The North-South Institute
L´Institut Nord-Sud

Policy Response to Unfettered Finance and the Reshaping of the Global Economy

Prepared by

Aniket Bhushan
Roy Culpeper
John Foster
Pablo Heidrich

February 2009

First Draft: do not cite without permission,
Comments welcome at abhushan@nsi-ins.ca

Policy Response to Unfettered Finance and the Reshaping of the Global Economy[1]

Executive Summary

This discussion paper is divided into four main sections. The first section begins by situating the ongoing financial crisis in a historical context.

From the 1970s, OECD countries increasingly deregulated the financial sector and liberalized the capital account, eroding or reversing the policy constraints imposed as a result of the Great Depression. These initiatives consequently helped to trigger risky lending and a series of financial crises in the 1980s and 1990s. When centred in developing countries such crises had severe and long-lasting economic impacts. However, only with the eruption in 2007 of the sub-prime meltdown in the U.S. has a financial crisis turned into a global economic crisis.

The recurrent crises that have marked the past three decades illustrate the cogency of Minksy's financial instability hypothesis, according to which, in market economies, prolonged periods of expansion lead to instability and crisis. The implication is that counter-cyclical macroeconomic and regulatory measures are needed to constrain these tendencies. Moreover, in the current context, growing international imbalances have fed the tendencies to increasingly speculative and risky lending behaviour in deficit countries. The international currency system is also increasingly vulnerable to destabilizing adjustments. Policies to respond to these weaknesses could include targeting monetary policy on asset bubbles, diversifying the pool of reserve currencies, inhibiting international capital flows, and reforming the international financial institutions, particularly the IMF, in order to play a more effective role in maintaining systemic stability.

This next section takes a broad view of financial innovation and highlights the need to deepen our understanding of the dynamic between financial innovation and regulation.

[1] This paper was prepared by The North-South Institute as part of the input into the "Policy Responses to Unfettered Finance" research project. We are grateful to the Ford Foundation for its generous support of this project and to the Canadian International Development Agency (CIDA) for their continued institutional support of The North-South Institute.

Policy reversals and regulatory negligence are at least partly responsible for the worsening crisis. Innovations in banking business models, in the treatment of risk and internal risk management and alarming conflicts of interest within the financial sector are key features of this crisis.

Financial innovations (particularly in credit derivatives markets) have heightened the endogenous risk problem by linking relatively uncorrelated markets and asset classes. A combination of reporting procedures (namely mark-to-market), ad-hoc policy responses (e.g. Lehman failure) and typical herding and hypersensitivity induced a generalized panic in key financial markets (credit, equity and money markets), which in turn has induced a deeper confidence crisis. The challenge now is to repair a broken incentive structure and encourage the right sort of innovations that lead to positive and widely beneficial externalities that are relevant beyond the financial sector, and promote long-term as opposed to short-term biases.

The third section covers how relevant the BRIC countries and other large emerging markets have become for global finance. It looks at why they have been repeatedly named “the new actors” given their growing importance in financial flows, aggregate demand and trade competitiveness. The focus is precisely on what is new about them, referring to their main instruments for intervention in the global financial system: trade surpluses, accumulation of reserves, expansion of their sovereign wealth funds (SWFs) and the role played by their enlarged national stock markets.

The discussion is then framed within the de-coupling versus contagion debate to understand what role these larger developing countries will have in the current crisis and its possible resolutions. In the short-term, contagion seems to have won, carried mostly via trade and financial flows, but in the medium term, the BRICS and other emerging countries remain well positioned with their generous reserves and investment funds to play a very significant role.

The challenge then is how to reform the financial system in a manner that is compatible with their interests and thus draws in their willing support. The alternative of searching for a systemic solution that ignores their particular situation and strengths is deemed unstable, and probably, unworkable in the long term.

Four principle questions emerge from the final section which focuses on civil society perspectives on systemic reforms.

Tipping point: is the system in crisis or not? A fundamental argument is going on between those who argue there is a crisis *in* the system and those who argue that it is the system which is in *crisis*. To what extent is a consensus for transformative change developing among key actors, or iterative reform dominant?

Governance: legitimacy and the locus of decision-making. The locus and agenda (comprehensive or limited) of key decision-making processes is fundamental, thus the relative popularity of the comprehensive multi-thematic approach of the UN Financing for Development process, where civil society, major agencies and the private sector are all "inside the tent". There is fundamental concern for legitimacy and accountability. The planned UN-convened Conference (at the highest level) for 2009, and the contribution of the Commission of Experts offer the opportunity to address the systemic and governance issues in a comprehensive fashion. What agreements should be priorities for the Conference and what strategies are required to achieve them?

Mandate/charter change: a new "Bretton Woods moment" Is the current crisis equivalent in depth to the situation at the end of World War II, and thus the occasion of the Bretton Woods Conference? Have we reached a BW moment? How might the political momentum to achieve new mandates be constructed?

Interim solutions and civil society campaigns: In the current context, given the strengths and weaknesses of civil society networks and campaigns, their contribution to the achievement of regulatory reforms and other short term measures could be considerable. What objectives ought to be a priority for the next six to twelve months and what civil society strategies might be most effective?

Introduction

The global economy and policymakers the world over are facing a monumental economic crisis. The purpose of this paper is to animate discussions surrounding key challenges and opportunities for systemic financial reform at three expert workshops, during the course of the year 2009-2010. These workshops are part of The North South Institute's research initiative on the global financial and economic crisis, and are supported by funding from the Ford Foundation. More information on the project is available on the project website.[2]

The key research question we put forward is as follows: *What reforms are required to the global, regional and national governance of financial markets in light of the recent financial turmoil, particularly from the perspective of emerging markets and developing countries?* The answer to this question must be one that best serves the economic and social needs of those countries while reducing their vulnerability to financial shocks. The aim of the project is threefold:

- To put forward new policy ideas and proposals for reforming governance of financial and capital markets to help stabilize the international economy and protect developing countries from destabilizing financial shocks.
- To test new ways of broadening the closed decision-making circle that dominates policy in this area.
- To forge new networks of change agents seeking to inform governance of financial and capital markets, and to encourage cross-learning across different communities of interest.

[2] See: http://www.nsi-ins.ca/english/research/progress/61.asp

This paper is a working document that will be updated and revised during the course of the inputs received in the workshops. The paper is divided into four main sections. Each section concludes with a series of questions intended to provoke discussion.

Systemic Reform: key challenges and policy dilemmas

The Financial and Economic Crisis of 2007-8: Historical Context

The relationship between financial instability and fluctuations in the "real" economy—in employment, output and price levels—was clearly recognized by the industrial countries in the Great Depression. Regulations were introduced in the 1930s (e.g. the Glass-Steagall Act in the United States) to curb speculative activity that had fuelled the stock market bubble. Deposit insurance was introduced to protect consumers and depositors, many of whom had lost their savings in the aftermath of the crash. Legislative steps were taken to encourage workers' organizations to achieve greater equity and social protection.

Macro-economic policy in the first three postwar decades was strongly focused on the real economy, although the principal concern shifted during this period from the need to maintain full employment to the need to maintain price stability, particularly in the inflation-plagued 1970s. This gave rise to the doctrine of inflation targeting, primarily through the use of monetary policy, during the 1980s and 1990s. By the current decade mainstream economists[3] were congratulating themselves that the "Great Moderation", an era of relative stability in output, employment and price levels, had arrived in developed countries.

In contrast, financial policy has played an increasingly subordinate role to the conventional macroeconomic tools of fiscal, monetary and exchange-rate policies. A growing bias against regulatory intervention in the financial sector was buttressed in the 1960s by the "efficient markets hypothesis" which suggests that securities prices typically converge to their true equilibrium values (i.e. securities markets are efficient) since they fully incorporate all available information (Fama 1965, 1970). While subsequently this hypothesis has been vigorously contested (Grossman and Stiglitz, 1980) it has led to the notion that security price fluctuations may be expected in line with changing information; neither individual investors nor the government can outguess the market. "Irrational exuberance", asset bubbles and asset deflation are to be expected as natural in a market economy. There is nothing governments should, or indeed can, do to counter such fluctuations[4].

Accordingly, during the 1980s and 1990s, as inflationary pressures gradually abated and recessions tended to be short and mild, the financial sector was liberalized, relaxing many

[3] Specifically, Ben Bernanke (2004), prior to his appointment as Chairman of the Federal Reserve.

[4] The notion of efficient markets is in turn sympathetic to the hypothesis of rational expectations, which suggests the futility of *any* Keynesian counter-cyclical government intervention, since market agents will effectively neutralize whatever government tries to achieve through fiscal or monetary policy.

of the measures introduced during the Depression (Glass-Steagall was repealed by the Clinton Administration in 1999). Financial markets were concurrently internationalized with the movement in developed countries to capital-account liberalization. An attempt was made in 1997 to phase out the IMF Articles' allowance of capital controls, but this was aborted by the Asian financial crisis.

Notwithstanding the failure to universalize capital account liberalization, as a result of these policy initiatives, the size and relative share of the financial sector in developed economies[5] has increased dramatically with the proliferation of new financial institutions and instruments, some of increasing complexity. Concurrently, financial markets became globalized, beginning with the massive recycling of petrodollars during the 1970s. This led to the rapid accumulation of developing country debt, and the international debt crises of the 1980s and 1990s.

Aggressive and imprudent international lending by commercial banks was a critical factor contributing to developing-country debt crisis of the 1980s. In order to create a more level international playing field among banks, and to limit the degree of leveraging they could undertake, the Basel Accord on capital adequacy ("Basel I")came into effect in 1988. However, technical shortcomings in the Accord and regulatory arbitrage among banks subsequently eroded the efficacy of Basel I, leading to Basel II, which came into effect in 2004. However, the capital adequacy framework of Basel II, which has relied heavily on the internal risk-assessment models of larger OECD-based banks, needs to be reviewed. The rationale of such an approach was that, given the complex nature of banks' assets and liabilities, due to sophisticated investment, debt or derivative vehicles that are better comprehended by the banks than by external regulators, the banks are in the best position to assess the nature and vulnerability to different kinds of risk. However, the utilization of banks' internal risk assessment processes is tantamount to self-regulation, and to the abdication of oversight and supervision by public regulatory authorities.

The recurrence, intensity and international scope of financial crises since the developing country debt crisis in the 1980s has increasingly brought into question much of the thinking and policy framework relating to financial markets and their role in the wider economy. Many of these had severe impacts at the national or even regional level (for example, the "lost decade" of the1980s in Latin America). Indeed, evidence strongly suggests that the negative impact of financial crises tends to be considerably more severe for developing countries (in terms of slower or negative growth, increases in poverty, and deteriorating indicators of social well-being). Furthermore, financial or debt crises led to demands for reforms by the international financial institutions that were contested on both political and technical grounds, particularly in the developing and emerging-market countries at the epicentre of crises in the 1980s (particularly the Latin American countries) and 1990s (East Asian countries).

However, none of these crises threatened to precipitate a major global economic downturn until the subprime mortgage meltdown erupted in the United States in August

[5] In the U.S., financial firms as a percentage of S&P market capitalization rose from 9 percent in 1990 to 25 percent at the height of the housing boom in 2006.

2007. This burgeoned into a generalized banking and financial crisis and a collapse in share prices in the ensuing fourteen months. The crisis simultaneously erupted in Europe, emerging markets and other parts of the world. The process of deleveraging and the contraction of inter-bank lending led in turn to a fall in investment and aggregate demand. Growing agreement that the current crisis is similar in severity to the crash of 1929, which was followed by the Great Depression, led to the convening of the leaders of the Group of 20 industrial and emerging-market countries in Washington in mid-November.

Participants at the G20 meeting clearly acknowledged that financial instability was at the root of the economic crisis. They pointed to undue risk-taking and excessive leverage by market participants, and inadequate financial regulation and supervision by public officials and policy-makers, as contributory factors. In effect, by recommending more effective regulation and greater coordination among market supervisors across countries, the G20 were acknowledging the fundamental importance of financial stability to global economic growth and well-being. In so doing they recognized that financial liberalization and deregulation during the last three decades may have gone too far.

The Link between Financial Instability and Economic Crises

In the light of the current crisis and its antecedents, there is a renewed focus on the role of the financial sector in general, and of financial instability in particular, in generating economic crises. Financial markets are no longer expected to be "efficient", and it is now accepted that they have potentially destabilizing effects for the real economy. But how should the linkages between the financial sector and the real economy be conceptualized?

The work of Hyman Minsky, which has been rediscovered and validated in the current crisis, provided a theoretical framework to examine these links. In particular, his "financial instability hypothesis" (Minsky 1992; see also Kindleberger 1996) maintains that market economies either have financing regimes under which they are stable, or regimes under which they are unstable. Paradoxically, over periods of prolonged prosperity, the economy transits from financing regimes that are stable, to those that are unstable. The advent of the "Great Moderation" alluded to above in the case of OECD countries from the mid-1980s, with steady growth at low inflation, provided such a setting.

During periods of prosperity, the propensity to speculate increases, sometimes around a particular commodity (e.g. oil prices recently) or a sector (the "Dot-Com" boom during the 1990s), thereby driving up commodity or asset prices. The process is typically led by the expansion of bank and other credit (and thus the accumulation of debt). Investment is drawn into increasingly riskier assets seeking higher returns. In protracted periods of prosperity a greater proportion of investment takes the form of Ponzi financing, under which debts can only be paid through rising asset values abetted by continuing investor demand—as was the case with sub-prime mortgages. The speculative boom can for some time be self-fulfilling, pushing up asset values to unsustainable levels, but eventually the bubble bursts.

The process of asset deflation, which is accompanied by a contraction of credit and bank lending, results in falling investment and output, and a recession, unless governments step in and provide credit to the banking system and inject spending. In its most severe forms the process is intensified by panic behaviour on the part of households and businesses which reduce their spending as a precautionary measure, causing further economic contraction. Left unchecked, financial instability leads to a systemic crisis. To the extent financial transactions cross borders, with market participants borrowing and/or investing in other countries, the systemic crisis is global in scope.

The Minsky model suggests that market economies are inherently unstable, and become more vulnerable to instability during prolonged economic expansions. The source of instability is the financial sector, which is prone to cycles of speculative excess followed by deflation. In the short term, resolving the crisis must involve revitalizing the financial sector and inducing it to resume lending and borrowing at a level that will restore commercial activity and economic growth. In the medium to longer-term, the prevention, or containment, of financial instability resides in reforming regulation of the financial sector, in countercyclical macro-economic policy and in reforms of the international financial architecture.

The Link between Global Imbalances and the Crisis

There is a direct and organic link between the growing global payments imbalances during this decade, and the financial crisis. Following the last financial crisis of the late 1990s Asian countries regained their export-led growth momentum but simultaneously insured themselves against the possibility of a similar financial shock imposed by external creditors. In effect, they transformed themselves from debtor to creditor status. They did so by rapidly increasing their savings and building up their foreign exchange reserves—China, for example, saving almost 50 percent of its GDP and accumulating almost $2 trillion in reserves. Collectively, Asian countries have accumulated some $4 trillion in reserves[6]. Much of this has gone into US treasuries and other US securities, including the obligations of mortgage finance companies Fannie Mae and Freddie Mac. The result was to drive up the dollar and to reduce borrowing costs for US households and firms. Ironically, the fallout from the last crisis, which involved excess foreign borrowing by Asian countries, led to excess borrowing by the US, fed to a considerable degree by foreign savings.

Following the "dot.com" crash in 2000 and market uncertainties after the terrorist attacks of September 11, 2001, this strategy supported vigorous growth for six years both in Asia (via exports) and in the US and Europe (via credit-based consumption, including housing purchases). However, it also contributed to the asset bubbles in the US and Europe. The particularly close relationship between the generation of Chinese surpluses and American deficits is captured by Niall Ferguson's (2008) composite "Chimerica". A parallel phenomenon, the so-called carry trade, has involved Japan, with short-term borrowers

[6] Besides the Asian countries, oil exporting countries and other emerging market countries such as Brazil have accumulated significant surpluses.

taking advantage of low yen interest rates and investing the proceeds in higher-yielding securities elsewhere, including US dollar bonds. The bursting of these bubbles has sundered this symbiotic relationship between excess savings in Asia and excess consumption in the West, leading to reduced growth prospects in Asia and a serious recession in the OECD countries. The urgent challenge over the medium-term is to agree an internationally coordinated macroeconomic response that will arrest and reverse what could become a downward cycle.

In the longer term, there are sobering implications for the globalization of financial and capital markets. Lenders have been eager to engage in interest-rate and currency arbitrage to exploit profitable opportunities. Borrowers have taken on short-term liabilities, along with interest rate and currency risk. The burden of adjustment has principally been on the latter during a period, even years, of low or negative growth, not to mention the policy conditionality accompanying IMF rescue packages. However, self-insurance and current account surpluses have transformed the erstwhile debtors into creditors and the erstwhile creditors into debtors with monumental liabilities, the unserviceability of which has shaken the global financial system to its foundations.

Another likely casualty of the current crisis is the international currency system, which since World War II has been dominated by the US dollar. But the dollar's position as the world's principal reserve currency is facing a more serious challenge than at any time in the postwar period. Ironically, the short-term impact of the crisis has been to reverse the significant decline that has taken place since 2002 in the relative value of the dollar, as the process of deleveraging has resulted in a flight to US dollar-denominated securities. However, as the crisis recedes, given the mounting domestic and foreign liabilities accumulated by the US prior to and during the crisis, the potential exists for a disorderly decline, even a collapse, of the US dollar. Discussions are urgently needed to permit governments to diversify their reserves away from dollars to a broader pool of currencies and reserve assets such as the SDR. Proposals such as the substitution account that had been considered in the 1970s aimed at enhancing the role of the SDR need to be revisited (E. Helleiner, 2008).

A conclusion could be that apart from short-term financing related to trade, international financial flows may be on balance problematic rather than a source of stable, long-term growth and development. If this is correct, then national and international measures to inhibit such financial flows (particularly short-term flows) need again to be given much more serious consideration.

From Financial Crisis to Systemic Reform: questions for consideration

In the short term, many of the measures required to revitalize the financial sector so that it resumes lending and borrowing have been launched by the authorities in the U.S., Europe and emerging economies. These measures include the recapitalization of banks, the unfreezing of credit markets, and the provision of liquidity, buttressed by supportive monetary policy (i.e. lower interest rates) and fiscal policy (increased spending and fiscal deficits as necessary).

The issue in the very short term—over the next three to six months—is the extent to which financial regulations should be reformed, for example, to strengthen transparency and accountability, enhance prudential oversight, and improve risk management[7]. *If vigorously implemented, might such actions have the unintended consequence of discouraging market participants from borrowing and lending? In other words, could increasing regulatory tightness at this stage in the economic cycle—at the beginning of an economic downturn—have a perverse effect?* In the Minsky model, the time for greater regulatory constraint is during the upswing, when risk-taking and speculation is in the ascendancy, rather than in the current downswing.

If so, the principal levers available to policy-makers reside in the macro-economic tools of monetary and fiscal policy. The most direct and stimulating tool is fiscal policy, particularly enhanced spending (e.g. via infrastructure projects) which elevate effective demand and inject purchasing power into the economy. This would help to reduce panic, restore confidence, and encourage firms and households to increase expenditures.

Additionally, governments that have recapitalized the financial sector by taking equity positions in commercial banks may exercise their influence on the Boards of these institutions by encouraging their managements to resume lending, or at any rate to relax constraints against lending for example to creditworthy borrowers.

In the medium- to long-term, there are a number of regulatory challenges and policy dilemmas that must be resolved. The G20 meeting in November has not fully addressed any of these:

- <u>Capital adequacy, risk management, and pro-cyclical behaviour</u>. A new capital adequacy and risk management framework needs to be put in place of Basel II. The new framework should be transparent and uniform. Another problem with Basel II was that it was pro-cyclical. At a minimum the new framework should eliminate any pro-cyclical bias; preferably, it should encourage counter-cyclical behaviour. However, the Basel framework is a creature of the Basel Committee on Banking Supervision, a body created by the G-10 central banks from industrial countries[8]. Reforming the framework raises governance issues, since no emerging market or developing countries are represented. *How are these governance issues to be addressed (e.g. by expanding the membership of the Basel Committee)? Is it possible to adopt a new framework based on counter-cyclical objectives?*

- <u>Monetary policy and asset bubbles</u>. Prolonged periods of easy credit and low interest rates were rationalized by success in meeting conventional macroeconomic targets—economic growth with price stability. The role played by such policies in feeding speculation and risk-taking, including the housing bubble, needs to be acknowledged. Reformed monetary and credit policies need

[7] These are measures recommended in the G20 communiqué for short-term action.
[8] Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, Sweden, Switzerland, U.K., and U.S.A.

to take into account asset price inflation, and work in tandem with more stringent regulations to counteract such trends before they threaten systemic stability. *What are the constraints and downsides to monetary and credit policies that include asset prices among their objectives?*

- Reform of the International Financial Architecture. To begin with, the role of the G20 in spearheading international reform is problematic. It is not a universally representative institution, and for that reason lacks legitimacy in the eyes of many experts and excluded countries. The G20 recommended a reform of the Bretton Woods institutions and the Financial Stability Forum to give greater voice and representation to emerging market and developing countries. But, particularly in the case of the Bretton Woods institutions, there is little guarantee that members with a disproportionate voice (particularly the European members) will accede to a reduced role in order to allow this to happen. *Can European members of the IFIs be persuaded (via incentives, e.g. a greater international role for the euro as a reserve currency) to reduce their voice and vote in favour of developing and emerging market countries? Can a greater role be accorded to the United Nations, which is ultimately the most legitimate and representative international organization, in order to arrive at reforms that will be universally acceptable?*

- A New Role for the International Monetary Fund? The IMF was created in 1944 to assist countries experiencing short-term balance of payments problems. Over the past decade, confidence has substantially diminished in the ability of the IMF to play a key role in helping to stabilize the world economy or to support the needs of individual members facing acute economic crises. The fact that, prior to the current crisis, most borrowing members had chosen to prepay their obligations to the IMF, and others to adopt a strategy of self-insurance (by rapidly accumulating foreign reserves), strongly suggests that demand for the IMF's services must be rebuilt by members before it is invested with the resources to supply them. Such demand can only be rebuilt if the conditionality of IMF support is acceptable to potential borrowers. The IMF's recently-launched short-term liquidity facility is a promising step in this direction. The possibility of reviving the SDR, which is issued by the IMF, as part of a strategy of reserve currency diversification, has been alluded to. The orderly reduction of global imbalances is another role that the IMF has attempted to address through multilateral surveillance. *Do such ideas constitute a sufficient basis for a reformed IMF, so that it can play a more effective role in maintaining the stability of the monetary and financial system?*

Innovation and the Evolution of Financial Markets

This section focuses on financial innovation from a broad perspective. We identify some of the key arenas of innovation over the past three decades that have played a significant role in the evolution of financial markets. Rapid build-up of leverage and unchecked proliferation of poorly understood financial instruments and products are defining features of this crisis. The discussion below highlights the need to better understand the dynamic relationship between financial innovation and regulation. Given this crisis is rooted in credit markets – the building blocks of the financial and real economy – it is arguably a foundational crisis and responding to it will require raising foundational questions about the assumptions that underpin modern finance.

Relationship between financial innovation and deregulation
The dynamic between innovation and regulation is central to this crisis and requires deeper exploration. One of the core drivers of financial innovation is the desire to by-pass regulation and capture every possible profit making opportunity.

Policy laxity and reversals bear at least partial responsibility for this crisis as they created the space for innovations that have taken place in the banking and 'shadow banking' sector. The repeal of the Glass-Steagall act (1933)[9] in 1999 is one such example of a policy reversal that has facilitated financial innovation. The banking sector has lobbied aggressively for the repeal of the Glass-Steagall act for many decades, arguing that firewalls created by legislation increased risk in the banking sector by restricting the ability of banks to diversify exposure. Furthermore, the commercial banking sector in the US faced increasing competition from the non-bank financial sector (comprising investment banks, pension funds and the likes), particularly as domestic financial liberalization and deregulation gathered pace in the 1980s and 90s.

While Glass-Steagall and its repeal occurred at the national level, at the global level a trend away from regulation to de-regulation and self-regulation is evident in the evolution of the Basel capital adequacy framework.

The Basel capital adequacy framework since its start in the late 80s has looked at systemic risk one bank at a time.[10] The underlying assumption is that if each institution is safe the system would be safe. However banks in their search for profits over time favored more risky lending that would by-pass Basel I requirements. This stimulated sharp growth in the proliferation of new instruments and risk transfer techniques, and the use of off-balance-sheet provisions; which ultimately led to the development of a new and improved risk-weighted approach (Basel II). The emerging consensus is that Basel II is tantamount to self-regulation and has exacerbated pro-cyclical tendencies, and thus deepened the impact of the crisis.[11]

That the financial industry undergoes waves of innovation, regulation, deregulation, marked by periods of stability and instability is widely accepted going back to the work of Hyman Minsky in particular. However, crises also create space for bold forward looking policy responses and thus present an opportunity to fundamentally strengthen the financial system as an agent of the broader economy.[12] This crisis presents an opportunity

[9] Glass-Steagall separated investment banking and commercial banking activities in order to curb risk-taking and protect depositor's exposure to volatile markets
[10] These issues are covered in more detail in the previous section
[11] We should note that the Basel Committee on Banking Supervision (BCBS) is presently holding consultations on reforms to the Basel II framework, see: http://www.bis.org/press/p090116.htm
[12] A good example is the Federal Deposit Insurance Corporation (FDIC) which was created in the wake of the great depression in the 1930s and is a key player in the policy response to the present crisis in the US.

to stimulate fresh thinking on the desired role of the financial sector in the modern economic system. The foremost foundational questions center on the *purpose* of the financial system and therefore a deeper understanding of the dynamic between innovation, regulation and deregulation should be the starting point of analyses.

Arenas of financial innovation

Over the past three decades a number of important innovations have taken place in global finance that have energized markets and increased risks. While it is not possible to recount these in detail, a summary of the key arenas is provided in the table below.

Mechanical/functional efficiency	Innovation and improvement in information technologies, computerization of trading, information services and real time global markets
Intellectual	'Finance view of the world' (efficient market school, general equilibrium capital asset pricing model, CAPM) challenges the 'economics view of the world'
Ideological – policy innovation and market orthodoxy	Dominance of monetarism; major scale-back in the role of the government in financial sector; focus on limited objectives (inflation containment and price stability), interest rates – primary policy tool; backlash against Keynesian
Financial liberalization and trade globalization (of "real" economy)	Trade liberalization and tariff reduction; removal of the gold-standard; financial sector liberalization in advanced economies and liberalization of trade finance (growth of multinational corporations and complex global value chains)
Redefining risk and risk management	Emergence of new risk transfer and assessment techniques; increased prominence and use of minimalist risk models like value-at-risk (VaR); sharp growth in credit derivatives markets, new risk transfer techniques (CDOs, CDSs)
Accounting conventions	Mark-to-market (where trading volumes permit), and mark-to-model for securities whose trading volumes are low (i.e. tantamount to self regulation)
"Un-regulation"	Active decision not to regulate as complexity increases; particularly evident in the rapid growth of the credit default swap (CDS) market; so-called "light-touch" approach

As noted above, redefinition of risk and risk management is at the core of the present crisis. A number of the key processes however are not entirely new. Securitization and collateralization –pooling of assets into interest bearing securities– got their start back in the 70s when mortgages were pooled by US government sponsored agencies. Increasing number of institutions securitize assets to transfer credit risk associated with assets they originate from their balance sheets. Securitization made it cheaper to raise money (securitized assets being cheaper to hold as regulatory requirements are more lenient). In principle this approach brings economic benefits by diffusing risk concentration and thus reducing systemic vulnerability.

What is novel however is the dramatic growth in the scale and interconnectedness of activity in derivatives markets. The following are central to recent developments:

The US Federal Reserve system itself is an example of a bold institutional response to the 1907 US banking collapse

- *Shift to 'originate-to-distribute' banking model*: in the traditional banking business model banks made loans for long periods (e.g. 5yrs for commercial loans, 25-30yrs in mortgages). The new 'originate-distribute' model (early 90s) is based on increasing loan velocity and minimizing the cost of locking in capital against regulatory requirements. In this model future interest earnings are discounted back and recognized immediately by hiving mortgage backed securities (MBS) off bank's balance sheet and into special purpose vehicles (SPV). The highest rated tranches of these securities found willing buyers in the 'shadow' banking sector, comprising hedge funds, private equity, state pension and insurance funds and other large institutional investors. The flipside of the system is that new loans need to be made to maintain the dramatic rise in earnings[13]. This created pressure to find new borrowers in order to maintain lending volumes and brought down lending standards. Other assets that generate relatively predictable cash-flows were similarly securitized into asset backed securities (ABS). New players with neither the credit-monitoring skills nor the interest to conduct due diligence entered the market sensing profit making opportunities.

- *Redefinition of risk, with widespread acceptance of risk transfer techniques*: in the early 90s innovation took securitization to a higher level of abstraction by bundling MBSs and ABSs into collateralized debt obligations (CDO), essentially repackaging assets of different quality in order to distribute to investors. Typical CDOs comprise a higher percentage of highly rated debt and smaller tranches of lower quality debt. In this way default risk is diffused and willing creditors could be found for what at the time seemed like relatively safe securities that offered better returns than government paper. By 1997 bankers at JP Morgan looking for ways to further reduce risk surmised it would be possible to purely transfer underlying credit risk without the transfer of actual securities (MBS, ABS etc). The result was the creation of computer generated models derived from credit default probabilities and cost of insuring against the same (fittingly called 'synthetic CDOs'). These developments bred a false sense of complacency in new risk management techniques.

- *Reliance on minimalist risk evaluation models*: evolution of risk modeling is at the core of the present crisis. Chief amongst these is the ascendance of value-at-risk (VaR) modeling. VaR essentially models 'worst case scenarios' for a specific level of confidence, across a specific time period and provides an estimate of investment losses. However, by its nature VaR looks at risk from the perspective of a single institution and cannot take into account counterparty and correlated risks.[14] In this sense it is deficient and excessively minimalist, and from a systemic perspective exacerbates pro-cyclical tendencies.

---

[13] According to one illustration from a 12.50% return-on-equity in the traditional model vs. 50.0% in the 'originate-distribute' model (Satyajit Das, 2008)

[14] Another critical weakness is "tail risk": the assumption that the normal distribution (bell-curve) matches the real world in all parts of the curve. As Benoit Mandelbrot famously showed, while the distribution reflects reality in the middle of the curve (i.e. reflecting high-frequency events), it is highly inaccurate

- *Globalization of securitization*: the success of the new business model, premised on innovative risk transfer technologies and opaque derivatives, lay in its ability to create vast amounts of leverage. In a remarkably short period of time an amazing array of institutions from Iceland to Japan to municipalities in Australia wilfully jumped on to the securitization bandwagon witnessing the stupendous profits on Wall Street. Securitization became the biggest US export of the 21st century totalling an astounding $27 trillion (since 2001). According to Joe Stiglitz, 'the dramatic proliferation of securitization was based on the premise that a fool is born every minute, and globalization meant a global landscape on which to search for fools – and find them everywhere' (Pittman, Bloomberg 2008).

- *Growth of large new markets completely beyond the regulatory purview*: the best example is the explosive growth of the credit default swap (CDS) market over the past decade. A CDS is an insurance policy that banks buy to protect against potential default of their borrowers. Except that CDSs indemnify default confined to the underlying security; actual defaults could go beyond the underlying 'real' securities to defaulting derivatives contracts. The speed of growth of the CDS market is nothing short of astounding, from $1 trillion in 2001 to over $57 trillion in 2008 (Das, 2008; BIS 2008).[15] Banks are supposed to use default swaps to diversify exposure to default risk; however there is evidence that much of the CDS activity by the largest banks is in fact related to CDS trading and not actual loan hedging (Duffie, BIS 2008).

- *Pervasive conflicts of interest*: ratings agencies are supposed to play a key signalling role in capital markets. These were subject to an enormous conflict of interest as rating securitized debt became a major source of their revenues; 40% of Moody's 2005 revenue came from rating securitized debt (Wharton, 2008).

The subprime crisis is a crisis of the good times. US median house prices rose 40 percent from 2000-06. Subprime loans (which form 25 percent of the mortgage market) were fine as long as the housing market continued to boom and interest rates stayed low.

However, the crisis did not come out of the blue. Astute observers have warned of a looming systemic meltdown for some time now (BIS, 2004–06; Roubini 2006-07; Reinhart and Rogoff; George Sorors, amongst several others). What is notable is how many red flags market participants, policymakers and regulators have collectively ignored. Financial innovations, from the more mundane mechanical and technological to the more recent exotic advances in derivatives markets, played a key role in disguising

---

where it matters most, at the tails (reflecting rare events). VaR models are unable to reflect rare/extreme events adequately and breed a dangerously false sense of security.

[15] CDS documentation is highly standardized to facilitate trading. A contract is triggered by a "credit event", however, a buyer of protection is not protected against "all" defaults but only against default on a specified obligations. "Publicly available information" must be used to trigger a valid credit event to trigger a CDS. This has a systemic dimension. A CDS protection buyer may have to put the reference entity into bankruptcy in order to be able to settle the contract. CDS contracts may create incentives for creditors to push troubled companies into bankruptcy thus exacerbating losses in case of defaults (Das, 2008)

risks and perpetuating the belief that somehow financial markets and the global economy had changed radically over the course of the past decade.

As early as 2003-04 credit growth became separate from borrower's income growth. In the US, mortgages and house prices were going up in areas where income growth was negative. This should have set off some sort of red flags. The fact that it did not has much to do with innovations in debt securitization (Sufi, 2008).

Finance and Economics

The deeper roots of this crisis can be traced to the intellectual disconnect between the finance and economics view of the world. At least since the work of Fisher Black, Myron Scholes, Robert Merton (if not earlier) which led to the development of the options pricing theory in the 60s and 70s, modern financial theory has increasingly broken from the underlying assumptions of economic theory. As Wolf (2008) notes, prior to the 90s most economists interested in macroeconomics thought little about finance, and those interested in finance thought little about macroeconomics.

In his recent biography of Fischer Black, Perry Mehrling (2000) recounts the sources of the schism between the finance and economics view of the world; these are worth reflecting on here.

The most fundamental source of misunderstanding comes from the difference between an economics and a finance vision of the nature of the economy. The classical economist habitually thinks of the present as determined from the past. In Adam Smith capital is an 'accumulation from the savings of past generations' and much of economics retains this old idea of the essential scarcity of capital. The financial point of view by contrast sees 'the present as determined by the future or by ideas about the future. Capital is less a thing than an expectation about future income flows discounted to the present, and the quantity of capital can therefore change without prior savings'.

A second fundamental source of misunderstanding comes from the 'liquidity scarcity view of economics and the liquidity abundance view of finance'. Economists intuitively view real liquidity of the economy from the prism of scarcity, and thus attempts to increase liquidity by expanding nominal money must reckon with fundamental real scarcity. The finance view 'abstracts from the scarcity of liquidity and treats all commodities as equally and perfectly liquid (however unrealistic in practice)'. The distinction between money and credit remains as the economist's guide to the apparent hierarchy of liquidity, with credit viewed as a mechanism for stretching scarce liquidity. 'What seems to economists as a qualitative difference between more and less liquid commodities seems to a finance person as just a matter of price'. Thus what is a 'liquidity crisis' to an economist, appears to a finance person as 'price discontinuity' or 'volatility jump'. System wide liquidity fluctuations appear to a finance person as part of the general category of 'market risk'.

These are fundamental disconnects with far-reaching implications for how financial markets have developed. As Mehrling notes, Fischer Black and other proponents of the finance view could not accept the intellectual constraints that would have come from placing finance under economics departments of the time, thus their strategy was to consolidate an intellectual base in finance departments within business schools. Their efforts were aimed at those in the position to set up new institutions to exploit profitable opportunities afforded by real world deviations from the ideal form financial reality embodied in modern financial models. The proponents of the finance view aimed their ideas primarily at entrepreneurs and only secondarily at academics. This explains the importance attached to developing simple and workable models that people would want to use, and to allow theory and practice to evolve simultaneously.

The schism between intellectual underpinnings of modern finance theory and economics is a key foundational issue and one that requires further reflection as we think about reform measures. This section of the paper concludes with a summary of the key issues thrown up by financial innovation and a few discussion questions.

Key issues thrown up by financial innovation and questions for further discussion:

- *Endogenous risk problem*: financial theory, such as the efficient market hypothesis, option pricing theory and others focus exclusively on external risks, i.e. fluctuations emerging from information or events outside market operation. However, there is evidence to suggest that the main risks are endogenous, in that they emerge from the way participants react to information and events. There are a number of examples of crises exacerbated by endogenous factors such as the models and trading strategies employed by players. These range from the 1987 crash to the LTCM crisis in 1998. In each case participants assumed normal (or liquid) markets and tried to push through trades for which there were no counterparties on the other side, further driving down prices and exacerbating losses. Fischer Black himself cautioned against the popularity of the option pricing formula, and showed that because the model had become so prevalent the use of the model itself became a source of noise.
- *New and heightened risks*: heightened counterparty and correlation risks are key features of the present crisis. Innovations in credit derivatives markets have led to increased default correlation amongst various types and classes of debt instruments (the opposite of what they were intended to do). Failure due to exposure to a counterparty that is unable to deliver on its commitment even as the underlying fundamentals of the original party are sound is an important new source of risk. Modeling joint probabilities of new and heightened risk factors has become extremely complicated.
- *Herding and hypersensitivity*: mechanical and technological innovations have exacerbated the cost of herding behaviour that is characteristic of markets. Some have suggested that far from efficiency, hypersensitivity and exaggeration both on the upside and downside has become the key feature of financial markets. These sustained exaggerated upward and downward swings undermine long-term fundamentals and a long-term outlook (Soros, 2008). Hypersensitivity breeds excessive short-termism. As markets are in a perpetual race to price in every permutation, combination and eventuality it is only natural for participants to emphasize the short term over the long.

- *Overdependence on simplistic and limited parameters*: the financial view of the world is obsessed with the price parameter. One of the main underlying assumptions is that markets correctly price everything, and are capable of reacting appropriately to all relevant information instantly. In this view all potential risks are 'priceable' and therefore manageable, as long as markets are large and liquid enough.
- *Incentive structure breakdown*: this has already been discussed (with reference to the ratings industry). Another fundamental problem is the disjuncture between risks and rewards. The operational incentive structure in markets disproportionately rewards a high-risk short-term perspective. A more fundamental problem is that markets excessively reward creation of new, ever more complex, and opaque financial products and instruments as opposed to productive investments that deliver widely beneficial and socially desirable outcomes that accrue beyond financial markets.
- *Deeper confidence crisis*: to insiders 'confidence' implies confidence in a) the functionality of financial markets, i.e. certainty that buyers and sellers will find and mutually settle at market clearing prices, and b) confidence in the belief that free and open markets are the most efficient and productive way to turn savings into desirable investments that serve future needs. However, as this crisis brings the assumptions and governing paradigms that underscore the day-to-day operations of the financial industry into greater public focus, the core of the confidence crisis increasingly centers on limited understanding about what the financial industry as a whole and market players as individuals actually do, how it is valued, if this is acceptable and what if any are alternatives to the status-quo?

The discussion above provokes the following discussion questions:

- How can we conceptualize the relationship between innovation and regulation? Is it possible to assess whether new products, instruments and services are aimed at addressing specific needs and desirable solutions or primarily aimed at by-passing existing regulation?
- Can we create an incentive system be created that encourages the right sorts of innovations, i.e. leading to positive rather than negative externalities; long term rather than short-term bias? What sorts of financial sector policies would be needed?
- A broader question is how can regulation stay a step ahead (or at least in step with) financial innovation? What changes, not only in terms of policies but also the policy development process and mindset of regulators, are required?
- What about the limitations of regulation and policy efficacy? To what extent has regulatory failure eroded public faith – regulators missed everything from Enron (till late in the game) to Madoff? How do we hold regulation to higher public standards (regulate the regulators)?
- In the present situation is it enough to think about capital adequacy levels and charges, or do we need to think more fundamentally about definitional issues (what qualifies as 'capital' and why, i.e. capital standards and composition)?
- Changes in banking sector business models have played an important role in stimulating financial innovation and instability. Policy and regulatory reversals paved the way for vertical and horizontal integration in the financial sector. The largest banks have changed their business model from the traditional long term on-lending model to the 'originate-distribute' model, stimulating unprecedented growth in credit

derivatives markets. However, the fall out of this crisis is bringing about a new set of business models as investment banks either merge (Merrill Lynch) or reincarnate into (Goldman Sachs) bank holding companies. How will (and indeed should) this affect future regulation and what are the wider policy implications?

- How much leverage is too much? Is there an appropriate level and is it knowable?
- What is the relationship between innovation and leverage?
- How does the feedback from derivative to underlying markets work (e.g. deleveraging process and downside correlation)?

New Actors and Emerging Trends in Global Finance

The following section covers how relevant the BRIC countries and other large emerging markets have become for global finance. It looks at them as they have been repeatedly named "the new actors" given their growing importance in financial flows, aggregate demand and trade competitiveness. The focus is precisely on what is new about them, especially referring to their main instruments for intervention in the global financial system: trade surpluses vis a vis the developed economies, accumulation of reserves, expansion of their sovereign wealth funds (SWFs) and the role played by their enlarged national stock markets[16].

What is *new* in the new actors of global finance?

The BRICS countries are most often cited in the international economic press as being the main *new* actors in global finance. Some of these nations are, however, only relatively new since they have been relevant, but irregularly so, participants to international financial flows for over 200 years, such as Brazil, Russia and China. Others are indeed much newer actors, such as South Africa and India. Other non-BRICS, such as Mexico, Turkey and Saudi Arabia plus several more, have joined them in a smaller scale since the 1990s. In fact, a few of the BRICS and quasi-BRICS today referred to as "new actors" had been notorious protagonists between 1997 and 2001, when a series of financial crashes affected different regions of the developing world. Despite those setbacks, these "emerging" markets have accrued a very large importance in global finance in the last few years as net sources of financial funds, avid investors in the latest financial innovations, and as increasingly recognized fields of action when listing and trading securities on a global scale.

This brings in the notion that their acting, defined as their role in international finance, is what is actually new. That does not necessarily imply that they are new themselves and therefore, we need to keep in mind what the crucial differences between the actions and the internal structure of an agent might be. For example, country X (i.e. China) might be acting with a very significant clout in global finances thanks to the investment of its national reserves in foreign assets, the investments done by its array of SWFs, or the surging capitalization of its national stock market, or all these aspects combined.

[16] This section does not attempt to cover how the global financial affects all developing countries, but starts with the reverse line of investigation instead: how some developing countries affect global finances and then, it also deals with their individual relationship to this global system.

Nonetheless, the internal economic, political and business governance structures of this country might not be changing at all from the time it was a marginal actor in global finance, or (more likely) they might be changing at a different speed, or in a different direction.

RIP for De-coupling, Long Life for Contagion?

It is in that distance, between their acting in a particular field, international finance, and their overall being as political and economic units, that some of the answers lay for what the BRICS' role in this crisis is now and will be in the future. The rest of the answer probably lies in how de-coupling or contagion affects them individually, or by regions. By extension, the same applies to the other smaller emerging markets.

De-coupling, one of the most popular of all the newest products from the industry of financial commentary, referred since early 2007 to the BRICS and other emerging markets sailing through the incoming US financial crisis due to three main factors: their exports had been diversifying away from the US and other developed markets, the increased vitality of the domestic financial markets and consequent force of domestic investment, plus the large size of their foreign currency reserves, acting as barriers to speculators.

But in the last months, *contagion* has come and reminded all of the severe underside of economic interactions brought about by financial crises, rapidly superseding de-coupling as the prism through which to interpret the new role of the BRICS and other emerging markets. Contagion has most visibly brought the capitalization of the financial markets in most of these countries down by some 50% from their 2008 peaks, a fall even deeper than the one in OECD markets[17]. In trade, contagion has drastically reduced the earnings of the commodity exporters among them with plummeting prices for oil, minerals and some agricultural goods, while affecting slightly less those more focused on exporting manufactures, this time hit by rapidly reduced orders and prospects of diminishing demands for consumer goods[18]. In terms of their domestic financial climate, contagion has raised its head with quick but drastic reductions in available credit for private consumption and mortgages, the latest engine in domestic expansion at these developing countries[19]. In sum, global contagion from this US financial crisis has acted according to its already well-known channels: common creditor, trade linkages, and macroeconomic similarity.

To attempt to settle the score between de-coupling and contagion correctly, it is worth looking at each one of these currents in detail.

---

[17] See http://www.blnz.com/news/2009/01/06/2008_slump_wipes_trillion_dollars_5477.html accessed on 01/23/09.
[18] See http://www.blnz.com/news/2009/01/13/trade_deficit_drops_plunging_global_3138.html accessed on 01/23/09.
[19] See http://www.blnz.com/news/2009/01/06/2008_slump_wipes_trillion_dollars_5477.html accessed on 01/23/09.

Basically, the BRICS and other emerging markets have suffered greatly because some of the largest institutional investors in the US, the UK and other crisis countries, pulled out their investments from Southern markets in order to cover losses in their home Northern markets[20]. That common creditor contagion channel shows then that the depth of financial internationalization might actually be quite disadvantageous in times of crises. De-coupling was argued on the premise that since the BRICS and several of the largest emerging markets had become of late net creditors, such channel would not affect them. That ignored the fact that North-South financial flows could actually be more short-term and volatile than South-North ones, often in the form of states investing reserves or SWFs, investing in search of longer term returns. In the end, the situation so far has shown crisis-hit Northern investors withdrawing massively from the South, thus contributing to the latter's contagion.

Macroeconomic similarity, that is similarity in macro indicators such as GDP growth, current account balances and productivity growth, is the least likely suspect here as a contagion channel since widespread domestic assets appreciation (i.e. real estate) had not played as significant role in the BRICS and other emerging markets as in the US, UK and several other European countries. Besides, major emerging markets and most of the BRICS had fiscal and current account surpluses, unlike the most crisis-hit industrialized nations. Nonetheless, those Southern countries that had favoured banking and monetary policies similar to the latter to replicate highly-leveraged domestic consumption booms have been particularly hit. The clearest examples are Brazil, Mexico and South Africa, which perhaps helps explain their rather sheepish attitude during the G-20 meeting in November, endorsing Bush's idea to protect financial deregulation and global integration.

None of the above compare to the enormous staying power of the trade channel to promote contagion. While trade flows are only slowly changing in quantities, commodity prices have dived and left those emerging markets dependent on them literally naked. With most commodity prices retreating to their levels in the early 2000s (and much further once inflation is computed), not much hope is left for those hoping for hardcore fans of *de-coupling*, enamoured of China and India's demand as the great game-changer. That is because the BRICS' quantities of exported manufactures to Northern markets have already started to fall across the board, reducing in turn intra-South trade for the inputs needed for those exports, a sort of ripple effect that rapidly erases that last bastion of *de-coupling* optimists. It is rather ironic that the last delay for that taking full wind so far is the sustained strength of the US dollar, which helps maintain some of the competitiveness of South-North manufactures trade.

High reserves: last frontier of decoupling, first one for engagement.

In the stricter monetary side, much of the support for *de-coupling* was coming from observers who marvelled at the level of reserves accumulated by some of the BRICS countries and other emerging markets. China, as expected, leads the ranking with close to

[20] An alternative explanation is that Northern institutional investors pulled their funds due to the guarantees they were being offered late last year if they kept them in their home branches in the US, UK, etc. This rationale is anyway complementary to the one offered above, in the main text.

US$ 2 trillion, but it is by no means alone as the other BRICS and the rest of the East Asian nations have amassed a similar amount. That is a fundamentally different situation from: a) what most industrialized countries have as reserves, b) what most emerging markets and the BRICS had last time there was a financial crisis of global proportions, such as the Asian one of 1997.

The *de-coupling* argument has held only partially in the proof given so far (mid-November 2008) by Russia, which has maintained its currency value in the face of 2 months of relentless speculative attacks, at the cost of over US$ 210 billion (Financial Times, November 21st, 2008). It is not *de-coupling* by almost any extent but shows the value of having extraordinary amounts in reserve when facing contagion from a crisis. In contrast, Ukraine, Hungary, Pakistan and other less self-insured countries have had to go to the IMF requesting funds, with the consequent loss of financial policy sovereignty. Therefore, very high levels of reserves are proving valuable to the BRICS and other well-prepared emerging markets to cope with short-term volatility and speculation on their policy reactions.

Beyond the short-term impact of the crisis, the high accumulation of reserves in the last decade among some of the BRICS and other emerging economies has given way to another form of participation in global finances, through the enlarging or outright creation of sovereign wealth funds (SWFs). Given the commodity prices increases observed from 2003 onwards and especially, with their peaks during 2007 and 2008, China, Russia, other East Asian and Gulf exporting countries had problems sterilizing their massive gains from trade without running into either Dutch disease, high-inflation, or both. SWFs grew in size from that need and rather dramatically so, permitting a continued accumulation of surpluses but without having to bring those funds into their domestic economy completely, or in a different form and later time.

SWFs, a thermometer of the relationship with the North.

SWFs, or sovereign wealth funds, are an interesting case for the role of new actors in global finance. The SWFs are government-owned and/or government-controlled pool of financial assets, often including some international ones. Most SWFs and most of the biggest ones are from developing countries, accounting for some 3,000 billion US$ (SWF Institute, 2008, at http://www.swfinstitute.org/funds.php). In spite of their enormous size, they had not received much attention in the Western financial press, academia and government circles for two rather simple reasons. One is that they were not that substantial in the past, namely 5 years ago. The other is that most investments they made were domestic, and when international, they were long term and in minority shareholding positions. In other words, the collective of SWFs had the characteristics of a very strong, rapidly developing, but still clumsy teen-ager in the sophisticated world of global finance.

Most of the SWFs sources is in the commodities boom of the mid-2000s, with oil or gas in over 90% of the cases. Only for China, Hong Kong, Korea and Singapore, the sources were fiscal or trade surpluses coming from the export of manufactures and technological services. By early 2008, they were said to be reflecting " a dramatic redistribution of international wealth from traditional industrial countries as the United States to countries that historically have not been major players in international finance and have had little or no role in shaping the practices, norms, and conventions governing the international financial system” (Truman, 2008, p. 3). Furthermore, the SWFs rise also represented a dramatic return of the state into the decision-making process of international economic relations, something that had been supposedly done away with the privatizations of the previous decade, and the liquidation of state banking in most developing countries. Before going into how the US, the EU and through their influence, the IMF and the OECD, respectively, have tried to tame this menace (for the Northern policy establishment), a list of the suspects is in order:

Region	Countries	Assets ($ billions)	Origin
Gulf	UAE, Saudi Arabia, Bahrain, Oman, Qatar	1,692	Oil and gas
China	China, Hong Kong	590	Non-commodity exports
East Asia (exc. China)	Singapore, South Korea, Malaysia, Vietnam, Brunei	552	Non-commodity exports, oil and gas
Central Europe and Central Asia	Russia, Kazakhstan, Iran, Azerbaijan	250	Oil and gas
Africa	Libya, Algeria, Nigeria, Botswana, Mauritania	106	Oil, gas, diamonds, other minerals
Latin America and Caribbean	Chile, Venezuela, Trinidad & Tobago	24	Oil and gas, copper.
Pacific	East Timor and Kiribati	4	Oil and gas, phosphates
OECD	Australia, US (Alaska), Ireland, Norway	515	Non-commodity exports, oil and gas
TOTAL		**3,977**	

Note: other state investing agencies such as Canada’s are not included because they are purpose specific, namely, as pension funds.

The attempts at taming are relevant here insofar they provide a perspective on how Northern industrialized countries perceive Southern instruments of international financial growth or expansion. Thus, the industrialized countries’ concerns on Southern SWFs can be summarized as follows:

1. Developing country governments are often corrupt and prone to mismanagement. Therefore, SWFs must remain at arms-length and be governed by structures build under the IMF advice and supervision.
2. Developing country governments might use SWFs to pursue political or economic objectives (national champions or industry-specific technological leadership) and thus try to modify the current structure of the global economy.

3. FDI protectionism might arise in anticipation of take-overs from SWFs or in response to their actions. Such behaviour could lead to a globalization backlash.
4. Since their operations are opaque, it is hard to determine a priori if SWFs investments could contribute to market stability or actually aggravate turmoil.

In order to mitigate those concerns, the G-7 ministers of finance asked the IMF, the World Bank and the OECD on October 19th, 2007, to examine these issues and draw a roadmap to bring SWFs into a compatible mode with the rest of the international financial system. Such roadmap was to identify "best practices" first, then make SWFs commit to follow them, and finally set up a Northern-controlled monitoring system for them. The IMF responded positively to such request the very next day (Truman, 2008).

Different publications of the IMF, the OECD and the European Commission elaborate rankings of the SWFs that consistently put those from the US, Norway, Canada and those in developing countries set up under IMF-WB guidance as the role models, while listing SWFs from the Gulf countries, China, Iran and Venezuela as the worst in terms of government minding, lack of transparency, lack of accountability[21]. Such clearly ideologically correlated ratings do not help in bridging Northern and Southern financial actors together, but surely clarify the distances between their respective positions.

Meanwhile, 2007 and 2008 have been peak years for the SWFs, when they have invested over a trillion US dollars into the international (non-domestic) economy. Investment tracking companies identified 5,676 as the total number of cross-border purchases done by SWF since the 1970s, with 26% in banking, and 50% in manufacturing. Fotak et al (2008) found however that SWFs are not particularly good at picking good companies to invest in, calculating that even before their massive investments in Western financial institutions went sour in late 2008, SWFs had been having negative 14% returns in the first two years as average on their investments. Nonetheless, SWFs remained put with those investments, even when in most cases they were minority positions without much leverage on the actual management of the firms invested on. These results were robust to differences by nationality of the fund, its age, and source of its wealth (oil or others).

Stock markets in the BRICS and other emerging economies

Stock markets of the largest developing economies have captured much of the drama, the up and downs of the incursion of these markets into the globalized economy. The stock markets of the BRICS, for example, have risen from a mere 1% of largest four stock exchanges' capitalization (US, Japan, UK and Germany) in 2001, to over 15% in mid-2008. They attracted very large flows of capital from abroad, but also increasingly numerous domestic investors. In other words, stock markets in most of the emerging markets were becoming up to 2008 the main focal point for investment domestically.

[21] Truman (2008) disaggregated each of the "best practices" proposed by the IMF, WB, and EU organizations into 44 different indicators, looking at over 50 SWFs, thus making very clear what the Northern fears are, and what they propel then as remedies for SWFs to change.

While commentary in this subject was closely linked to the gains from investing in the new multinationals of the South, such as Embraer, Lenovo, Haier, Tata, Cemex, Lukoil, etc; the rather unglamorous truth about these stock markets is that they remained very much dependent on a few firms' stocks, and that most of those firms were actually state-owned, as in China, Russia and to lesser extents, in Brazil, India and South Africa. The markets in each of the BRICS indeed present different characteristics but it is still useful to pick a couple for more detailed analysis.

In Russian stock markets, for example, Gazprom, the state gas conglomerate, accounts for a whole third of the country's market capitalization, two other state firms, Rosneft and Sberbank, complete another third. Six hundred more companies also participate in the market, and most of the them are private but small. Brazil presents a slightly different case, with Petrobras, a partially owned state oil company, accounting for close to 20% of the stock market's capitalization, while two other recently privatized minerals and steel exporters, accounted for a third more. That dependency on state-built firms was however covered up by the frenzy developed there in the last years by private IPOs, bought up by foreign investors to the tune of over 80% of all stock issued. Just as in Russia, the supposed strength of the stock markets was just a combination of dependency on the more traditional sectors of the economy (commodities and energy), often with strong state participation, plus a set of high expectations on future development of other sectors.

It is not surprising then to see how a global financial crisis would affect these countries and their stock markets greatly, without their hoped-for strengths being able to play much of a positive role. In fact, stock markets have so far amplified their exposure to the global upheaval, underlining how financial flows this time northbound reduce their size and positive domestic role[22]. It remains to be seen whether local firms in the BRICS countries and other emerging markets that now need capital more than before due to their loss of export markets can actually count on their national stock markets for any relief.

Discussion questions proposed

1. Given the revealed strengths of the BRICS and most other emerging markets in keeping trade surpluses and abundant reserves (plus large SWFs), as well as their revealed weaknesses, such as a dependence on Northern markets to buy their exports, and to provide funds for their inflated local stock markets, *what can we expect their main policy interests to be in regards to reforms in the financial architecture?*
2. US and other OECD country demands on the role of the BRICS and other large emerging markets in international finance seem to be rather contradictory: on the one side, China, India and less so, the other large developing countries, are expected to remain as large pools of global consumer demand that can ameliorate the reduction in consumption happening in the OECD countries. On the other hand, they are warned not to undo their positions in US private and government debt or their other US Dollar holdings and also accept more IMF-made regulations for their SWFs. *How can*

[22] See http://www.ft.com/cms/s/0/6fab9488-ecbf-11dd-a534-0000779fd2ac.html accessed on 1/26/09.

all these demands be made to be seen as compatible with the long term interests of the BRICS national governments and their populations?

3. The developing countries participating at the G-20 meeting in Washington DC last Fall demanded a stronger voice in the IMF and other instruments that govern the international financial architecture. It remains unclear, however, whether this is because either some of them individually or all as a group have a distinct view on how to organize the financial system at the global level; or simply a guarantee that their individual national interests are better accounted for in the reforms that we are likely to have in 2009-2010. *How is that claim expected to interact with the effects of contagion and reduced financial flows towards developing countries?*
4. What observed and claimed representativeness do the BRICS and other G-20 emerging countries have for the developing world as a whole? Do they actually bring the interests of all other developing countries to the G-20 meetings, or just their own? Why should they? *Is the issue of representation a relevant dimension to keep in mind when reforming the global financial architecture or should the emergency nature of the response be given priority?*

Civil Society Perspectives on Systemic Reform

This section examines current positions, priority concerns and proposals of civil society organizations that have an interest in issues of international systemic reform.

The focus is on areas of convergence, despite diversity of opinion and of depth of consideration in the broader civil society demography. Although extensive world-wide "sign-on" is characteristic of some recent statements, an extensive inter-group negotiation process occurred in the context of the Doha FFD preparatory process and conference. Nevertheless, emphases originating with "northern" groups remain considerable.

The context

While a number of CSOs have taken positions on reform of international finance and related matters like debt, tax havens, etc., over time[23], many of these positions, and many new CSOs, have come into play in the preparation for the UN Doha review conference on Financing for Development at the end of November, advocacy at the event and response to its result. Other positions have been taken in response to the G-20 Summit in mid-November. Preparations for the former extended over the past year, for the latter little more than a month.

Some transnational CSOs have internal capacity for policy development and representation, and issue research-based declarations and briefs, a few national focused CSOs and coalitions have also developed detailed policy capacities. However, in the broader international CSO demographic, many linkages are shorter term and negotiated around specific issues or international official policy processes and events. The preparatory process for the Doha FFD conference involved the development of CSO

[23] See for example a number of statements and initiatives developed through UBUNTU's World Campaign for the Reform of International Institutions (www.reformcampaign.net/?lg=eng, in particular *Proposals to Reform the System of International Institutions. Future Scenarios.* of March 2004.

"benchmarks" and detailed recommendations for policy advance, negotiated during preparatory sessions in the first half of 2008. [24] These were signed by a significant number of CSOs and networks, providing a basis for ongoing advocacy during the preparatory process, as well as for a Civil Society Forum in Doha where they were elaborated and in advocacy at the official Conference itself.

The announcement of the G-20 Summit provoked two extensive networking exercises in which hundreds of CSOs, diverse in regional and national background, expressed their position on the modalities of international decision-making (the legitimacy of the G-20, the importance of the UN, etc.) in an international *Statement on the proposed "Global Summit" to reform the international financial system* (October 29, 2008) and in principles and areas of content sought from that summit in a civil society declaration *Towards an Economic System that Works for People and the Planet* (November 14, 2008). Each of these statements gained several hundred organizational endorsements as well as individual "sign-ons" in a very limited time.[25]

Transnational CSOs themselves have issued statements in their own right, as, for example, the OXFAM Briefing Note "If Not Now, When?" issued in November, before the G-20 Summit and the statement of ATTAC "The time has come: Let's shut down the financial casino".[26] The International Trade Union Confederation issued a "Washington Declaration" regarding the Summit and followed up with an evaluation.[27]

New formulations are anticipated in the preparatory period for the April G-20 meeting in London.

Rejection of neo-liberalism and market fundamentalism

Virtually all statements reject the key elements of the "Washington consensus", and the proposals that the primary administrators of such policies, including the Bank and the Fund, should be instrumental in designing or governing solutions. The Centre for Economic and Policy Research notes that the IMF in extending packages to Hungary,

[24] *Civil Society Benchmarks for the Doha Preparatory Process on Financing for Development*. June 27, 2008 and *Civil Society Key Recommendations for the Doha Draft Outcome Document.* June 27, 2008, as well as more detailed statement on each of the six themes of the Monterrey Declaration. www.ffdngo.org

[25] *Statement on the proposed "Global Summit" to reform the international financial system* , Halifax Initiative, Ottawa, Ontario, Canada. www.halifaxinitiative.org As of November 17, the Statement was endorsed by more than 2500 signatories including 850 organizations in 112 countries.
Declaration: *Towards an Economic System that Works for People and the Planet. Institute* for Policy Studies. Washington, D.C., U.S.A. November 14, 2008. www.ips-dc.org As of November 17, the Declaration gained signatories (526 total: 211 organizations from 52 countries and 315 individuals). For an extensive listing of CSO statements and analyses see: www.choike.org/nuevo_eng/informes/7121.html

[26] Oxfam Briefing Note, "If Not Now, When?" www.oxfam.org.uk/ , "The time has come: Let's shut down the financial casino:ATTAC's statement on the financial crisis and democratic alternatives." Also available in French. www.attac.france.org (ATTAC is *l'Association pour la taxation des transactions financières pour l'aide aux citoyens* founded in France in1998 and now international.

[27] See Trade Union Statement to the "G-20 Crisis Summit": The Global Unions "Washington Declaration", November, 2008. www.ituc-csi.org. and statements by ITUC officials reported in: Onlines"Global Economic Crisis: G20 Declaration Insufficient, But Better News from the ILO" 21 November, 2008. www.ituc-csi..org

Ukraine, Iceland, Pakistan, etc., exhibits many of the same characteristics that led to a deepening of crises during the Asian crises of the 1990s. This contributes to debate regarding competing or alternative channels of lending to developing countries, regional monetary organizations, etc.[28]

This reversion to pattern as well as official resistance to acceptance of responsibility for the crisis outrages many. The Transnational Institute statement on the G-20 comments: "In our view, the global financial implosion is but one of several converging crises caused by government neglect and an ideology celebrating an individualist-based, free-for-all market fundamentalism over the need for civic responsibility." Consequent on this neglect, "two other enormous global problems now worsen and converge with the financial crisis: the planetary climate crisis and inequality within and across nations."[29]

The moment: Transformation

In their joint pre-G20 statement of October 29 the diverse CSOs stated the need for "the fundamental and far-reaching *transformation* of the international financial and economic system. Again in the declaration of November 14, the associated CSOs state that the current global crisis "demonstrates quite definitively that a real transformation of the system is required." As to the objective of transformation, ATTAC, for example, seeks "another paradigm, where finance has to contribute to social justice, economic stability and sustainable development."[30]

More specifically, elements of transformation include:

- The means for developing new approaches must break from the past, neither the G-8 nor the G-20, nor the Bank and the Fund are appropriate, many of them are responsible for the current "melt-down", and thus "the wrong group to be changed with reworking global economic rules and institutions."[31]
- The purposes and scope of a reworking of global institutions must be much broader and socially oriented than mere regulatory reform.
- The principles which must govern the development of reformed institutions are key
- The participants in the process must include *all* governments, with inclusion of civil society.

Action by *public* authorities is clearly demanded. As a number of national organizations in the UK said in their 14 November letter to Prime Minister Gordon Brown: "The current structures and policies actively restrict the ability of governments to do what is needed to serve the public interest, and must be changed."[32]

---

[28] CEPR Warns of Dangers of IMF Resurgence" Press Release. Center for Economic and Policy Research, Washington, D.C., U.S.A. November 14, 2008. www.cepr.net

[29] "Statement on the G-20 Summit on the Financial Crisis, 15 November, 2008" Transnational Institute, 17 November, 2008. www.tni.org/detail_page.phtml?act_id=18942&usename=guest@tni.org...

[30] Ibid.

[31] Declaration. November 14, 2008

[32] Letter to the Prime Minister urging him to radically rewrite global financial rules. Bretton Woods Project and organizational signatories. 14 November, 2008. http://brettonwoodsproject.org/art.shtml?x=562960

This priotizes the need, often repeated in civil society statements, to ensure that "policy space" is available to democratic governments, particularly those facing development challenges. As a coalition of Canadian organizations stated in their October 10 letter to their foreign minister, the outcome of the Doha FFD conference must support "efforts by developing countries to regain real democratic ownership of their domestic policy space – without interference from donors or the Bretton Woods Institutions – that allow the creation of tax, trade and investment policies, which maximize potential domestic resource mobilization and improve resource utilization."[33]

Capping these objectives is the overall demand for institutions of global decision-making which are not only democratic but are capable of addressing social and environmental as well as economic crises comprehensively.[34]

Social and environmental objectives

Although some groups/statements go into greater detail on the technical and regulatory reform dimensions, virtually all converge on the demand that reform not be limited to such dimensions but include social, governance and environmental objectives. Dealing with the crises in the financial sector and their deleterious inter-relations with the "real economy" and on global inequities needs to be governed by broader principles, and fully aware of social impact, particularly on development.

The social vision put forward varies in extent, specificity and depth in the diverse statements and declarations but some of the elements are:

- A major recovery plan is demanded by labour. ATTAC advocates the creation of a major crisis fund in each country fed by a levy on all capital income over 50,000 Euro, so that a "speculator pays" principle might be implemented. (Washington Declaration)
- Economic democracy and equity, including the development of local economies, and community control and protection of water, seeds, genes, air, communal lands, fisheries and other "commons" (Nov. 14 Declaration)
- Combat inequality with distributive justice (Washington Declaration)
- The fulfillment, protection and promotion of all human rights, gender, racial, ethnic and intergenerational justice and equality (Nov.14 Declaration)
- Ecological sustainability, environmental justice and a Green New Deal – creating jobs through alternative energy development, energy saving and conservation (Nov. 14 Declaration, Washington Declaration)
- Flexible balance of payment support to help boost demand, support social spending and stimulate economic activity (If Not Now, When?)

---

[33] Letter to Minister Emerson re Financing for Development. October 20.2008. www.halifaxinitiative/org/index.php/correspondence/1115

[34] As the Oxfam Briefing Note states, what is needed is to "build a new representative global governance system so it can tackle the economic, food, and energy crises.Oxfam Briefing Note. As the Global Unions "Washington Declaration" puts it "The G20 governments must acknowledge the urgent need to begin work on a more inclusive, just and democratic system for the governance of global markets." ITUC-TUAC-Global Unions. The Global Unions "Washington Declaration" November, 2008. www.ituc-csi.org

- Maintain development assistance budgets and increase ODA and meet the MDGs, (If Not Now, When?, Nov. 14)
- Debt cancellation and a new international debt "work-out" mechanism (various)
- Counter-cyclical monetary and economic policies (Washington Declaration)
- End economic policy conditionality by the IFIs (Washington Declaration)

Statements like "If Not Now, When?" note, in some detail, the particular negative run-on effects of the financial crisis on developing economies and populations, including falling exchange rates, currency speculation, cut-backs in ODA, reduced export markets, reduced remittances, etc. These occur in societies lacking effective safety nets, driving populations back into poverty.

Institutional reform

Overall:
As the Nov. 14 Declaration points out, there is a current contradiction in the high-level rhetoric regarding re-regulation, supervision and risk reduction, with the policies of the WTO, Bank and Fund which continue to advocate a roll-back in the regulation of the financial services sector as a whole.

The Declaration notes that concentration on banks is insufficient and that reform must deal with the financial system as a whole, including hedge funds and private equity funds.

With regard to financial sector reform, the Transnational Institute offers four principles which it suggests official agendas lack, but require:

- Total transparency – all financial instruments and all financial institutions to report fully on their activities and this information made available to the public.
- A 10 percent rule – eliminate uninhibited leveraging by requiring a minimum 10 percent collateral/capital reserves on all financial instruments.
- All current and future financial instruments to be brought under the umbrella of financial regulation.
- New national and global regulatory systems to be subject to the widest and deepest democratic participation, including oversight, monitoring, and access to decision-making.[35]

IFIs:
Reform, regionalization and democratization are essential characteristics of the many demands regarding the Bank, Fund, Financial Stabilization Forum and other key multilateral bodies. As "If Not Now, When?" points out the current situation of voting power in organizations like the IMF is untenable, as is the US veto power. A radical overhaul of governance is required, and countries like China should use their expanded leverage (access to their huge reserves) to that end.

[35] "Statement on the G-20 Summit on the Financial Crisis, 15 November, 2008" Transnational Institute, 17 November, 2008. www.tni.org/detail_page.phtml?act_id=18942&usename=guest@tni.org...

New attention and emphasis should be given to developing regional bodies like the Bank of the South (Latin America) and the proposed Asian Monetary Fund.

Interim steps for IFI reform include, adoption of the principle of double majority (majority of members, majority of share capital), at least "south"/"north" parity in voting membership, democratization of the selection of Managing Director of the IMF and President of the World Bank, withdrawal of the IMF from development financing, etc. [36]

The membership and voting structures of the Financial Stability Forum, Basel Committees, etc., should be opened up "with the goal of achieving balanced, institutionalized and full participation of developing country governments."[37]

Regulation:
Among regulatory reforms advocated:

- Limit and regulate derivatives
- Ending speculation in staple food commodities
- Applying stricter international capital reserve requirements
- Taxation of all financial transfers including currency transactions
- Testing by supervisors of all new financial products re their impact on financial stability and society
- Progressive taxation of capital income
- Closing tax havens
- Restrict the extent and regulate investment banking
- Bring rating agencies under public control
- Stronger transparency rules
- Stop privatization of social systems and important infrastructure such as energy and transport, review of privatization of pension funds

As the Nov. 14 Declaration points out "Governments will also need to renegotiate the dozens of free-trade agreements and bilateral investment treaties that currently ban governments from placing controls on capital flows and applying other sensible conditions to foreign investment and other financial transactions."[38]

Tax cooperation:
Because of the priority concern with controlling south-north flows, facilitating domestic resource mobilization and the importance of strengthening national and redistributive tax regimes, CSOs have put considerable emphasis on a) reforming accounting standards to make international transfers transparent and b) strengthening the UN's (universal) role in tax cooperation through the upgrading of the Committee of Experts to an intergovernmental body.

---

[36] Civil Society Key Recommendations for Doha Draft Outcome Document. With regard to the IMF see also Bringing Balance to the IMF Reform Debate: Issues and Recommendations. September 9, 2008. New Rules for Global Finance, CIGI & Oxford University's Global Economic Governance Programme.
[37] Ibid.
[38] Declaration, November 14, 2008.

Means: inclusive

Whether in the context of preparation for the Doha FFD Conference or in response to the G-20 Summit, there is a rejection of limited participation in global economic decision-making. There is a clear failure of trust in "the usual criminals", and unwillingness to grant legitimacy to a limited group, even with a grudging admission that the G-20 is "better" than the G-8.

The October 29 joint statement supports "a major international conference convened by the UN to review the international financial and monetary architecture, its institutions and its governance, but only if the meeting follows a process that:

1. is inclusive and participatory of all governments of the world;
2. includes representatives from civil society, citizen's groups, social movements and other stakeholders.
3. has a clear timeline and process for regional consultations, particularly with the poor, those most seriously affected by the crises.
4. is comprehensive in scope, tackling the full array of issues and institutions;
5. is transparent, with proposals and draft outcome documents made publicly available and discussed well in advance of the meeting."[39]

The Doha Conference resulted in the agreement to hold a Conference at UN initiative.

A key divergence

Among powerful capitalist governments there are divergences which parallel in part those described above. President Sakozy of France and allies "call for a new global financial architecture that starts with, and gives primacy to, new cross-border global financial regulatory authorities." Such institutions – despite the limited-membership Financial Stability Forum and Basel Committee on Banking Supervision -- don't presently exist and should be created. On the other hand, the U.S. emphasizes national regulation, subject to closer democratic control. As the Transnational Institute points out, "Behind these arguments…lie both ideology and the desire to protect the U.S.'s and UK's financial sectors' competitiveness as global financial industry centres."[40] The Institute also argues that the weakness of the G-20 *communique* indicates the strength of the "financial lobbies" rather than concern with the interests and needs of citizens worldwide.

At the same time, calls for cross-border financial regulatory authorities and accompanying regulatory frameworks, could run into significant opposition not only by sovereignty-conscious developing country governments, but also by civil society networks which have spent decades fighting the policies of such bodies as currently exist, particularly the IMF.

---

[39] Statement. October 29, 2008. This demand is summarized in less explicit form in the November 14, 2008 Declaration.

[40] "Statement on the G-20 Summit on the Financial Crisis, 15 November, 2008" Transnational Institute, 17 November, 2008. www.tni.org/detail_page.phtml?act_id=18942&usename=guest@tni.org...

This brief would argues that the predominant tendency among civil society organizations lies with systemic and comprehensive international reform. However, in the context of response to the evolving G-20 and UN processes it remains “early days”.

Evaluation: key questions

- ***Tipping point: is the system is in crisis or not?***

A fundamental argument is going on between those who argue there is a crisis *in* the system and those who argue that it is *the system which is in crisis*. This is partly played out between those who think the IFIs and those governments that dominate them can work out the iterative steps needed to “correct” imbalances, and those arguing that these very institutions and governments are part of the problem. It is also embodied in demands for long-term as well as immediate responses and reforms. Demands for comprehensive changes as distinct from only iterative and regulatory reforms also arise. This emerge the various expressions of need for “transformation” of the system and its institutions and, hopefully, the ethos which guides them. *To what extent is a consensus for transformative change developing among key actors, or iterative reform dominant?*

- ***Governance: legitimacy and the locus of decision-making***

The locus and agenda (comprehensive or limited) of key decision-making processes is fundamental, thus the relative popularity of the comprehensive multi-thematic approach of the Financing for Development process, where civil society, major agencies and the private sector are all “inside the tent”. While IFI-(Washington)-focused CSOs have often expressed scepticism about engagement through UN channels, the opening up of debates and options in the past six months, including “socialism for the rich”, the G-20 and other developments, have reinforced fundamental questions about who is part of decision-making, and how the frame of decision is set.[41]

The debate moved forward through the intense fight at the Doha Conference, between those who favoured a comprehensive UN-Centered process and global conference, and those who clearly opposed it. There is fundamental concern for **legitimacy** of decisions made, thus defence of the political universality and charter-based authority of the UN and the General Assembly, the G-192 as distinct from the G-8, G-20, etc. For many civil society organizations this is rooted in a concern for inclusiveness and for equity, for representation of the voices of the poor and relatively powerless. There is, further, a concern with overall **accountability** of specific and less representative bodies and interim decision-making forums.

This should not break down into an argument regarding political legitimacy versus technical or economic efficiency. In fact both are essential for success. The issue is how

---

[41] While IFI-(Washington)-focused CSOs have often expressed scepticism about engagement through UN channels, the opening up of debates and options in the past six months, including “socialism for the rich”, the G-20 and other developments, have reinforced fundamental questions about who is part of decision-making, and how the frame of decision is set.

to increase representation and inclusiveness in interim or subsidiary decision-making bodies and bring them into overall reporting, review and accountability relationships with overall political authority.

The planned UN-convened Conference (at the highest level) for 2009, and the contribution of the Commission of Experts offer the opportunity to address the systemic and governance issues in a comprehensive fashion. *What agreements should be priorities for the Conference and what strategies are required to achieve them?*

- ***Mandate/charter change: a new "Bretton Woods moment"***

The sense that those who brought us the crisis should not design the corrective and preventative reforms is embodied in demands to change the IFIs, their objectives and mandates, asserting that the current crisis is equivalent in depth to the situation at the end of World War II, the occasion of the Bretton Woods Conference.

At the Doha Conference, the U.S., Canada, Japan and allies built a rhetorical wall against any threat to "established mandates" for the IFIs while CSOs and others pressed for a new global "architecture", sometimes summarized as a call for Bretton Woods II. As one CSO spokesperson, Aldo Caliari of the Center of Concern, pointed out in November, one of the reasons why the G-20 Summit was such a rush job was to head off the Doha Conference. But as he noted, a true Bretton Woods II should include all the forces assembled for Financing for Development, not the restricted gang gathered in Washington.[42]

Inclusivity and legitimacy are only part of the issue. The objectives of the institutions are also in question, particularly with regard to development objectives, equity –including gender justice, employment, poverty eradication, sustainability and transparency. *Have we reached a BW moment? How might the political momentum to achieve new mandates be constructed?*

- ***Interim solutions and civil society campaigns***

Persistent advocacy by a number of organizations – the Tax Justice Network, for example, as well as organizations pressing for innovative financing and a number of women's organizations and networks – has resulted in some advances.
- Women's organizations evaluating the results of the Doha FFD Conference found that their demands for recognition of women as economic actors were represented, in recognition in the final outcome if not in specific action commitments.
- Leadership by the French government as well as persistent lobbying by the CTT for FFD civil society coalition kept the innovative approach in the declaration with a call for a comprehensive report by the Secretary General.

[42] Aldo Caliari. "We Only Need One 'Bretton Woods II'" Foreign Policy In Focus. October 28, 2008. www.fpif.org/fpiftxt/5630

- The Tax Justice Network noted significant recognition of issues they had been raising in the Secretary-General's preparatory documents, if not nearly as adequately in the final outcome.[43]

In the current context, given the strengths and weaknesses of civil society networks and campaigns, their contribution to the achievement of regulatory reforms and other short term measures could be considerable. *What objectives ought to be a priority for the next six to twelve months and what civil society strategies might be most effective?*

Strategic challenges

While persistent and focused advocacy, contributed to some specific results, fundamental and comprehensive reform, such as that sought by some CSOs requires much greater energy, particularly if we are at a global "tipping point".

In this case, broad attempts to develop a suggestive international civil society strategy, such as the World Social Forum and its regional and national components, have not (yet) demonstrated effective coalescence and clarity. The diversity which is a key strength of civil society is often equally a fundamental challenge to effectiveness. The tactics that led from Seattle to Genoa, from Birmingham to Cancun, seem unlikely to succeed against increased repressive legislation and practice, and the extent of corporate media control.

To restate the obvious, political commitment is a pre-requisite for iterative or comprehensive change. The contribution of a single social democratic government, like that of Norway to a number of elements on the agendas outlined above has been remarkable, and from time to time the German coalition government provides leadership for elements of change. The scope and content of change in the approach of the U.S. administration is as yet unclear. There can be surprises, as the Chirac/Lula alliance which brought about the Leading Group. There can also be productive civil society/government alliances.

Beyond outrage – as for example over the effects of the financial melt-down on the poor and development agendas, or the executive "take" on various bail-out initiatives – the agenda of comprehensive and radical systemic change has not yet "grown legs" in terms of mass social communication and support. National advocacy strategies vary considerable in capacity, intensity and impact. The WSF provides a learning cauldron where exchange and growth can occur, but the overall challenge remains. The work-up to the next G-20 round and the proposed UN high level conference provide moments for a new level of coherence and application of political ingenuity.

[43] The Doha Outcome hardly met their broader expectations, the U.S. delegation removed "progressive" from the reference to making tax systems more pro-poor (Para.16), references to "tax evasion" were excised, but TJN declared the cup "half full". While stronger action on upgrading was not taken directly, the Outcome includes a request to the ECOSOC "to examine the strengthening of institutional arrangements, including the United Nations Committee of Experts on International Cooperation in Tax Matters.

Concluding Remarks: New Strategies to Stimulate Policy Change in Global Finance

The challenges facing the global economy are deep and multifaceted. A crisis that began in housing and credit markets in the United States has rapidly degenerated into a wider economic crisis and a global slowdown that is affecting all countries without exception.

The locus of debate and decision making in the financial sector, both at the global level in multilateral financial institutions and at the national level, often takes place in a closed circle and with a ‘behind-closed-doors’ attitude. As a result disparate communities of interest – such as academics, policymakers, private-sector practitioners and civil society members – rarely get an opportunity to collaborate on a common platform.

The objective of this project is precisely to open up the closed circle of decision making that dominates financial policy, create new networks amongst participants and generate policy responses that take into consideration the needs and priorities of a wider group of affected countries. Our efforts will help relate ongoing financial and regulatory developments to a wider audience in order to spur a more productive public debate. Doing so is essential to stimulate fresh thinking on the role and desired social purpose of finance in our modern economic systems, and to build credibility around reform processes underway.

This paper is intended as a backgrounder to stimulate discussions at the three workshops envisioned in this project, and covered four key dimensions in responding to the crisis: policy and institutional dilemmas facing systemic reform; the dynamic relationship between regulation and financial innovations and the challenge of rebuilding a desperately broken financial sector incentive structure; the role and impact of the emergence of significant new actors in global finance; and the role and efficacy of civil society groups responding to the crisis.

References

Bernanke, Ben (2004), “The Great Moderation,” remarks by Ben S. Bernanke at the meetings of the Eastern Economic Association, Washington, DC.

Bookstaber, Richard (2007), *A Demon of Our Own Design: Markets, Hedge Funds and the Perils of Financial Innovation*, John Wiley and Sons.

Das, Satyajit (2008), *De-leveraging Fairy Tale Endings*, in Prudent Bear, October 20, 2008

Das, Satyajit (2008), *Voodoo Banking: The Outlook for Banks*.

Duffie, Darrell (2008) *Innovations in credit risk transfer: implications for financial stability*, BIS Working Papers No 255.

Fama, Eugene (1970), “Efficient Capital Markets: a Review of Theory and Empirical Work.” *Journal of Finance.*

Ferguson, Niall (2008). *The Ascent of Money*. New York: Penguin.

Grossman, Sanford J. and Joseph E. Stiglitz (1980), “on the Impossibility of Informationally Efficient Markets,” *American Economic Review* **70** (3), 393-408.

Helleiner, Eric (2008), “International Payments Imbalances and Global Governance.” CIGI Policy Brief no. 8 (November).

Kindleberger, Charles P. (1996). *Manias, Panics and Crashes: a History of Financial Crises.* New York: Wiley.

Knowledge@Wharton (2008), *‘Regulation-induced Innovation’ and Other Outcomes: The Role of the Central Bank in the Subprime Crisis*, Wharton School of the University of Pennsylvania.

Mehrling, Perry (2000), *Understanding Fischer Black, Barnard College*, Columbia University.

Michael Mah-Hui Lim (2008), *Old Wine in New Bottles: Subprime Mortgage Crisis-causes and consequences*, Levy Economics Institute, Working paper no. 532.

Minsky, Hyman P (1992), “The Financial Instability Hypothesis.” *Working Paper* # 74. The Jerome Levy Economics Institute, New York: Annandale-on-Hudson. November.

Morgenson, Gretchen, *How Merrill’s Thundering Herd Fell*, International Herald Tribune, Sunday November 9, 2008.

Persaud, Avinash (2008), *Reason with the messenger, don’t shoot him: value accounting, risk management and financial system resilience*.

Persaud, Avinash (2000), *Sending the Herd of the Cliff*, E-Risk.com

Pittman, Mark, *Evil Wall Street Exports Boomed with ‘Fools’ Born to Buy Debts*, Bloomberg, October 27, 2008.

Roubini, Nouriel (2008), *The Rising Risk of a Systemic Financial Meltdown: The Twelve Steps to Financial Disaster*, RGE Monitor.

Soros, George (2008), *The Sixty Year Storm*, The New York Review of Books.

Sufi, Amir (2008), *Securitization Likely Culprit in Subprime Crisis*, The Credit Crisis: a lecture series, October 21st, Initiative on Global Markets, University of Chicago

Wolf, Martin (2008), *Fixing Global Finance*, Johns Hopkins University Press.