countries over their natural resources or traditional communities over their ancestral knowledge. The first of these issues have been posed as the relationship between TRIPS and the Convention on Biological Diversity

Finally, it must be added that many developing countries have found several problems of implementation of the WTO agreements (both by developed countries and their own obligations), including the fact that the SDT provisions in various agreements were non-operational and non-binding in nature, and were thus of little practical use. Although these issues have been in the WTO agenda in recent years, the associated negotiations have been characterized by missed deadlines and very limited progress in terms of concrete, substantive outcomes.⁵

The Proliferation of Free Trade Agreements

The greatest challenge to the multilateral trading system has come over the past two decades not through the complex negotiations taking place in WTO but through the proliferation of free trade agreements. This process has ended up eroding more than anything the two fundamental principles of the WTO: the general principle of non-discrimination and its major exception, special and differential treatment.

GATT and now the WTO allow two exceptions to the MFN principle (there was actually a third, preexisting colonial preferences, which is now in the process of being dismantled). The first exception is in Article XXIV, which was created to allow for the formation of customs unions and the subscription of free trade agreements. The exception had two major conditions: that the agreement should involve “substantially all trade” (or, in the case of the parallel provision of Article V of GATS, that it should have “substantial sector coverage”), and that it should not increase trade barriers for other WTO contracting parties.

⁵ A good account of the progress (or lack of it) in the negotiations on special and differential treatment and other “development issues” in the Doha Work Programme is Onguglo (2005).

The second exception was non-reciprocity associated to special and preferential treatment (SDT) for developing countries, when it was accepted as an essential principle of GATT in the 1960s and the 1979 “Enabling Clause”. As in Article XXIV, the exception was made on the basis that these preferences should not increase protection vis-à-vis third parties. The Enabling Clause also allowed for mutual trade liberalization among developing countries without the proviso of Article XXIV that it should involve “substantially all trade”, and could thus involve partial scope agreements.

Interestingly, aside from this specific provision for customs unions or free trade agreements among developing countries included in the Enabling Clause, there was never any attempt to design specific rules for non-reciprocal trade agreements between industrial and developing countries. The major ones were the former colonial preferences, which were also originally accepted as an exception to the MFN principle in Article I of GATT –and thus as a third exception to the general rule. These preferences were harmonized and consolidated by the European Economic Community in the 1972 Lomé Convention. The major reason why there was no attempt to design general rules for preferential trade agreements between industrial and developing countries was that preferences agreed to in the context of SDT were supposed to be, in principle, general preferences for developing countries, as the name of GSP (Generalized System of Preferences) implied, which now are understood to include general preferences vis-à-vis least developed countries. A 2003 Appellate Panel ruling determined, however, that there could be discrimination among different beneficiaries of GSP program, so long as a program for a specific group of beneficiaries was available to all developing countries in similar conditions (Hoekman and Mavroidis, (2007), ch. 6).⁶

Table 4: Active Customs Unions and Free Trade Agreements Announced to GATT/WTO

	pre-1990	1990s	2000s	Early announc	Total	Enabling Clause
Europe	5	5	9		19	
Europe-extraregional	2	7	21	8	36	
Ex-USSR		7	21		28	
North America-centered	1	3	10	9	23	
Intra-LAC	4	1	10		15	3
LA-Asia			8	1	9	1
East Asia and Pacific-centered	5	2	24	12	43	10
South Asia			3		3	3
Western Asia	1				1	1
Turkey-centered			11		11	1
Africa	5	2			7	5
Interegional developing	3	1			4	3
Total	26	28	117	30	201	
Using Enabling Clause	12	7	8			27

Source: Authors' estimates based on WTO database. Excludes accessions, enlargements and extension of agreements into new areas (generally services). In the case of Europe, includes agreements with Faroe Islands.

⁶ The ruling related to special benefits given to Pakistan as part of special program for developing countries involved in combating drug production and trafficking. The decision of the Appellate Body implied that it was consistent with WTO rules if similar trade preferences were given to other developing countries that were combating drug trafficking. It overruled the panel decision that GSP had to be made available to all developing countries without differentiation.

The history of customs unions and free trade agreements notified to GATT / WTO is summarized in Table 4. Most of the exceptions prior to 1990 were integration processes involving several member countries, both in Europe (the European Economic Community and the European Free Trade Association, and agreements between members of these two arrangements) and among developing countries; a slightly later vintage of this type of agreements was the 1983 Australia - New Zealand Closer Economic Agreement. In the developing world, the most active regions were Latin America and the Caribbean, and Africa, but there were also some agreements in the Middle East (the Gulf Cooperation Council), East Asia (ASEAN) and the Pacific. They also include the 1971 Protocol on Trade Negotiations among Developing Countries and the 1988 Global System of Trade Preferences among Developing Countries (GSTP). Most agreements among developing countries were covered by the Enabling Clause and were partial in scope. Also, with the exception of the broader frameworks of negotiations among developing countries, the agreements were essentially regional in character.

These initial exceptions made sense from the point of view of the emerging trade order and thus as exceptions to the general MFN principle, as they involved “deep integration” processes, in which a region became the unit of trade that negotiated with the rest of the world (with the EU being the most remarkable example), and the promotion of South-South trade through the “Enabling Clause”. However, the agreements that came later ended up significantly eroding – or even destroying – the two fundamental principles of such a multilateral order. The new trend had some precedents in the 1980s (such as the 1985 United States Israel Free Trade Area and the 1988 Canada - United States Free Trade Agreement, which was superseded by the 1993 NAFTA) but took off in the 1990s and led to a veritable proliferation of free trade agreements over the past decade. As Table 4 indicates, of the 2001 agreements notified or announced by April 2009 (eliminating double counting⁷), three-fourths were signed in the 2000s. They generally include goods and services, and are thus covered by Articles XXIV of GATT and V of GATS, but also intellectual property provisions and the “Singapore issues” as well as labor and environmental standards. The enabling clause continues to be also a framework for some deals among developing countries, particularly those of partial scope.

These agreements came in waves and increasingly went beyond their regional character to cover interregional agreements. This is a reason why the concept of “regional trade agreements” (RTAs) and “regionalism” commonly used to refer to them is increasingly inappropriate. The term “preferential trade agreements” (PTAs) is also inappropriate, as it does not differentiate those preferences that are associated with Article XXIV and those that derive from SDT.

The major clusters that are identified in Table 4 indicate that the largest number of these agreements center in Europe and increasingly involve deals between the EU or EFTA and extra-regional partners. The Americas are also very active early on, both the United States and Canada as well as some Latin American countries – Chile and Mexico, in particular – and in all cases involve an increasing number of interregional agreements. To this we must add the agreements among Latin American countries that are done in the context of the Latin American Integration Association (LAIA), which is in fact a flexible framework for partial or full scope agreements among its members. The former members of the USSR also became active in the late 1990s, essentially replacing the old trade arrangements of the Soviet era with free trade agreements among themselves, with Ukraine being the most active country and involved in FTAs with other regions (such as countries that made up former Yugoslavia).

⁷ The number of agreements is actually larger, 228 excluding accessions, but there is some double counting associated with the expansion of existing agreements which were already notified.

In the 2000s, the East Asian region became the most dynamic region in the subscription of FTAs, again led by a few countries, particularly Singapore and, increasingly, Japan. Turkey also became an active member of the FTA club over the past decade. Outside Latin America and East Asia, other developing country regions were much less active, particularly South and Western Asia (with the exception of Turkey). In Africa, the old integration agreements of the 1960s, 1970s and early 1980s remained the essential frameworks for intraregional trade. Some of these countries have also been involved in negotiating Economic Partnership Agreements (EPAs) with the EU, with great reluctance in several cases.

Viewed as a whole, the process has been uneven across the world. The EU, EFTA, three industrial countries (Canada, Japan and the US), four developing countries (Chile, Mexico, Turkey and Singapore) and a transition economy (Ukraine) have been most active in these negotiations. The unevenness of the process is also true within some regions. In Latin America, for example, the activism of Chile and Mexico is in sharp contrast with the reluctance of Argentina and Brazil to enter into this race.

The consequence of this trend for the MFN principle was ably summarized in the report on the "Future of WTO" led by Peter Sutherland: *"MFN is no longer the rule; it is almost the exception (. . .) Certainly the term might now be better defined as LFN, Least-Favoured-Nation Treatment"* (WTO, (2004), p. 19). The "spaghetti" or "noodle" bowl of rules that this implies is extremely problematic, not only in relation to tariffs but also non-tariff rules and, particularly, rules of origin. Indeed, managing the complexity of rules has become an additional trade restriction. Even if, on balance, trade creation rather than trade diversion has prevailed, the basic idea that was embedded in the reconstruction of a multilateral trading system in the post-war years is now essentially moribund. We are essentially back to the complexity of bilateral rules that characterized the 1930s, curiously for the opposite reason: competitive liberalization rather than competitive protectionism. The attempt to be ahead of others to access markets – which can be properly called "beggar-thy-neighbor" liberalization – may in the end be largely futile if others follow in the competitive race and sign FTAs to avoid being displaced from those markets. Curiously enough, the major way to block this process, by not accepting their compatibility with multilateralism through a rejection of these agreements in WTO, has been totally dysfunctional, as there is an implicit agreement not to step on each other's toes.

What makes things worse is the fact that the very uneven negotiating power between developed and developing countries in these deals has brought into the agreements the non-trade issues that developing countries have refused to negotiate in WTO⁸. As Bhagwati ((2008), pp. 70-71) has concluded: *"Because of the spaghetti bowl, and because hegemonic powers use PTAs to impose a host of expensive trade-unrelated demands on the poor country partners in PTS, that reflect lobbying demands in the hegemon, PTAs are a particularly unattractive trade option for the poor countries relative to multilateralism"*.⁹

Equally problematic is the fact that these agreements have also dealt a hard, even a death blow to SDT. The reason is that, although the agreements may include some provisions that allow a more gradual liberalization of trade or broader exceptions for rules for developing countries, the double condition of liberalization of "substantially all trade" ("substantial sector coverage" in services) and reciprocity imply that only very weak forms of SDT can be incorporated into the agreements. Given the greater fiscal capacity that industrial countries have to use the subsidy schemes that are allowed by these arrangements, SDT may actually be turned upside down, with the special treatment enjoyed by the developed and not developing

⁸ See Khor (2008) for a critique of North-South FTAs, especially the implications of the non-trade issues in these FTAs.

⁹ See a broader analysis of this issue in Bhagwati (1991 and 2008). See also WTO (2004, p. 23, paragraph 87).

countries. Particularly, in the area of agriculture, developing countries may end up competing with subsidized goods from industrial countries, without having the possibility of protecting their own local goods. Similarly, under the FTAs, the developing countries' higher technology infant industries are given no protection and must compete with the science and technology subsidies of industrial countries.

Furthermore, the excessive expansion of these agreements into non-trade areas constrains the policy space that developing countries have to a much larger extent than WTO rules do. The ongoing debates on the EPAs of developing countries with the EU reflect this fact, as the debate on FTAs of the US with Latin American has done for several years. In fact, the experiences of the FTA that has been applied for a longer time period, NAFTA, indicates that it helps to generate foreign investment and export growth, but it does not necessarily help accelerate economic growth (see, for example, the analysis on Mexico by UNCTAD, (2007)).

The new rules represent also a challenge for the promotion of South – South trade, as envisioned in the Enabling Clause which permits developing countries to promote such trade by given each other preferences that are not extended to industrial countries. Indeed, to the extent that FTAs include a MFN clause among contracting parties, South – South agreements signed by any of its developing country parties of the FTA would have to be extended to the industrial country partners of the FTA. So, for example, given the rules of the EPA signed between the EU and the Caribbean countries, preferences extended by Brazil to the Caribbean countries would be automatically extended to the EU. This fact by itself reduces the room for South – South trade negotiations.

Crucial in this regard is, of course, the fact that **the negotiating capacity that developing countries have in WTO**, and which has been more actively used in recent years, is entirely lost in the wave of FTAs. Indeed, industrial countries have forced into these agreements issues and provisions that developing countries have refused to negotiate in WTO.

WTO Governance Structures

1. Surveillance and Dispute Settlement

Among the novelties of WTO was the establishment of a surveillance instrument and an improved dispute settlement mechanism. The first of these, the Trade Policy Review, was adopted during the Uruguay Round negotiations and began to function before the negotiations ended. It involves both a document prepared by the WTO Secretariat, reviewing developments and the state of trade policy of a country, and a document prepared by the country itself. They are presented to the Trade Policy Review Body for peer review deliberations. The four largest trading members – the EU, the US, Japan and China – are reviewed every two years, the next 16 every four years, and the rest of the members every six years or more.

The WTO's dispute settlement mechanism is a strengthened version of the one previously used in GATT. Although this mechanism had a well established record of acceptance of its decisions by member countries, it had three troublesome features: the lack of a clear timetable, the possibility that the country against which complaints had been levied could block the naming of the panel, and the consensus rule to adopt its decisions, which make them contingent on acceptance by the said country. The new mechanism established a more rigorous process, which involves, sequentially and with a strict timetable

1. a phase of consultations;
2. if it failed to lead to agreement, the convening of a panel;

3. an eventual appeal to an Appellate Body; and
4. adoption of corrective measures by the party that incurred in violations of commitments. As the decisions of the panel and the Appellate Body can only be rejected by consensus, they are in practice binding. If corrective measures are not adopted, the affected party (or parties) can adopt retaliatory measures.

This is the most elaborate and rigorous enforcement mechanism of its kind in global economic governance. Its record has generated a broad consensus regarding its efficiency and effectiveness, though also the need to make improvements in certain areas¹⁰.

More than half of the disputes are settled during consultations and few decisions of panels of the Appellate Body have not been complied with and thus led to countermeasures. The positive view of early evaluations of the Uruguay Round that the dispute settlement mechanism is an advance over the GATT instrument in terms of effectiveness has therefore been confirmed in practice.

Table 5 summarizes the history of the utilization of this mechanism. It was more actively used in the second half of the 1990s and early 2000s, and less so during the recent years of booming world trade. About two-fifths of the cases have been complaints among developed countries. However, the WTO mechanism has been more actively used by developing countries than the previous GATT one, although much more by middle-income rather than low-income countries. Also, given the additional commitments undertaken by developing countries, they also became subject to complaints by other WTO members. About one-fifth of the cases have been complaints of developing countries against developed countries, and a fairly similar amount has been complaints by developed against developing countries. A slightly smaller number have been disputes among developing countries.

Table 5: Dispute-Settlement Cases

Complaints							
against by	Developed			Developing			Total
	Developed	Developing	Mixed	Developed	Developing	Mixed	
1995	13	7	1	1	3	0	25
1996	15	4	2	12	4	2	39
1997	25	7	0	17	1	0	50
1998	21	5	0	12	3	0	41
1999	18	0	1	6	5	0	30
2000	8	5	1	10	10	0	34
2001	4	5	1	0	13	0	23
2002	17	13	0	2	5	0	37
2003	8	8	0	3	7	0	26
2004	11	3	0	3	2	0	19
2005	2	3	0	3	4	0	12
2006	6	5	0	5	4	0	20
2007	3	4	0	4	2	0	13
2008	3	7	0	6	3	0	19
Total	154	76	6	84	66	2	388
	39.7%	19.6%	1.5%	21.6%	17.0%	0.5%	100.0%

Source: WTO, Dispute Settlement Database

¹⁰ See, for example, Hoekman and Kostecki (2001), ch. 3; Das (2003), pp. 61-64, 96-104 and 226-8; Srinivasan (2007) and the Sutherland Report, published as WTO (2004), ch. VI.



A closer look at the nearly 400 cases dealt with in 1995-2008 indicates that slightly less than half relate to market access issues in the area of goods, with agricultural issues (including fishing) being by far the most common. Several of the disputes in this area involved domestic taxation rules that are seen by the demanding party as being inconsistent with national treatment of imported goods. The second set of complaints – slightly less than a third through the history of the mechanism – relate to antidumping provisions, countervailing duties and safeguards. More interestingly perhaps, the relative importance of disputes in the three areas of contingency protection has increased through time. Export and production subsidies come a distant third. The fear that TRIPS could lead to many disputes has not been confirmed.

TRIMS generated a small number of disputes in the 1990s but not in the 2000s, whereas a few disputes in the area of services and government procurement (among countries who are signatories of the associated plurilateral agreement) complete the inventory of controversies.

One of the most common criticisms of the mechanism is the fact that the retaliatory measures of last resort generate a significant asymmetry between developed and developing countries – particularly the weakest among the latter – as the costs of measures that they can adopt are unlikely to affect much the developed countries that violated WTO rules. In recent negotiations, there have therefore been proposals by developing countries to introduce monetary compensation of damages or to allow the possibility of tradable remedies or collective action against violators of the rules.

The costs of using the system are also high, potentially limiting the use of the mechanism by poor and small countries. To reduce the costs of using the mechanism, 29 countries agreed in Seattle to create an Advisory Centre on WTO Law, an independent legal aid intergovernmental organization separate from WTO, which started to operate in 2001. This organization provides subsidized legal assistance to developing countries during dispute settlement proceedings, as well as other legal services and training.

Equally important are the issues that relate to conflicts regarding the areas of competence of institutions of the WTO. In this regard, there have been complaints that some jurisprudence of the Appellate Body may have intruded into areas that belong to the mandate or competence of some of the political bodies of the WTO, and that in such cases the former should refrain from doing so, and instead allow the political bodies be in charge of the issues involved. Equally important, and again to avoid a collision of competences, there have been proposals to guarantee a total separation of the Appellate Body from the WTO Secretariat.¹¹

2. WTO Decision-Making

The WTO was designed as an institution in which all members are formally equal in terms of decision-making rights. This contrasts favorably with the system in the International Monetary Fund and the World Bank, in which the voting rights of members are based on the allocation of quotas, which are skewed in favor of the developed countries.

This is also reflected in the naming of the Director General. Whereas the process of election of the heads of both IMF and the World Bank lacks transparency and has always led to the election of an European and a

¹¹ See, on both issues, Das (2003).

US citizen, respectively, WTO has a more open and competitive system in which a citizen from any of the member countries can participate and be elected.

In reality, some developing countries have been unable to realize their participation rights because they do not even have a Mission or a representative in Geneva and are thus unable to take part in the meetings. Moreover, many Missions of developing countries in Geneva are understaffed and thus have been unable to adequately follow the discussions and negotiations. Even if they are present, many officials from developing countries are unable to adequately keep up with the often complex negotiating issues involved and thus are unable to make the impact they may want to. Unequal capacity thus leads to unequal degrees of participation

This problem is made more acute by the relative lack of transparency in some key aspects of WTO operations. The main reason for this is its working methods and system of decision making. In terms of formal arrangements, decisions are made on the basis of “one country, one vote” and by consensus, which implies that any member has, in principle, the right to block any decision.

In practice, however, GATT and the WTO have been dominated by a few major industrial countries. Often, these countries negotiate and decide among themselves, and embark on an exercise of winning over a selected number of more important or influential developing countries, in “informal meetings”. Most WTO members may not be invited to these informal meetings and may not even know that they take place, or what happens there. When agreement is reached among a relatively small group, the decisions are rather easier to pass through. The meeting of a limited number of countries to work out an agreement among themselves is referred to in WTO jargon as the “Green Room” process.

In the GATT and in the first decade of the WTO, the most powerful members by far were the so-called “Quad” (comprising the US, EU, Japan and Canada), which had the practice of formulating a common position among themselves, and then seeking to influence more and more countries around that position, until a “consensus” is said to have been formed. The informal “Quad-led system” operated until a few years ago, when it was realized that this old way of getting business done could not work anymore, because of the emergence of developing countries, which could not be “rolled over” in the same way as before. In 2004, a new informal “Group of 6” emerged in the agriculture negotiations, comprising the US, EU, Japan, Australia, Brazil and India. Members of this group negotiated among themselves during a mini-Ministerial meeting in July 2004, and again at Ministerial level at various stages of the Doha negotiations in 2006 to 2008, while at the mini-Ministerial meeting in July 2008, China was included in this small-group negotiation.

The inclusion of Brazil, India and now China in this small-group configuration has widened the role of developing countries in the “core” of the informal circle of decision-making, with this “core” functioning at critical moments. However, the reality remains that for the majority of developing countries, participation in real decision-making remains out of reach. The developing countries in this innermost circle have also made it clear that they do not “represent” the developing countries (nor have they been mandated to do so) inside the Group of 6, and only carry their own views.

A positive trend in recent years is the formation of various groupings of developing countries which have been actively participating in the debates and negotiations. They include the G20, G33, Africa Group, LDC group and ACP group, the group of “small and vulnerable economies” and the

group of four African cotton producers. The participation of these groups in WTO negotiations has built up gradually through the years. Nevertheless, as described above, the real fulcrum of decision-making power lies not in the democratic and equal exercise of the groupings, but in the small grouping of six or seven countries which have undertaken the “real negotiations” at critical moments in the past few years.

What this implies is that, although there is “formal democracy” at the WTO, with each country having an equal say, and with decisions taken by consensus, in fact it operates as an “informal oligarchy”, to borrow Evan’s appropriate characterization (Evans, (2003)). In this system, representatives of many of developing country groupings have been invited to some of the Green Room meetings. However, it is still a smaller grouping, or groupings, that make the key decisions. The meetings of this small groupm) have recently been convened by the Director General of the WTO. However there are no formal announcements that the meetings would be held, nor formal reports or minutes of the meetings. Neither are there reports or minutes of the meetings of the mini-Ministerial meetings, nor of the “Green Room meetings” held during the formal Ministerial conferences.

There are divergent views on whether and how to reform the decision-making system in the WTO, which is widely perceived to be non-transparent and non-inclusive. Those who advocate the retention of the status quo may even agree that the system is exclusionary but claim that for the sake of “efficiency” in coming up with an outcome, the decision-making system has to be confined to a relatively few delegations, while the other members not in the inner circle can also make their views heard through their representatives in the “Green Room.” On the other hand, those who are critical of the non-transparent and non-participatory nature of decision-making argue that the exclusionary system and the manipulations that often characterize the operations of meetings and production of drafts do not guarantee that an outcome will be obtained, as seen by the conferences and mini-Ministerials ending more times in failure and collapses than in success. And even in the case of one of the few “successes”, the Doha Conference of 2001, the decisions concerning some of the most controversial elements could not be sustained and were overthrown by another decision subsequently.

A good critical account of the problems of this system is given in a Memorandum on the need to improve internal transparency and participation in the WTO that was issued by several NGOs that are involved in WTO related issues.¹² Among the practices at the Ministerial conferences that it documents are the misuse of the opening ceremony for obtaining approvals for important substantive decisions, the undemocratic adoption of the Draft Declaration as the basis for conference negotiations, the undemocratic selection of chairpersons or so-called “friends of the chair” to conduct negotiations on key issues, the holding of “informal”, undocumented and exclusive meetings that undermine transparency and participation, the sidelining of views of many members that are not reflected in the negotiating texts, and the fact that operation of the “Green Room” process excludes many members from meetings and decision-making.

This indicates that it is essential to make the system more open, democratic and inclusive. This implies, foremost, that that the consensus system should be applied in a manner that fully respects the views of developing country members. WTO practice indicates that this implies that there should be agreed procedures for smaller, issue-based meetings, with authorization coming from all members and the meetings being governed by transparent rules. It also implies that there should be agreed terms of

¹² See TWN et al (2003) for the memorandum that documents the manifold problems and provides proposals for reforming the decision-making system.

reference for the roles of chairs of formal and informal groups, as well as agreed procedures for drafting of texts, which should fairly reflect the divergence of views, if any, among members. During Ministerial conferences, the Opening Ceremony should not adopt decisions on business matters, and members (not the conference chairman) should appoint the chairs and facilitators to conduct discussions and determine their role and terms of reference. If “Green Room” or “mini-Ministerials” are to be held to speed up negotiations, they should be called by members, who should also determine the system of representation. All meetings should be inclusive and transparent, minutes should be kept and subject to members’ approval. Finally, the neutrality and impartiality of the Secretariat should be observed at all times, and particularly during Ministerials.

Concluding Remarks

The multilateral trading system is in an inadequate condition and several critics describe it as being in a major crisis. To its credit, it has established a stable legal framework that accompanied a substantial growth of international trade and a significant though very uneven diversification of exports in the developing countries. Despite the formal democratic character of WTO, its decision making process is full of flaws. Although developing countries have been unable to use the negotiating power they have to block unfavorable deals, the call for a “Development Round” is perhaps the most clear recognition that the interests of developing countries have not been successfully advanced in the multilateral trading system. Despite their many attempts to correct the inadequacies of the system, there has been only very limited advance on the issues of agriculture, tariff peaks and tariff escalation that developing countries have put on the table since the 1960s, or on more recent issues, such as the Mode 4 liberalization in services. The Uruguay Round added an additional series of imbalances, including the inclusion in the WTO of a non-trade issue, intellectual property rights, and there have been additional pressures since then to include further non-trade issues. The Doha Round was born as an uneasy North-South compromise to rebalance the world trading system, but as the negotiations developed it has become almost a pure market-access Round, with no clear end in sight.

It is thus time to undertake a fundamental review of the international trading order that has emerged in recent decades and to re-think what a better order would be like in the future. A major part of such a review would have to include a deep consideration of what has happened to the two basic principles that were formulated in the post-war period: non-discrimination (and, particularly, the Most-Favored Nation) and Special and Differential Treatment, two principles for which the bells are now tolling. The second principle is, of course, an exception to the first, but it recognizes that the world economy is still a highly unlevel playing field, and that equal rules for unequal players and circumstances will worsen inequalities.

Thus the present impasse in the Doha Round should provide the opportunity for initiating reforms to the international trade architecture. Such a reform should include the following:

- 1. Standstill on FTAs until clear rules can be agreed on how to reestablish the primacy of global over bilateral or plurilateral rules.**
- 2. A standstill on the introduction of new non-trade issues and a review of whether it is appropriate for existing non-trade issues (especially intellectual property) to be included in the mandate and legal framework of WTO.**
- 3. Review the rules in agriculture to ensure that there will be really substantial reduction or elimination**

of domestic support in developed countries, and not merely a shifting between types of subsidies, and ensure the promotion of developing countries' food security and farmers' livelihoods through an effective special safeguard mechanism.

4. Align the trade rules to the production development needs of developing countries by ensuring sufficient policy space for the growth of existing and new industries. Consideration of what types of development policies are essential to build production (or supply) capacities in the development world, and what international transfers of resources and technology are essential to support, in particular, the development of such capacities in least developed countries.
5. A proper process to consider the "implementation issues" and the proposals to strengthen SDT provisions, as well as to establish a "SDT architecture" as envisaged in the Doha Declaration.
6. Measures and institutional mechanisms to address the commodity issues, including instability of commodity prices, fluctuations in demand, processing and diversification.
7. Advance in Mode 4 of service liberalization, where very limited advance has been made.
8. Design of rules that guarantee the transparency and representativeness of WTO decision making.

Another major aspect of reconsidering the international trade architecture is the allocation of roles and mandates to different organizations. As pointed out in the introduction, it is a mistake to identify the WTO as the multilateral trading system. There are aspects of trade that the WTO's rules do not cover and that the WTO is not equipped to deal with, such as boosting the production capacity of developing countries so that they can engage better in trade, or addressing the wide range of commodity issues. The roles of other organizations should be remembered and strengthened as part of the reform process. For example, the commodities issue is best dealt with by UNCTAD, and intellectual property issues by WIPO, CBD and FAO, while improving the production capacity of developing countries is an issue that is addressed by many departments and agencies of the United Nations, and should again be brought at the center of the activities of multilateral development banks.

References

- Agosin Manuel R., Tussie Diana and Crespi Gustavo (1995)** *"Developing Countries and the Uruguay Round: An Evaluation and Issues for the Future"*, International Monetary and Financial Issues for the 1990s, New York: United Nations. Volume VI, pp. 1-34
- Akyüz Yilmaz (2005)** *"The WTO Negotiations on Industrial Tariffs: What is At Stake for Developing Countries"*, Third World Network, Penang
- Bhagwati Jagdish (2008)** *"Termites in the Trading System: How Preferential Agreements Undermine Free Trade"*, Oxford: Oxford University Press.
- Brown Drusilla K., Deardorff Alan V. and Stern Robert M.,(2002)** *"Computational Analysis of Multilateral Trade Liberalization in the Uruguay Round and the Doha Development Round"*, Discussion Paper 489, Research Seminar in International Economics, School of Public Policy, University of Michigan, December
- Buffie Edward, (2001)** *"Trade Policy in Developing Countries"*, Cambridge: Cambridge University Press.
- Das Bhagirath Lal.** *"The WTO and the Multilateral Trading System: Past, Present and Future"*, London, Zed Books and Penang: Third World Network
- Evans Peter, (2003)** *"Economic Governance Institutions in a Global Political Economy: Implications for Developing Countries"*, in John Toye (ed.), Trade and Development: Directions for the 21st Century, Cheltenham: Edward Elgar, ch. 13, pp. 288-307.

- M Hoekman Bernard, and M. Kostecki Michel, (2001) and Mavroidis Petros C., (2007)** *The Political Economy of the World Trading System: The WTO and Beyond*, Second Edition. New York: Oxford University Press.
The World Trade Organization: Law, Economics, and Politics. New York: Routledge.
- Karensky Guy and Laird Sam (1987)** "The Generalized System of Preferences: A Quantitative Assessment of the Direct Trade Effects and of Policy Options", UNCTAD *Discussion Paper* No. 18, Geneva: UNCTAD.
- Khor Martin (2008) and Goh Chien Yen, (2006)** *Bilateral and Regional Free Trade Agreements: Some Critical Elements and Development Implications*. Penang: Third World Network.
The WTO Negotiations on Non-Agricultural Market Access: A Development Perspective. Third World Network, Penang.
- Laird Sam, (2002)** "Market Access Issues and the WTO: An Overview", in Bernard Hoekman, Aaditya Matoo and Philip English (eds.), *Development, Trade and the WTO: A Handbook*. Washington D.C.: World Bank, chapter 11, pp. 97-104.
- Marchetti Juan A., (2004)** "Developing Countries in the WTO Services Negotiations", *WTO Staff Working Paper ERSD-2004-06*, September.
- Ocampo José Antonio, (1992)** "Developing Countries and the GATT Uruguay Round: A (Preliminary) Balance. *International Monetary and Financial Issues for the 1990s*. New York: United Nations. Volume I, pp. 31-53.
- OECD (2008)** *Agricultural Policies in OECD Countries: Monitoring and Evaluation*. Paris: OECD.
- Onguglo Bonpas, (2005)** "Development issues in the post-July package period: Myth or Reality?". Third World Network Trade & Development Series No. 27.
- Rodrik Dani, (1995)** "Developing Countries after the Uruguay Round". *International Monetary and Financial Issues for the 1990s*. New York: United Nations. Volume VI, pp. 35-60.
- Srinivasan T.N., (2007)** "The Dispute Settlement Mechanism of the WTO: A Brief History and an Evaluation from the Economic, Contractarian and Legal Perspectives", *World Economy*, 30(7), p. 1033-1068.
- E. Stiglitz Joseph and Charlton Andrew, (2005)** *Fair Trade for All: How Trade can Promote Development*. New York: Oxford University Press.
- TWN (Third World Network) et al., (2003)** "Memorandum on the need to improve internal transparency and participation in the WTO."
- UNCTAD (United Nations Conference on Trade and Development), (2007)** *Trade and Development Report 2007*, Geneva.
- Whalley John, (1990)** "Non-discriminatory Discrimination: Special and Differential Treatment und the GATT for Developing Countries". *Economic Journal*, Vol. 100, December, pp. 1318-28.
- World Bank, (2004) (2005) (2007) (2008)** *Global Monitoring Report*, Washington D.C.: World Bank.
Global Monitoring Report, Washington D.C.: World Bank.
World Development Report 2008: Agriculture for Development, Washington D.C.: World Bank.
Global Monitoring Report, Washington D.C.: World Bank.
- WTO (World Trade Organization), (2004)** *The Future of the WTO: Assessing Institutional Challenges in the New Millennium*. Report by the Consultative Board to the Director General. Geneva: WTO.

Biography note

Martin KHOR is the Executive Director of the South Centre, which is an inter-governmental body with 51 member states of the developing world. The Centre's secretariat is in Geneva. He was previously the Director of the Third World Network, which is a network of NGOs and research centers in the developing world. Khor is an economist, with degrees from Cambridge University and the Science University of Malaysia. He is the author of several books and papers on issues relating to trade and development, environment and sustainable development, including "Globalisation and the South", and "Intellectual Property, Biodiversity and Sustainable Development". He has also been following the recent negotiations at the UNFCCC.

Biography note

Jose Antonio OCAMPO is Professor in the School of International and Public Affairs and Fellow of the Committee on Global Thought at Columbia University. Prior to his appointment at Columbia, Professor Ocampo served as the United Nations Under-Secretary-General for Economic and Social Affairs, and head of UN Department of Economic and Social Affairs (DESA), as Executive Secretary of the UN Economic Commission for Latin America and the Caribbean (ECLAC), and has held a number of high-level posts in the Government of Colombia, including Minister of Finance and Public Credit, Director of the National Planning Department, and Minister of Agriculture. Professor Ocampo is author or editor of over 30 books and has published over 200 scholarly articles on macroeconomic theory and policy, international financial issues, economic development, international trade, and Colombian and Latin American economic history.



Towards a **progressive** **trade agenda**

by **Pascal LAMY**



I am often asked how I reconcile my social-democrat beliefs with my trade opening credentials. As if the two were incompatible! If there is a contradiction, it is not between the precepts of social democracy and trade opening; it is between trade policy and trade politics. While the existing trade policy model sees trade opening as an essential tool to promote growth and development, trade politics often see it as a problem. Yet, a progressive trade agenda that promotes trade opening fairness and social justice is possible. What I wish to offer here are a few thoughts on how to reconcile these two approaches in order to build a progressive trade agenda that is fair, i.e. that benefits everyone.

What does the existing trade policy model tell us? That trade opening works better than protectionist policies to generate growth and reduce poverty. Both theory and practice support this view, and the development successes of the last few decades attest to this. The efficiency gains that stem from the functioning of market forces favour consumers across the board, be they rich or poor. Overall, trade opening is a positive sum game.

What is true, however, is that the welfare gains resulting from trade opening may not be fairly shared. Some may win more than others. Some may lose. The distributional impact of trade opening policies may create inequalities and lead to job destructions. This needs to be acknowledged and taken into account in the design of trade policies. Safety nets, redistributive policies and adequate regulation need to be put in place at the domestic level to redistribute wealth or provide safeguards to the men and women whose living conditions are disrupted by trade opening.

However, such policies are still to a large extent the privilege of richer countries. Rare are those developing countries that have the means to put in place adequate domestic redistributive policies. Given the historical legacy of “trade colonialism” - not in its political and administrative meaning, but understood as the pattern of the international division of labour that prevailed throughout the 20th century and that resulted in the domination of industrialized countries over developing countries - distributional issues cannot, from an ethical

point of view, be confined to the domestic arena; they are as much a matter for global policies. Where domestic resources are insufficient to counter the distributional impact of trade opening, mechanisms are required at the international level to assist the countries concerned build their trade capacity. It is in response to this challenge that the WTO launched in 2005 the Aid-for-Trade initiative with the support of the international community, to help developing countries, particularly least-developed ones, develop the trade-related capacity, such as skills and infrastructures that are needed to expand their trade and to benefit from trade opening .

The existing trade policy model is fairly clear. Trade opening generates growth and reduces poverty, provided it is properly regulated at the global level in order to ensure fairness and is accompanied by adequate domestic policies, and where necessary international support, to address potential distributional impacts.

Trade politics, however, is more complicated, for several reasons. First, the losers are always more vocal than the winners. While this is not proper to the trade field, the challenge with trade opening is that the losers are often among the most vulnerable - even if they do win as consumers.

Second, trade unions, which are a traditional constituency of the center left, have a systemic problem with trade opening which erodes the “old economy”, where their traditional pool of members is, and expands the “new economy”, where they are generally weak. This “structural weakening” is coupled with a global weakening. **At the global level, trade unions are losing ground in industrialized countries and have only registered limited gains in emerging economies and developing countries. While trade opening is presented as a win-win by most economists, many trade unions perceive it as a lose-lose.**

If one adds to this the fact that in market economies, the idea that we are victims of “unfair competition” is widespread, that blaming foreigners remains a winning formula of the populist discourse, and that trade opening is often used as a scapegoat in attacks against “unfettered markets”, one should not wonder that the political pressure to protect is greater than that to open markets, a fortiori in times of economic crisis and higher unemployment. This is particularly true in bigger economies, which feel less dependent on other markets than smaller countries.

How can, in these circumstances, trade policy and trade politics be reconciled?

One first needs to get the analysis right to better inform the public debate. Trade issues are highly and increasingly complex and dubious analyses are frequent.

Take the question of trade imbalances, for example. Lasting trade imbalances are not a trade issue per se; they are primarily a sign of macroeconomic imbalances, of international differences in aggregate savings and investment behaviour. My sense is that trade imbalances are not a problem as long as they can be financed. The proper way to address them is not through trade policy, but through macro-economic rebalancing.

The debate on this issue is, also, distorted by the way trade is calculated. Thanks to reductions in transport costs, the information technology revolution, and more open economic policies, production chains have become global. Products are now “made in the world” and a large part of international trade is trade in intermediate products. However, trade statistics are still compiled on the basis of the gross value of products. Every time an iPod is exported from China to the US, for example, some \$150 are added to the US trade deficit, while in reality only \$4 to 5 were produced in China. Trade statistics need to evolve to capture the value actually added at each step of the production chain. If trade was measured in value-added, estimates are that

the US trade deficit vis-à-vis China would be cut by 30 to 50%. Relying on conventional trade statistics gives us a distorted picture of trade imbalances between countries.

Another debate which gives rise to doubtful analyses is that of wage competition. A large part of the wage differential is due to productivity differences. Few people realize that about eight Chinese workers are necessary to produce goods and services that, in the US, would necessitate only one worker.

Many people also underestimate the role of technology in globalization. While trade opening measures are often presented as the main cause for job destructions and growing wage inequalities, various studies have shown that the impact of technology changes on jobs, employment and wage inequality is much greater than that of trade, although trade was as a transmission mechanism of these changes.

As to protectionism, it is an illusion. Protectionism does not protect. In today's world of growing economic interdependence, taxing your imports equals taxing my exports. Protection is needed but it should take other forms, such as social protection. Some countries have understood it and used it successfully during the crisis. Germany, for example, chose to protect its economy by encouraging part-time employment.

Likewise, **too many people still confuse trade opening with deregulation. These are two different concepts.** Deregulation means the removal of legal barriers, i.e. rules, while trade opening implies the reduction in trade barriers or a reduction of those measures that discriminate against foreign goods and services. A country that opens up to trade does not compromise its ability to regulate, provided of course those regulations do not discriminate in an unjustifiable manner against foreign goods and services. Trade opening as advocated by the WTO is all about rules, about facilitating trade flows through the adoption of common disciplines binding on all WTO Members.

Finally, the argument – often used – of lack of policy space to justify the opposing trade opening also needs to be carefully looked at. Much flexibility has been included in the WTO Agreements to allow Members to take action against unfair competition and unexpected surges in imports. WTO Members can, under certain conditions, impose anti-dumping, countervailing and safeguard measures to protect their domestic production. These instruments are widely used, not only by developed countries, but also, and increasingly so, by developing countries. Furthermore, developing countries and least-developed countries benefit from additional flexibility in the implementation of their WTO commitments. The “special and differential treatment” they enjoy takes the form of longer implementation periods, less strict commitments, and even exemptions from certain obligations.

Many of these analyses are, in many respects, counterintuitive. This is why **an informed and objective public debate, shielded from vested interests, needs to be organized with the public at large and in parliaments. What matters for people, a fortiori in these times of crisis, are jobs, well-paid jobs. The debate about trade needs to shift to the value-added content of trade, which is where jobs are.**

Second, a proper, i.e. **coherent, articulation needs to be built between local and global policy frameworks and approaches.** Trade is undoubtedly the area where global rules play a prime role and where global governance is the most achieved. WTO agreements are indeed the most accomplished set of multilateral rules. It is also the one area where political globalization has not been outpaced by economic globalization.

The global trade agenda is well established. It covers disciplines ranging from tariffs to non-tariff barriers, trade in services, intellectual property, and subsidies. It includes flexibilities to address unfair competition,

surges in imports, and the needs of poor countries, and provides policy space to address tensions between global public goods, such as the environment and health, and open trade. It provides a framework to settle disputes and to adjust and update existing disciplines through rounds of negotiations, of which the on-going one the Doha Round aims to rebalance commitments in a more pro-development way. This global trade agenda is an essential component of the global governance system, of which the WTO forms an integral part, alongside the United Nations, the G20, and other international organizations. How could it be otherwise when trade is at the crossroad of so many issues that govern our everyday lives?

The main issue remains the domestic level where the various components of an “active” trade policy must be blended to ensure a positive social outcome. The ingredients of such a policy are known: decent work agenda, education, innovation, social safety nets, and union rights. These ingredients need to be weighted carefully depending on the conditions of temperature and pressure in the country concerned. There is no one size fits all approach. More importantly, perhaps, coherence needs to be ensured between the resulting local policy approach and the position of the country concerned at the global level. It appears too often that the right hand does not know what the left hand is advocating, leading to contradictions in global fora, thereby impairing the move towards greater coherence at the global level.

Between the local and the global, another level deserves greater attention: the regional level, the increasing relevance of which should be recognized. Many capacity issues, such as those related to infrastructure, are best addressed at an “infra global”, but “supra national” level. This is the case in Africa, for example, whose infrastructural challenges are such compared to the size of most African economies taken individually that only a regional approach can successfully address them.

So yes, a progressive trade opening agenda that benefits everyone is possible. But for this to happen, one needs to start by reconciling trade policy and trade politics. And it all starts at home. An informed public debate over trade issues and greater coherence between the various levels of governance would, in my view, go a long way to putting in place the premises of a more progressive trade agenda.

Biography note

Pascal LAMY holds degrees from the Paris based Ecole des Hautes Études Commerciales (HEC), from the Institut d'Études Politiques (IEP) and from the Ecole Nationale d'Administration (ENA). He began his career in the French civil service at the Inspection Générale des finances and at the Treasury. He then became an advisor to the Finance Minister Jacques Delors, and subsequently to Prime Minister Pierre Mauroy. In Brussels from 1985 to 1994, Pascal Lamy was Chief of staff for the President of the European Commission, Jacques Delors, and his representative as Sherpa in the G7. In November 1994, he joined the team in charge of rescuing Credit Lyonnais, and later became CEO of the bank until its privatisation in 1999. Between 1999 and 2004, Pascal Lamy was Commissioner for Trade at the European Commission under Romano Prodi.



Queries



03

A new political economic response

Next to disastrous financial and economic consequences, the recent crisis has had a great impact on the ways people think about themselves and sense of their lives. An overwhelming anxieties, connected with fears of potentially losing all one worked for, has been deepened by the fact that people no longer trust that rescue could come from state, government, politicians. This leads to their further detachment from politics, as also in resentment and distrust in any proposed scenario. This is why the mission of the progressives to put forward comprehensive and credible solution, to formulate *A new political economic response* is more important than ever. Massimo D'ALEMA responds to that historical call, showing the path towards a new global architecture, bases on international solidarity instead of the particular interest of nation states. He points out that there is a need to build it on the bases of democratic legitimacy and rules of transparency. Pervanche BERÈS echoes his arguments, calling not only for a new monetary order, but also for establishment of Mr/Mrs Euro as a component of it. Finally, Roy CULPEPER enumerates ingredients of a feasible, successful global response.

Global Economic Governance for Balanced Growth. Institutional Issues¹



By **Massimo D'ALEMA**

For many years, the debate around the question of redesigning global economic governance has mainly been theoretical. The existing multilateral system was built more than sixty years ago in very different political and economic circumstances. Despite the common awareness that it is increasingly inadequate to respond to the challenges of an ever more globalized world, so far discussions and analyses on the tools, mechanisms and institutions to fill the gaps and adjust the system to the new global context remained mere speculations.

The financial and economic crisis that befell us subverted that perspective. Nowadays, the reconstruction of global economic governance is no longer a question of choice. It is a question of necessity. We have finally realized that the idea that self-regulated markets might continue to work without rules, without institutions enforcing those rules and monitoring their correct functioning, was wishful thinking. The wild neoliberalism that dominated the era of globalization, fed this great illusion for years.

We have been told that we are living at a time of the end of ideologies. But neoliberalism is to be the last of the 20th Century ideologies. The crisis is not just an accident in the path towards a full and bright realization of globalization, provoked by the mistakes in calculation or unscrupulous greed of a few bankers. It was indeed the crisis that exposed the contradictions of this globalization, which has grown too quickly and too unregulated.

Beyond the nation-state, but state nevertheless

The utter lack of regulations and controls reflects a democratic deficit, which is due to the asymmetry between the ascent of a global economy, the weakness of international institutions, and the inadequacy of old nation states.

¹ The article is based on a speech delivered by Massimo D'Alema at the IPD/FEPS Conference on Global Economic Governance, 07-08 October 2010, Washington

During the course of the 20th century, the development of capitalism was counterbalanced by the principles and limits imposed and implemented by nation states. Thus capitalism, social cohesion and democracy could live together, at least in Europe, thanks to the role played by governments. However, the drive towards deregulation focused on rejecting the state as an economic actor. The assumption was that social order could be found without state involvement or intervention. This proved to be a dangerous proposition and its obvious consequence was the weakening of the state as a guarantor of social justice.

Hence, the most extraordinary catastrophe befell the “casino capitalism” (Strange, (1987)) that emerged from the era of deregulation. Rather than exercising autonomy, tax-paying individuals – through the workings of the much criticised state – were forced to prop up financial institutions which were now “too big to fail”. Around the world, states were forced to engage in the most extraordinary expenditure, not to provide public services, but to maintain stability in the supposedly self-regulating financial sector. This state of affairs was facilitated by a lack of international coordination and of institutions capable of stabilizing, governing and restraining the impact and effects of global capitalism and global financial markets.

This is now the challenge that we have to face. We must build a new international architecture able to guarantee the unfolding of a fair globalization, while reducing inequalities and ensuring a sustainable development. We must recognize that such an outcome cannot be achieved through the sole action of single states. We must recognize that the challenge of a global world lies in the ability to govern processes at a supranational level. **We must recognize that politics and democratic institutions must orient and regulate the economy, because this is the only way in which capitalist development can be reconciled with the principles of democracy and social justice.**

Today, 27 European countries are part of a unique project in which economic and political life are not confined to the nation-state. This is supported by an institutional framework which seeks to meet the needs of the people through stability, interdependence and cooperation. Therefore, **the European Union represents an impressive positive experiment to be considered while designing the new architecture.**

G20 and the global governance architecture

Although one can take comfort from the consolidation of the G20 over the G8, the G20 is still lacking in representative legitimacy, because it fails to give adequate representation to the global population based on the present and on future forecasts, while the economic landscape is changing rapidly, forcing us to adapt to this. Developing economies will probably be the only available engines of future global economic growth (Ocampo, (2009)) and as Ocampo has proposed, we must encourage further expansion of countries like Brazil, India and China; otherwise we will miss a huge opportunity to address our own problems. Worse still, inaction will prevent us from helping to bring many millions out of the shackles of poverty and unemployment.

It is true that the G20 was instrumental in providing the immediate reaction to the crisis (Woods, (2010)). But now the G20 is entering in a new phase and longer term objectives are becoming the priority. The framework for strong and balanced growth has the ambition to increase growth, while making it more sustainable – also in terms of social equality and to fight poverty – and avoiding the development of large imbalances. The process of coordination within the G20 is at a critical stage as the risks of “currency wars” are still existent. The breakdown of macroeconomic policy coordination among this Group of Twenty will have a strong impact on the world economy as a whole, not only on those countries that have a seat at the table. If

the G20 cannot achieve its objectives for its own members, how can it be expected to do so for the rest of the world? We must ask hard questions if we seek honest answers!

Europe should play a major role in the process of finding collective agreements among countries that represent 80 per cent of world GDP and which cover a broad variety of cultures, preferences and approaches to policy and governance. So far Europe has been hesitant, to say the least, putting a premium on fiscal consolidation with respect to supporting demand. Given the serious crisis that a number of European countries are facing, fiscal consolidation is indispensable. However, Europe should take the opportunity of the crisis to move towards those growth oriented policies – many of which are contemplated in the Europe 2020 Strategy – that are necessary to strengthen the quality of life of European citizens and adjust the European welfare systems to the challenges of the new global environment.

It is equally important that the UN system represents a fundamental pillar of any global governance. The document “For a global new deal”, drafted by the Global Progressive Forum together with FEPS, outlines in a very convincing way the strategy for an effective global economic governance: “*the political drive should be given by a triangle composed by United Nations bodies, by the international agencies (including IMF, WTO and the World Bank) and by the G20*”. Regarding to international agencies, particularly the IMF and the World Bank, we should insist on a single seat for the EU and for the reallocation of voting powers in favour of so-called emerging countries.

Global financial stability and fair trade as public goods

The great contradiction of economic life at the beginning of the 21st century is that financial markets are inherently globalised, while regulation is still predominantly national and regional. This has allowed actors in financial markets to take extreme risks and the consequences of this anomaly have been truly catastrophic.

If regulation is to work, it must be genuinely international. Regulatory bodies must be operated under institutions of global governance that are accountable to governments and, by proxy, to our citizens. Thus, any effort to improve international financial regulation must be based upon the will to build an ethical and comprehensive institutional framework. When we discuss the features of this new international framework, it is not enough to simply criticise proponents of economic orthodoxy and financial deregulation. We must look at the systemic problems that the global economy faces and we must offer an alternative based on the values of social justice and the pursuit of global public goods.

“Fair trade” has become something of a buzz phrase, a logo and a brand. This threatens to rob it of its meaning. **Trade must be to the benefit of all, and not only the rich countries of the world. This is the fundamental question of global governance and if we do not address the injustices in our trade system, we show dishonesty in our concern for the poor. This will require reform in the global trade architecture to offset the vulnerabilities of the developing world.**

When addressing these subjects under discussion, we must also analyse how we tackle issues of governance, economics and international politics. We cannot just talk about the will of “the markets”. We must invoke the concept of genuinely global public goods (Kaul et. al., (2003)), of which financial stability and fair trade relations are just two. It is our challenge to offer an alternative in which the markets serve our people and place global public goods at the centre of our idea of progressive global economic governance.

Global governance for balanced growth

In our discourse on global governance, we must argue the case for balanced growth. The trade relationship between the US and China is inherently imbalanced and this reverberates in overall global imbalances. This has created tensions in both countries, in the face of rising unemployment in America as a consequence of the recession, and pressure on China to appreciate its currency and to increase domestic demand. China has built up huge reserves of dollars which is, of course, problematic, but it has also provided the global economy with the benefits of a powerful fiscal expansion.

Stiglitz (2010) has proposed the development of a global reserve currency. Indeed, this was what Keynes had in mind in his original conception of the International Monetary Fund. This may be an idea worth pursuing, and we should acknowledge that it can be a long term solution. In the meantime it is important that new institutions, such as multilateral or regional “financial safety nets”, are set up. Also, the global financial crisis has shown the importance of a new approach to regulation that would support long term investment and facilitate the flow of resources towards emerging and developing countries.

Such proposals provide concrete solutions to the complicated problems that we face. Therefore, what we seek is not just an ad hoc response to an ad hoc crisis. We seek to prevent future crises.

Concluding remarks

The future international financial architecture should not only guarantee sound regulation, supervision and governance of financial markets, or prevent speculative phenomena. We must design a monetary and financial system which serves a just economy, able to ensure the largest access to the advantages of development, the reduction of inequalities and an economic growth compatible with the protection of the environment.

Right after the outbreak of the crisis, the international debate seemed to be dominated by the will to change. Such an approach must not fade away. We must not give in to the temptation of returning to the previous setup; we cannot wait for another crisis to decide to change.

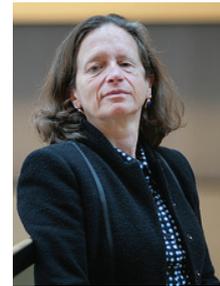
References

- Ocampo Jose Antonio, (2010)** *"Global Economic Prospects and the Developing World"*, Emerging Markets Economonitor, Roubini website. http://www.roubini.com/emergingmarketsmonitor/258809/global_economic_prospects_and_the_developing_world
- Kaul Inge et. al., (2003)** *"Providing Global Public Goods. Managing Globalization"*, New York, Oxford University Press, 646 p
- Stiglitz Joseph E., (2010)** *"Freefall. Free Markets and the Sinking of the Global Economy"*, London, Allen Lane, 361 p
- Woods Ngaire, (2010)** *"Global Governance after the financial crisis: A New Multilateralism of the Last Grasp of the Great Powers"*, Global Policy 1 (1), pp 51-63
- "Trade Policy in Developing Countries"*. Cambridge, Cambridge University Press
- Strange S. (1987)** *"Casino Capitalism"*, Oxford, New York, B. Blackwell, 207 p

Biography note

Massimo D'ALEMA is the President of the Foundation for European Progressive Studies (FEPS) and the Italian think tank « Italianieuropei ». Former Prime Minister of Italy between 1998 and 2000. Since 2003 he is also Vice-President of Socialist International.

Global Economic Governance, an audacious rebuilding from a European Perspective¹



By **Pervenche BERÈS**

After the liquidity crisis declared in August 2007, the collapse of the financial and banking system in September 2008 and its consequences on the real economy has a social impact never seen since the great Depression. The International Labour Office (ILO) estimates that *"the global economic crisis has had devastating consequences on labour markets. Unemployment has increased to 210 million, the highest level ever recorded [...]"*².

The bailout of the banking sector will have cost countries worldwide 650 billion Euros; almost 25 million people are today unemployed in the EU and almost 8 million of whom will have lost their jobs because of the crisis³.

Some political and financial actors directly responsible for the current dramatic turmoil consider that everything is now back to normal and promise that they have changed their practices. However, a risk appears that this crisis could be wasted while lessons that must be drawn from the crisis still did not produce their full effects. In the absence of a deep reform of the economic and financial system, there is no rationale to exclude a crisis of the type and magnitude, which affects the world for more than two years now. Public authorities were not able - or even worse, refused - to think about the way the system was functioning and to modify the profound mechanism having led our economies on the brink of the abyss. Finally, because of the failures of its own governance, the European Union is too weak and divided to promote its own interest and to speak with one voice on the international scene.

The successful audience for the concept of governance in the public debate and academic field illustrates paradoxically the expectations and frustrations resulting from it.

¹ This article is largely based on the conclusion of the interim report of the European Parliament on the Financial, economic and social crisis.

² International Labour Office, *Global Wage Report 2010/11: wage policies in times of crisis*.

³ http://www.oecd.org/document/46/0,3746,en_2649_37457_40401454_1_1_1_37457,00.html

First of all, **it is essential to provide the core elements of the concept of (global) governance before any analysis because there is often some confusion and misunderstanding concerning the sense of the notion: governance merely refers to the making process and implementation of collective actions of a group of different actors with divergent goals.**⁴

The greatest audience of the concept of global economic governance is inseparable from the globalisation one: it mainly results from the fears generated by economic, social and environmental consequences of a globalisation giving often the impression to be exempted from any legitimate bases and rules or democratic control.

During the 1990's, various academic works start to spread the idea that globalisation linked to liberalisation of capital markets (Ohmae (1990)⁵, Reich⁶ (1993), Strange⁷ (1996) create news limits for sovereign states.

The acceleration of globalisation refers to new technology, impressive increase of trade or the exponential growth of financial transactions through free movement of capital settled every day in a world where the Bretton Wood System had been abolish. Globalisation results also in the emergence of new global actors following divergent objectives: global market players⁸, international companies in favour of a more flexible market, NGOs involved in the fight against climate change, lobbies... Sovereign states interact now – and sometimes compete with – these global actors of a new type, increasing the risk of conflicts of interest and regulatory capture.

Doubts created by economic governance are mainly associated with a large number of criticisms: reflecting the post second world war equilibrium, illegitimate, inefficient, suspected to favour advanced countries at the expense of developing countries and within the countries, the richest at the expense of the poorest... The denunciation of global economic governance is always linked to the globalisation one. *"The global village seems devoid of rules, cohesion, redistribution of resources, and justice, as if it only existed for the benefit of its most powerful members"* as noticed by Pierre Calame⁹.

In order to give a comprehensive answer to these major questions, three fundamental issues will be tackled with in this article:

1. For Europe: consolidate its integration and its role within international institutions.
2. Organise and enhance the legitimacy of international organisations at the core of global economic governance.
3. Elaborate a new international economic and monetary order notably to ward off the risk of currency war.

The European Union, naive economic giant but political dwarf of the global governance?

The 2009 UN summit on climate change in Copenhagen has demonstrated if needed the EU institutional loopholes and the damage of an intergovernmental approach on a topic where it should have had a leading position.

4 Jean-Marc Siroën, 2006, *vers une gouvernance économique mondiale ?*, cahiers français, la documentation française

5 Ohmae K., 1990, *the borderless world: power and strategy in the interlinked economy*, Fontana

6 Reich R., 1993, *L'économie mondialisée*, Dunod.

7 Strange S., 1996, *The retreat of the State. The diffusion of power in the world economy*, Cambridge University Press, Cambridge.

8 In 2009, the four biggest US banks controled 35%of deposits against 5% in 1996. Cf. Aglietta M., 2010, *La crise, les voies de sortie*, Michalon.

9 <http://www.institut-gouvernance.org/fr/analyse/fiche-analyse-36.html>

The Union should be a strong advocate of multilateralism. Its best interest would be to speak with one voice and to make sure that multilateral organization are updated and regarded as relevant structure for global governance. Unfortunately progresses in this field are very slow.

The fragmentation of EU representation at the global scale is an obstacle to its influence: today, when the Union talks about external trade, it is the Commission which does so on behalf of the 27 Member States, the external representation of the euro and the voice of the Union on exchange rates may be the Commission, the President of the Eurogroup and the President of ECB on behalf of 17 eurozone members; the Union has 7 seats out of 24 in the IMF, 5 of which for eurozone Member States, and when it comes to environment or social issues, it is the 27 Member State themselves that voice their opinions. This fragmentation impairs the Union's capacity to impose its weight in discussions on the major macroeconomic imbalances, particularly with the United States and China.

If Europe is willing to play its role in the redefinition of the global governance and wants to ensure that international economic and financial institutions are legitimate and effective, member states have to accept to speak with one voice and also to support an effective redistribution of their seats and voting rights in order to demonstrate their involvement to favour a better representation of all stakeholders. The European Parliament has been asking for such a move since long, notably with its report on the strategic review of the International Monetary Fund¹⁰.

To prevent the division and political weakening of the EU, the creation of "Mr. or Mrs. Euro" should be envisaged: this person would be tasked with ensuring that EU economic activity is consistent. She/ he would, as vice-president of the Commission oversees how it exercises its economic, monetary and financial-market-related responsibilities. She/ he should also participate in the work of the European Council, chair the Ecofin Council and the Eurogroup and represent the EU on relevant international forum and organization such as the G20 or the International Monetary Fund. This would pave the way for a European treasury and by doing so to overcome internal governance imbalances inside the Union. We knew before the crisis that they would need to be tackle; we should now acknowledge that they are not sustainable.

By its behaviour also, the Union, sometime, seems to neglect tools of multilateralism. For example, in the social field, it is striking that not all member states have ratified the ILO updated conventions as if they were for developing countries. But if we want them to be ratified by others, we better give the example. In addition, following the adoption of the Lisbon treaty, the Union should be full member of this organization.

Strong debates have also been raised on the role the IMF could or should have when dealing with sovereign debt in the eurozone. Once more, **if Europe believes the IMF should play this role in the world, it should also authorize it for itself and benefit from the expertise of the Fund when dealing with such crisis.** But, it should not prevent eurozone to better fix its economic governance that in the end could not be left in ordinary time in the hands of the IMF or even of the ECB like the temptation seems to raise notably in Germany, because the level and the quality of public expenditure is a matter for politics.

Final example regarding **the role of the World Bank: it has a big capacity building and institutional development expertise that could be usefully utilised in new members states of the Union where catching up programmes in terms of combating corruption or establishing a strong administration has sometime been abandoned too early after accession to the EU.**

¹⁰ <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2006-0076&language=FR&ring=A6-2006-0022>

On the other hand, we also have to recognise that international institutions are frequently still too reluctant to cooperate with regional institutions as the EU because they view them as competitors¹¹

Enhance the legitimacy and efficiency of international organisation

The economic and financial crisis has highlighted the loopholes between international institutions, regional as national authorities and central banks, as their inability to prevent the creation and the burst of speculative bubbles, which nearly destroyed the real economy.

To this respect, a G20 summit should be devoted solely to the reform required in governance at world level with the objective to conceive a more integrated normative and institutional process regarding macroeconomic issues and the impact of market developments.

The current architecture of the global economic governance is weakened by lack of legitimacy and visibility: emerging as developing countries need to have a say in these matters while advanced countries are obviously overrepresented in the governance structure of these organisations inherited from after second world war. It is also essential to involve parliamentarians more closely in the work of the various international financial institutions.

Part of the underlying causes for the financial crisis is also linked to the laxity of regulatory authorities of financial markets and to the explosion of social and economic inequalities. Furthermore, the weakness - or the absence - of transparent and efficient binding decisions towards countries participating to the policy making process is unquestionable. To this respect, we can only regret that structures, which have developed, had done so more as had hoc structures than as genuine institutions. The Basel Committee, where investment banks are over influential, was not able to give full consideration to all stakeholders and G8 did not have the resources and continuity mechanisms of international institutions. If the transformation of the G8 into the G20 is a good thing, this forum remains an informal structure without the legal basis and attributes of international institutions for preparing and monitoring the implementation of binding decisions, even if the IMF is helpful in preparing the G20's meeting.

The difficult case here is that we have not been able up to now to convince the Chinese government of the relevance of multilateralism thanks to our reluctance to reform it vigorously enough. It would be in our best interest to convince them now not to copy-paste the behaviour of the US as a superpower reluctant vis à vis multilateralism once they will have overtaken the US. Because of this, the only arena where, like the US, they agree to discuss global economic governance is the G20. One proposal to overcome this difficulty could be the integration of the G20 as a council of ministers to the structure of the IMF.

In order to improve the cohesion of the international financial and banking regulation and to insure reciprocity the agreements delivered by the Basel Committee on Banking Supervision should come into force in the form of international treaties.

An other element has to be considered regarding the regulation of financial markets: for too long, public authorities (governments, public institutions, national and regional regulators and supervisors) integrated the

¹¹ Padoa-Schioppa T., 2009, *Contre la courte vue, entretiens sur le Grand Krach*, Odile Jacob

arguments developed by the banking and financial actors developing conflict of interest and regulatory capture. This relation contrasts with the under representation of workers, consumers and end-users to start with in the consultative bodies. It would be therefore important to think about the conditions in which these stakeholders would all have the opportunity to express their views and to imagine new watchdogs to prevent the influence of vested interested on the decision process. **This is why at the European level¹² we have launched the Finance watch initiative.**

The same risk exists when governance structures are developing on the base of self regulation. Here many lessons should be draw out of what has happen with the accounting standards and the role played by the International accounting standards board (IASB).

Finally, one important element of the debate we need to discuss is the proper institutional framework for global economic governance and the integration of the IMF in a broader picture. This is also true because the proliferation of international regulators creates urgent issues relating to the consistency and effectiveness of the international legal order, particularly as regards the protection of public health, the environment and fundamental human rights. This is why proposals are on the table to set up a judicial body, the Sustainable Development Council, under the auspices of the United Nations to take responsibility for arbitrating on conflicts between international standards. **The redefinition of global governance should then be geared to greater integration of regulatory bodies into the legal order of the United Nations and conduct to greater respect for the principles espoused by its specialised agencies, particularly the ILO and WHO.** This is critical because otherwise the necessary reform of the international monetary and financial structure would obscure the social impact of the crisis in developing countries and more generally the importance of issues relating to food, the environment, health and society arising from the globalisation of trade. In 2010, the first social minister G20 or the joint meeting in Oslo between the IMF and the ILO is de facto recognition of this need. It needs to be developed.

Elaborate a new international economic and monetary order to ward off the risk of global imbalances and currency war

The tension registered on the exchange rates of the US Dollar and the Chinese Yuan coupled with the ongoing uncertainties on the future of the Euro zone are grounds for fearing the worse case scenario as mentioned by the Brazilian Minister for Finance in September 2010: "a currency war"¹³.

Who are the main protagonists and what are the underlying motives of this war? China and the United-States each accuse the other of undervaluation of their respective currency (undervaluation of the Yuan which is stuck to the evolution of the Dollar, the US FED's decision to print money on a big scale)... At this game, the Europeans appear to be reduced to witnesses as the EU suffers the effects of the overvaluation of its currency at a time that is characterized by sluggish economic activity in the Euro zone. After all, M. Guido Mantegna's concept drawn from the military imagery was first and foremost the expression of his great concern as regards the appreciation of the Brazilian Real against to the American Dollar (+26% since the beginning of 2009).¹⁴

¹² <http://www.callforfinancewatch.org/>

¹³ <http://www.ft.com/cms/s/0/33ff9624-ca48-11df-a860-00144feab49a.html#axzz1A17UapqY>

¹⁴ <http://www.ft.com/cms/s/0/33ff9624-ca48-11df-a860-00144feab49a.html#axzz1A17UapqY>



The currency war scenario is common knowledge: one or more countries choose to directly intervene on the exchange rate of their currency by buying foreign currencies in vast quantities which in turn induces the appreciation of these currencies, all this with the goal to create a comparative advantage over the given country's main trading partners and to foster economic growth and job creation within its borders.

These competitive devaluation strategies, whether done openly or not, contribute to exchange rate volatility, destabilize the substructure of international trade and ultimately create the risk of inducing a collapse in exchanges because of retaliation measures from countries that believe to be under threat.

Furthermore, one can not ignore the purely speculative role played by the carry traders (pension fund, hedge fund or investment banks) who have become powerful market stakeholders on exchange markets through speculation on different asset classes and by borrowing using a currency yielding small returns in order to invest in another currency with higher returns. Faced with this behavior, national public authorities and central banks often remain helpless¹⁵.

Today it is more than ever necessary to initiate the debate on the major innovations to bring to the current international monetary system in order to ensure its stability. Therefore, **we have to start thinking on the creation of an international currency based on a currency basket. In this field, the eurozone may have an important back ground to contribute based on its one experience.** This was a strong conviction of one of the father of the euro, Tommaso Padoa Schioppa, reason why he had been appointed to prepare the French presidency of the G20 on this topic together with Michel Camdessus and Alexandre Lamfalussy¹⁶.

The second **urgent need is to introduce a tax on financial transactions in order to penalise socially useless and purely speculative trading and to collect new revenue for long term investments. In this respect, the European Parliament took a significant step in October 2010¹⁷. The battle for a financial transaction tax must be pursued and linked to keeping pressure on tax heaven.**

Third, we witness a justified growing concern on the price and the risk of speculation on raw materials. Acknowledging this requires new regulation and supervision.

Finally, in trade the difficult negotiation of the Doha round and the impact of the crisis should favour a new debate on fair trade as a better form than free trade. In this respect, some progress is clear in the French socialist party's international convention¹⁸. The PES has taken up the debate and is now also usefully engaging in this discussion. More generally, one can feel that the tone of the debate is changing and that questions such as reciprocity are now being openly discussed. We believe it could be useful to introduce the concept of a social and environmental lock. This is also related to the debate on a carbon tax.

¹⁵ *Jacqué L., décembre 2010, mythes et réalités de la guerre des monnaies, le Monde Diplomatique.*

¹⁶ *Camdessus M., Lamfalussy A., Padoa-Schioppa T., 2011, La réforme du système monétaire international : une approche coopérative pour le vingt-et-unième siècle, Documentation française.*

¹⁷ *Paragraph 73 of the European Parliament resolution of 20 October 2010 on the financial, economic and social crisis: recommendations concerning measures and initiatives to be taken (mid-term report)*

¹⁸ *www.parti-socialiste.fr/static/8739/convention-internationale-texte-definitif-avec-tous-les-amendements.pdf?issuu=ignore*

Conclusion

If globalisation is today perceived as a threat instead of an opportunity by the citizens, if the feeling of revolt and social as economic inequalities still increase all over the world, if certain financial actors and some of their practices have for too long profited from the shortcomings of the economic and financial system, time has come to rebuild global economic governance in order to ensure sustainable development contributing to reduce inequalities between advanced and developing countries.

The impetus generated two years ago by the financial disaster was the signal for an important regulatory reform of the banking and financial system. Some reforms have already been adopted. However, this step has never been sufficient to overcome the major institutional loopholes of the global economic governance. G20 leaders give the impression to go back to business as usual and seem to be more interested on the very next economic and politic future instead of fighting short-termism. Lack of long term vision is the greatest danger for a sustainable recovery: *“Short-termism is a pervasive element of the mindset in which we live today and it affects government, the financial sector and business”*¹⁹.

Too often, sovereign states are reluctant to draw the lessons resulting from the statements and decisions agreed at the international level by invoking their sovereignty. While sustainable regulation are supposed to be applied to internationalised entities or markets, governments have to promote a better legitimacy of international institutions and to increase the transparency of their decisions through a better worldwide representation as a closer cooperation with national and regional parliaments, representatives of the civil societies and social partners.

The crisis will be beyond our societies when the whole set of major failures and loopholes of the global economic governance will be closed: the crisis is not over.

Biography note

Pervenche BERÈS has been a Member of the European Parliament since 1994. In the current mandate she is its Chairwoman of the Employment and Social Affairs Committee, but also she serves as a substitute member of the Economic and Monetary Affairs Committee. She has been appointed rapporteur of the Temporary Committee on the Financial, Economic and Social Crisis. Previously, she was Chairwoman of the EP Economic and Monetary Affairs Committee (2004 – 2009), head of the French Socialists’ Delegation and Vice-President of the Socialist / PES Group in the EP (June 1997 – June 2004). Between December 1999 and October 2000 Mrs Berès was a Vice-President of the EP Delegation to the European Convention in charge of elaborating a Charter of Fundamental Rights for the European Union. Furthermore, between February 2002 and July 2003 she was a member of the European Convention on the Future of Europe, which drafted the Treaty establishing Constitution for Europe.

¹⁹ http://astrid.eu/Riforma-de/Documenti/EUROFI-FORUM-2010_FINAL-REPORT.pdf

Global Economic Governance, in search of a New Policy framework



By **Roy CULPEPER**

Introduction

The system of global economic governance that emerged from the Second World War was more than a set of international institutions. The institutions were created with specific mandates, based on a clear conceptual framework that articulated how nation-states and the world community can work toward the objectives of economic stability and prosperity.

The conceptual framework underlying the system was forged during the Great Depression principally by John Maynard Keynes, and the international architecture was erected at Bretton Woods in 1944. In a sense, the system became a victim of its own success (an unprecedented quarter century of world economic growth). It was also a victim of the Triffin dilemma, which pointed to one of its fundamental flaws, namely, the consequences of anchoring the international monetary system on the currency of one particular country, the United States of America. Such a system must balance precariously between a dollar shortage and a dollar glut, the former leading to deflation and the latter sowing instability and uncertainty.

But when the Bretton Woods fixed exchange rate regime came to end in the early 1970s, more than the Triffin dilemma was at work. Over the next three decades, an alternate conceptual framework emerged, challenging the Keynesian policy assumptions underlying the postwar framework of national and global economic governance. The challenge was manifested at a number of levels. First, the stability of a world of (relatively) fixed exchange rates, created to avoid the competitive devaluations of the 1930s, gave way to one in which the exchange rate must be viewed as just another price to be determined by sometimes erratic and volatile market forces.

Second, at the national level, the scope of macroeconomic policy, and particularly countercyclical demand management, became much narrower. Fiscal policy became discredited and the role of the state in managing aggregate demand diminished. Monetary policy remained as a countercyclical tool, but it became singularly focused on inflation targeting, typically to the neglect of output and unemployment in the real economy. Under the growing influence of the Rational Expectations hypothesis, the presumption was that the macroeconomy does the best it can, absent shocks and market frictions. Moreover, involuntary unemployment is assumed not to exist, and public policy can typically only make things worse, except perhaps by attacking sources of wage and price inflexibility, for example labour unions (see Solow (2010)).

Third, extensive financial regulation to constrain the speculative tendencies of the market, prompted by the banking crises of the 1930s, was increasingly questioned. The intellectual foundation for this trend was the “Efficient Markets” hypothesis, which led to financial deregulation in the 1980s and 1990s. Eventually, constraints on international capital flows (embodied in the postwar architecture, notably in the Articles of Agreement of the International Monetary Fund) also came under assault.

But by then the “Tequila” and the Asian Financial Crises (as well as the debt crises of the 1980s) had demonstrated that the new intellectual order had some grave shortcomings illustrated by growing instability and recurrent crisis. However, despite these and other warning signs (for example, the Savings and Loan crash in 1987 and the dot-com bubble in the 1990s), the new intellectual edifice of economic liberalization, characterized by George Soros (1998) as “market fundamentalism,” remained paramount.

A decade after the Asian crisis the world has experienced the most serious global economic turmoil since the Great Depression. In order to properly understand its genesis and to seek comprehensive solutions, it is imperative to go beyond simply revisiting the institutional architecture of governance, to the intellectual underpinnings of economic policy, which have become increasingly at odds with what the postwar system was created to do. Indeed, in some ways the current economic policy framework represents a return to that prevailing in the 1920s.

Much of the current debate around global economic governance and its reform does not explicitly take into account the distinction between policy means and ultimate ends. Debates over details of institutional reform, such as representation, accountability or effectiveness of specific organizations, tend to ignore the underlying policy framework which has shifted profoundly since the institutions were created 65 years ago. These institutional issues are certainly important, but their importance is surely of a lower order. Without examining the compatibility of the underlying policy framework with the rationale and aims of the international institutions, such debates may be fruitless in bringing about a more stable and prosperous global economy. Moreover, without such an examination there is a danger that the policies of the last three decades will continue to prevail while viable policy alternatives will not get the consideration they deserve.

The aim of this background note is to bring this distinction into sharper focus as a contribution toward the current debate on global economic governance. The next section briefly describes the evolution of postwar global economic governance, set against the return of policies of economic liberalization. In the third section the role of liberalization policies is put into the context of the current crisis. The fourth section examines the actions taken under the leadership of the G20 leaders to address the crisis and to lay the foundations for a return to stability and growth. The final section, drawing on the lessons of the current and previous crises, suggests the basic policy elements necessary to a fundamental reform of global economic governance. The paper ends with a short conclusion.

The Postwar Architecture and the Rise of the Gs

When the United Nations, the International Monetary Fund and the World Bank were formally established in 1945 (and the General Agreement on Tariffs and Trade was established in 1947), these international organizations were considered instruments working towards the specific ends spelled out in their charters. The UN had broader aims, encompassing peace and security, but also including “international cooperation in solving international problems of an economic, social, cultural or humanitarian character” and to be “a centre for harmonizing the actions of nations in the attainment of these common ends.”² The IMF, Bank and GATT/WTO, on the other hand, were considered the primary instruments of global economic governance.

Today, in 2010, “global economic governance” encompasses not only these multilateral organizations, but a host of other formal multilateral agencies and institutions, including the Bank for International Settlements, the International Labour Organization (both of which predate the UN, IMF and World Bank), and a number of other international financial institutions such as the regional and sub-regional development banks.

Since the 1970s, however, global economic governance has come increasingly to refer to informal groups of member states – the G10, G24, G5, G7 and G8, and latterly the G20³. These groupings (the “Gs”) materialized in order to address presumed weaknesses in the formal organizations, and to coordinate the positions of their members within and in some cases beyond them. More specifically, with the breakdown of the Bretton Woods fixed exchange rate regime in the 1970s, the G5 and G7 were formed to coordinate their economic policies and in the late 1990s, the G20 (at the level of Finance Ministers) was formed to address responses to the Asian financial crisis.

However, judging by its actions, the more fundamental purpose of the Gs (here meaning principally the G7 and the G20) since the 1970s has been to promote the agenda of economic liberalization on a global scale (i.e. economic globalization) – through multilateral trade negotiations and by pursuing financial and capital account liberalization. The crucial difference between the Gs and those of the formal global economic organizations is that while the formal organizations clearly state their ultimate objectives in their charters, the Gs were formed without any such charters.

Specifically, the formal organizations’ charters are very clear about their ultimate objectives. For example, the IMF’s objectives include:-

“To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy” (*Article 1, section ii*),

and:

“To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation” (*section iii*).

1 Its successor, the World Trade Organization, was established in 1995.

2 Article 1, section 3, “Purposes of the United Nations.” This is consistent with the proposal by the UN Expert Commission (2009) to create a Global Economic Coordination Council—see below. The IMF’s six purposes are set out in Article 1 of its articles of agreement; the five purposes of the International Bank for Reconstruction and Development are set out in Article 1 of its articles of agreement.

3 This list comprises groupings that have a primarily economic rationale and excludes the political groupings such as the Group of 77 in the United Nations. Similarly, the G8, which includes Russia, is primarily a political rather than an economic grouping. For an analysis of the evolution and implications of the Gs, see Culpeper (2001).

In contrast, as informal organizations the Gs have chosen to pursue policies, rooted in their domestic political economy, through the formal organizations and beyond. The important point is that the agenda of economic liberalization is viewed as an end in itself rather than a means toward “real” objectives such as high levels of employment and real income, or orderly exchange arrangements.

The underlying motivation of the Gs may in fact have been that economic liberalization will help to achieve the objectives of the formal organizations. Or, more likely, it may have rested on a belief that such policies are inherently desirable in themselves on the grounds that they will enhance economic efficiency on a global scale, no matter their impact on real output, incomes or employment.

The distinction is important. *If the pursuit of policies of liberalization is the fundamental objective of the Gs, rather than real outcomes such as the standard of living or conditions of labour (to cite the World Bank’s Charter⁴) it is difficult to hold the Gs accountable for the results of actions that have been taken due to their endorsement or pressure⁵.*

Moreover, the whole purpose of global economic governance becomes clouded, once policy means are given pre-eminence over the ultimate policy objectives. If undesirable outcomes occur – such as the many episodes of financial crises and instability over the past three decades – they can be attributed to improper or incomplete policy implementation, rather than to shortcomings in the policies themselves, which are deemed desirable in themselves and hence beyond reproach.

The Crisis of 2008-9: Liberalization and Its Consequences

While each financial crisis has its own unique features, there are many commonalities going back several decades, indeed, a few centuries. Moreover, each crisis often sows the seeds for the next one, and the crises of the 1990s and 2008-9 were no different (Kindleberger (1996), Reinhart and Rogoff (2009)).

A number of factors combined to precipitate the current crisis: low interest rates in the United States and other industrial countries, prevailing over lengthy periods; financial deregulation and innovation including increasingly exotic instruments; and growing international payments imbalances, particularly China’s surpluses. The net impact was to feed increasingly speculative investment, and to inflate asset bubbles and debt to unsustainable levels.

While all these factors played important roles, some observers emphasize growing global imbalances as “the” prime factor (e.g. Krugman and Wells, (2010)). This emphasis in turn leads to an over-emphasis on the reduction of “excessive Chinese savings”, and to putting considerable weight on revaluation of the renminbi, as key to the restoration of global financial stability.

It is true that widening international payments imbalances have provided considerable fuel for the crisis. A particularly important finding by Reinhart and Rogoff (2009) is that periods of high capital mobility have repeatedly precipitated international banking crises in the 19th and 20th centuries. For example, the banking crises in the 1930s,

⁴ Article 1, section iii.

⁵ The same argument may be applied to the European Union and its pursuit of Economic Partnership Agreements with developing countries.



1980s and 1990s were all preceded by surges of international capital mobility. (In contrast, the post-Second World War period (1945-70) featured both low international capital mobility and few banking crises.)

There is also no doubt that in the run-up to the 2008-9 crisis international capital mobility played an important role (Wolf 2008). In particular, the accumulation of current account surpluses, not only by China, but also Japan, a number of other emerging market countries in Asia, Germany, and oil exporters, with a corresponding buildup of deficits in the United States, the U.K., and central and eastern Europe, was reflected in a capital outflow from surplus to deficit regions. Much (but not all) of the outflow took the form of accumulating foreign exchange reserves in the surplus countries, much of them invested in U.S. Treasuries.

As Minsky often pointed out, preceding all financial crises there is a buildup of debt during periods of financial stability and economic expansion. The longer are periods of economic stability, the greater the propensity of investors to expand leverage and take increasingly risky positions in the financial market and of borrowers to become over-indebted (Minsky 1992; Kindleberger 1996). When accompanied by periods of low interest rates, these tendencies accelerate, feeding asset bubbles that eventually burst, precipitating the crisis.

In 2004, while Federal Reserve Governor Ben Bernanke was celebrating the “Great Moderation”⁶ era of low interest rates, relatively high employment and respectable economic growth, financial markets and households were engaged in a feeding frenzy of speculative lending and borrowing (particularly for housing), driving up house and asset prices.

Much of the fuel for this frenzy, it is true, was supplied by savings surplus countries, which flowed into US Treasuries, helping to reinforce the historically low interest rate regime of the Federal Reserve. But the capital inflow had important knock-on effects. As other (primarily domestic) investors sought higher yields, they increasingly took to more speculative and risky investments, including sub-prime mortgages repackaged in opaque vehicles and certified by ratings agencies as low-risk.

But it is also critical to put the genesis of increasing surpluses by China and other emerging market countries into historical perspective as an illustration of how each crisis can sow the seeds of the next one. Specifically, the adoption by Asian countries of a strategy aimed at generating increasing surpluses can be clearly linked to the Asian financial crisis in the late 1990s. The lesson was that reliance on foreign creditors can be dangerous and that, in a financial crisis, the IMF can insist on adjustment policies that are politically unacceptable. Accordingly Asian countries concluded that self-insurance, in the form of substantial foreign exchange reserves (notwithstanding the underlying costs), was much to be preferred over the vagaries of the capital markets or the vicissitudes of IMF policy.

A related issue precipitated by an increasingly liberalized trade and investment environment, separate from that of volatile short-term capital surges, is that of longer term capital flight, or to use a less biased term⁷,

⁶ “The Great Moderation”. Remarks by Governor Ben S. Bernanke at the meetings of the Eastern Economic Association, Washington, DC, February 20, 2004.

⁷ The term “capital flight” puts the onus on the countries of origin—which are responsible for capital outflows due to bad policies, poor business conditions, political instability etc. While such factors are undoubtedly a reality in many countries, they should be captured by legal and recorded outflows. “Illicit flows” on the other hand reflect an intention to evade laws, regulations, and tax liabilities, and involve the complicity of financial institutions that are recipients of such illicit flows, typically in industrial countries.





“illicit financial flows”. These involve the transfer of money earned through illegal activities such as corruption, transactions involving contraband goods, criminal activities, and efforts to shelter wealth from a country’s tax authorities. Recent estimates suggest that the level of such illicit outflows from developing countries is substantial, representing a huge opportunity cost to countries most of which should be destinations rather than sources of capital. To distinguish such flows from legal and reported capital flows, they cover only unrecorded private flows that are illegally earned and transferred in contravention of applicable tax laws and regulatory frameworks (including capital controls). In the years preceding the financial crisis, under the most conservative assumptions illicit outflows from developing countries have been estimated at an average of \$612 billion per year between 2002 and 2006, rising at a rate of 18.2 percent annually to reach a level of at least \$858.6 billion in 2006. Illicit outflows from Africa alone over the 39-year period 1970-2008 have been estimated to be at least \$854 billion. For sub-Saharan Africa, illicit outflows amounted to 179 percent of ODA inflows over this period (Kar and Cartwright-Smith, (2008), (2010)).

Another factor underlying the crisis is that of growing inequality within countries. Some observers (Jomo K.S. and Baudot, (2007); UN (2009); Stiglitz (2010)) point to the clear links between rising inequality and policies of economic liberalization. Interestingly from a more conservative perspective, Rajan (2010) also situates increasing inequality among American households as the basis of misguided U.S. macroeconomic policies to provide cheap credit, in an attempt to contain this trend by making home ownership more accessible and by stimulating job creation.

The point is that all these factors – short-term and long – have intersected, and that it is misleading to “blame” particular agents – whether China or other emerging market or developing countries responsible for “the savings glut”; or profligate consumers in the U.S. and elsewhere, ignoring the risks of hyper-indebtedness; or financial deregulation; or greedy bankers; or lax central banks and governments. Instead, as Skidelsky (2009) points out, “...the root of the crisis was not failure of character or competence but a failure of ideas...The present crisis is, to a large extent, the fruit of the intellectual failure of the economics profession.” The implications of this line of argument (see also Krugman (2009); Stiglitz (2010)) are taken up in the final section.

Response to the Crisis: Good News and Bad

As the financial crisis deepened in the course of 2008, it became clear that nothing less than an internationally coordinated response by world leaders was necessary in order to prevent a Second Great Depression. The G20, elevated from a club of Finance Ministers to a club of Heads of Government, met in Washington in November 2008, London in April 2009, Pittsburgh in September 2009, and Toronto in June 2010. The rescue package that emerged from the first two G20 Summits consisted of a massive coordinated fiscal stimulus to thwart a depression, multi-billion dollar bailouts to arrest a widespread collapse of banks, and a program of regulatory reform aimed at checking the speculative excesses of the financial sector.

The good news is that the attempt to thwart a serious depression was (at least until the time of writing) successful. The Washington and London G20 Summits stimulated a rally on financial markets and there was much talk during the spring of 2009 of the “green shoots” of recovery. But this presumed success was also bad news. With the ebbing of the crisis, popular anger over multi-billion dollar bank bailouts subsided. Intense

pressures to address the root causes of the crisis, and to carry through on the regulatory reform of the financial sector, began to dissipate while resistance from the financial sector grew. Global imbalances resumed their momentum. The reversion to a business-as-usual agenda, both in the financial sector and in the councils of economic policy-makers (many of whom were part of earlier administrations when deregulation and liberalization were the order of the day – see Stiglitz (2010)), seemed too evident.

The bad news went further. Having arrested the crisis before it became a full-blown depression, the G20 then seemed willing to risk undermining the economic recovery. At its Toronto Summit in June 2010, the G20 tried to converge on “growth-friendly fiscal consolidation” plans to reduce the legacy of deficits and debts caused by the crisis. Their declaration aimed at least at halving fiscal deficits by 2013 and stabilizing or reducing government debt to GDP ratios by 2016. Such “fiscal consolidation” is justified on the grounds of restoring the confidence of markets. But it could easily have the opposite effect by triggering a “double dip”.

It remains to be seen whether G20 members will adhere to commitments on fiscal consolidation articulated in the Toronto summit. It is possible that continuing high unemployment and low growth will lead to a postponement of plans for fiscal consolidation. But there are in addition other elements of the G20 reform agenda which are stalling.

Specifically, the agenda on financial regulation risks falling far short of the aims and aspirations of a number of experts from disparate viewpoints, who regard the unreformed financial sector as potentially very dangerous (see, for example, LSE Report (2010)). Second, even though financial reform legislation is being enacted at the national level (e.g. the Dodd-Frank Act in the U.S.), major issues (for example on minimum capital standards) can only be resolved at the international level for a “level playing field” among banks of different nationalities. Moreover, the ability of under-resourced regulatory authorities to keep abreast of financial innovation, and the resistance of the financial industry to the appointment of zealous regulators⁸, do not augur well for the emerging regulatory system.

With regard to capital adequacy standards, the new *Basel III* framework agreement that emerged in September (presumably to be agreed at the next G20 Summit in Korea in November) has already been vigorously criticized as demanding too little from banks, and to be implemented over too long a time period. Instead of the new 7% risk-weighted capital ratio recommended in the framework agreement, experts are calling for ratios as high as 20 to 30% in order to bolster the safety of the financial system to withstand a shock of similar magnitude to 2008-9 (Wolf (2010); Johnson (2010)).

While higher capital adequacy standards would serve to make the banking system more resilient and less likely to suffer crisis and bank failure, more is needed to contain the “irrational exuberance” of credit expansion which feeds asset bubbles during upswings. This will require the deployment of countercyclical macroprudential tools such as automatic or discretionary variation of capital or liquidity requirements across the cycle (Turner in LSE (2010)). Such tools could parallel a more activist countercyclical monetary policy, one that goes beyond inflation targeting to aim at containing the growth of asset bubbles.

Moreover, the agenda for regulatory reform of the financial must reach well beyond the banks to other financial institutions that have come to play an increasingly prominent role in the sector. The focus on bank capital is no longer adequate to manage liquidity and solvency in an increasingly market-based financial system. Central banks have traditionally managed liquidity primarily through banks, but given the significant and growing share

⁸ In the case of the U.S., the (non-)appointment of Elizabeth Warren to the Consumer Financial Protection Bureau created by the new legislation.

of non-deposit taking financial institutions, hedge funds and private pools of capital, it seems crucial that regulation and supervision reach all such segments of the financial system (D'Arista and Griffith-Jones, 2009).

However, as the promises of recovery in 2009 gave way to uncertainties and fears of a double dip in 2010 (notwithstanding political pressures for early “fiscal consolidation”), such forward-looking possibilities for regulatory and macroeconomic reform – aimed at preventing the next crisis–seem increasingly remote.

Reforming Global Economic Governance: Some Basic Policy Ingredients

Although the G20 has succeeded, at least for the time being, in averting a Second Great Depression, it is clear that it faces major challenges going forward in reaching consensus on managing the recovery, let alone an agenda to reform global economic governance. Within the G20, clear disagreements have emerged between the old “great powers” congregated in the G7, and the emerging market members, particularly the “BRIC” group, no longer content to do their bidding. In analyzing what has been achieved by G20 leaders, Woods (2010) argues that far from giving rise to a “new multilateralism” in which, for example, the IMF will be able to tackle global imbalances through more effective surveillance, what the world is actually witnessing is the “last gasp” of the great powers.

It is possible, but by no means certain, that the crisis is bringing to an end the era of rampant economic liberalization and market fundamentalism. The Washington Consensus may be discredited, but it is not quite dead. The question is, what, if anything, is to take its place? And what should become of the international system created by the “great powers” and prevailing for the last six decades? Given the heterogeneity of the members of the G20, it will not be easy, nor perhaps even possible, to articulate an alternative policy and institutional framework that will command consensus.

The lesson of 2008-9, like the financial crises of the past 30 years, is that collapse averted means crisis forgotten. Absent another Great Depression, more crises are regrettably to be expected rather than prevented – their seeds, no doubt, have already been sown with the anemic regulatory reforms now in motion, not to mention the possibility of premature fiscal consolidation. Therefore, policy and institutional change is more likely to be incremental rather than radical or sweeping. And despite its heterogeneity and internal divisions, the G20 is likely to preside over change, at least in the coming decade if not beyond.

At the end of the day, incremental reform is better than no reform. So what are the most compelling issues that should form the basic elements of an **incremental policy reform** agenda? The following list, in no particular order, arises from the foregoing discussion. To its great credit, the U.N. (2009), through its Commission of Experts of the President of the General Assembly, has made a critical, and much more comprehensive, list of recommendations. Some of the themes in the Commission’s report are reflected both in the above discussion and in the following list.

The first of these issues is **the need to attack growing inequality in most countries around the world.** As the Commission put it these are not only socially unjust but have also contributed to the problem of weak effective demand. The problem is that globalization and increased openness has not only widened inequalities; it has also made government policies of redistribution more difficult (Bertola and Lo Prete (2008)). Financial markets can step into the breach with private credit and insurance (Rajan (2010)) but when they fail, as they did in 2008-9, they can cause widespread bankruptcy and misery. The policy implication is that if governments

are not to resort to protectionism, the international community has to find a better equilibrium between global economic integration, national sovereignty, and a socially acceptable level of distribution (see Rodrik (2007) on “the inescapable trilemma of the world economy”).

The second relates to the role of international capital mobility in precipitating instability and financial crises, and also in illicit outflows which in many cases deprive developing countries of more resources than they obtain through official flows such as foreign aid. While the move toward official capital account liberalization was checked by the Asian Financial Crisis in the 1990s, it still figures as part of the unofficial agenda of the international financial institutions and among the longer-term objectives of many developing countries. It is time that the regulation of such flows be formally recognized by the international financial institutions as part of the legitimate apparatus of prudential management and crisis prevention (Epstein (2009); Akyüz (2009)). An issue pertinent to constraining illicit outflows and facilitating the repatriation of flight capital is ending bank secrecy. **Greater transparency is in the global public interest, as well as in the interest of national tax authorities in both industrial and developing countries.**

Given the dangers for developing countries of excessive reliance on external resources, the third relates to the importance of enhancing domestic resource mobilization, both through the public sector and the domestic financial markets. For the most part this calls for improving the integrity, effectiveness and efficiency of developing countries’ tax authorities. It equally calls for extending the reach of public and private financial intermediaries so they are able to provide financial services and credit to a greater proportion of the population, the vast majority of which are typically excluded (Culpeper and Bhushan, (2010); Culpeper (2010)). But there are also international implications. **A practical illustration is the need for better taxation of transnational enterprises, which often seek and receive tax exemptions that deeply erode the revenue base of host countries keen to attract foreign investment. At the international level, this requires greater tax cooperation to reduce tax competition among countries. It also calls for greater transparency and disclosure by transnational companies, for example through country-by-country reporting rather than consolidated global accounting.**

A fourth issue relates to **the importance of countercyclical policies. These must include fiscal and regulatory policies, as well as monetary policy.** Prior to the current crisis countercyclical fiscal policy had widely fallen into disuse. The injection of fiscal stimulus coordinated by the G20 to arrest the deepening recession demonstrated that it is still a potent countercyclical instrument. However, the clamour for fiscal consolidation suggests that some governments are still wary of fiscal deficits to the point that it may still not be accepted as a regular instrument of countercyclical management. Countercyclical regulatory or macro-prudential measures are newer than fiscal policy, so whether they emerge intact from the current regulatory reform initiatives remains to be seen.

Fifth, **it is obvious that a new global reserve system is urgently needed.** The “international non-system” that emerged from the dissolution of the Bretton Woods exchange rate regime has provided fertile ground for currency instability, financial crises, and illicit financial flows. Nor is a return to the Bretton Woods regime desirable, even if it were possible, given its deflationary bias, instability and inequity in inducing resource flows from poorer to reserve currency countries (Ocampo (2009)). Instead, a new system based on a global reserve such as Special Drawing Rights (recently revived from their moribund status by the G20), makes the most sense, but as the UN Expert Commission (2009) pointed out, there are many alternative designs that may help achieve a number of broader objectives, including social, economic and environmental objectives (Culpeper (2010)).

Last but certainly not least, **while the G20 can be expected, for the coming years, to continue in its role coordinating economic policy among the “systemically significant” states of the world, it lacks legitimacy.** Its exclusion of 172 countries many of which have a profound stake in improving global economic governance, and most of which are poor, limits both the reach and the ability of the G20 to exercise the leadership required to undertake necessary reforms. The UN Expert Commission ((2009), Chapter 4) makes a compelling case for a new Global Economic Coordination Council under the auspices of the United Nations, if such legitimacy is to transpire, and such international leadership is to be exercised. Such a Council would be far better positioned to preside (for example) over international discussions on a new global reserve system, or new protocols governing international capital movements, or international tax cooperation.

The above list is minimal, and it only begins to address the needs of developing countries (for example, the need to increase their resilience to climate change). However, if any headway is made on these, palpable improvements in global economic governance is likely to result.

Conclusion

A new policy framework is urgently needed to supersede the market fundamentalism of the last generation, and to inform global economic governance over the next generation. It needs to retain the positive aspects of economic liberalization – its incentives to innovation and enhanced productivity – while discarding the negative – its vulnerability to recurrent crisis, and its tendency to deepen inequality. Principles of equity and solidarity, and the responsibility to help and protect the vulnerable should be at its core. In many respects such a framework has already been articulated in the report of the UN Expert Commission (2009), along with a host of ideas and recommendations that deserve the serious consideration of the world community – and the G20.

But ultimately actions speak louder, and are more convincing, than words. If incremental rather than sweeping or comprehensive policy change is to be the order of the day, at least until the next crisis arrives, there is much that can be usefully done, even in a piecemeal fashion.

References

- Akyuz Yilmaz, (2009)** *“Policy Response to the Global Financial Crisis: Key Issues for Developing Countries”*, Chapter 4 in Jomo K.S, (2009)
- Bertola Giuseppe and Ana Lo Prete, (2008)** *“Finance, redistribution, globalization”*, Vox, <http://voxeu.org/index.php?q=node/2641>
- Culpeper Roy (2010)** *“Global Governance, International Support Mechanisms and LDCs: Reality and Opportunities”* Background paper for UNCTAD (forthcoming), *Least Developed Countries Report 2010*.
- Culpeper, Roy and Aniket Bhushan (2010)** *“Do-it-yourself Development: A Synthesis Report on Domestic Resource Mobilization in Sub-Saharan Africa”*, Ottawa, The North-South Institute, <http://www.nsi-ins.ca/english/pdf/SynthesisFINALPOST.pdf>

- Culpeper Roy, (2001)** *"Systemic Reform at a Standstill: a Flock of "Gs" in Search of Global Financial Stability"*, in Stephany Griffith-Jones and Amar Bhattacharya, *Developing Countries and the Global Financial System*, (London: Commonwealth Secretariat)
- D'Arista Jane and Griffith-Jones Stephany, (2009)** *"Agenda and Criteria for Financial Regulatory Reform"*, In Jomo K.S., (2009)
- Epstein Gerald, (2009)** *"Should Financial Flows be Regulated? Yes"*, Chapter 5 in Jomo K.S., (2009).
- Johnson Simon, (2010)** *"Basel III: the Fatal Flaw"*, *Baseline Scenario*, posted September 16. <http://baselinescenario.com/2010/09/16/basel-iii-the-fatal-flaw/#more-8037>
- Jomo K.S., ed., (2009)** *"Reforming the International Financial System for Development. Lessons from the Current and Recent Crises in Developing Countries"*, Washington, DC: G24.
- Jomo K.S. with Baudot Jacques, (2007)** *"Flat World, Big Gaps: Economic Liberalization, globalization, Poverty and Inequality"*, London and New York: Orient Longman, Zed Books, and TWN, in association with the United Nations.
- Kar Dev and Cartwright-Smith Devon, (2008)** *"Illicit Financial Flows from Developing Countries, 2002-2006"*, Washington, DC: Global Financial Integrity
- Kar Dev and Cartwright-Smith Devon, (2010)** *"Illicit Financial Flows from Africa: Hidden Resource for Development"*, Washington, DC: Global Financial Integrity
- Kindleberger, Charles P. (1996)** *"Manias, Panics and Crashes: A History of Financial Crises"*, New York: John Wiley and Sons Inc. Third edition
- Krugman Paul and Wells Robin (2010)** *"The Slump Goes On: Why?"*, *The New York Review of Books*. (Sept. 30)
- Krugman Paul, (2009)** *"The Return of Depression Economics and the Crisis of 2008"*, New York and London, W.W. Norton & Co
- LSE Report (2010)** *"The Future of Finance"*, London, London School of Economics and Political Science
- Hyman Minsky, (1992)** *"The Financial Instability Hypothesis"* Jerome Levy Institute of Bard College
- Ocampo José Antonio, (2009)** *"Special Drawing Rights and the Reform of the Global Reserve System"* Chapter 11 in Jomo K.S. (2009)
- Rajan Raghuram, (2010)** *"Fault Lines: How Hidden Fractures Still Threaten the World Economy"*, Princeton, Princeton University Press.
- Reinhart Carmen, and Rogoff Kenneth, (2009)** *"This Time is Different: Eight Centuries of Financial Folly"*, Princeton, Princeton University Press.
- Rodrik Dani, (2007)** *"The inescapable trilemma of the world economy"* Dani Rodrik's weblog, http://rodrik.typepad.com/dani_rodriks_weblog/2007/06/the-inescapable.html, June 27
- Skidelsky Robert, (2009)** *"Keynes: The Return of the Master"*, London: Allen Lane
- Solow Robert, (2010)** *"Building a Science of Economics for the Real World"* Prepared statement to the House Committee on Science and Technology, Subcommittee on Investigations and Oversight, July 20

- Soros George, (1998)** *"The Crisis of Global Capitalism: Open Society Endangered"*, New York, Public Affairs
- Stiglitz Joseph E.** *"Freefall: America, Free Markets and the Sinking of the World Economy"*, New York, W.W. Norton & Co
- Turner Adair, (2010)** *"What do Banks Do? Why do Credit Booms and Busts occur? What can Public Policy do about it?"* Chapter 1 in LSE Report (2010)
- United Nations (2009)** *"Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System"*, (Stiglitz Commission), New York, September 21
- Wolf Martin** *"Basel III: Too Soft, Not Enough"* *Business Spectator*. 15 September
- Wolf Martin, (2008)** *"Fixing Global Finance"*, Baltimore, The Johns Hopkins University Press
- Woods Ngaire, (2010)** *"Global Governance after the Financial Crisis: A New Multilateralism or the Last Gasp of the Great Powers?"* *Global Policy* 1:1 (January)

Biography note

Roy CULPEPER served as President & CEO of The North-South Institute in Ottawa from 1995 to 2010. Prior to joining the Institute he had served as an adviser to the Canadian Executive Director at the World Bank, and as an official in Canada's federal Departments of Finance and External Affairs. He is currently a Distinguished Research Fellow at The North-South Institute, an Adjunct Professor at Carleton University's School of Public Policy and Administration, and a Senior Fellow of the School of International Development and Global Studies at the University of Ottawa. In January 2011 he was appointed Fulbright Canada Visiting Research Chair at the Woodrow Wilson International Center for Scholars in Washington, D.C. Mr. Culpeper has a Ph.D. in Economics from the University of Toronto. He has a number of publications relating to international finance and development.

Queries



04

Conference report

The contemporary challenge to construct an innovative vision for a *NEXT Global Deal* has inspired FEPS (Foundation for European Progressive Studies) and IPD (Initiative for Policy Dialogue) to stimulate and enable an exchange of ideas between leading politicians, stake-holders and academics. The conference took place in Washington D.C. (USA) in October 2010 and was a great momentum, during which several valuable, feasible proposals were formulated. Many of them have been already mirrored in the articles gathered in the previous Chapters; however some arguments were articulated only during and as a result of this debate. Therefore the last Chapter of *Queries* includes the detailed report of the discussions, bringing together their significant conclusions.

Global Economic Governance Conference



Summary prepared by **Ariane Ortiz MARRUFO**

The global financial crisis and its economic and social consequences underscored the importance and urgency to deal with global governance issues that have long remained unsolved: What should the appropriate national response be during a recession? How can the international community better coordinate the macro responses in a legitimate and institutional way? How can we strengthen financial regulation? These and other crucial questions were addressed by policy-makers, analysts, and multilateral institution officers who gathered at the Global Economic Governance Conference organized by the Initiative for Policy Dialogue (IPD) and the Foundation for European Progressive Studies (FEPS) at Brookings Institution in Washington, D.C. The conference was part of an ongoing effort of the IPD Financial Market Task Force to stimulate debate on global governance issues, as well as FEPS' commitment to seek fresh thinking in reshaping the economy in a more progressive and balanced way.

This report sums up the most relevant points from the presentations and discussions of the conference. The first section reviews the discussion on institutional issues for global governance, while the second section presents the panel ideas on macro-governance. The third section discusses if fiscal stimulus is needed for economic recovery, while the fourth section summarizes the panel on finance and development. The fifth section presents the arguments discussed in the panel on trade. The final section presents the main points stated at the public and concluding panel: "Global Economic Governance for World Development".

Discussion on Institutional Issues for Global Governance

Participants agreed that **global governance reform is a question of necessity and stressed that a new global architecture needs to be designed to ensure sustainable development. Political players must understand that the global financial crisis deserves a political economic response in accordance to the magnitude and character of the crisis. The importance of explaining what is meant by progressive global governance was also highlighted, since it is crucial to undertake reform that is informed by a body of thinking that supports equitable and sustainable growth under a new synthesis of economic thought.**

Several obstacles need to be addressed to conduct reform; **all institutions need to make decisions faster and in a more efficient way**. Cultures that are embedded in international organizations need to change, and power structures should be rebalanced to embrace a plurality of ideas, backgrounds, and geographies.

Besides addressing efficiency issues, **most participants underscored the importance of finding a better and more equal way to include developing countries in global institutions, given that the G20 does not legitimately represent 172 countries – poor countries are not represented at all**. The general view is that the G20 should be institutionalized and perhaps linked to the UN to have more legitimacy. Some encouraged discussion on further strengthening the Economic and Social Council to enable it to fulfill the role ascribed to it in the Charter of the United Nations, as agreed at the International Conference on Financing for Development in Monterrey, Mexico in 2002. The Council could fill gaps in areas where the World Bank, IMF, and WTO conflict. In relation to legitimacy issues, several participants suggested that the UN Security Council should expand voting power for emerging countries and merge the seats of the European Union into one.

A few other participants argued in favor of the G20 by mentioning its benefits. They stressed that the G20 was swift in its response to the crisis and has distributed tasks across different organizations in a timely manner. They considered the G20 not only a decision-making body but also an effective agenda-setting group. They proposed the G20 to be a crisis committee, while the international organizations continue to create and implement policies.

Even though many participants agreed that the triangle of G20, UN, and IMF should complement each other, meaning that they are not mutually exclusive, other participants disagreed, stating that the G7 and the G20 sidetracked other international organizations. They argued that all decisions made by the G20 could have been made by the IMF. It was also mentioned that if the G20 was simply enlarged it would still not solve the legitimacy problem because international organizations would be weakened. The proponents of a strong G20 countered by saying that if the IMF had been the one to decide to issue additional monetary resources it would have taken years to respond.

In relation to global financial institutions, **the legitimacy of the Bank of International Settlements (BIS) and the Financial Stability Board (FSB) as true global institutions was questioned**. Robust measures at a national and regional level, before seeking a new global architecture, were suggested. Others disagreed with the idea of waiting for the FSB and other supranational financial regulatory institutions to be more representative before giving them more power. The argument is that as of now we are hostage to arbitrage and volatile global capital flows and that stronger global regulation is paramount.

While discussing the political difficulties ahead and acknowledging the difficulty to change embedded bureaucratic cultures in international organizations, some stressed the need to discuss what the most politically feasible or acceptable solution was, rather than the desirable characteristics of the most effective mechanism.

Discussion on Macro-governance

The discussants agreed that the main problems of the international monetary system are:

1. Asymmetry of adjustment tilted against deficit countries (surplus countries are not forced to adjust);

2. The world is hostage to U.S. domestic policy since the dollar is the reserve currency;
3. The self-insurance policy of developing countries, though rational from individual countries' points of view, fuels global imbalance.

Central for the discussion were exchange rate regimes and capital account regulation, as well as the macro-governance system. **In regards to the exchange rate regime, high exchange rate volatility needs to be addressed and alternatives such as the targeted system proposed by John Williamson some years ago should be considered. It was mentioned that capital account regulation is a major issue for developing countries. There is a structural imbalance that forces developing countries to have higher exchange rates than developed countries and that drives excessive capital flows to emerging markets. It is also important to discuss what capital control measures imposed by developing countries would be acceptable for developed countries,** as well as cross-border finance issues.

Some participants added that the imbalance of the current monetary system is reinforced by the need of emerging economies to accumulate international reserves to avoid IMF borrowing and conditionality, while others build-up reserves to support their export-led growth model. Since currency depreciations are only allowed via traditional restrictive monetary policy, but not by intervention in forex markets, the policy option is to accumulate reserves.

Other participants, however, questioned the veracity of the last argument, stating that the export-led model of East Asian economies has not contributed to worsen the global imbalance. They argued that Asian countries have adopted export-led models since 1960s, while the global imbalance concerns are very recent. In addition, countries such as Germany and Japan also have large current account surplus and it is clear that they are not pursuing a self-insurance strategy. They added that China's exchange rate policy was not a cause of global imbalance given that China's trade surplus increased until 2005.

According to them, the global imbalance is better explained by

1. Fed's low interest rate policy after the burst of dot-com bubbles in 2001;
2. Deregulation in the 1980s, which led to over risk-taking, high leverage, and bubbles;
3. Over-consumption in U.S. households and rising U.S. public sector debt;
4. U.S. ability to run a persistent and large current account deficit because it has a reserve currency.

Discussants, however, continued to argue that China was not setting the renminbi by free market mechanisms and that it avoided consumer imports, artificially depressed wages, and subsidized exports, decisively contributing to the global imbalance. Others stated that it is not clear that China is following a mercantilist approach, but that it is probably following a self-insurance strategy with the end result of increasing reserve accumulation. It was mentioned that letting China float its exchange rate may not be a solution since it could create important economic distortions in the country. Even though there was not a clear agreement on what are the major causes of the global imbalance, most discussants agreed that both China's and U.S.'s economic policies are to blame.

Proposals to address the problems of the current monetary system included the creation of a new more democratic and collaborative system, perhaps based on SDRs. Unfortunately, it is not easy to see



how money will be created and what will back-up SDRs. Resistance to the issuance of SDRs may come from developed countries, but developing countries could benefit from additional allocations of SDRs and could make their use more likely by holding a large part of their precautionary reserves in SDRs.

In relation to macro-governance collaboration, the main view has been that national policies are the ones that matter, with only some recognition that international coordination is needed. Participants agreed that a global governance system is an unsettled and insufficiently discussed issue, and different agencies in the international system should coordinate to raise and address the issue. Some discussants suggested that the IMF, World Bank, and WTO should be part of the UN system to allow better coordination.

Improving macro-governance and addressing the global imbalance are paramount issues, particularly in a world in which emerging markets will grow faster than high-income countries. It was stressed that as of now, emerging markets are intervening heavily in foreign exchange markets to avoid disruption and volatility. They are in the business of intervening between private capital flows and US treasury securities, which is ridiculous. Large changes in prices and volatile capital flows have large welfare and distribution costs. The rules of the game need to be set up and a decision made on coordination, to allow full capital mobility with clear multilateral rules. If not, someone said, the best arrangement would be minimum rules in the macro-level with the allowance for more national policy space for countries.

Discussion on the need for fiscal stimulus

Discussants were concerned about the overall weak global economic recovery, some even stating that anything normal is years away. For example, the IMF forecast for average GDP growth in the euro area in 2010 was 1.7%, well below that in 2008. The forecast for the euro area in 2011 is 1.5%. In the U.S., the labor market remains weak and mortgage foreclosures continue to transform homes from major assets to liabilities for American families. Credit has not been restored to pre-crisis levels and neither consumption nor investment is picking up to sustain the global economy.

The significant global imbalance may also hinder economic recovery, since it creates a lack of global demand. Some countries produce more than they are consuming. The increase in international reserves, which has more than tripled since 2002, has created a global aggregate surplus. Excess savings, however, are not being translated into more investment and interest rates can't go any lower.

How can policymakers promote economic recovery? Economic analysts have argued that additional fiscal stimulus would not work and that it is unaffordable. Most participants at the meeting, however, argued that fiscal stimulus will work and that we cannot afford not to do it. They pointed out that interest rates are so small that any additional change will not modify large business's decisions to invest, while small businesses pay much higher interest rates. Some forms of stimulus can take advantage of changing inter-temporal prices, such as temporary investment tax credits, and lead to further private investment. Some

participants suggested that assistance should be provided for countries that cannot implement fiscal expansion, and countries that can implement fiscal expansion should be encouraged to do so. **Global cooperation is needed to avoid weak global growth, protectionism, instability, and financial market fragmentation.**

Discussion on Finance and Development

Participants agreed that the financial sector should better serve **the real economy and should adequately deliver financing to small and medium enterprises.** Second, the financial system should act as a consumption smoothening over time, particularly for low-income people. Third, **it should provide safe custody of savings without serious risk of loss of value. Financial regulation should focus on these issues, creating a reliable and stable financial system.**

There are currently two broad sets of ideas for reform: the idea that reform should be implemented at an individual country level vs. the idea that a minimum standard should be set as per G20 and *Basel III* agreements. Participants, however, agreed that there is a strong need for global regulation, given that the impact of regulation on cross-border activities is unclear. Regulation for domestic banking activity has no global externality and so international banks that are large institutions that operate across markets and across tax issues are sources of instability and crisis. Some discussants stressed that empirical work over a broad period of time shows that financial market liberalization has led to instability, has decreased the flow of funds to small and medium enterprises, and has adversely affected development.

It was also mentioned that **although Basel III had some interesting and positive elements (such as regulating excess liquidity and increasing capital requirements), a source of serious concern is that regulating leverage has been given a secondary role. This is a serious mistake given that the leverage ratio of the shadow banking system was very high and faced little regulation in the years preceding the crisis.** An additional issue discussed was financial sector management and the need for it to create buffers for times of crisis and avoid over-risking.

Participants also addressed the question of how to properly tax the financial system, for example by introducing a global transactional tax. The tax should include derivatives, since most of the volatility of financial markets came from them. There is a coordinated effort in the E.U. to introduce measures that would trigger a financial transaction tax at a level of 0.05%. The U.S. is an absent player in this matter.

Some argued that socially responsible long-term investors should be encouraged to be concerned about the environment, development, and the consequences of their actions. Sovereign Wealth Funds were mentioned as a new set of players that may have a potential role as long-term investors with some degree of

social responsibility, after the great example set by Norway. Finally, some stressed that standards at international levels should take into account different levels of development. In developing countries, commercial banks typically devote themselves to consumption and short-term lending, while charging very high interest rates. There is a need to encourage commercial banks to have longer term roles and to promote development banks in developing countries.

Discussion on Trade

The panel on trade began with a discussion about the tension between trade policy and trade politics. **In general, one could agree that trade works with the cooperation of market forces and on the whole it favors consumers across the board, including poor consumers. Trade politics, however, are much trickier for several reasons. Favoring one industry may come at the cost of another, and it forces one to choose between constituencies. It is politically tricky, especially in market economies, because one can feel like a victim of unfair market competition. To reconcile both approaches, a serious and objective analysis must be done and the proper articulation must be found amongst governance levels. Trade issues are unfortunately rather complex and many incorrect analyses can flourish.**

Adding to the complexity, today's production is so globally fragmented that trade accounting is also spread out. Some suggested that trade should stop being counted with added value and should now be conducted heavily through supply chains and services. A participant added that taxing imports should also imply taxing exports. A discussant added that the notion of opening trade means opening immigration is a misconception. Others stated that if we want free capital flows and free trade flows we should also allow free labor flows. Limited labor flows, they argued, creates distortions of income and distribution both within countries and internationally.

Another participant stated that the major changes in trade are the continuum and deepening of globalization and the shift of power between north and south. These changes are driven partly by trade openness but also by technological changes, which makes it difficult for developing countries to define the right trade policy. To understand the current trade system, the participant considers two elements: the organization of work production through regional value chains and the increasing impact of trade competitiveness in agricultural products.

In relation to trade governance, discussants mentioned that the main focus remains at national systems. The right level of trade governance, however, appears to be at a regional level and this is where improvements need to be made. Many participants mentioned that bilateral agreements -- Free Trade Agreements (FTAs) and Preferential Trade Agreements (PTAs) -- are unfair and introduce distortions to the rest of the world. It was mentioned that the proliferation of FTAs are undermining tariffs, quotas, and subsidies as the main instruments of trade and industrial policies. Exchange rates and labor market policies have thus become more important determinants of trade outcomes.

To deal with FTAs, knowing that the ideal is a multilateral system but that FTAs are the ones proliferating, it was suggested to "multilateralize" the FTAs. This could be politically complex but perhaps more feasible than to try to eliminate them. It could be easier for parties to join by improving FTA rules and by increasing strictness on rules of origin and improving the connection between FTAs, keeping in mind development and equity elements.

Public Panel: Global Economic Governance for World Development

Concerning the global economy, participants of the public panel expressed concern about the fragile global recovery and argued that **sustained growth depends on the elimination of high unemployment and large excess capacity in high income countries.** It was mentioned that the way out for the developed countries is to find large export demand for their capital goods. Developing countries on the other hand have opportunities for bottleneck releasing and productivity-enhancing projects. Investments in those projects could create demand for capital goods produced in high-income countries and promote long-term growth in developing countries.

In relation to global governance, the world economy and finance will become more globalized (in a few years China's GDP will equate that of the U.S.) and soon there will be an important governance gap. The panel focused on the governance problems the current system has and on the right institutional framework required for the new world.

The problems of the current system are the lack of a reserve currency system, which has contributed to the persistence of the imbalances, and financial deregulation over the last three decades that has created a system which is extremely incoherent, unstable, and difficult to reform. This is a situation that promotes capital account liberalization without sufficient safeguards to cover risks of exchange rate volatility. In addition, it was argued that risk is not shifted from the poor to the rich like it ought to be in a well functioning market. **A system that finances growth more effectively and that is far more developmental is also needed; financial inclusion is necessary and it was not discussed in Bretton Woods.**

Moreover, among the range of issues on governance reform that was raised is the recognition that **Europe is over represented in the current Bretton Woods institution.** If an inclusive multilateral system is built, there are other challenges such as a sovereign debt restructuring mechanism. It was also mentioned the need to give incentives to restart a "global green New Deal" in investment and job creation, especially in terms of addressing environment sustainability, concerns in climate change, and problems of food agriculture. Another issue of "climate justice" was raised, as a participant explained that when developing countries provide resources, such as rainforests, they bear most of the cost of global warming and they need to be compensated for their environmental services.

Another area that is important is technology and the knowledge gap between countries. It was mentioned that **TRIPS, the intellectual property regime of the WTO, has big deficiencies.** A participant argued that the recent rounds have not really addressed concerns of developing countries such as non-tariff barriers, migration, escalating tariffs, and agricultural subsidies. The recent crisis highlights that the advanced industrial countries have provided massive subsidies to their agricultural, banking, and auto sectors.

In terms of what could be done to fix the system, some lamented that the Bretton Woods moment for transforming the basic rules of the game had been lost. This moment came out of a sense of crisis and futility in the last quarter of 2008. There is, however, a sense of complacency after success that has undermined the chances for reform.

Participants nonetheless mentioned different governance proposals to address the challenges. It was highlighted that **global governance must extend to every area: finance,** the monetary system, trade, climate

change, and development. Moreover, due to the failure of the international community to move forward, there is a big vacuum that has been filled by the G20 and a number of international collaborations. Participants recognized that the G20 has proved to be effective in coordinating monetary responses and facilitating fiscal stimulus, and that it is a good forum for discussing current global challenges. But the G20 has serious problems of legitimacy and accountability that need to be addressed.

Participants pointed out that **progress in global governance cannot be made without the UN** as a fundamental pillar. It was suggested that political drivers should be composed of a triangle of international agencies, the G20, and the UN. Discussants agreed that there is a need for a global economic coordinating council which could be small enough for meaningful discussion but representative enough and with political legitimacy so that it could be more effective than the G20. This council could be brought within an international framework of the UN system.

The Global Economic Council requires a Charter change in the UN, which can be easily resisted for a number of reasons. In the interim, there are at least two possible mechanisms that can be undertaken, if there is political will. First, there could be a special arrangement of the Economic and Social Council meeting at the leaders' level. Another alternative is for a general committee of the general assembly to meet on the leaders' level that would meet on the eve of the general assembly.

On another issue, a participant mentioned that the fact that the WTO is not part of the UN system institutionally raises certain challenges. It was noted, however, that there is increased ownership by developing countries in the WTO and that even though this institution is not a development agency, there is a need to consider developing countries' necessities and bilateral development agencies.

Finally, it was mentioned that international agencies such as the IMF and World Bank should work together for reallocation of voting power for developing countries. The World Bank should reflect the new global scenario, one in which emerging economies are more important. Some improvements to increase representation have been made. The World Bank increased the voting power of developing countries by 47% and three managing directors come from developing countries.

Biography note

Ariane ORTIZ MARRUFFO recently completed a Master of Public Administration at Columbia's School of International and Public Affairs (SIPA), concentrating in Advanced Policy and Economic Analysis. Ariane has worked for the Initiative for Policy Dialogue, co-organizing three high-level conferences which addressed strengthening financial regulation and reform of the world reserve system. She also conducted research and data analysis for several publications, measuring the impact of the recent crisis in the developing world and international financial regulation, and acted as Academic Co-Chair of the Latin American Student Association (LASA). Prior to Columbia, she worked for Citigroup's Corporate and Investment Bank in Monterrey, Mexico where she conducted credit analysis for several corporate clients. Ariane holds a Bachelor's Degree in Economics from the Instituto Tecnológico y de Estudios Superiores de Monterrey (ITESM) in Monterrey, Mexico

The series



NEXT LEFT, NEXT EUROPE

In 2009, FEPS launched a call for papers addressing PhD and PhD candidates to elaborate on how they saw Europe in a decade, within the framework of its [Next Left] programme, run under the leadership of former Austrian Chancellor Alfred GUSENBAUER. The first release of Queries contains a selection of the most interesting pieces.

Contents: Future of Social Europe | Changing European Society | Green Agenda for a Sustainable Europe | Europe of Democracy and Civic Participation | International Responsibility of Europe in a Global Age



THE NEXT WAVE OF EMANCIPATION

Since the beginning FEPS has been strongly involved in a debate on gender equality, which in fact was one of the very first projects that it established. This issue reviews the history of the struggle for gender equality in national member states, in Europe and elaborates on the progressive agenda for the future.

Contents: Gender sensitive, progressive Europe | A commitment that arises from a century struggle | Stronger from the past, encouraging experiences | The next agenda for changing society



WHAT COMES BEFORE, WHAT COMES NEXT

A tribute to Tony JUDT

*Queries serving as a guideline in selecting themes and articles that pose the most crucial questions and can stimulate an intellectual debate, it comes with no surprise that this issue commemorates late Tony Judd and his work. As Ernst STETTER, FEPS Secretary General writes, the last book of Tony Judd, *Ill Fares the Land*, poses an extraordinary challenge. This very particular intellectual testament of an outstanding academic and universalist socialist encompasses a fair, though bitter, assessment of today's world. It touches upon the mission that a renewed social democracy must embark upon in order to reverse the negative processes corroding our societies, through respecting all the achievements of past generations and being optimistic about the chances for the progressives to succeed in the future. This motivated the title of this issue.*

The NEXT Global Deal

The disastrous consequences of the recent financial, economic and social crisis exposed the bankruptcy of today's world order, dictated by a neo-liberal ideology. Its obvious inability to respond to global challenges makes it inadequate for the 21st century. Realizing this, one needs to call for a new, feasible agenda. For progressives this call is both a challenge and a chance to present our *NEXT Global Deal*.

First and foremost, there is number of ideals and principles that lay the foundations for a new agenda. These are the principles of solidarity, fairness and social justice. This is why Chapter 1 of this issue of *Queries* is devoted to the need for regulations of the global financial system. Also the questions of appropriate supervision and a need for a new generation global governance era are being tackled.

Secondly, the vision of the *NEXT Global Deal* must provide a complex answer to the most profound contemporary questions. Therefore the authors of the articles in Chapter 2 look into its details and examine for instance the current development and trade agenda, tackle questions of labour standards and the realization of the prerogative of decent work and explore new elements as the incorporation of environmental issues. Much attention is given to the role that Europe should play in the fundamentally changed international world and the concept of multilateralism it should advocate for. Last but not least, the proposals for reforming the institutional framework in general, and certain institutions such as the International Financial Institutions, are outlined.

New answers seem above all indispensable in current circumstances, in which people lose their confidence in international institutions, their governments and politicians in general. Their detachment from the world of politics and disbelief can be overcome once the democratic rules are put back in place, as far as global governance and European decision making processes are concerned. The issues of legitimacy and transparency are discussed by the authors of the articles in Chapter 3.

This issue of *Queries* – *The NEXT Global Deal* is opened with the forewords of Ernst STETTER and Joseph STIGLITZ. The articles have been written by outstanding politicians, stake-holders and academics who all met to discuss these issues in-depth at the FEPS-IPD Conference (Washington D.C., October 2010). The echoes of this memorable debate can be found in the closing chapter of this issue.

Dr. Ania SKRZYPEK

FEPS Policy Advisor – Managing Editor of *Queries*