Regulate Finance for Development

The Stress Test for Global Financial Governance

Economic Governance under Conditions of Crisis
Problems, Trends and Alternatives
A civil society perspective

Written by Peter Wahl, WEED

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This publication has been produced as part of a project of six European NGOs (BWP, CRBM, CCFD, EURODAD, GLOPOLIS and WEED) on raising awareness about the creation a global financial system fit for development.

As of now, the EU is hardly present as a regulatory actor but there are proposals for its role to grow substantially. The project wants to contribute to a more coherent and common political approach for financial regulation and supervision inside the EU and for common positions in international processes of reform, such as G20, IMF, FSB and the UN.

For more information, please go to:
www.regulatefinancefordevelopment.org

The report has been written by Peter Wahl of WEED, World Economy, Ecology and Development.

Useful comments and information have been given by: BWP; Antonio Tricarico, CRBM; Marta Ruiz and Nuria Molina, Eurodad; Jean Merckaert, CCFD.

Graphic design and layout: Carlo Dojmi di Delupis

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Summary

The world is witnessing fast-paced changes and extraordinary challenges including the financial and economic crisis, climate change and the increasing scarcity of important resources, first and foremost oil.

In order to cope with these multiple crises, regional and global level institutions are needed urgently. Existing procedures and institutions are not able to adequately deal with these challenges. No global agreement has been possible for the Kyoto follow-up and the management of the financial crisis was mainly handled at the level of the nation state.

At the same time, big powers continue to use traditional methods of power politics. These structures underlie the existing procedures and institutions of global governance, undermining their efficiency. Additionally, regional integration as in the case of the EU is marked by a democratic deficit.
Globalisation, which was triggered by the liberalisation of finance in the aftermath of the collapse of the post war Bretton Woods system in 1972, has established an asymmetry between the economy and governance: while global economic players act increasingly at transnational level, the domain of political governance and democracy remain very much bound to the nation state. There is an inherent trend in economic globalisation to erode democracy. Therefore, to be democratic, politics have to regain control over the economy, and in the first place over the financial markets.

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The report argues furthermore, that there is a basic dilemma: the contradiction between the size of social entities and the complexity of problems on the one hand and the capacity of citizens and institutions to cope with them. Size and complexity matter for democracy.
The report then analyses the existing structures of global governance such as the G8 and G20, whose informal make-up means that these institutions and their impact lack transparency. They are neither a global government nor a mere public relations exercise. They can be effective in areas where there is consensus among the members. If the heterogeneity increases, which is already the case through the increasing number of members, they risk to become ineffective.
With the establishment of the G20, the G8 has lost importance. The G20 marks a certain progress in the areas of representation, although there is still a democratic deficit. It represents two-thirds of the world population, 80 per cent of world trade and 85 per cent of world GDP. This is why it cannot be treated just like the G8. But still 90% of countries on earth are still excluded.
However, as the conflicts of interest within the G20 are much higher than in the G8, its capacity to solve global problems should not be overestimated. This also refers to the G20 proposals to reform the financial system. Increasing capital requirements, regulating derivatives and highly leveraged institutions and strengthening supervision are steps in the right direction, however, they are not enough. As long as casino capitalism continues, there will be no sustainable solution.

With regard to the institutional dimensions of a reform, the G20 remains very conservative. Strengthening the IMF and the World Bank, institutions that have been rather part of the problems than of the solution, will not allow for substantial change unless there is dramatic change in their economic paradigm and their governance and practical behaviour. Other institutions, such as the Basle Committee, the Financial Stability Board and standard setting bodies are analysed. The conclusion is that they all need to be more democratic and to undergo a paradigmatic change. The neo-liberal model has failed. Another paradigm has to be put in place, which serves stability, social justice and sustainable development.

The report then deals with the changes in the international system, such as the decline of US dominance and the rise of China and other new powers. The emergence of the Chiang Mai initiative, the BRICs, the Banco del Sur and the Shanghai Group highlight a trend toward regional integration and the establishment of new alliances outside the traditional institutions.
Such changes in the balance of power within the global arena indicate that the present era is coming to its end. After 500 years of economic, political, military and cultural dominance, Europe and its North American offshoot

will not take so easily to the looming historical break. The report then addresses the marginal role played by the EU in the management of the financial crisis, which was largely handled by national governments. The crisis was a consequence of the lack of regulation and supervision, spurred by policies built on the ideology that liberalised financial markets would be efficient.

There are now hectic attempts to improve the situation. Several initiatives are underway, such as directives on the regulation of hedge funds, capital requirements, derivatives, rating agencies and European supervision. Although the process is not yet finished, at present, the proposals are not legally binding, as in the case of the derivatives directive. Furthermore they are too limited, as shown by the amendments of the directives on capital requirements and on hedge funds, and they deal with non-core issues, which may only have marginal impact, such as the directive on rating agencies. Strong resistance against "too much" regulation can be expected from the City of London and the entire financial industry, which uses its lobbying power to water down any effective regulation.

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The last chapter of the report deals with alternatives. As a basic approach it suggests a selective de-globalisation of finance. Building on Keynes' position, that trade should be globalised but finance contained at national level - because it is not possible to ride the tiger - measures on national, regional and global for a reform are presented. These reforms propose not only to shrink finance, but to change its role so that it serves the real economy, and in particular supports the transformation towards a carbon free economy and to combat poverty. Furthermore the "speculator pays principle" must be implemented, ensuring that those who have made incredible fortunes in the past have to now pay the costs.

The financial casino that has been established over the last decades not only negatively impacted stability, but also distribution and democracy. This is why redistribution from above to below, through appropriate taxation systems and public services for health care, pensions and education, is now on the agenda. The subordination of these public goods by finance's goal of maximising profits has to be ended.

At the European level, the report suggests a strict regulation of the financial sector and the reform of the European Central Bank (ECB). Jobs and sustainable growth have to be included into the ECB mandate, while the objective of controlling inflation has to be expanded to include asset prices. No efficient financial regulation can be thought of as long as tax havens keep on undermining any regulation. The EU should be a forerunner in that respect and start to dismantle these jurisdictions under the control of member states, including the Cayman Islands (British) and alike.

At global level, the report advocates the establishment of a global economic coordination council under the premise of the UN and the democratisation of the Bretton Woods Institutions, the Basle Committee and the standard setting bodies.

Finally, a supranational monetary system is needed to end the dominance of one national currency as the leading currency internationally. A basket of currencies and Special Drawing Rights could serve as an intermediate step towards a global currency

Berlin, March 2010

1. Global financial governance at a time of upheaval

New York, 2010
Photo by Riccardo Carraro

We are witnesses to fast-paced economic and political changes[1]. There are major questions about how multiple global crises such as the financial crisis, global warming and the scarcity of carbon-based energy and other important raw materials can be mastered.

Which types of institutions are needed at local, national and international levels? What should be the relationship between the nation state, regional integration and global cooperation? How can global governance be made democratic while providing efficient solutions at the same time? And crucially, how can the solutions to these crises be provided on time?

Because the time factor has reached a new quality. The time horizon of chemical, physical and biological processes does not follow the dynamic of political decision making, power politics, diplomacy and multilateral negotiations. Once a "tipping point" is reached irreversible damage may occur. There have been such situations in the past, like the deforestation of Italy and Spain 2000 years ago, the failure of the Vikings' agriculture in Greenland or the decline of the Maya culture in Yucatan a thousand years ago. But these were regional disasters, which could be compensated for to a certain extent. Today however, for the first time in human history, mankind is capable of triggering irreversible disasters of global dimensions. And it is within the next two decades when the decision on where we are going will be taken, making this a time of exceptional historic conjuncture.

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Global finance, with its developments over the last forty years and its far reaching consequences up to the currently unfolding economic crisis, is a perfect case-study with which to inform analyses and proposals about the systemic policy and governance changes needed at all levels.

The financial and economic crises have made the gaps and limitations in the current system of global governance abundantly clear. The current patchwork of diverse organizations is incoherent with its incomplete coverage, unbalanced representation, inequitable rules and inefficient practices. They also have limited powers to force or persuade more powerful countries to adopt any measures that are agreed on. Whether we like it or not, the power of a country in military, economic, political and cultural terms is still the basic factor determining the structure and dynamics of the international system. The existing system of global governance is therefore subject to asymmetric and hegemonic power.

The fall of the Berlin wall twenty years ago gave rise to hopes that the world would move beyond bi-polar confrontations and imperialistic rivalry to a system of multilateral global governance. This would enable coordinated solutions to be found to global problems and enable people to find ways to live together cooperatively and peacefully. The aim was to find a way to move beyond a politics based primarily on competitive nation-states to one where national and global interests were considered together.

1 Hobsbawm, Eric (1994): Age of Extremes. The Short Twentieth Century, 1914-1991. London

COP 15 UN climate Forum - demonstration
Copenhagen, December 2009
Photo by Carlo Dojmi di Delupis

1.1. Financial globalization – the spearhead of neoliberal globalisation

The present phase of globalization commenced with the abandonment of fixed exchange rates in 1972, and the ensuing deregulation of financial markets, which became the engine of the globalization of trade and production. The framework for these changes was provided by neoclassical market competition policies, and by monetarism in public finance. Neoclassical theory claims that the public sector should reduce its share of economic activity and allow private companies to freely determine where to invest their money and how to provide goods and services. These multiple private decisions will, according to the theory, produce an optimal social outcome for all.

In reality, the traditional relationship between the real economy and the financial system, in which the latter was at the service of the real economy, had been reversed. The logic and dynamic of financial speculation dominated over the rest of the economy, marking a new step in capitalist development, which became finance led and finance driven. The economist John Maynard Keynes called this a "casino" economy; others speak of *financialisation*, and others of *finance-capitalism*. However you name it, a new type of economy had emerged.

The entire process has been driven by power-relations[2]. As poverty increased, so did social polarization; there has been a bottom-up redistribution of wealth, with the rich getting richer, and the poor getting poorer. Even large parts of the middle class are threatened by social degradation. The main winners are the finance industry and transnational corporations.

Representative democracy has been undermined. The internationalization of the economy has not been matched by the internationalization of democratic decision-making processes. There is no international or global state with appropriate democratic institutions. This has resulted in an asymmetry between business operating transnationally and a democracy limited to the nation-state.

In 2008, the brave new world of finance capitalism collapsed, adding to the already existing crises. For the first time after more than twenty years, a new debate has emerged about the failure of this model, the rapid changes which took place in the last years in the geo-economic and political map of the world, and how to get out from a highly financialised world economy. The question of new governance models at national, regional and global levels is at the top of the agenda, combined with a search for alternative financial and economic policies. It is not yet the end of neoliberalism or monetarism, but its discursive hegemony is broken and we are heading toward a transition phase in which some of their assumptions will inevitably be questioned and changes will happen, but it is still unclear into which final direction.

2 Cf. Brand, Ulrich et al. (2000): Global Governance. Alternative zur neoliberalen Globalisierung? [Alternative to neoliberal globalization?] Münster.

2. Global governance to regulate economic globalisation?

The 'global governance' approach addresses some of the problems of contemporary economic globalization and aims to develop alternatives.

The approach considers that policies must be debated politically and ethically and while the state must play a role in delivering them, it is no longer capable of solving the global problems alone. Therefore the private sector and civil society are increasingly called upon to actively take part in international policymaking[3]. It contrasts with market fundamentalism, which holds that the market is the optimal form for regulating societal interaction.

Global governance also deals with the multi-level problem, i.e. the linkages and the coordination between local, regional and global decision-making and problem solving. The market cannot adequately define or solve global problems. "The goal must be to implement a new, this time global, institutional embedding of the world market economy, following the taming of the national market economies by the rule of law and the welfare state."[4]

Major international reports, such as the *Independent Commission on International Development Issues* - known as the *Brandt Report* - have, since the 1970s, called for responsible global thinking, global peace, development and just economic policy[5]. The *Brundtland Report,* which served as a blueprint for the 1992 Rio 'Earth Summit', popularized the idea of sustainable development[6]. The *Commission on Global Governance* drafted a vision for solving global problems in its 1995 report *Our Global Neighbourhood*. The approach outlined in these reports was to use international cooperation to solve the problems thrown up by economic globalization. It insists on political and ethical discussion about societal goals and state regulation of the economy. It contrasts with the market fundamentalism, which holds that the market is the optimal form for regulating societal interaction.

2.1 The democratic deficit of global governance

Confronted with dramatic multiple crises and the time pressure described above one might be tempted to say that absolute priority has to be given to efficient problem-solving and that anything else, including democracy does not matter much any longer. We believe that this is a fallacy. Democracy is not only a value in itself, but in a pluralistic world also a prerequisite for efficiency. It is only through democratic consensus that international problems can be solved. Otherwise, conflict and war will ravage and make it even more difficult to meet the exceptional challenges of our times. This is why the issue of democracy is a leitmotiv of this text.

The nation-state, with its democratic institutions and procedures, has achieved a historically unprecedented degree of citizen participation in decision-making. However, by now it is impossible to translate this level of democracy to the international system.

The European Union, as the most advanced supranational integration project of our time, is an instructive example for the dilemmas that may occur if nation states are supposed to integrate into a major entity. The EU suffers from a considerable deficit of democracy. The German Federal Constitutional Court in its June 2009 ruling on the Treaty of Lisbon stated that the EU as presently constituted does not satisfy the requirements for a democratic association. According to the ruling, the European Parliament is "*not elected on the basis of equality,*" and is not authorized to make "*substantive political decisions*." It did not, the ruling continued, represent any "*sovereign European people.*" While a German MEP represents 833,000 voters at one end of the scale, an MEP from Luxemburg represents only 66,667 at the other[7]. There is an inequality of

3 Of course, governments, the private sector and civil society actors (CSOs) are not equal. For instance, transnational corporations may dispose of huge economic power which allows for blackmailing countries or entire regions. On the other hand CSOs may dispose of more "soft power", i.e. prestige and ethical integrity. Furthermore, the presence of civil society actors can be ambiguous or even negative when it becomes part of a screen shielding the public from the poor results of the processes going on behind it. NGOs often aid governments merely as an additional resource to reinforce their own problem-solving capacities;

4 Nuscheler, Franz (1998): Warum brauchen wir Entwicklungstheorien? [Why do we need development theories?] In: E+Z Entwicklung und Zusammenarbeit. Vol. 39, # 11.

5 North-South: A Program for Survival, 1980; named after former West German Chancellor Willy Brandt.

6 Our Common Future, 1987; named after Norwegian Prime Minister Gro Harlem Brundtland.

7 The phenomenon is called digressive proportionality.

voter power, which undermines the foundational "one person, one vote" principle of modern democracy. Another fundamental deficit is the absence of the division of powers, into their legislative, executive and judicial types, as developed first by Montesquieu, marking a basic rule of any modern democracy. The European Parliament lacks a basic right of a democratic parliament: legislation. The European Commission – and behind it the Council – has the only right to initiate legislation while being at the same time the executive organ of the EU. With the Lisbon Treaty the rights of the European Parliament have been slightly expanded. Nevertheless, the basic deficit still exists.

As a consequence of the democratic vacuum, there is much scope for informal influence by various interest groups. The most striking example is the private sector, which with all its money is able to maintain a powerful lobbying machinery, influencing governments and EU-institutions far more easily than civil society or anybody else. The democratic deficit of the EU derives from the basic asymmetries of the integration process, where absolute priority is given to the establishment of a common market over socio-political concerns. While liberalisation, deregulation and privatisation were heavily pushed in favour of capital interests, other aspects like democracy and social concerns lagged dramatically behind. Prominent examples of the neoliberal hijack of the European project are the so called *Growth and Stability Pact*, the policies of the *European Central Bank* and the anchoring of other neoliberal principles, such as competition and free-trade as per the Lisbon Treaty (see also chapter 5).
Beyond the EU, there is a more significant asymmetry at global level - between the global space of economic power and confinement of democratic governance to the national sphere.

The democratic deficit of the EU derives from the basic asymmetries of the integration process, where absolute priority is given to the establishment of a common market

2.2 Nation state and global governance – a basic dilemma

"*This global crisis calls for a global reaction. Unfortunately however, the competences are still located at the national level.*" With this observation, Nobel Prize winner Joseph Stiglitz [8] pinpointed that nation is still the dominant framework for social integration. Of course, big nation states such as the US and China still contain greater power to shape history than any other type of actor in the international system.

The financial and economic crisis has highlighted the importance of the nation state. Under globalization economies became disembedded from the regulatory framework of the nation state. As described in Chapter 1, this has weakened the state's control and problem-solving abilities since no sufficient substitute for the nation state has as yet been created. The nation state, albeit weakened by globalization, is still the most important authority for policy regulation. The financial crash has delegitimized those who believed that the market is under any circumstances the optimal mechanism to regulate the economy and society.[9]

On the other hand, global institutions have not proved capable of decisive action. It was nation states, with their rescue and economic stimulus packages, and in some cases with nationalization and expropriation, which prevented the complete collapse of the financial system. So far richer governments have spent some $18 trillion to bail out or guarantee their private financial institutions[10]. In comparison, the multilateral institutions are paper tigers, where even the IMF and World Bank are powerless without the backing of the US and – to a lesser extent – the other rich industrialized countries.

Nonetheless, the management of the crisis by nation states has been geared towards the interests of the financial industry. It has lacked transparency, and has long-

8 *Financial Times Deutschland*, April 17, 2009

9 This does not mean that the markets should be abolished. What is needed is an embedding of markets into political regulation and a strong public sector in key areas such as health, pensions, education, electronic mass media, finance, transport and energy.

10 This total comprises financial rescue packages including government contingent liabilities through guarantees and liquidity injections into financial systems from September 2008 to March 2009. 'The world financial and economic crisis and its impact on development', UN Secretary General, June 2009: www.un.org/ga/search/view_doc.asp?symbol=A/CONF.214/4&Lang=E

term negative implications for lower and middle-income groups. The support for (environmentally unfriendly) industries such as automobiles has missed a golden opportunity to reshape the technological basis for growth. However, in contrast to the Great Depression of 1929, governments have learnt a lesson and are using typically Keynesian approaches to overcome the crisis. By pursuing counter-cyclical fiscal policies, they have prevented total collapse of the financial system, which was not the case in 1929.

The fact that they have done so using the tools of the nation-state was because the instruments available for crisis fighting still exist only at the level of the nation-state. Only national governments have the money, the institutional, financial and legal means, which are needed to react to the crisis. Even the IMF and the World Bank, virtually the most powerful multilateral institutions are nothing without the US and – to a lesser extent – the other big industrialized countries - backing them. The nation-state is likely to remain the institutional centre for responding to crises and managing globalization for a long while. Of course, nation states have differing capacities to implement policies domestically, and to influence decisions in the international and multilateral system. There is a tremendous gap between Burkina Faso and the US, between China and Bangladesh, for example.

Only national governments have the money, the institutional, financial and legal means, which are needed to react to the crisis

At first glance, the UN system seems to offer a solution to the differences between nation-states in giving each of them one vote in multilateral institutions. The UN has often been cited as a possible counter-force to global markets. The UN system looks more democratic than the Bretton Woods institutions, where decision-making capability is determined by economic power. However, it remains that a few countries in the Security Council carry veto power, and China with a population of 1.3 billion formally counts as much as Iceland with a population of 300,000. Embedded within the formal procedures is the global balance of power – if big players such as the US or China object, a majority vote by the rest of the world would not help, as demonstrated by the failure of the Copenhagen climate negotiations in December 2009.

To address the democratic deficit, calls have been made for the introduction of civil-society chambers to decision-making bodies, such as the UN General Assembly, and for the formalized participation of stakeholders in decision-making. Known as co-determination models, their implementation could indeed reduce the democratic deficit of global governance somewhat, but it would not solve the fundamental issues.

One reason is that civil-society actors, and to a greater extent, the business sector, have limited or in some cases lack legitimacy. Managers, boards of directors, and shareholders lack any trace of democratic legitimacy.
By satisfying the fundamental right of any human being to self-determination and self-government, democracy is an aim in itself. However, it also carries instrumental value as it is a means to solve problems within a community. Larger communities are usually subject to greater conflicts of interests, decision-making is more complex and takes usually much more time than in smaller communities. This is why size and complexity matter in democracy. What is true for communities of individuals is even more relevant for the international community, i.e. the more than 190 nation-states and multilateral institutions and procedures they have established in the last hundred years.

2.3 Size and complexity matter

Sensible demands are often rejected because of the failure of a key player to cooperate. Caps on financial sector bonuses may be blocked by the US, or France may impede the abolition of agricultural protectionism in the EU, or the Chinese speak out against strict regulation of tax havens and offshore centres.

This raises the question as to whether it might not be

UN security council
Photo by Bernd Untiedt, January 2005

possible to use pressure to force more cooperation. The US did this successfully in 2009 by threatening Switzerland with sanctions if Swiss banks operating in the US did not become more transparent about US citizens who may have evaded taxes. In this case, it worked well. The reverse side, however, is that this outcome was not the result of a consensus among equal partners. The balance of power was the decisive element. In this case, the US were advocating a legitimate cause: the democratic principle of tax justice. But on the basis of their power, they are also to enforce illegitimate interest. The history is full of examples for this.

In principle, there need not be a contradiction between efficiency and democracy, and the two concepts often reinforce each other. Decisions taken without sufficient legitimacy and participation can prove inefficient if those excluded from the decision making process do not support them.

Even in large nation states, the decision making chain between the individual citizen and the national government has become extremely thin

Inclusion may increase efficiency but it also involves greater complexity when arriving at decisions. This problem arises in all multilateral bodies and institutions, be they small informal groups like the G8, where intense contradictions and rivalries exist behind the smokescreen of the diplomatic rhetoric of consensus[11], or such universal groupings as the UN, which represents the 192 nation-states.

Existing multilateral mechanisms may not be able to agree common solutions on tough problems such as climate change, as the Copenhagen negotiations show[12]. Even if multilateral agreements are reached, their enforcement is another problem[13] as demonstrated by the history of foreign aid. Forty years after donor countries committed 70 to provide 0.7% of their GDP for overseas development assistance, only four governments have actually managed it.
In conclusion, size and complexity matter for democracy. The bigger the constituency of democracy, the more complex its problems are, making it difficult to reach a consensus without resorting to pressure or even violence. This poses an inherent difficulty to achieving democracy at global level. Even in large nation states, the decision making chain between the individual citizen and the national government has become extremely thin.

Selective de-globalisation may be partly a way out of such a dilemma. Decentralization and regionalization of economic and political processes would allow for more subsidiarity, allowing for more problems to be diagnosed and solved at regional and local levels. It might be argued that democracy has a greater affinity to the small-scale and community level, as it is more easily managed. Therefore nation states with large populations find themselves virtually pushing against the "natural" limits of democracy.
All this is no plea for ideologies such as nationalism, patriotism or comparable manifestations of collective identity, but only an indication that social structures and proceedings must retain dimensions which don't leave us powerless. The promotion and management of global public goods, such as climate stability or knowledge production remains a challenge where joint international action and coordination is likely to be necessary.

But as regards the economy, and particularly finance, which as become increasingly globalised over last decades, a shift back to a more controllable scale may well be a way out of the current crisis. However, it is clear that in order to "de-globalise" in some spheres of the world economy, some level of international coordination

11 Consider the strategic differences between Russia and the USA, or the trade policy rivalry between the EU and the USA.

12 Thus, Canada, Russia and the temperate zones of Europe are preparing for an improvement in agricultural conditions, with such ideas as red wine from Copenhagen or wheat from Siberia, or enhanced tourism and lower heating costs.

13 'High Noon: 20 global issues, 20 years to solve them', Jean-Francois Rischard 2002

at the multilateral level is desirable. While it makes sense to restrict free trade in some important areas, be it to avoid dumping and other unfair practices, or to protect legitimate interests such as food security, environmental protection and health and consumer protection, such restrictions should be negotiated and agreed by the partners involved. Unilateral measures would only trigger a chain reaction of anarchic trade wars.

The concept of selective deglobalization finds an interesting argument in a proposal made already by Keynes. Although he was in favour of liberalizing trade globally he suggested that finance should remain under national control. He suggested that "*control of capital movements both inward and outward, should be a permanent feature of the post-war system.*"[14] Keynes proposed a "*machinery of exchange control for all transactions even though a general open licence is given for all remittances in respect of current trade.*"[15] He reserves to the national state and its central bank "*unqualified control over the capital transactions of its residents both outward and inward … and it shall be entitled to call on the collaboration of other member banks to prevent unlicensed movements.*"[16]

14 Keynes, John Maynard (1942): PROPOSAL FOR AN INTERNATIONAL CLEARING UNION. London. p. 9

15 Keynes, John Maynard (1941): Proposals for an International Currency Union (Second Draft, November 18,1941) London. Appendix C.

16 ibid

In fact, the risks presented by globalised finance cannot be controlled. It is impossible to ride the tiger, as demonstrated by the current crisis. Keynes reserves to the national state and its central bank "*unqualified control over the capital transactions of its residents both outward and inward … and it shall be entitled to call on the collaboration of other member banks to prevent unlicensed movements.*"[17]
Additionally, there may be other sectors where selective de-globalisation might be an appropriate strategy. It is time to put these discussions on the agenda.

17 Keynes, John Maynard (1941): Proposals for an International Currency Union (Second Draft, November 18,1941) London. Appendix C.

3. Real-Existing Global Economic Governance

The international sphere has been for most of human history an area where no rules and no regulation existed. The only „law" was the law of the strongest: violence. International relations were dominated by military and war.

In the 17th century after the *Thirty Years' War* the first germs of international law emerged, however, they remained vague and were not enforceable and not anchored in a respective institution. The first Geneva Convention in 1864 created an element of enforcement: national ratification of international rules. But there was still no supranational instrument of enforcement. The League of Nations, founded in 1920, was the attempt to create a multilateral institution with the task of peacekeeping. It failed already in the forefield of World War II.
In 1944 the League of Nations was replaced by the UN, which contained much stronger elements of enforcement, including the use of military power - under the condition that the Security Council decides unanimously.
Under the impression of the Great Depression of 1929 a new field of international cooperation was developed: the economy. The Bretton Woods System with the IMF and the World Bank was established in 1944 to regulate international financial relations. Also a trade organisation was conceived and the *Social and Economic Council* of the UN (ECOSOC) was meant to become a strong body for social and economic issues at international level. The Cold War prevented the UN-system to fully deploy its potential. Although there are today dozens of international special agencies dealing with technical issues, standard setting etc. most of them under the umbrella of the UN, in the areas of security and economy the UN is marginalised either by traditional big power politics or competing multilateral institutions which are backed by big powers, such as the Bretton Woods institutions and their thematic and regional affiliates and the WTO. The ECOSOC is insignificant and other UN institutions such as UNCTAD, ILO and FAO have very limited scope.

3.1. The "G-clubs" – an new phenomenon of global governance

In the seventies of the last century a new phenomenon of governance was emerging: *informal groupings and institutions*. Thus, 77 developing countries in 1964 gathered in the G77 (today 130 members) in order to better represent their common interests inside the UN. There are many other of these groupings (G24, G4 etc.) sometimes coming together on an ad hoc basis, sometimes permanently in a more or less lose cooperation. In most cases these groupings operate inside formal institutions like the UN or the WTO. Only two of them: the Group of 7 (G7, later on the G8) and recently the G20, are really important on a global level. Unlike the UN or the Bretton Woods institutions and the WTO, these bodies have no legal status and no formal legitimacy in international law. They have no formal rules, no formal structure, no fixed leadership, no formal procedures of decision-making (except for a vague consensus), no executive function, no headquarters. Membership is like in a club through self-selection: later others can be invited to participate temporarily or permanently by the old members as it was the case with the Soviet Union of Gorbachev and later on as with Russia in the G7/8, but there is no formal procedure to get access.

G-8 summit in L'Aquila, Italy, July 8, 2009
(Official White House Photo by Pete Souza)

As a result of this opacity, the potential impact these informal institutions may have and what they actually deliver remains a controversial issue. On the one hand, they are considered as a kind of global government or politbureau, which decides on the destiny of mankind, and on the other hand they are seen as a public relations exercise, a political show business without any real impact. Of course, the reality is more complex. The G8 and G20 have an impact. First they serve for the members as a sphere of communication, of debate, of testing positions on potential conflicts and potential consensus. They serve as a moderator in a continuous process of defining members' positions and strategies. They constitute an element of soft pressure on one or more members. They can also help to prepare decisions either in formal multilateral institutions or simultaneously at national level.

As an outside effect, such an informal body can influence public opinion through the tremendous media coverage of the summits. Thus, the G7 has contributed considerably to the hegemony (i.e. dominance through consensus) of the neoliberal paradigm in the 1980s and 1990s. They can also have considerable impact on important policy sectors. For instance, in the 90s the G7 provided the guidelines for the management of the developing country debt, which were then implemented by the Paris Club, the IMF, the World Bank and the MDBs. This was "hard" politics and very efficient, although only from the point of view of the creditors.

In the 90s the G7 provided the guidelines for the management of the developing countries debt

This impact was only possible because there were converging interests and a consensus among members. If the interests are conflicting and no consensus is reached, the G7/8 is powerless. And even if a consensus is reached, all its declarations are mere recommendations. Individual member states can implement them at their whim. This is why both the G8 and the G20 are far from being a global government. They can impose nothing in real terms.
During the Cold War, there was strong pressure toward conformity in the G7. This was, of course, supported by the ruling position of the US as the superpower. With the end of the Cold War, the uniting factor of the common enemy disappeared and the power of the US faced a relative decline. In addition, Russia joined the club. As a result, the heterogeneity increased, internal contradictions increased and the G8 was less able to make decisions with a concrete impact.

As for the G20, the diversity and heterogeneity is greater than other bodies. It is an important element of the global governance structure, but the real impact of this body should not be overestimated. It finds its limits in the national interests of its members. Whether these limits can be changed continues to depend on the balance of power between the big nation states - not on the existence of the G20. Given the very diverse composition of the G20 and given the increasing power of emerging economies like China, India or Brazil, the G20 will have even more difficulty implementing new policies.
However, one highly problematic effect of the G8 and G20 is in any case the further marginalization of the UN.

3.2 The G8 in transition

In the past, the G8 has been the top channel for international economic governance. Its eight members - Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States - represent about 14 per cent of the world population and 60 per cent of global GDP. In general, decisions taken by the G8 tend to take the form of broad agreements laid out in the communiqués. The importance of the G8 regarding financial and economic issues has shrank considerably with the rise of the G20. The meeting of G8 leaders in L'Aquila, Italy in 2009 merely restated most of decisions already taken in the context of the G20. And the Pittsburgh declaration of the G20 clearly stated: "*We designated the G-20 to be the premier forum for our international economic cooperation.*"
The L'Aquila summit showed how a division of competences is emerging between the two forums, even though not clearly defined, where the G20 handles economic and financial issues while the G8 will coordinate security and geopolitical policy of the West. Within the G8 itself there are different views about finally closing the forum in years to come. It is expected that 2011, when both the G8 and G20 are to be chaired by France, there may be a key decision taken on this issue

3.3. The G20: the new spider in the web of global economic governance

The G20 is now the most important informal group in the system of global governance. At the beginning, membership in the G20 was decided by the G8. Apart from the members of the G8, the G20 includes key large emerging markets, namely China, Brazil, Russia, India, as well as Australia, Indonesia[18], Mexico, South Africa, Turkey, South Korea and Saudi Arabia. The EU is represented by

18 Indonesia is the biggest Islamic country. This is an important element of cultural representation.

G20 at a Glance

	Population 2008 (Mio)[1]	GNP absolute nominal 2008 (bn. USD)[1]	GNP per capita 2008 (USD)[1]	Foreign trade turn over 2008(e) (bn. USD)[2]		Military expenditure 2007[3]		Relative poverty	
Country				Exports	Imports	absolute constant figures (2005) US$ m.	% of GBP	60% of median income (mid-2000s)[4]	Share of population below national poverty line (2000-2007)[5]
Argentina	39,9	291,4	7307,6	80,9	69,4	1,738	0,8	-	-
Australia	20,9	978,8	46832.8	234,1	235,3	14,896	1,9	20,3	-
Brazil	193.9	1615.1	8328.0	194,1	189,8	14,737	1,5	-	21,5
China	1336.9	3710.6	2775.5	1661,0	1406,3	57,861	2,0	-	2,8
Germany	82.4	3682.2	44674.9	1739,9	1553,1	37,233	1,3	17,2	-
European Union (27)[a,b,c]	495.1	14852,4	29946	1924,7	2280,8	-	-	16,0	-
France	61.8	2844.7	46004.6	745,9	834,0	53,403	2,3	14,1	-
UK	60.8	2611.8	42988.3	775,2	895,3	55,746	2,4	15,5	-
India	1183.2	1233.0	1042.1	303,6	396,7	23,535	2,5	-	28,6
Indonesia	234.3	477.8	2039.6	175,3	143,5	4,131	1,2	-	16,0
Italy	58.7	2270.4	38699.9	622,3	659,4	32,988	1,8	19,7	-
Japan	127.8	4965.5	38851.0	865,7	842,1	43,460	0,9	20,8	-
Canada	33.1	1513.6	45791.1	553,0	539,2	14,817	1,2	19,0	-
Mexico	108.0	966.1	8941.6	332,2	358,8	3,931	0,4	25,3	-
Russia	141.7	1713.0	12085.6	513,2	356,5	33,821	3,5	-	19,6
Saudi Arabia	25.5	487.4	19137.1	352,8	188,8	33,320	9,3	-	-
South Africa	48.6	280.6	5767.7	99,2	107,9	4,027	1,4	-	-
South Korea[d]	48.4	924.0	19088.9	434,5	440,4	22,119	2,6	20,8	-
Turkey	75.7	729.9	9637.8	174,0	207,4	11,155	2,1	24,3	27,0
USA	308.3	14002.2	45411.3	1866,9	2555,7	524,591	4,0	23,9	-

e=estimated
1 Source: World Bank (http://go.worldbank.org/G5FQ5EQYJ0)
2 Source: World Bank (http://go.worldbank.org/9JRT5ZDDK0)
3 Source: SIPRI (http://milexdata.sipri.org/)
4 Source: OECD (http://stats.oecd.org/index.aspx)
5 Source: UNDP, Human Development Indices 2008 (http://hdr.undp.org/en/media/HDI_2008_EN_Tables.pdf)
a Figures for population, absolute GNP and GNP per capita from OECD 2007 (http://stats.oecd.org/index.aspx),
b Figures for relative poverty 2007 from Eurostat (http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=de&pcode=tsisc030)
c Figures for exports and imports for 2008 from Eurostat (http://epp.eurostat.ec.europa.eu/tgm/refreshTableAction.do?tab=table&plugin=1&init=1&pcode=tet00018&language=de) calculated with Euro/USD-exchange rate for 2008 (http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=de&pcode=tec00033&plugin=1)
d Figures for exports and Imports for 2007 from OECD (http://stats.oecd.org/index.aspx)

its current presidency and representatives of the IMF, the World Bank and the Financial Stability Board are also present. During the London summit, Spain and the Netherlands lobbied successfully to take part as well.

The G20 countries represent two-thirds of the world population, 80 per cent of world trade (including intra-EU trade) and 85 per cent of world GDP. However, no low-income country is included in the process, nor can it be assumed that the developing countries included will represent the interests of the other, non-member countries. For example, the only African member country is South Africa, which is a financial services exporter to the other African countries and has thus very different interests regarding financial services liberalisation and capital controls than other African countries. Therefore, even World Bank President Robert Zoellick has suggested the incorporation of a second African country into the G20.
Nevertheless, in spite of all its limitations, the G20 is a historic step forward compared to the G8. Its rise reflects that the 500 year period of dominance of the Western world over the rest of the world is coming to an end. It indicates that the age of unilateralism of one single super power is over. The world is transforming itself into a multipolar system, though it is unclear what the ultimate result will be. Therefore the G20 cannot be treated like the G8.

***"Nothing short of closing down the big casino will provide a lasting solution"* (UNCTAD)**

Agreements of the G20 members are published in the form of joint communiqués after each summit. But these declarations are not binding and cannot be enforced.

The London and Pittsburgh G20 summits in 2009 made many recommendations for restructuring the financial system. In particular they committed to:

- build *high quality capital* and *mitigating pro-cyclicality* by developing by end-2010 internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage. This would include counter-cyclical capital buffers, higher capital requirements for risky products and off-balance sheet activities;

- reform *compensation practices* to support financial stability by aligning compensation with long-term value creation instead of excessive risk-taking, by avoiding multi-year guaranteed bonuses and requiring a significant portion of variable compensation to be deferred, tied to performance

- improve *over-the-counter derivatives markets*: All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms and cleared through central counterparties by end-2012 at the latest.

- address *cross-border resolutions* and systemically important financial institutions by end-2010 and to establish supervision at international level.

They also mandated the IMF to prepare a report with an assessment of how the financial industry could contribute to the costs of the crisis. This could also include the implementation of a financial transaction tax (FTT) on all kinds of trade with financial assets – shares, bonds, securities, derivatives, currencies etc.

All these measures are steps into the right direction, although they still reflect a simplistic understanding of the roots of the crisis. According to this understanding, excessive risk taking and other exaggerations were the causes of the crash, while the system as such was sound. This is why these measures are not enough and will not change substantially the dynamics of the financial markets. What is needed is a much broader approach to address these issues (see chapter 6). Using a quote from UNCTAD, it could be said that: "*Nothing short of closing down the big casino will provide a lasting solution*"[19]

With regard to the institutional consequences to be drawn from the crisis the G20 remain conservative. Their main proposals are to:

- *increase the resources of the IMF* and renew its mandate while supporting the reform of the voting

19 UNCTAD (2009):The Global Economic Crisis: Systemic Failures and Multilateral Remedies. Report by the UNCTAD Secretariat Task Force on Systemic Issues and Economic Cooperation. New York/Geneva

system which was underway anyhow. They want a shift in IMF quota share to emerging markets and developing countries of at least 5% from over-represented countries to under-represented countries. For the World Bank they propose an increase of at least 3% of voting power for developing and transition countries, in addition to the 1.46% increase under the first phase of the adjustment;

- *rebrand the Financial Stability Forum* – set up in 1999 in the aftermath of the South-East Asia financial crisis - as the Financial Stability Board and increase its membership by including the emerging countries

- leaving the OECD with the mandate of addressing tax havens, even though it is still very limited from a developing country perspective and has failed to call for a multilateral agreement on tax information exchange.

At the same time, the United Nations (the most representative international forum) has so far been largely excluded from the decision making process regarding international financial governance. This has been done despite the UN had set up a commission chaired by Joseph Stiglitz, which had made some interesting proposals.

3.4. The IMF: failure to oversee the system

The International Monetary Fund (IMF) is charged with a surveillance role to oversee the global financial system. Current IMF activities can be broadly categorised in four areas: (1) lending money to countries with temporary balance of payments problems; (2) surveillance of the global financial and monetary system, including an early warning system and the monitoring of countries' financial regulation and macroeconomic policies; (3) technical assistance; and (4) the issuance of an international reserve asset, the special drawing right (SDR).

One of the core activities of the IMF is lending money to countries with temporary balance of payment problems. In most cases, the IMF attaches conditionality to its loans, dictating countries' macroeconomic and other policies, sometimes including forced budget cuts and liberalisation of the financial sector.

This conditionality has been highly ideologically driven in

UN Commission of Experts calls for fundamental reform

A week before the G20 met in London in April 2009, the UN General Assembly president's commission on financial reforms released its draft report. The commission was led by Nobel laureate Joseph Stiglitz and included a breadth of academic and policy- making insight, including from developing country leaders.
The recommendations included that: "short term measures to stabilize the current situation must ensure the protection of the world's poor", while "long term measures to make another recurrence less likely must ensure sustainable financing to strengthen the policy response of developing countries."
The commission was not unwilling to lay blame: "Loose monetary policy, inadequate regulation and lax supervision interacted to create financial instability," and there was "inadequate appreciation of the limits of markets." The report split its recommendations up into things to be done immediately- and those that should be on the agenda for systemic reform.

Among the immediate goals, it called for:
- **a global fiscal stimulus**, a new credit facility with better governance arrangements than currently exists at institutions such as the IMF;
- **an end to pro-cyclical conditionality** and rolling back the limits on developing country policy space- created by trade agreements. For the financial sector the commission noted "*While greater transparency is important, much more is needed than improving the clarity of financial instruments,*" and recommended the use of rules and incentives to limit excess leverage, prevent tax evasion, and address the regulatory race to the bottom.

While the short-term recommendations were sometimes eye-catching, the systemic demands captured the essence of the problems with global economic governance. The commission's call for "**a new global reserve system**" echoed the demand to end the US dollar's privileged position as international reserve currency made by many countries in 2009.
On long-term changes to financial regulation, the commission listed seven areas for reform and warned against "merely cosmetic changes". Notably it said: "The fact that correlated behaviour of a large number of institutions, each of which is not systemically significant, can give rise to "systemic vulnerability", makes oversight of all institutions necessary." This contrasted with the G20's plans for regulating only 'systemically-important' financial institutions.
The commission supported the idea for a UN-based Global Economic Council at the head of state level to oversee the changes that need to be made. The council would essentially bring a G20 type structure under the auspices of the UN system in order to make it more representative and accountable than the G20.

A demonstration during UN Climate Negotiations in Bangkok, 2009
(photo by Elena Gerebizza, CRBM)

the last twenty years. Following the so called *Washington Consensus*, the IMF has been a driving force to implement neoliberal reforms when and wherever possible, increasing inequality and often worsening the situation of the poor.

Although the Asian financial crisis and Argentina's crisis in the 1990s seriously put into question the IMF preferred model of financial liberalisation, including the abandonment of capital controls and fixed exchange rates, the Fund stuck to its dogmas. The Fund's role in crises resolution has been damaging the economies of the borrowers. In response, developing countries have moved into regional arrangements and alternative forms of crisis prevention, including self-insurance through increased currency reserves. Even in the current crisis, while the IMF has been extolling counter-cyclical policies in rich countries, the majority of countries are still facing adverse conditions, which often command budget cuts and other pro-cyclical policies.[20]

Apart from lending, the IMF has been mandated to oversee the global financial and monetary system, including an early warning system to anticipate crises and review countries' regulatory regimes. But the IMF failed to adequately warn of the current crisis. Although badly needed, the ability to forecast crises and successfully implement an early warning system, seems at best very limited. Efforts to establish such a system have been under way for decades, but have failed due to the unpredictability of very fragile and complex financial markets that are prone to sudden changes in behaviour and judgement by market participants.

While the IMF has been extolling counter-cyclical policies in rich countries, the majority of countries are still facing adverse conditions

To sum up, the IMF's role in ensuring a stable and well functioning financial and monetary system is limited due to its lopsided governance. Changes in the policy arena have been stymied by its governance structures, which the G20 failed to reform to any meaningful degree.

3.5 World Bank: privatising finance and then lending to clean it up

The current financial crisis has had especially devastating effects for the economies of developing countries. Like the IMF, the World Bank has long been criticised for the ideologically driven conditions it attaches to its loans. The Bank, particularly its private-sector arm the International Finance Corporation (IFC), has been instrumental in pushing deregulation of finance and deference to open financial markets. Through conditionality, technical assistance, and research the World Bank has pushed countries to open their capital markets, liberalise their banking systems and privatise their state-owned banks and other financial sector institutions. In Eastern Europe, one of the regions hardest hit by the crisis, the World Bank has been heavily implicated in creating the conditions for financial contagion by pushing to open up the banking system. This fuelled speculative activity in property markets and unsustainable levels of foreign currency borrowing by businesses and households in some countries[21], especially in Hungary and the Baltics. Howev-

20 CEPR paper, http://www.cepr.net/index.php/publications/reports/imf-supported-macroeconomic-policies-and-the-world-recession/

21 "The World Bank, the IFC and the antecedents of the financial crisis", Paulo dos Santos, Bretton Woods Project, 27 November 2008, http://www.brettonwoodsproject.org/art-563119.

er, not all problems in the region are directly related to the financial crisis. Other hardly hit countries suffered from international trade slowdown, such as Slovakia, Czech Republic and Poland where the financial crisis didn't hit so much directly[22].

While the financial and economic crisis engulfed developing countries, the World Bank and other actors have continuously stressed the need for an increase in aid and concessionary lending. The World Bank has greatly increased its lending from $37 billion in fiscal year 2008 to $59 billion in 2009, with the greatest increase in lending to middle-income countries.

This increase is, however, not generally welcomed. More lending means more debt, and NGOs and the UNCTAD itself have warned that a new debt crisis might build up as a consequence.

Furthermore, the World Bank has been criticised for continuing to use conditionality in sensitive areas of economic policy, undermining the domestic policies of developing countries. The World Bank suffers from similar problems as the IMF regarding governance with an imbalance in representation on its executive boards, dominated by rich countries and an unwillingness to open up its post of president to anyone but representatives of the United States.

3.6 Behind the scenes - The Financial Stability Board

The Financial Stability Board (FSB) evolved from the Financial Stability Forum, an informal expert group founded by the then G7 in response to the Asian crisis. Its aims are to facilitate discussion and coordination among the regulators and finance the ministries and central banks of major economies. At the London Summit, the G20 agreed to change the name of the FSF into the Financial Stability Board (FSB). Its main task is providing advice on world financial issues.

By now, all G20 members plus Spain and the European Commission are represented in the FSB. There are also the IMF, the World Bank, the European Central Bank, the Bank of International Settlements, the OECD and the most important financial standard-setting bodies (see below). The G20 have not only decided to broaden the membership, but also the mandate of the FSB. It is required to consult with banks and other financial institutions about its dealings, but it is not required to discuss its issues with civil society organisations.

The FSB is now set to perform an early warning exercise: to identify gaps in global financial regulation; to integrate and monitor governance and to work for various standard-setting bodies.

The FSB does not adopt formal decisions nor are its reports binding, but it has great discursive power, influencing debates through its analytical work.[23]

3.7 Standard Setting Bodies

A set of voluntary standards and principles developed by a range of private and public standard setting bodies and multilateral organisations play an important role in the regulation of the international financial system.

The by far most important is the **Basle Committee on Banking Supervision (BCBS)**, hosted by the Bank of International Settlements (BIS) in Basle, Switzerland. The BIS is the association of the central banks of the OECD countries. Although the BCBS does not issue legally binding decisions, their banking standard, the so-called Basel Accord has been seen as an important standard. Banks that do not follow this standard are considered to be risky partners and will have to pay higher interest rates. This is why the Basle standards are widely followed. In several countries the standards are introduced into legislation.

A renewed version (Basle II) was made mandatory within the European Union in January 2008.

The Basle Accord is about risk management, in particular capital requirements for banks. Whereas Basle I had a general requirement of 8% of own assets for each bank, Basle II introduced a more flexible and complex system, which was very much influenced by the philosophy of self-regulation. The main problem with the Basle Accord is, however, that it is dealing with risk only at micro-level, whereas systemic risk is not considered. As a consequence

22 "The World Bank, the IFC and the antecedents of the financial crisis", Paulo dos Santos, Bretton Woods Project, 27 November 2008, http://www.brettonwoodsproject.org/art-563119.

23 Schmelzer, Matthias, 2009, Towards a New Bretton Woods? A Critical Synopsis of Governmental, non Governmental and Private Sector Proposals to Reform the International Financial System, http://www.weed-online.org/themen/iwf/2593529.html, p 23.

of the crisis, the Basle II is now in decline and a Basle III is expected to be prepared in 2010.

The International Accounting Standards Board (IASB) is a private body, comprised of fifteen accountants. Private national accounting standard-setters appoint trustees, which then choose the experts on the basis of expertise in an open application process. Being a private body the IASB is unaccountable to its external stakeholders and the general public.

Given the globalisation of finance, common accounting standards are important both for reasons of transparency and risk management and for cost efficiency. Different accounting systems increase the transaction costs in international deals.

The accounting system can have dramatic systemic implications. This became obvious in the rule of "mark to market accounting". Financial assets can be valued either at their face value or their market value. For example, if a share of Volkswagen at a face value of €100 is falling at the stock exchange to € 60 at the date of accounting, how will the difference to the face value be accounted for in the books? Because three months later it could rise to €100 or over again, these shifts might go unaccounted for. The *mark to market* method valuates it at the market value, in our case € 60. Mark to market accounting inflates balance sheets during booms and shrinks them during recessions, thus playing a pro-cyclical role. With the crash, the assets of many banks and other actors were worthless according to the *mark to market system* and they would have to undergo insolvency. On the other hand, with fresh money they might indeed recover.

Other Standard setting bodies are the *IOSCO - the International Organisation of Securities Commissions and International Association of Insurance Supervisors*. A general reform of the supervisory system would have to put all these institutions under public control and develop standards in a transparent way, open to all stakeholders.

3.8 WTO as a tool for liberalisation of trade in financial services

From a financial governance perspective, the World Trade Organisation (WTO) has been important, because developed countries have pressed for liberalisation in financial services under the General Agreement for Trade in Services (GATS). In an annex to the GATS dealing with financial services, the WTO promotes financial sector liberalisation and deregulation. In the Doha Round, the industrialised countries presented many requests to emerging markets and developing countries so as to open up their financial sector (see Lipke/Vander Stichele 2003[24]).

Financial services liberalisation means opening up domestic markets in services to foreign financial firms and giving them more freedom to invest. Financial services liberalisation facilitates the entry of foreign banks which may have several negative consequences for developing countries, including excessive competition locally, decreased access of poorer households to basic financial services, shifts from credit for productive activities to credits for personal consumption and pressures toward privatisation of health care and pension services[25].

Furthermore, by liberalising capital flows new channels of contagion are created and free access is given to risky business models such as *carry trade*[26] and other kinds of speculative operations, which can endanger stability.

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24 Lipke, Isabel/ Vander Stichele, Myriam (2003): Financial Services in the WTO: LICENSE TO CASH IN? A Civil-Societal Critique of the Liberalization of Financial Services in the GATS Negotiations. Berlin. WEED Working paper

25 World Development Movement, March 2009, Taking the credit: How financial services liberalization fails the poor, http://wdm.gn.apc.org/sites/default/files/takingthecredit09032009.pdf.

26 Carry trade uses the differences between interest rates in different countries. With a credit taken in a low interest rate country like Japan with e.g. 2% one can earn much money by giving the same credit as a loan in Brazil with an interest rate of 15%. Carry Trade was an important destabilising factor in the crisis.

4. The Changing Balance: The Rise of New Powers

Skyline of the financial district of Shanghai (China)
Istock photos

The "real existing Global Governance" essentially emerged in two steps: post World War II and in the last decade of the Twentieth Century. This was mainly done under the unipolar dominance of the US - though this dominance lasted, an extremely short period of time, historically speaking.

The undisputed predominance of the US is today eroding however. This is both the result of a weakening of the US and the emergence of new powers. This will change the entire international system and initiate a new era. We can claim already that we are living in a multipolar world, despite its governance architecture is still in the making and existing structures are yet to consolidate themselves. However, it has yet to be seen how much this new configuration will reflect a multilateral and more democratic approach. Not enough is known as to how current imbalances of power will be re-ordained, how local regionalisms and the emergence of new regional powers will affect these balances and how the institutionalization of these new powers will affect the entire power paradigm.

4.1. The Dawn of the US-Hegemony

The weakening of the US has several dimensions:

- The war on terror has been a failure. The withdrawal from Iraq has already been decided by the Obama administration and the withdrawal from Afghanistan can be expected in the foreseeable future;
  The military power of the US was planned for the type of "big war" of the Twentieth Century, but it is not able to cope with the asymmetric warfare waged by transnational networks of non-state actors like Al-Qaeda. This leads to a certain devaluation of the traditional military machinery;

- The complexity of global warming issues and the new challenges of energy security, together with the scarcity of natural resources exceeds the capacities even of a super-power like the US.

- The collapse of casino capitalism is accelerating the erosion of the US-hegemony. The model was invented in the US and it spread from there to other developed countries. The crash originated, just like the Great Depression therefore, in the centre of the system.

- The US is – together with China - at the centre of the so-called global imbalances, i.e. the balance of payment deficit of the US and the respective surplus of China, which was one of the structural causes of the crash.

- As a result of these economic distortions not only the casino system has been put into question, but also the long-standing pillars of the economic post war order. In particular, the dominance of the US dollar as leading currency may now begin its descent. Even if its dominance will not disappear anytime soon, the long-term descent has already started.

4.2 China – a historically unprecedented phenomenon

The descent of the US hegemony is accentuated and accelerated through the rise of new powers. In the first place this is China, whose development is unprecedented throughout history. In the light of the big population of 1,3 billion people, its huge territory, its natural resources and its military power, (including some weapons of mass destruction), the rise of China has been predicted for a long time. But only few expected rise so early, so dynamically and strong. Obviously two factors have been underestimated by the forecasts:

- The dynamics of the very specific economic model, this unique mixture of market economy and central planning, the system of communist capitalism or capitalist communism. Its resilience vis-à-vis the crisis has even increased its standing in the world. The re-emergence of double-digit growth rates has become an anchor for the recovery of the global economy. Chinese communism saving the capitalist world economy!

- The flexibility and efficiency of the political system, this specific model of authoritarian rule, which is completely different from stagnant and inefficient system of the former Soviet Union.

It should be reminded that China has been one of the few countries, which have not implemented the diktat of the IMF on liberalising the capital account - a decision, which contributed to minimizing the impact on China of several financial crises, which took place since the '90s.
The economic success of China has international radiation in particular for other emerging economies. This effect is amplified by the contrasting failure of the neo-liberal paradigm. But the success of the political system has, from an emancipatory point of view, something deeply disturbing. The undemocratic and autocratic system and the violation of basic human rights are unacceptable. But what, if this system proves to be also successful in organizing the transition towards a carbon free economy?

China has been one of the few countries, which have not implemented the diktat of the IMF on liberalising the capital account

Are democracy and, on an international level, the respect for other countries' cultures a handicap for progress? Or should we expose the need to structurally rethink the concept and practice of multilateralism, in order to ensure its effectiveness and fundamental democratic dimension?

Of course, China has also its own tremendous problems. However, an abrupt change is not desirable. It seems as if the world is condemned to accept the Chinese system as it is, hoping for the best part, a gradual change that avoids major shocks. Anyhow, the rise of China makes emerge a lot of questions for which there are no quick answers.

4.3. Not only China

China is the most spectacular but not the only element in the reconfiguration of the international system. There is also a renaissance of Russia as a big power. After the implosion of the Soviet Union and the sell-out policies of the Yeltsin era, the country is recovering economically. Not at the same pace as China, but it has followed a similar path. Together with its huge potential of nuclear arms, Russia will probably be part of the four or five members of a new global system of balance of power.

Russia is also actively involved in new alliances such as the *Shanghai Cooperation Group* together with China, India and some other countries. Moreover, this alliance could turn into a countervailing power to NATO in Asia. Also through bilateral cooperation with countries like Venezuela and Iran, Russia is increasing its international influence. Similar processes can be observed in Latin America. The subcontinent is emancipated from its former status as the backyard of the US. Regional integration is developing with Brazil as the regional hegemonial power and Venezuela as an ideologically inspired turbo of integration. The *Banco del Sur*, although still small, is an innovative project of a regional development bank beyond the realm of the Bretton Woods institutions.

Recently, India has economically also made a considerable leap forward. Its growth rates are with an average of 8% impressing. Similar to China, India has always pursued a cautious approach in terms of capital account liberalisation, as well as financial services liberalisation. Despite its approach, it has slightly changed in the last years in order to favour the establishment of Special Export Zones for multinational companies.

It is legitimate at this point, to wonder how much the emergence of new regional and possibly global powers will reproduce old patterns of regional hegemony over their neighbours or whether harsh military and economic conflicts at the borders of these spheres of influence will be repeated. Whether the proposals and new regionalist practices (including the establishment of new economic and financial institutions) is configuring new territories on which to experiment new brand of multilateralism?

In this context it should be noted that a new grouping is emerging more formally, gathering all major regional powers mentioned above, that is the BRIC – Brazil, Russia, India, China. Leaders of these four countries met in mid-June 2009 in Yekaterinburg, Russia, at the margin of the annual summit of the Shanghai Cooperation Group. This has been the first "official" summit of the BRIC, whose aim is to discuss how to further strengthen their collaboration. In the final communiqué[27] BRIC leaders called for a reform of IFIs, including a greater voice for developing and emerging economies, as well as stressing the "*strong need for a stable, predictable and more diversified international monetary system*". Specifically on financial regulation matters, they stated that a "*reformed financial and economic architecture should be based, inter alia, on the following principles: democratic and transparent decision making and implementation process at the international financial organisations; solid legal basis; compatibility of activities of effective national regulatory institutions and international standard-setting bodies; strengthening of risk management and supervisory practices.*"

A new grouping is emerging more formally, gathering all major regional powers [...] that is the BRIC – Brazil, Russia, India, China

Despite BRIC leaders restating the central role of the G20 in dealing with financial and economic crises, they also affirmed their "*strong commitment to multilateral diplomacy with the United Nations playing the central role in dealing with global challenges and threats*", by hinting also at the need to permanently include India and Brazil in a reformed Security Council (so that it would become a new but different G7 group). Despite their focus on strengthening their multilateral cooperation on some matters, they also advocated a global agenda in the interest of other countries. The BRIC forum, therefore, emerges as a first example to balance different regional blocks in order to minimise future conflicts. This approach has also been framed as South-South cooperation as opposed to the North-North trilateral cooperation (US, EU, Japan), which has been at the basis of the G7 functioning.

27 http://eng.kremlin.ru/text/docs/2009/06/217963.shtml

4.4 New regional initiatives and institutions

The Chiang Mai Initiative (CMI), which is a regional financial arrangement for East Asia, was agreed upon at the Finance Ministers' meeting of the South East Asian Nations plus China, Japan and Korea (ASEAN+3) held in May 2000 in Chiang Mai, Thailand. The CMI's objective is to establish a network of bilateral swap agreements among the ASEAN+3 members to provide liquidity support to countries experiencing balance of payments difficulties. The CMI is one of the tangible accomplishments of ASEAN+3, which met for the first time in December 1997 shortly after the onset of the East Asian financial crisis, to promote regional financial cooperation. The CMI is an important symbol of the development of East Asian regional financial cooperation.[28]

In May 2007, at the 10th meeting of ASEAN+3 Finance Ministers the CMI further progress was made. In February 2009, ASEAN+3 agreed to make a fund worth $120 billion, up from the original level of $80 billion proposed in 2008. Final agreement was expected to come in May 2009, and 80% of the fund is expected to come from China, Japan, and South Korea. However the relationship between this initiative and the IMF, and in particular how much it will asserts its full autonomy remains disputable.

Despite such an innovative approach towards an authentic regionalism in Latin America, it remains to be seen which will be the scope of action of the new institution in terms of fostering regional integration and its relationship with other regional and sub-regional initiatives such as the Bolivarian Alliance for Latin America (ALBA). Also, including the common currency of the alliance, the political Union of South American Nations and the MercoSur. At the same time, the degree of cooperation between these new initiatives and pre-existing regional financial institutions should be also assessed. Such initiatives as the Inter-American Development Bank and the Credito Andino de Fomento, which despite a larger representation of borrowing countries than the IFIs, have been harshly

28 http://www.mof.go.jp/english/if/regional_financial_cooperation.htm#CMI

criticised for imposing a Western led model to development without giving sufficient voice and real power to beneficiaries.

4.5 Regionalism and chaotic multilateralism

It should be further explored how much emerging regional aggregation will be represented in the pre-existing multilateral structures which are creeping today under the pressure of a new multipolar balance of powers at global level.

The experience of the European Union so far shows that the integration of its representation in international fora has been quite limited. Similarly, strategies and joint action on the institutions – thinking of the World Bank and the IMF – can be regarded as much lower than the accumulated potential of powers that all European Member States would yield.

Looking at the composition of the G20 and the countries, which are represented from each region of the world, it can be easily argued that, so far, these are not bringing a position agreed at regional level to the summits. At the same time, under the assumption that regionalism could be a building block for building a more effective as well as a more democratic multilateralism, it can also be argued that the current composition of the G20 is not so far away from a possible balanced composition of a Global Economic Coordination Council. This is a new body suggested by the UN– under the premises of the United Nations. What is missing however, is a mechanism of representation for the regional composition – to a certain extent the European Commission and the Presidency of the EU is included - but not at all other regional political institutions. The same is for an accountability process for how major regional powers act at G20 level vis à vis their regional agreements and commitments.

All in all, the changes in the balance of power indicate that an entire era is coming to an end. The 500 years of economic, political military and cultural dominance of Europe and its North American offshoot is soon to end its term. A deep historical break is looming- albeit not an easy one to digest for Europe and their North American counterparts alike.

5. The EU – Which model for financial governance?

The European Union is of particular importance when it comes to *global financial and economic governance* for two reasons. Firstly, the EU is the most advanced project of economic, social and political integration in contemporary history.

There is more transfer of national sovereignty and executive power from the national to the supranational level than in any other international institution. And secondly, the EU is considered to have a special interest in promoting global economic and financial governance and influencing the global agenda towards a development friendly and stable financial system, as well as the capacity and competence to do so.
However, the EU is also an instructive example of the problems, limits and dilemmas of social integration beyond the nation state.

5.1. The democratic deficit and regulatory capture on financial policies

The regulation and supervision of financial markets and financial services in the EU is very fragmented. European member states have retained a variety of regulations and supervisory systems with competences remaining at the national level with parliaments, central banks or other supervisory institutions. The fragmentation of financial regulation and supervision contrasts starkly with the expansion of the EU-wide financial markets and financial services providers. Several banks now have a presence in multiple EU countries, conducting trans-border capital transfers and selling of highly complex and risky financial services. The EU has facilitated liberalisation of financial services providers and of financial markets.

The fragmentation is not a result of a lack of will for integration. To the contrary, the lack of regulation was supported by the Commission's neoliberal belief that liberalised financial markets are efficient and could regulate themselves. And of course the major players such as UK, were resistant to European regulation out of fear that this would hamper their "competitiveness" in the financial sector.

Asymmetries between economic integration and social welfare in the EU

One of the most fundamental problems facing EU integration is the dominance of economic integration over social welfare, which leads to asymmetries. The establishment of the common market and the Maastricht Treaty in 1992 reinforced and accelerated this process. The establishment of a common currency was a further step in economic integration, yet the absence of the UK in this process has far reaching consequences. London is the biggest international financial market in the world and the Pound Sterling still remains a key international currency. While there is a common market with the free flow of capital, merchandise and people other socio-economic parameters are not transformed to European level. There is, for instance, no European tax regime, resulting in tax arbitrage. This means that companies and rich individuals can choose the country from which to pay taxes. This results in increasing tax competition between member states and a race to the bottom, which subsequently erodes the tax revenues of the nation state, undermining tax justice. As taxes are not only a means to create revenues for the state, but also to govern the economy through tax incentives or disincentives, the non-existence of a European tax system hampers political regulation of markets.
The same asymmetry can be found between markets and the social dimension of economy. While markets are integrated, social systems are not. As a result, the balance of power between capital and labour has shifted considerably in favour of capital, in particular after the neoliberal turn in Europe in the eighties. Since then, the European treaties, up until today's Lisbon Treaty, have been massively inspired by neoliberal ideology. In particular the European Commission has become a stronghold for neoliberal hardliners such as McCreevy or Bolkestein.

This is why the EU has been marginalised from the management of the crisis, and has practically played no role in the reform process. Not only did the Commission fail to foresee the crisis, but it did not use instruments to combat it. Crisis management was fully in the hands of the national governments, and for the euro zone - the European Central Bank, to a certain extent.

The crisis also represents the bankruptcy of neoclassical theory, monetarism and the neoliberal ideology. Or as the former German finance minister, Steinbrück, put it: "*In the crisis we all are Attac*". Although it is not possible at present to see how far it will go, the process of rethinking the economic system has at least started and there are now some haphazard attempts to release directives on regulation and supervision.

Beyond the space of national regulation and supervision, the EU can play a role in the operation of the EU-wide financial sector as far as national interests allow for it. The Commission is the legal initiative taker to liberalise financial services and to make them more competitive. The Directorate General Internal Market and Services (DG Market) leads the development of regulation and supervision of financial services at the EU level. A complex decision making process - the Lamfalussy process[29] - has been put in place at EU level to improve cooperation, convergence, harmonisation or standardisation of financial regulation and supervision.

The financial industry is able to exert its influence in this complex decision making process, through its well-equipped informal lobbying machinery as well as through the extensive official consultations set up by DG Market, the Lamfalussy Committees and the European Parliament. Other stakeholders such as consumers, however, have much less influence.

A report[30] commissioned by the Council and Commission on improving European financial regulation and supervision in response to the crisis was elaborated by the de Larosière group[31], a group of financial experts, many of whom have been strongly linked to the financial sector. This raises serious concerns about the independence and neutrality of Commission and Council views and advice in response to the financial crisis[32]. Indeed many experts have criticized the timidity of the report's recommendations (see box below).

Critiques of the de Larosière report by academics:

The de Larosière report fails to tackle the main fault lines that the credit crisis has shown to exist in the EU supervisory landscape;

The report does nothing to repair the absence of clear EU-wide authority to take decisions, also in respect of the supervision, bail-out or liquidation of individual firms, or the clear lack of effectiveness of colleges of supervisors (see Fortis) which already operated without transparent decision making;

The report does not address the danger that each such college will develop differently from its peers overseeing other cross-border firms, which would undermine effective supervision and a level playing field among the larger institutions themselves;

The report proposals are very timid in respect of deposit guarantee schemes. An EU-wide fund to finance pay-outs is exactly what should be considered to prevent 'passing the buck' problems; Not making the ECB competent or, at least, closely involving it in prudential supervision, is a mistake which the report should not have made[1]

1 See: http://www.euractiv.com/29/images/De%20Larosi%C3%83%C2%A8re%20-%20fine%20recommendations%20fail%20to%20tackle%20main%20issues%20(2)_tcm29-181013.doc

29 See annex

30 known as the De Larosière report. See: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

31 Chaired by Jacques de Larosière, who has been co-chair of the financial sector lobby organization, Eurofi and until recently, adviser to the French bank BNP Paribas for a decade.

32 See: „Would you bank on them? Why we shouldn't trust the EU's financial wise men" : http://www.corporateeurope.org/system/files/files/resource/WouldYouBankOnThem.pdf

Given the generally weak and fragmented structures of European regulation and supervision, financial industry lobbying exerts significant influence at the different levels of decision-making. One of the privileged ways in which the financial industry can lobby to influence regulation is through official channels of consultation organised by EU institutions. Because of the complexity of the issues, the EU officials, who often lack expertise and knowledge, call upon financial 'experts'. A recent civil society report showed that "*the vast majority of financial 'experts' advising the European Commission represent the banks and investors responsible for the global economic crisis*". The report explains "*Today, there are 19 expert groups advising the Commission on financial issues. Of these 19 groups, seven consist mainly of representatives from member states. Of the remaining twelve groups, eight are dominated by industry, one has equal non-government and industry membership; and three cannot be assessed as their full membership is not disclosed*". The report concludes that this imbalance in the membership of Expert Groups "*is putting the Commission in breach of its own regulations. Commission guidelines on the use of expertise state that a diversity of views must be sought*".[33]

Corporate pressure is also strong at the national level, with the sector influencing the positions of member states sitting in the various Council and Commission committees. To give themselves more weight among national governments, the financial industry lobby positions themselves as a vital sector and claims that they have been introducing important innovations and creating jobs, income and economic growth. Additionally, some members of the financial industry have threatened to leave the country if the government were to introduce regulations that they consider too costly.

5.2. The emerging debate on European financial governance: competing interests within the EU

All of the major European institutions are somehow involved in financial regulation and supervision, however they often lack effectiveness and accountability at a pan-European level.

The Economic and Financial Affairs Council, or ECOFIN, has co-decision powers with the European Parliament to decide on directives proposed by DG Market related to financial services and financial markets.

The European parliament (EP) has the right to accept or reject legislation proposed by the Commission, however it lacks the power to amend. Additionally, the EP does not have the right to propose legislation, which is the prerogative of the Commission.

The European Central Bank (ECB) has no legal mandate to regulate or supervise banks, other financial actors or financial markets. Part of the ECB's mandate is to preserve financial stability – drawing on its competence to provide liquidity to the EU financial markets. Indeed, it has been active during the financial crisis, since August 2007. The ECB plays an advisory role to many EU structures and institutions and is legally mandated to provide information in support of action on financial stability.
Given the lack of coordinated supervision at EU level and the continued influence of Anglo-Saxon thinking and vested interests, it remains important to discuss regulatory and supervisory issues with the relevant national ministries, supervisors, central banks and regulators. As long as the internal contradictions in the EU remain, common regulatory and supervisory policies are unlikely to have substantial impact.

Radical and systemic changes within the EU are unlikely to happen in the short-term for several reasons. These include the co-existence of the euro zone and the non euro countries, the tremendous political weight of the finance industry in the UK, the historically deep rooted differences in the financial "culture", the determined ideological opposition to regulation by the new member states and the general crisis of integration of the union.

On the multilateral level, even though EU and its member states are well represented in international financial institutions, their positions and interventions remain fragmented, and some member states are excluded.
The financial crisis also triggered a new debate in Europe about which financial governance models are more appropriate for preventing new crises, thus questioning

33 Alter EU. A captive Commission. The role of the financial industry in shaping EU regulation. 5 November 2009. see: http://www.corporateeurope.org/lobbycracy/content/2009/11/financial-industry-shapes-eu-regulation

whether macro-financial and prudential competences should be allocated at an EU level.

In September 2009, the European Commission published a "Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB)"[34] . The ESRB would be an entirely new European body, which would be responsible for macro-prudential oversight. There are three main objectives of the ESRB:

An EU level macro-prudential stability board is probably needed, given the level of integration of financial markets and banks at European level.

- It shall develop a European macro-prudential perspective to address the problem of fragmented individual risk analysis at national level;
- It shall enhance the effectiveness of early warning mechanisms by improving the interaction between micro-and macro-prudential analysis. The soundness of individual firms was too often supervised in isolation with little focus on the degree of interdependence within the financial system;
- It shall allow for risk assessments to be translated into action by the relevant authorities.

The ESRB would not have any binding powers to impose measures on Member States or national authorities. It has been conceived as a "reputational" body with a high level composition that should influence the actions of policy makers and supervisors by means of its moral authority.

An EU level macro-prudential stability board is probably needed, given the level of integration of financial markets and banks at European level. However, the current proposals for the ESRB are misguided as they make the central banks the dominant players in the systemic risk game. Central banks have so far proved to lack the technical knowledge, tools and instruments and the legitimacy to dominate the macro-prudential financial stability framework[35]. Furthermore, the proposal gives significant independence to the ESRC, repeating an undesirable feature of the ECB: the absence of any substantive accountability. The Commission's proposal only requires the ESRC to report informatively to European institutions and governments, such as sending annual reports to the European Parliament and Council, however it fails to include measures for control and eventual sanctioning mechanisms for failures. This lack of substantive accountability should not be extended from the monetary policy sphere to the domain of financial stability, which is an inherently political rather than just a technical issue in most European countries. Therefore a more effective and democratic governance proposal should be advanced.

At the same time the European Commission also proposed the establishment of three new pan-European agencies to oversee the financial services sector, dealing particularly with banks, securities and insurance markets – and being respectively based in London, Paris and Frankfurt.

At the ECOFIN meeting in December 2009, finance ministers agreed complex voting and appeals procedures should any country that new authorities were overstepping their brief and intruding on areas of national sovereignty. In particular Britain has been concerned to protect the City of London's dominant role in financial services[36]. The three new European supervisory authorities would not handle day-to-day supervision of individual financial institutions - a role that will remain with national watchdogs. But they will have the task of coordinating the actions of national supervisors, have direct supervisory powers over credit rating agencies, and work towards a "common rulebook" for all EU financial institutions. The new authorities will not be able to take decisions that impinge on national budgets, or so-called fiscal sovereignty and further safeguards have been agreed to ensure this. Furthermore there would be different protec-

34 European Commission, 25 September 2009 "Proposal for a regulation of the European Parliament and the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board"; COM(2009) 499 final -. 2009/0140 (COD)

35 Financial Times, 28 October 2009, http://blogs.ft.com/maverecon/2009/10/the-proposed-european-systemic-risk-board-is-overweight-central-bankers/

36 Financial Times, 2 December 2009, http://www.ft.com/cms/s/0/905b3dce-df66-11de-98ca-00144feab49a.html?nclick_check=1

tive mechanisms depending on whether the situation was deemed a "crisis" or not – with the member states, rather than the European Commission, deciding on whether crisis conditions applied.

Broadly speaking member states will be able to challenge decisions made by the supervisory authority before EU finance ministers, who will decide by simple majority whether to revoke a decision. If ministers decide against taking action, the state can still take the matter to the European Council of government leaders, which works by consensus.

There are wide reservations about how effective the new authorities will be and how they will cope with a much-increased workload despite fairly limited resources. It is also not clear to what extent they will be insulated from pressures from private sector lobby groups or the national industry interests of the few influential European governments.

It is not acceptable, however, that the European Commission has left important issues off the agenda. For example there has been no mention of establishing EU level agencies to protect consumer rights. Additionally, the new proposed agencies lack representation from not-for-profit civil society actors in the decision making processes.

5.3. Some key steps on Financial Regulation and Supervision in the EU

The Commission has started regulatory initiatives on the following issues[37]:

- directive on the regulation of hedge funds,
- directive on the regulation of rating agencies (which has already been adopted),
- directive on derivatives,
- harmonization of supervision among member states - the so called "Directive on a Systemic Risk Council", and
- an "Omnibus Directive", aiming at integrating the new regulations into the existing regulations of the EU.

37 For more details see: Denis, Gaspard (2009): Finance: l'Europe impose la régulation … avec modération. Bruxelles. In: 'Ensemble : pour la solidarité, contre l'exclusion' http://www.asbl-csce.be/

Two previously existing directives have been amended in light of the crisis. First, the 2003 savings directive, which aimed at fighting tax evasion, is to be extended from individual persons to cover some legal entities. Second, the amendment on the directive on capital requirements, through which the Basel II accord in the EU had been implemented (2006), expands the capital requirements of banks to certificates. The certification of credits, the transformation of debts into tradable assets (such as Credit Default Swaps), has been one of the most important causes of the crash.
Finally, regulation of executive bonuses was proposed by the EU at the G20 summit in Pittsburgh in September 2009.
Although the legislative process has started, there is uncertainty as to the direction it will take as the decision making process in the EU is highly complex. The following assessment, therefore, is only preliminary and based on the situation as it is end of 2009.

At first glance, the package of proposed regulatory initiatives looks impressive, and indeed they indicate steps in the right direction. However, a closer analysis shows that the scope of the measures is very limited.

A typical example of the Commission's approach is the **Directive on Alternative Investment Fund Managers** (AIFMs). This comprises hedge funds, private equity funds, commodity funds, real estate funds and infrastructure funds, which are all institutional investors who play an important role in the speculative financial system. They form the vanguard of high-risk institutional speculators, using highly risky business models such as leverage and (naked) short selling.[38] It has been acknowledged since in 1999, after the collapse of the Long Term Capital Management

38 Leverage is the use of third party capital - normally short term credits from banks and other institutional investors. Short selling is speculation on falling asset prices. Naked means that at the moment when the speculative operation starts the speculator does not yet dispose of the required capital to cover the costs of the operation.

Fund almost caused a systemic crisis, that these funds present a high risk to stability.

Hedge Funds are increasingly involved in speculative trading of commodity futures, which has contributed considerably to the hike in food prices in 2008, causing a hunger crisis in several developing countries.[39] Private Equity Funds not only have a speculative business model, but also represent a conveyor belt for shareholder capitalism from the financial to the real economy[40] . Therefore, this type of institutional speculator should be banned, or at least strictly regulated. The Commission concentrates on transparency and reporting, which is a necessary step, but the proposed text has many loopholes and the main risks are not dealt with. Consequently, the funds can continue with minimum restrictions to their business model:

Hedge Funds are increasingly involved in speculative trading of commodity futures, which has contributed considerably to the hike in food prices in 2008

- The first important loophole is that the directive only applies to fund managers but not the funds themselves;
- Funds with less than 100 million assets under management are not regulated at all. Bigger funds can easily take advantage of this by splitting up into smaller sub-funds;
- Funds that do not use leverage are allowed to have 500 million under management without falling under the directive;
- Funds, which use leverage to a large extent should meet special requirements. What is meant by considerable leverage or by special requirements are yet to be defined;
- For funds which use leverage, a limit on the maximum leverage shall be fixed, but as the funds would manage the leverage "dynamically" it is unclear where this limit is;
- The effective capital requirements are under 5%;
- Funds which speculate with shares of small and medium enterprises are exempt from the directive;
- Naked short selling is not banned, and it is only required to be documented in an annual report.

Despite the very moderate directive, UK has already voiced strong opposition and accused the European Commission of producing "naïve" proposals[41], and the fund industry lobby is mobilising against the directive. Therefore, the initiative can be expected to be watered down even further.

As for the **Capital Requirements directive**[42] the proposals are only piecemeal and do not address the main criticisms made against the international standards of Basel II, on pro-cyclicality and self-regulation. The current proposals fail to substantially increase, beyond those the Basel II agreements, banks' compulsory reserve requirements for credit that feeds speculation. The proposal does not address one of the most serious failures of Basel II, in that it allowed banks to have their own risks assessment mechanisms. Furthermore, no mention is made to include social and environmental risks through additional capital requirements or changes in the risk assessment mechanisms, which currently assess financial instability.
Last but not least, there is no distinction made between bank activities that serve the public interest and those which, finance speculation. So far there is no official proposal for a clear separation between commercial and investment banks.

With regard to the **Derivatives' Markets Regulation** the financial industry is the primary stakeholder be-

39 See: Wahl, Peter (2008): Food Speculation - The Main Factor of the Price Bubble in 2008. WEED-Briefing Paper. Berlin

40 See: Wahl, Peter (2008): Superstars in the Emperor's New Clothes. Hedge Funds and Private Equity Funds. What is at Stake? WEED-Briefing Paper, Berlin

41 Financial Times, October 22 2009. See: www.ft.com/cms/s/0/d3825f24-b96e-11de-abac-00144feab49a.html?nclick_check=1

42 For a detailed analysis of this directive see „An oversight of selected financial reforms on the EU agenda. Towards a progressive European response to the financial crisis" September 2009. Available at: www.cncd.be/spip.php?article806

Mali, 2008
Photo by Caterina Amicucci (CRBM)

ing heard in the consultation process launched by the EC. Following the G20 conclusions, the EC has received proposals from the financial industry[43]. In July 2009 the EC issued a communication[44] claiming that it will introduce measures that make derivatives "*efficient, safe and sound*"[45] . However, a number of experts have suggested that many types of derivatives cannot be made safe and should be banned.
The EC's proposals are tentative, with lots of qualifications. On central counter-party clearing, the Commission suggests that it is "considering ways to strengthen incentives wherever possible". The EC proposes that only some derivatives, such as Credit Default Swaps (CDS), will be standardised. To enhance transparency, the Commission proposes establishing a central data depositary for all over the counter (OTC) derivatives. Finally the EC proposes the use of public exchange markets for trading standardised derivatives. The EC acknowledges that this "would improve transparency and strengthen risk management" but stresses the potential costs of "satisfying the wide diversity of trading and risk management needs".

In summary, there are several limitations and weaknesses of the Commission's approach, whose proposals are either:

- not legally binding recommendations, as with the case of the derivatives directive,
- too moderate from the outset, as illustrated by the amendment of the directive on capital requirements and on hedge funds, or
- deal with non-core issues which may only have marginal impact, such as the directive on rating agencies.

5.4 Impact of EU financial policies on developing countries

The financial crisis originated in the US is having severe impacts in Europe, but even more so in developing countries. Developing countries are suffering from a shortage of credit, reduced exports, increased food prices, volatility and increased risk of debt distress amongst others. Moreover, they are suffering the effects of a crisis they are not responsible for.

On the one hand, major European governments have been promoting a strong liberalisation and deregulation of financial markets at both European and international levels. They have done this in the belief that this would strengthen European economic and monetary policies. With the crisis, bank activities have been redirected to the North depriving developing economies from access to credit.

On the other hand, the European Union has committed itself to ensuring that policies such as fisheries, energy and trade do not undermine its development pledges. This *Policy Coherence for Development* approach (PCD)[46] was launched in 2005 as part of the *European Consensus on Development*. Its review, published by the EC in September 2009[47] says that PCD "allows for a systematic exploration of the effects that EU policies other than aid might have on development and on the achievement of the MDGs". Yet, the EU entirely omits the financial and economic policies which cause instability and massive financial outflows from developing countries to other destinies.

43 ISDA letter to McCreevy on Clearing of CDS in a European clearing house. 11March 2009.

44 See: http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm

45 EC, Commission staff working document accompanying the Commission communication - Ensuring efficient, safe and sound derivatives markets, 7 July 2009. http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/communication_en.pdf

46 See: http://ec.europa.eu/development/icenter/repository/COM_2009_458_part1_en.pdf

47 See: http://ec.europa.eu/development/policies/policy_coherence_en.cfm

Speculation has played an important role in the rise and fall of food, oil and other commodity prices in recent years[48] . Hedge funds and other institutional investors have very actively invested in commodity markets, driving prices up and artificially inflating the market. This behaviour has had dramatic consequences for poor countries. The UNCTAD has shown that price hikes between 2007 and the middle of 2008 resulted in an additional 100 million people having inadequate access to food[49]. It adds that the positions held by finance companies such as hedge funds became "*so large that they can significantly influence prices and create speculative bubbles, with extremely detrimental effects*". Yet, when it comes to regulating derivative markets and hedge funds, European governments are failing to look at their implications for development.

The lack of effective regulation and supervision at EU level also resulted in a host of problems that these developing countries faced prior to the financial crash, such as:

- Unregulated rating agencies had conflict of interests when rating governments and companies in developing countries, or had little interest in rating them.

- Unregulated private equity and hedge funds - with loans from Western banks - started to lure capital from rich people in developing countries and to buy up companies with operations in the South with a view to making short-term profits.

- A lack of cooperation and information sharing among supervisors from host and home countries, depriving host countries from an insight of (cross-border) capital flows by foreign financial service providers. The lack of a unified voice at international financial forums also made it difficult for developing countries to deal with EU member states.

In general, financial markets in their present condition have a significantly negative impact on developmental processes in poor countries. Given the current crisis of development finance and the limited scope of this in helping poor countries to overcome the exogenous shocks and crises generated by financial markets, it is crucial that strengthened international and national financial regulation/supervision soon addresses this major loophole in policy coherence for development, in particular at European Union levels.

48 See: http://www.eurodad.org/uploadedFiles/Whats_New/News/Food%20speculation%202%20pager%20final.pdf

49 UNCTAD, Least Developed Countries Report 2009. See: http://www.unctad.org/en/docs/ldc2009_en.pdf

6. Conclusions and perspectives

"I share the view that central control of capital movements, both inward and outward, should be a permanent feature of the post-war system."

The central bank "shall have unqualified control over the capital transactions of its residents"

Keynes

In the context of the financial and economic crises, John Maynard Keynes and his view of macroeconomic management has often been referred to by analysts and commentators.

We believe that Keynes's view about the scope of financial markets, as stated above, still remains a crucial guiding principle for restoring financial stability and making finance contribute to a sustainable development worldwide.

This vision generally entails to reduce the financial sector and to reverse the dominance of finance over real economy. Finance usually has a servicing role. Notwithstanding, the "speculator pays" principle has thus to be implemented, hence those who may have made incredible fortunes in the past may have to pay the bill today.

Attempts to regulate financial markets remind us of the myth of Sisyphus: *... any regulation can be bypassed and will trigger new innovation by the financial industry increasing systemic risks and speculation, or more perversely, will allow more financial arbitrage, not just among different regulations which can be harmonised- but between different sectors, or on information regarding the markets...* and so on.

Financial markets can therefore and have to be de-globalised. Taking them back into the realm of national economies would make them controllable again

Thus structural change is needed, and soon. Regulating the banking sector through the splitting of banks and the strict limitation of some financial instruments could help, but will never be enough. Only a single global market of capital with its own financial services will doubtlessly present new challenges, which will soon emerge. Therefore a different and more limited and controlled infrastructure of financial markets has to be put in place.

As the crisis shows, it was not possible to "*ride the tiger*" or "*the monster*", as the German president and former IMF director Köhler used to call the financial markets. Financial markets can therefore and have to be de-globalised. Taking them back into the realm of national economies would make them controllable again. That is often regarded as an almost impossible task, yet the history of the last century shows that the globalisation of financial markets is a reversible process if there is political will to do it. In the 1920s, global markets had a very large scope of action at a global level with only a few rules and many excesses. This was one of the causes of the 1929 Wall Street collapse and the subsequent Great Depression. By understanding this, the negotiators at the Bretton Woods Conference in 1944, among whom was Keynes - decided to opt for a relatively static and very stable international monetary and financial system (which lasted for three decades) bringing significant economic growth and some redistribution at national and international levels. In 1944, political will and a critical recognition of previous mistakes made this possible up to the 1970s. Then the pendulum swung again and neoliberal ideology took over with the detrimental consequences that are evident today.
De-globalising financial markets should be part of an approach towards a "selective de-globalisation" of the economy. That would mean that in order to make public authorities capable of controlling significant sectors of the economy again - in the name of public interest, some components of global markets can be de-structured and taken back into the realm of national or regional economies. This, instead, would not necessarily be required for other sectors of societies affected by globalisation. For instance more freedom of movement for migrants should be a central component of any global justice 'recipe'. However, this publication shows that there is a compelling case that financial markets should be the first elements to undergo this process of selective de-globalisation.

At the same time, this would be a necessary - but not sufficient - to make finance serve a social function or one of supporting the real economy and a sustainable development. It is crucial to reclaim the function of governments to pursue public policies that reflect the public interest. They may do this by avoiding a financialisation of sectors traditionally closer to the public sectors – like the pension schemes, health and housing. This is crucial for reclaiming a justice and redistributive principle in financial and economic policies, including the promotion of access to credit for the poor.

De-globalising financial markets would be also beneficial for developing countries, in the perspective of allowing them to retain more resources domestically for development purposes. This would be a key long-term element contributing to breaking aid dependency, which today affects most low-income countries. This would also restore "policy space" at national level, to enable decisions to determine which monetary and macro-financial policies are more adequate to sustain their development processes. In this framework, international movements of capital could still exist to a certain extent, as long as they do not disrupt financial stability but contribute to the economy and sustainable developments both in the North and the South.

Today we confront a global financial market. The Dubai financial crisis shows how the same dangerous attitude which took us to the brink of the collapse of the global economy previously, is still alive and kicking in most of the executive board-rooms. Perhaps only a few lessons have been learnt by the decision-makers and financial operators. In this context, the de-globalisation of financial markets has governance implications and necessarily requires strong action to be taken on financial governance at all levels, including the global one.

We suggest below a road map for decision-makers and international civil society to be pursued with renewed sustained efforts in the future in order to avoid new financial crises and allow governments to implement redistributive and development-friendly patterns. As said, it is a matter of political will, and not only of technical solutions. Only a strong political action resisting corporate lobbies would allow to overcome current resistance toward some fundamentally positive changes.

National level

- It is crucial that national governments reintroduce capital controls.

- Regulation and supervision have to be improved considerably. A stricter public control should be established on central banks and supervisory bodies.

- Strong citizens/consumers protection agencies should be established in order to balance other supervisory bodies on financial markets.

- The public and cooperative banking sector subjected to strict public control should be developed as a counter veiling power to the private sector. The public sector should be the engine to finance the transformation to a carbon free economy and society.

- Banks which are too big to fail should be downsized.

- Domestic demand should be promoted. One of the major driving forces behind the crisis is the decline in wages and purchasing power of the working people.
- Tax policies should target the financial sector in order to make it smaller.
- Common needs like health, pension systems and education should preferably be public. Private systems inflate the financial sector and hamper equal access for all to high quality services.

Regional level

Regional integration or coordination of financial matters is welcome as a building block for a different, more effective and balanced international financial governance. In particular, regional initiatives on reserve accumulation and possible short-term emergency lending in the context of unpredictable crises should be strengthened. At the same time, it is important to have more South-South cooperation if aimed at financial stability and redistribution and to foster development and domestic resource mobilisation. As concerns the European Union,

- A tough regulation on corporate lobbies has to be introduced in order to reduce their reach and influence on decision-makers.

- At the same time it is central to improve the democratic deficit of the European Union as concerning European financial governance.

- There is a need to reform the ECB mandate. Jobs and sustainable growth should therein to be included. Inflation control has to be expanded to asset prices.

- The introduction of a financial transaction tax would have both a regulatory effect and a potential redistributive one. However, such a tax would not be sufficient to thoroughly regulate financial markets by itself. Pilot implementation can happen at regional level – for instance in the Euro zone - and not necessarily at the global level. It could also apply to currency transactions as a first step towards a tax on all financial transactions.

- Off balance sheets and any other forms of shadow banking have to be banned.
- OTC trade with derivatives should come under public regulation and supervision and the overall derivative's markets have to be restricted to non-speculative operations.
- Hedge Funds and other highly leveraged institutions have either to be regulated as banks or be banned.
- All tax havens have to be closed down. The EU should be a forerunner in this respect and dismantle those jurisdictions controlled member states, including the Cayman Islands (British) and alike.

Global level

At global level financial and monetary coordination is needed, but in the failure of current multilateral framework it is urgent to rethink in a more pragmatic and effective manner of what multilateralism could and should be. The proposal of the UN Commission on the economic crisis to establish a global economic coordination council under the premises of the UN- possibly based on regional blocks representation also- would represent an important step forward in the promotion and management of an effective inter-governmental economic and financial cooperation.

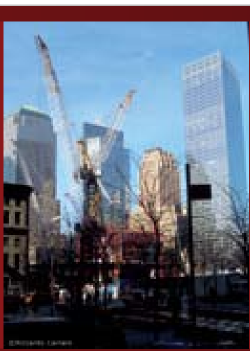
It is urgent to roll back most commitments of liberalisation of financial services under the GATS/WTO agreement. This should be included in a new negotiating agenda at the WTO, in the face of the current failure of the Doha negotiations.

The Financial Stability Board and the Basel Committee on Banking Supervision should be democratised and made more transparent. In particular, all developing countries should have access to decision-making processes in these bodies- and all stakeholders should be regularly informed and consulted about all affairs, including civil society and trade unions and not only the private financial sector.
The International Accounting Standards Board (IASB), which is today a private company, should come under public scrutiny. The crisis has shown to what extent accounting standards are not a mere technical matter but a highly political issue.

No legitimate international organisation currently tackles tax matters globally. The proposal to create an international tax organisation, expressed in particular in the 2001 Zedillo Report to the UN, should be seriously considered. The World Bank and the IMF should be democratised well beyond the existing proposals put forward by the G20. The EU should encourage this by eventually reducing its over-representation at board level and consolidating its representation at other levels.

Finally, a supranational monetary system is needed which would end the dominance of one national currency as the leading currency. As an intermediate step towards a global currency, a basket of currencies and Special Drawing Rights could serve the purpose more effectively. In the long term, a new Bretton Woods type of international conference is needed to democratically establish a new international monetary and financial system.

Notes



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