FINANCIAL SERVICES, ECONOMIC NEEDS AND GLOBAL FINANCIAL ARCHITECTURE: POLICY PROPOSALS

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The financial and economic crisis: ethical but also structural failure

The global financial system links a set of banks and financial markets around the world and impacts countries big and small. Its centres are in Europe and the United States, with sub-centres in Japan, Hong Kong, Singapore and the Gulf countries. It includes several large national markets of regional importance, such as in South Africa and Brazil. Virtually all countries have become attached to this global system to some degree, as national financial systems have become increasingly integrated into the global system.

When the collapse came in the latter months of 2008, there could no longer be any controversy about whether the global financial system was working well or poorly. Financial innovations in the face of only weak financial regulation in major financial centres created the conditions for a crisis of global proportions. Difficulties that had emerged in mortgage financing in 2007 in the world's largest economy, the United States, grew into a national financial crisis in 2008 and not only brought economic activity there to a virtual halt, but in much of the world as well, owing to the interwoven international financial markets and banking relationships around the world, and the ensuing impact on trade, as economic recessions and suddenly scarce financing spread around the world.

Since then, more and more cases of illegal or inappropriate financial behaviour have come to light in Europe and the United States. While distressing numbers of people appear to have crossed the line into illegal activities, many more stayed just within the legal framework but nevertheless took advantage of complexities in the system for personal profit in a way that has harmed financial stability and the supply of financial services that are essential for the smooth operation of modern economies. In particular, Wall Street and the London markets created highly dangerous Frankenstein-monster securities they did not themselves fully understand, but that the investor community eagerly bought up, much of it with borrowed money, raising the risk of collapse of the entire system when the promised payments could not be made. Meanwhile, financial industry lobbyists have focused on weakening or turning aside efforts to strengthen financial market regulation in the developed countries which could address these shortcomings.

Two senses of fairness are needed to hold modern societies together. One is the sense that the operation of the political, economic and social system is basically fair, that people who abuse their authority or opportunities are the exception, not the rule, and that abusers of society's standards will be caught and punished. The concerns frequently expressed about banker greed suggest that the world is failing this sense of fairness. The second sense of fairness is that the material outcome meets society's standard for an acceptable sharing of its benefits. The much commented widening of inequality in income and wealth within and between countries, especially since the 1980s, challenges the second sense. The fraying of the social safety net and its impact on poverty in the current crisis in many countries, aggravated by inopportune austerity policies, is already having an impact in the streets in some countries. Meanwhile, the excessive accumulations of wealth in finance and other economic sectors are distorting political processes and undermining democracy. This is not sustainable.

And yet, there seems to be only modest organized opposition to the finance-friendly policies in Europe, America or elsewhere in the world. Some groups of people have formed themselves to explicitly confront the power structures that rule them, ranging from the Arab Spring movements that were propelled by widespread unemployment and poverty, to the "Occupy" movements in the United States and Europe and broad demonstrations in Greece and Spain. The "occupiers" have mainly protested an economic and financial system that too easily tolerates dominance by the rich (the "1%") and by the private and official institutions they control. This protest is valuable but, unlike the Arab Spring, it has not yet been enough to mobilize the broad mass of people worldwide.

Insufficient measures for a stable and effective financial system

It is now four years since the crisis began and trillions of dollars and euros (and billions of pounds Sterling) have been used to rescue the financial institutions that have been at the heart of the crisis. Instead of strengthening the political resolve to fix the financial system, the failures of big

financial institutions increased the power over policy of the ones that were still standing. As a modern economy cannot operate without basic financial services (see annex), the institutions that were "too big to fail" had to be protected from their own follies, no matter the potentially great cost to taxpayers. In addition, national politicians in some countries have given disproportionate weight in public policies to what would please financial executives.

Moreover, the large increase in the global pool of funds that was generated by monetary emissions especially in the United States to save its financial sector has sent money rushing around the planet looking for profitable opportunities that investors no longer saw at home. This brought a surge of speculative financial inflows to a number of emerging markets, some of which imposed taxes on the inflows to discourage them.

Overall, developing countries remain vulnerable to renewed instability in the developed countries. A central problem in both the global commodity and emerging economy financial markets is volatility: exuberance is followed by disappointment, buying by selling, and highs by lows.

Insufficient measures for economic recovery

The global economic situation is not nearly enough improved. World output and trade are growing again, but slowly. Global unemployment remains dangerously high, putting grave social stresses on the families of unemployed workers and dimming the prospects of youth that have yet to find their first job.

Governments of several developed countries worsened their situations by prematurely embracing austerity policies to reduce their recession-expanded fiscal deficits out of fear of future inflation and so as not to disappoint presumed expectations in the financial markets. Little was done in the crisis countries for the mass of people with unsupportable debts. It is not surprising that consumers have been unwilling to resume spending above the bare necessities, when that was even possible. What most infuriates many citizens in the European Union and United States, however, is not only the degree of austerity attached to the financial support shields, but also the content of the cutbacks, which have favoured interests of the more powerful and wealthy groups over the social needs of the population, and inability to collect adequate taxes from the rich.

While developing countries largely escaped crises in their own financial sectors this time, they were still rocked by their trade and financial linkages to the countries that were in financial crisis. And yet, initial output recovery was quickest and most sustained in those countries. Nevertheless, austerity policies have since been embraced by developing countries as well as developed ones, reversing the counter-cyclical fiscal expansions many of them undertook when the crisis first spread around the globe, in many cases leaving government social expenditures below pre-crisis levels. In addition, although exporters of petroleum, food crops and other commodities have benefited from surges in their international prices, importers of these products suffered. This is a special worry for low-income food-importing countries where hunger is always near.

Strong public guidance and oversight are essential

It is universally recognized—especially post crisis—that finance requires close regulation and supervision. The reason is not simply that the industry plunged the world into economic crisis in 2008, but that there is something inherent in the nature of the financial business that must be addressed by policy.

Banking services are too important to the functioning of the economy to be allowed to periodically seize up, as they did regularly in the 19th century. Left to themselves, banks periodically expose themselves to excessive risk and failure. Risk is inherent in financial transactions. The more financial institutions "leverage" themselves (invest borrowed money), the greater the profit when risky projects pay off. However, high leverage can cause bankruptcy when risky projects fail; creditors may not then get repaid, while shareholders lose only their equity in the firm and managers need only look for another job.

Regulation of commercial and investment banks and brokerage houses

Excessive faith in managers of huge banks was embodied in a 2004 revision ("Basel II") of a 1988 set of recommended standards that were adopted by the Basel Committee on Banking Supervision, an international committee of regulators from the major economies that meets on a regular basis at the Bank for International Settlements (BIS) in Basle, Switzerland. Basle Committee recommendations have become the global standard for banking regulation, embraced by many developing as well as developed countries. Since the crisis, the Basle Committee has issued further revisions of its standards ("Basel II.5" and "Basel III"), meant to dial back some of the regulatory relaxation. In particular, the approach in Basel III timidly increases the equity backing for highly leveraged banks. Initial strengthening proposals had been watered down and implementation was delayed by banking industry lobbyists.

Even if Basel III is not as strong as might be desired, it warrants implementation as a first step. Indeed, tougher international regulatory standards for "systemically important financial institutions" are being devised by the Financial Stability Board, a committee of the major economy finance ministers, central bank governors and regulators. It is working on possible requirements for additional capital backing and to establish procedures to "resolve insolvencies" (deal with bankruptcy) of "too-big-to-fail" institutions. There is reason to fear this effort will also not be sufficiently tough.

While regulation of commercial banks has traditionally involved detailed oversight in order to prevent banking crises, regulation of the investment banking and brokerage community has been less intense, a view that needed to be revised post-2008. The point is that with the large variety of derivative and short-term securities issued and held by investment banks and several "too-big-to-fail" commercial banks that also operate in this space, a lightly-regulated "*shadow banking system*" arose in the major financial market economies and this shadow banking system was at the heart of the financial crisis. It provided a variety of alternatives to bank deposits and loans to financial and non-financial companies and households. However, it lacked the financial safety net and regulation of banking activities; e.g., it tolerates far less capital backing of the obligations to creditors than banks.

While tougher regulation of the shadow banking system will be discussed below, more effective commercial bank regulation is the *sine qua non* of regulatory reform. To ensure essential financial services are provided while protecting the taxpayer, the United States and other financial centre countries should put a protective fence around "boring banking" within which commercial banks convert deposits into loans, run the payments system and provide traditional derivatives that support the "real" (non-financial) economy, such as forward foreign exchange contracts. In effect, this means that the "too-big-to-fail" commercial banks should split off their inessential, if sometimes highly profitable but risky activities, in particular "proprietary" (on their own account) financial trading, and there should be no presumption that the central banks would rescue the successor businesses that carried on those high-risk activities. This would shrink the major banks (and probably the shadow system as well), while raising confidence in the soundness of the system as a whole. It also reduces the potential claim on public resources that will inescapably be spent to keep the banking system functioning. Indeed, the argument for breaking up the biggest banks is not only economic; it is also political, as the banks use the threat of systemic consequences of their collapse to distort policy making in their favour.

Financial vulnerability in the EU

Despite the rescue and stress-test policies that were undertaken in the euro area, the European financial system has been less than robust. In late 2011, European policy makers finally acknowledged the need to provide massive credit lines to their banks as the Americans and British had already done a few years before. Although boosted by the official credit infusions in December 2011 and February 2012 and although the banks have sold off some of their holdings of the weaker sovereign bonds of certain European governments, they still have large holdings and other higher risk loans. While default on the sovereign bonds is officially not expected, the patience of the citizens of Spain, Portugal, Ireland and Italy, not to mention Greece, with enforced austerity and hardship to repay bondholders is not limitless. European governments—indeed, all governments—need a fair, transparent, effective and timely process for resolving sovereign insolvencies. Postponing action on a hope and a prayer is not a policy (see also box on Greek debt workout).

This means that the governments of the major financial centre countries might again face a huge demand for emergency bailout resources. It is not obvious that parliaments in an austerity mood and with bailouts of banks decidedly unpopular would agree to approve such funds. European central banks have already provided massive funds, as noted above, and could do more, but the anti-inflation hawks would surely object strongly to massive increases in central bank lending to banks, raising the amount of money in circulation. A different source of funds for a banking rescue could be found in a proposal that civil society advocates had been recommending for years, the financial transaction tax (FTT). It suddenly got the attention of previously deaf finance ministers when Gordon Brown, at the time Prime Minister of the UK, proposed such a tax in November 2009 and the Group of 20 (G20) asked the International Monetary Fund (IMF) to propose how the financial sector could make "a fair and substantial contribution" to public revenues, post crisis. While some G20 members opposed any new tax on the financial sector, including the successor British Prime Minister, David Cameron, France, Germany and other European countries have taken up the idea of the FTT, which at the time of writing in July 2012 may be nearing formal agreement among a group of EU members. It may be hoped that if and when it is adopted that a portion of the revenues will be set aside for development and anti-poverty purposes as consistently called for by the civil society campaigns.

In sum, one may expect that in time banks will build their capital buffers, if not sufficiently, and perhaps some prominent bank names will disappear on both sides of the Atlantic. And perhaps governments will mobilize additional financial resources that they can deploy if needed in a new banking crisis. However, financial rescue does not equal financial reform. The bankers do not seem to have evidenced a changed sentiment toward risk; nor have they shown reticence to award themselves impressive bonuses for their self-assessed risk-taking prowess. Moreover, although the prices of bank stocks have fallen since the crisis began and some banks became insolvent and wiped out their shareholders, most bank shareholders have only had valuation losses. If the banks recover, so will the stock values. Indeed, having been rescued once, the banks, their managers and their shareholders have every reason to believe they would be rescued again, despite what policy makers say (and legislate). The "moral hazard" remains that governments may have to again bail out banks that are "too big to fail." If regulators keep bailing out the banks, why should they change their behaviour? This is a serious flaw in the current policy environment.

Serving people and protecting their interests

The five essential financial services—payments, short-term credit, long-term lending and equity issuance, insurance and savings (see annex)—are typically provided today by private companies. One consequence is that not all potential market segments are served or they may be served poorly, as by unscrupulous firms. In general, mainstream financial firms do not view the poor as attractive customers, for which reason public or other non-profit institutions typically provide whatever financial services poor people and their micro, small and medium-sized enterprises are able to obtain.

Moreover, it has increasingly been appreciated that middle-income as well as poor households need protection from what can only be called unethical practices by financial service providers. Practices have ranged from banks not informing customers of fees and charges for some of their services (credit cards being a prime example) to unethical investment advisors working in what are known as "boiler rooms," in which high-pressure salesmen push high-risk securities onto unsuspecting small investors (drawn from a "sucker list"). The problem extends as well to financial institutions that work with real estate companies to sell houses financed with mortgages that buyers cannot afford. Many of these abuses came into the public eye, in particular, in the United States, in the wake of the financial crisis.

It is indicative of the incentives built into the private financial structure that while outrage about financial abuses revealed in the crisis encouraged consumer advocates to push for strengthened consumer protection, the financial industry has fought back vigorously, weakening the attempted transition to a more transparent, robust, accountable and fair financial system. But establishing such a regulatory entity should be as uncontroversial as looking to government to certify food safety or new pharmaceuticals. In some economic sectors, the cost of *caveat emptor* (buyer beware) is simply too high to let people discover the problems on their own.

In some countries, moreover, non-profit institutions pursue a "double bottom line" of covering their costs while also providing socially oriented financial services. They provide an alternative to and even compete with the private financial sector. They include some large, even central, public institutions, including the incompletely privatised Japanese postal savings bank and insurance company, which by some indicators has been identified as the largest financial institution in the world. There are state-owned banks in some countries, in some cases operating alongside private institutions, including commercial banks, national savings banks, regional banks serving savings banks and non-bank customers (*Landesbanken* in Germany), government-run provident funds and national development banks. There are also numerous not-for-profit and client-owned institutions, such as savings and credit cooperatives and credit unions, and numerous microfinance institutions established by non-governmental organizations, some small and some huge, including BRAC, an innovative, Bangladeshi-based, highly diversified and now multi-country institution that is also the world's largest NGO, with about 120,000 employees.

For the most part, the public and non-profit financial institutions seek to fill a niche, rather than provide a nation's first-line financial services. Moreover, managers and staff of a number of these alternative institutions have been embroiled in scandals that are as anti-social as in the private sector. Some of the institutions have also taken on risks that exceed their basic mandates, for which they have paid with insolvency. One must thus be as aware of the potential for "government failure" as much as "market failure." Nevertheless, one might well listen to the frustrated voices that are beginning to question whether the financial status quo is inevitable, perhaps most dramatically in the "Occupy Wall Street" movement. Indeed, there is nascent emerging interest in revisiting public banking as an alternative and more socially responsible financial model.

Derivatives and "shadow banking"

Most financial derivatives are economically useful innovations, but they can be—and have been—a source of economic instability and financial crisis. Derivative securities fix a price for later purchase or sale or offer opportunities to buy or sell at a later time or swap obligations of one sort for another or make a payment depending on how another financial asset performs. It turns out that trading derivatives can substitute for cash transactions and provide short-term credit and savings vehicles. Coupled with other financial market innovations, such as "commercial paper" (short-term securities issued by large corporations) and "money market mutual funds" (investing in short-term securities and promising investors they can redeem their funds at a fixed price of $1 per share), a wide range of financial services are being provided. As they offer an alternative to banks but are not regulated like banks, this "shadow banking" system almost brought down the real banking system.

The global size of derivative markets per se is almost beyond comprehension. The larger of the two components of the derivatives market is made up of "over-the-counter" (OTC) derivatives that are designed by financial institutions for individual clients. Although some of the derivative contracts are relatively standardized (e.g., a contract to deliver a specified amount of a specified foreign currency to a client at a specified future date), many contracts are fully customized for a client's specific needs. Owners of the contracts can sell them, but the OTC market is opaque. A buyer will not know how many other buyers or sellers there are or what prices are being paid. Central banks in major financial centres have been collecting data on OTC contracts from financial institutions in their domains The BIS, which has been compiling these data, finds that in June 2011 they covered $708 *trillion* in assets. The contracts offered to change the payment streams or insure payment in one way or another on $65 trillion of pending foreign exchange transactions, $554 trillion of debts on which interest payment streams are altered, $7 trillion of equity securities, $3 trillion in a variety of commodities transactions, $32 trillion of debt securities that might default, and $47 trillion of bets on unidentified assets.

The second component of the market involves the trading of standardized contracts on formal exchanges (e.g., Chicago Board of Trade and London Metals Exchange). For example, instead of an OTC contract to deliver foreign currency at a chosen date, a customer can buy a standard "futures" contract that promises to deliver, say, £60,000 on 30 June 2012 at a price fixed when the contract was written, say 31 March. That contract can be bought or sold at a price that will be posted at the exchange. A US

importer might buy the contract on, say, 18 April and could sell it when he needs his currency, say on 16 May. Prices fluctuate in the market up to the date of maturity; indeed, most contracts, especially for commodities, clear before maturity as otherwise a purely financial speculator could end up owning, say, several railroad carloads of wheat. The other standard type of traded contract entails paying for the "option" to buy or sell, say, a security by (or on) a certain date. Futures and options are written on "underlying" commodities, currencies, credits and securities, the latter especially on shares of publicly traded stocks. The BIS has been collecting data on exchange-traded derivatives and reports that in June 2011 contracts were outstanding on $83 *trillion* of "notional principal," of which $30 trillion were in futures and $53 trillion in options. Trading on formal exchanges is thus very much the junior partner in the derivatives business, but the more transparent one.

Foreign exchange markets

The forward contract in foreign exchange, as noted above, is a traditional and generally useful OTC derivative. A variation on the forward contract is the foreign exchange swap, in which it is agreed to exchange two currencies at a set price on one date (e.g., today) and to reverse the exchange at a later date also at a pre-set price. A bank accommodating the foreign exchange need of an importer might enter into this type of transaction so that at the time of the future settlement, the bank is back to holding essentially the same currencies as it started with. These swaps are in fact the most prevalent transaction, although as indicated the exchange-traded futures contracts are also important. Considering all the instruments together, the market usually works smoothly for businesses and banks. However, foreign exchange derivatives can also aggravate exchange-rate instability.

The basic way to manage a currency market is central bank monetary policy, such as to lower interest rates when policy makers want to discourage inflows. However, countries usually have higher priority policy goals for monetary policy and either allow the exchange rate to find its own level in the market or supplement monetary policy with direct intervention in the foreign exchange market. There are essentially two types of policies. First, the country can impose exchange control and require that permission be given for making short-term financial movements into and out of the country. An alternative allows free movement of funds, but seeks to temper excessive exchange rate movements with financial disincentives. In this approach, a tax is imposed on short-term financial inflows so that excessive entry of funds is discouraged when the country is "hot" and thus fewer funds leave in a rush or bet on devaluation when market sentiment sours. A proposed variation on this approach would impose a small tax on capital inflows and outflows in normal times, but with a trigger mechanism to add a prohibitive surcharge when the currency was under speculative attack.

The degree to which such financial capital controls facilitate exchange rate management has been much debated. For decades the major developed economies and the IMF have opposed developing countries implementing them, although the Fund has become more eclectic about these policies in recent years. In fact, few developing countries feel secure enough to allow their exchange rate to fluctuate freely; capital controls of either an administrative or financial sort are the more common practice.

Financial capital controls as discussed here should be distinguished from proposals to place a tiny tax on every foreign exchange transaction, called the currency transaction tax (CTT), which is a special form of the FTT noted earlier. The primary aim of CTT advocates in civil society is to mobilize funds for development while not deterring traditional transactions. However, it appears that even a tiny CTT would discourage a relatively new and dangerous phenomenon, "high-frequency trades," in which computer algorithms buy and sell currencies at lightning speed, which can unhinge exchange rate management. Thus, even a tiny CTT could have a positive impact on stability in the foreign exchange market.

Commodity markets

Other derivative securities that are economically useful but can have adverse economic effects pertain to commodity prices, such as on wheat, coffee, pork bellies, orange juice, and crude petroleum. The latter was in the public eye again recently with the rise and then quick fall in international petroleum prices, exacerbated by speculation about the impact of a threatened international embargo on oil exports from Iran beginning in July 2012. As the rise in oil prices filtered down to the prices of consumer

products, the speculation raised the threat of a return to recession in the weak US and European economies. By mid-year, however, the actual weakness in demand in those economies brought oil prices back down sharply. Food prices have also been worryingly on the rise again, mainly reflecting disappointing supply forecasts in the face of continued strong demand. Evidence from the last large swing in food prices, which peaked in 2008, indicates that speculation accentuates the movement of these prices.

The speculators are not interested in taking possession of the oil or hog bellies or orange juice, but purely in profiting on a financial transaction. They are tolerated because they add liquidity to the market, even if they make underlying prices more volatile. The role of regulation is to try to preserve the good and limit the bad. Proposals to limit commodity price speculation have not focused on the specific exchange-traded or OTC instruments (except to bring the latter into the open, record them and centrally clear the purchases and sales). Instead, the main focus has been on putting limits on the size of speculators' bets, usually stated as putting limits on their exposure to risk. However, the financial industry is fighting the tougher regulation. In particular, although the US Dodd-Frank law of 2010 called for setting speculative position limits on 28 commodities, and although the Commodities Futures Trading Commission (CFTC) has set position limits for many years for a few agricultural commodities traded in the United States, the Commission has not been able to complete its work two years later. Position limits are under consideration in the European Union as well.

Stock market derivatives

The comparable derivatives markets for shares of stock include options to buy or sell at a future date ("puts" to sell and "calls" to buy), and are more about pure speculation on stock market prices than reducing uncertainty in essential "real" economic activities. There are trillions of dollars in these transactions as well. Generally, policy makers do not express alarm about fluctuations in stock market prices, knowing how volatile they are and how little they correlate with real economic activity. Stock prices are allowed to change as market sentiment changes. Nevertheless, some financial institutions, which usually strongly oppose any interference with financial markets, apparently lobbied intensively to halt one type of speculation during the worst days of the financial crisis.

That is, investors may "short" a stock that they think is going to fall in price. The investor can purchase a put option to sell a stock at a future date for a price contracted today based on the current situation which, the speculator believes, is overoptimistic. His intention is to buy the stock at a lower price when the option matures and transfer it to the buyer, hence profiting. If the price has fallen as expected, he wins and if the price is higher he loses.

In September 2008, when there was tremendous pressure on the stock markets in the United States and England after the failure of Lehman Brothers and other events, investors began heavily shorting the shares of financial institutions. The shorts were clearly signalling lack of market confidence in the financial institutions. To calm the market for the publicly traded financial company shares, the British and US Governments, plus 18 other countries, temporarily prohibited their short selling. With a similar concern, in August 2011 in the midst of a general loss of confidence in their financial institutions, Belgium, France, Italy and Spain temporarily prohibited short selling of the shares of their banks, also aiming to moderate the fall in the price of the shares. Bank managers apparently felt in both sets of cases that the speculators were unfairly targeting their firms, driving down their share prices to unrealistically low valuations. As creditors are reluctant to lend to firms that the market is signalling have lost considerable value, the plunging prices of financial institution shares were felt to be aggravating the financial crisis. In any case, the market was right as the financial firms were in trouble. One should keep this experience in mind the next time bankers opine that any intervention in the workings of the "free market" is unwarranted interference in the "invisible hand."

Credit default swaps

Credit default swaps (CDSs) are unique derivatives in having been invented not to provide a service but to get around a regulatory restraint on banks. If such an origin was not promising, the experience has been even worse from a public policy standpoint. And yet, the market for these instruments still provides a type of insurance on over $30 trillion of credits (as of June 2011), which

assuredly exceeds the value of the particular credits that are covered; i.e., it is not required that one owns a security to take a bet on its demise by purchasing a CDS.

The incentive to create the CDS lay in the limit on how much banks may lend, based on the size of their capital backing. Since the limit is based on a calculation that weights each loan by its risk classification, if a risky loan can be turned into a low-risk loan, it would count less in the calculation (or even zero if classified as risk free) and the bank would be able to lend out more money on which to earn profits without raising its capital. One way to reduce the risk of an asset is to insure it. Bankers at JP Morgan thus created a new contract that would pay them if a borrower defaulted within a set time period on a loan issued by the bank (usually 5 years) and in exchange the bank would pay the insurer a periodic fee. In effect, they separated the risk from the loan and sold the risk to the insuring investor. They just needed investors to take the bet who could make a large payout in the unlikely event of default. In the pre-crisis era of optimism, many large financial institutions saw issuing CDSs as an easy way to make money at "low" risk.

However, CDSs are very imperfect hedges as they pay off after a significant delay and thus do not reduce risk as much as might have first been thought. A proper hedge against, say, incurring a loss in paying a bill in foreign currency after a decline in the exchange rate would be to hold an asset in that currency that would mature at the same time as the bill had to be paid (e.g., a forward contract). Assuming the securities and payments cleared smoothly, there would be no gap between them, whereas there will be a gap of weeks in collecting on a CDS after default, meaning that the insured needs additional liquidity to cover the gap.

Another drawback in CDSs is that the buyer of the CDS should want to be confident that the "counterparty" on the other end of the contract can in fact cover the loss in the event of default. The counterparty, however, is not a regulated insurance company and there is no public tracking of how many CDS contracts the insurer has outstanding and thus no indication of whether it can cover its potential insurance claims. And, even when the writer of a CDS is an insurance company, the credit default swaps business is run outside the regulated insurance business, as was the case with AIG, the huge American insurer that was taken over by the US Government during the crisis.

Moreover, CDSs create unconventional incentives for investors in the underlying instruments when those instruments become "impaired." Usually, a bondholder will hope the issuer makes every effort to avoid default and stay current on its debt servicing obligations, especially when worsening economic difficulties convince the market of a growing likelihood of insolvency and the bonds thus trade at an increasing discount from face value. However, a bondholder with a CDS on the bond might prefer that the borrower default, as he would then collect the insurance payment, which would far exceed the market price of the bond before default (see box).

Despite these questionable features of CDSs, the market for them boomed. A decade after CDSs were first created in the mid-1990s, they were nominally covering over $6 trillion of credits. At the peak, in December 2007, $58 trillion in loans and bonds of various types were covered by CDSs. Some were written on individual credits and some were written on "multiple names" as would be held in a portfolio of credits, which could be an actual collection of loans that some bank wanted to insure or just a notional portfolio. Then the financial crisis came and many sellers of CDSs could not cover all the obligations they had assumed. Despite this experience, use of the instrument has been growing again. This probably reflects the fact that potential losses on counterparty failures were in several cases prevented by the government bailout of the biggest issuers in order to protect the banks that had bought the "protection," and because the net CDS position of some of the big banks entailed far less net exposure than their gross position indicated (i.e., they held contracts as insured as well as insurer).

How should derivatives be regulated?

It should be clear that the global derivatives market extends from routine financial instruments that are useful hedges for firms in the non-financial sector to exotic and complicated instruments that mainly serve to help financial investors take speculative positions on a range of securities and events. The general argument in favour of the speculative players is that they add liquidity to hedging markets.

They shift risk from those who want less of it to those willing to hold more of it, and presumably they have specialized expertise for assessing risk in the specific derivatives traded. The vast size of the market also indicates there is a demand for what the speculators are offering.

The Greek debt swap and the CDS market

The existence of CDSs on bonds of the Greek government led to a distorted process for reducing Greece's debt. In the March 2012 settlement, bondholders took a loss of 75% of the face value of the bonds. Bondholders with CDS protection would have had little incentive to accept such a debt exchange offer if they understood the alternative to be CDS payment once Greece was declared in default. Thus a great effort was made to depict the bond exchange as a "voluntary" restructuring of the debt, in which case payments to the CDS holders would not be triggered. In fact, a first request to find Greece in default was denied on 1 March by the arbiter of the question, the International Swaps and Derivatives Association (ISDA). Then, on the morning of 9 March, Greece announced it had received almost 86% voluntary participation in the exchange, which allowed it to invoke a recently legislated feature of the bonds that had been issued under Greek law. The feature, called a "collective action clause" (CAC), allowed the government to impose the bond exchange on the remaining holders of domestic law bonds. With that, ISDA declared on the same day that a "credit event" had occurred because invoking the CAC diminished the legal rights of bondholders.

In the end, 97% of Greek bondholders took the debt exchange offer. About $3 billion in CDSs were outstanding and had to be settled, down from over $9 billion in November 2009, which reflected the reduced belief that investors would be able to collect on them. The CDSs settled smoothly, as did the bond swap itself. However, prices of the restructured Greek bonds were trading soon after issue at a deep discount, meaning that the market feared that Greece remained insolvent even after the bondholders' "haircut" (loss). Moreover, saying that an actual default and debt workout was a "voluntary" exchange in order to prevent recognizing a "debt event" has set an uncertain precedent. Banks that issued CDSs on a debtor as large as Spain or Italy would clearly want any debt restructuring to be deemed a voluntary exchange to prevent having to make large payouts. This is not an honest way to undertake a sovereign debt restructuring.

However, there are important downsides. There is reason to ask if all those willing to take on the risks are actually able to meet the possible calls for payouts. The inter-linkages among the large financial institutions adds a systemic dimension in that if one institution cannot meet its counterparty obligations and defaults, the losses it imposes on its partners may bankrupt them as well, which could threaten other institutions for which they serve as a counterparty and so on, threatening a systemic breakdown. This fear was not abstract in the autumn of 2008 in the United States and Europe. Nothing exists in these markets to dissuade or discourage a run, like the government-supplied deposit insurance that can calm bank depositors or the circuit breaker that temporarily stops panicked trading on the New York Stock Exchange.

It is also increasingly being realized that the fundamental assumption on which financial institutions price their derivative offerings is wrong. That assumption is that the derivatives float above the underlying assets, as it were, and do not affect their market prices. As discussed above, experience from commodity markets, credit default swaps and elsewhere indicate this is not the case. Moreover, there is evidence that these markets move underlying securities away from "equilibrium." For believers in "efficient markets" theory, these are anomalies that need to be addressed.

There is a further problem in that the large pool of liquidity in the derivatives markets is largely outside the banking system. Even if banks create many of the instruments and even if there is increasing regulation of their "trading book," they are only a part of the market. Central banks have direct influence only over banks. Central banks can only indirectly and thus not assuredly drain liquidity from the "shadow banking" system when inflationary pressures build.

Thus, for both "macroprudential" (economy-wide) reasons and "microprudential" reasons (affecting individual firms, the financial sector and specific sectors, like food and energy), the derivative

markets warrant far stronger regulation. In fact, the G20 is working to strengthen oversight of the sector and has asked the aforementioned Financial Stability Board (FSB) to undertake the technical work on this and other areas of international regulatory reform. The principal thrust of the FSB's derivatives work is to bring more transparency to the OTC markets, as by listing contracts on central repositories, trading contracts on exchanges or electronic platforms where they would be recorded, and centrally settling the trades. Other initiatives would raise the capital backing required of banks arranging non-centrally cleared contracts and setting new limits for borrowing "on margin" to purchase contracts. Besides stricter indirect regulation of the system through banking regulations, the G20 is investigating direct regulation possibilities, as well as harmonizing different national accounting practices for financial institutions.

These reforms may improve the functioning of individual OTC markets, but they do not begin to address whether some of the securities should be prohibited, restricted, left alone or encouraged. Nor are guidelines being developed that might dissuade financial innovators from devising economically and socially unhelpful products. Regulators also need to prevent "regulatory arbitrage" by observing efforts of financial institutions to move activities to less regulated markets and to use loopholes to skirt important prudential restrictions. In this light, the most sensible policy would be to set simple rules to define the simple kinds of securities that financial institutions would be allowed to issue and trade, while keeping banks in particular away from the business of creating and trading opaque and risky derivatives. As noted earlier, both to protect banks from self-destructing and to facilitate effective central bank monetary management, a policy of returning banks to their core banking functions ("boring banking") has much to recommend it.

Moreover, there are good proposals to better align the incentives of individual securities traders and senior bank executives with the long-run interests of their firms, let alone with the needs of the economy at large, as in tying compensation to longer term rather than short-term trading performance, not to mention having pay bonuses reward business success and not failure. Similarly, there are proposals to require investment banks to retain a portion of the higher risk securities they create and sell so they would not be immune from losses if the securities did not perform well.

Toward a coherent and responsible international financial "architecture"

Regulation of financial services is everywhere a national and sometimes a sub-national responsibility, which governments have to complement with policies for providing emergency liquidity. However, financial services in different countries have become so interrelated that national policy makers have increasingly promoted common regulatory standards across countries. Indeed, sometimes they must deal with insolvent financial institutions that have obligations in different countries and currencies. In addition, when the authorities in major financial centre countries need to quickly deploy a large amount of official liquidity to counter a crisis in their banking systems, cooperation among their central banks has been very useful. This is often pre-arranged by creating bilateral "swap lines," which are promises to make immediate short-term loans of official foreign exchange reserves to each other when needed. But there are more than just a few countries in the world that may be burned by financial and economic crises.

Changing IMF and its governance

Important in this context, especially for countries not at the centre of the international economy, is the International Monetary Fund. While membership in IMF gives a country automatic access to a relatively small amount of funds, the substantial loans that IMF is empowered to make usually come with policy conditions that can be arduous and even misguided, as in "pro-cyclical" demands for austerity during a recession. Policy conditions are viewed as concessions the government makes to get the money, which is not a promising way to build national ownership and effective implementation of Fund proposals. And as the conditions are typically negotiated behind closed doors between a stressed national finance ministry and Fund staff, national social imperatives need not be addressed at all, even if the political leaders at IMF headquarters establish positive general policy guidelines, as on maintaining an effective social protection floor. Probably only a significantly reformed governance of the institution can force that change.

The proposal here, however, is not to further empower the IMF, but to recreate it for a multi-polar world that increases the priority of equitable and sustainable development, along with financial stability. In particular, a new governance structure is needed to guide policy at the new IMF, one without the US veto over major decisions and without the overrepresentation of developed countries. The committees that set international policy standards in banking and other financial regulations such as have been mentioned earlier also need restructuring into representative global institutions.

Reviving the concept of an international reserve currency

In the 1960s, IMF created a multilateral reserve asset called the "special drawing right" (SDR) to supplement government holdings of foreign currencies and gold as reserves. The IMF membership created SDRs in 1970-1972 and 1979-1981, although the amounts were never more than a small fraction of country reserves. Nothing followed, however, until 2009 when, as part of the counter-crisis effort, IMF created $250 billion of SDRs and finally was able to implement a $33 billion issue that had been pending since 1997, awaiting US Congressional approval. What is especially interesting about the SDR is that it was supposed to become the principle international reserve asset, eventually replacing the US dollar and the few other reserve currencies. This was attractive for two reasons. First, it would have put the global supply of reserve assets potentially under international policy guidance, rather than depend on policy making in one or a few countries, and secondly, the "seigniorage" that accrues to countries whose national currencies are used as reserves could instead be captured for international use (roughly, seigniorage comes from the use of a national currency as international money, which allows the nation supplying it to perpetually import more than it exports). Although no SDRs have been issued since 2009, the question again arose of whether IMF might steadily emit them and whether they might come to serve increasingly over time as the principal reserve asset in a newly multi-polar world. There is much to recommend this view. If not the SDR per se, some other composite multi-currency reserve asset could be devised.

A sovereign debt resolution mechanism

The continuing difficulties in Greece (and the substantial discount at which the government's new bonds are trading) even after the holders of Greek bonds took deep losses in March of this year underlines the unsatisfactory nature of the ad hoc and highly political international process for dealing with sovereign insolvency. Corporate reorganization under court-supervised bankruptcy guided by a national bankruptcy law aims to give the firm a "fresh start" when it emerges from bankruptcy. Something building on this model, but shaped to the sovereign context, would fill a gap in the global financial architecture. A few governments have expressed interest in developing the concept of a fair, comprehensive and timely workout from sovereign insolvencies. It is time to take that nascent interest forward.

Inadequacy of the G20

When the Group of 8 upgraded the group of 20 finance ministers to a summit meeting in November 2008, it in effect added new partners to the informal "executive committee" of the world economy. Some people thought this would redirect policy making towards a more inclusive interpretation of the "global" interest. Although a number of emerging economies now have a seat at the table of power, there seems no change in the pro-financial sector thrust of regulatory policy or in international cooperation more generally. Moreover, although the G20 has broadened its mandate to include certain development and social issues, it seems to separate those concerns from the financial ones.

When the G20 heads of state first met in Washington, D.C. to respond to the global financial collapse, they set in motion a two-track process of recovery and reform. The latter embodied a host of discussions on banking and financial market regulations, some aspects of which have been touched on above. The recovery track began with a coordinated fiscal stimulus by G20 countries to overcome the crisis-driven global collapse of private demand, but also included boosting multilateral rescue funds for governments, principally of developing economies, primarily by adding to the resources of IMF and the international development banks. Thus, at its second meeting in April 2009 in London, the G20 approved mobilizing $1.1 trillion in additional resources for official support. This underlines that diverse governments can work together to meet common emergencies. However, once the fear factor lessened, the G20 seemed—like the Group of 8 before it—too much a captive of the financial interests that caused

the crisis in the first place.

The argument for making the G20 the principal forum for addressing critical economic and financial policy matters was that the economies of this group of countries account for the overwhelming majority of world output and trade, not to mention international financial flows. In that sense it is inclusive, while limiting the size of the meetings so as to reach consensus more easily. However, there are two shortcomings with this argument. One is that the views and interests of the 173 other countries in the world also merit consideration, as all the world's wisdom was not poured into only 20 countries, regardless of how large and powerful they might be. The other is that it stands to reason that superior policy will result when all relevant stakeholders have an opportunity to influence policy development. Although the rotating G20 chairs have made efforts to consult with civil society on behalf of the other members of the Group, there is little effective dialogue *within* the preparatory processes. In contrast, financial industry lobbyists have their own channels of access. Formally, policy development takes place behind closed doors among a small number of participating governments and international institutions. It seems that the forum suffers from "inbreeding" and would benefit from more open and inclusive deliberations.

A global governance body

One forum for broad political debate on the major international economic and financial reform issues is the United Nations General Assembly and its subsidiary bodies. Indeed, heads of state and foreign ministers address the United Nations annually if not more frequently. However, in truth, this forum has been unwieldy and many have been frustrated by it. As a result, there are a variety of proposals to create structures that fall somewhere between the formality and inclusiveness of the General Assembly and the exclusive and private club of the G20.

In one such proposal, the "Stiglitz Commission" called in 2009 for a Global Economic Coordination Council (GECC) at the United Nations to promote coherent and effective policymaking on global economic, social and environmental issues. Because it would need to be relatively small but representative, the Commission proposed selecting government participants through a constituency system, as is the practice at IMF and the World Bank, where countries form themselves into groups (which in fact range from one to 22 member countries) and elect one of their own to represent the interests of the group. Representatives of the major international institutions would also participate in the GECC.

Other proposals have imagined more far-reaching change. In one, for example, a limited-size global council, would operate under the guidance of an inclusive global governance assembly. Responsibilities of the council would include responding to complex economic emergencies and addressing inconsistencies in the policies of a second tier of self-governing specialized international agencies. The council might have 15 members, including large states elected for 10-year terms and small states elected for 2-year terms. Super majorities (above 50%) would be required to adopt certain decisions and in any case losing minorities would have the ability to appeal to the Global Assembly.

While proposals of the second sort are far beyond ambitious in today's global political environment, informal variations on the first proposal have already been discussed in the United Nations, where some countries see the benefit of a multistakeholder discussion forum to bring together representatives of governments, international institutions, business and civil society, for serious and frank exchanges on specific policy matters such as have been discussed here. This had been the model in the successful UN Financing for Development process, which at least temporarily helped identify and build political momentum toward a new consensus on economic and financial policies at the Monterrey Summit in 2002. Experimentation with informal and participatory forums should not be beyond what diplomats and politicians might consider, especially if they were to feel stronger political pressure from citizens to think beyond business as usual.

Conclusion and recommendations

This paper has argued that the efforts to reform the domestic and international financial systems

since the crisis erupted have been meek and partial. It is past time for deeper, structural reform, but winning that requires large-scale, sustained and multinational public pressure to squarely face down the financial forces that so effectively protect their private interests. It requires a citizens' movement that, like the earlier civil rights and anti-apartheid movements and the anti-debt Jubilee movement, rejects a world so unfair, unequal and run for the benefit of the "1%". Leadership will go to the voices proposing the most compelling vision of how the world could work better, who gets the message out most effectively to the world at large, and who is most effective in mobilizing masses of people to say, "This must stop."

One impediment to elaborating this vision is the complexity of the financial system itself, which confuses political leaders as well as the common man and woman. That complexity works to the advantage of those protecting their private interests. The answer is to understand the complexity so as to confront it and to insist that essential financial services be safe, effective and fair. Governments need to be actively involved, in certain cases providing services directly and otherwise imposing regulations, monitoring and enforcing their implementation, and punishing violators. A menu of reforms could start with the following:

Serve the "real" economy

- Protect core banking services by prohibiting commercial banks from engaging in proprietary trading and other high-risk activities, such as selling or buying credit default swaps.
- Break up banks that are "too big to fail," including by forcing such banks to divest non-bank financial services businesses.
- Strengthen prudential regulation, including by requiring an adequate capital base for banks, and strengthen oversight capacity.
- Provide fully reliable, confidence-inspiring deposit insurance systems to discourage bank runs.
- Cooperate internationally to set and enforce position limits on traders on all formal exchanges to limit commodity price volatility.
- Permit trade in financial products only if they have standardized contracts and trade on formal exchanges with central clearing.
- Extend strong prudential oversight over "shadow banking" activities of any bank, investment bank or brokerage firm by requiring licenses and regulatory standards (such as capital backing) to sell or buy regulation-approved non-bank financial instruments.

Serve the people

- Protect retail customers by disallowing dangerous and unfair financial practices.
- Promote financial literacy through full disclosure and education.
- Boost access of the poor to basic financial services through either direct public provision (e.g., postal savings) or socially oriented financial service providers (e.g., credit unions).
- Strengthen the social protection floor through public programmes (e.g., unemployment insurance, health care).
- Assess the likely impact of a new financial instrument before it is sold to the public, considering whether the innovation serves a purpose that society supports or not.
- Introduce a financial transaction tax to more fairly mobilize tax revenues for financial rescues and to fund global social needs.

Coherent and responsible international guidance

- Replace the Group of 20 with a Global Economic Coordination Council of government leaders selected to represent regional constituencies to oversee the global economy and its trade and financial systems.
- As an interim step, create an informal forum to bring representatives of governments, multilateral institutions, private sector and civil society together to build consensus on financial policy reforms that serve society.
- Create a comprehensive, fair and transparent sovereign debt restructuring mechanism.
- Recreate the International Monetary Fund as a democratic and transparent forum for international financial stability, and equitable and sustained development.

- Ultimately replace the dollar-based international monetary system with one based on an international currency, such as the SDR.

Annex: Core financial services for modern economies

Frustration with financial system failures and iniquities might lead citizens to call for cancelling all debts, closing financial markets and nationalizing all banks. While this might have a certain emotional appeal, the fact is modern economies need a vibrant financial sector to deliver core financial services. As this does not include everything the financial system does, it may be useful to specify which financial services are in the core.

Payments: The network of commercial banks in a country and specialized clearing houses operate its payments system, which is the way that firms, the public sector and in developed countries most households pay for goods and services purchased. Payments across borders are a step more complicated as currencies must be exchanged, which again usually involves commercial banks and certain specialized international institutions. Only a small percentage of payments are on a cash basis.

Short-term credit: Businesses and the government need short-term credit to operate, most of which is traditionally provided by banks. Businesses need to advance wages and pay for inputs before receiving revenue from sales. Also, governments may receive tax revenues in quarterly surges but have to make expenditures smoothly during each quarter, and as a result will borrow short-term, as by issuing treasury bills (T-bills) in anticipation of tax revenues. Banks typically are happy to buy, hold and trade these government debts, as they need to maintain a supply of highly-liquid short-term assets to balance against normal withdrawals from their short-term liabilities (deposits). Similarly, they are popular with other financial institutions.

Long-term lending and equity investment: Longer-term credits are also essential, ranging from bank loans to purchase new industrial or farm equipment to mortgages to finance purchase of houses to government bond issues to pay for large infrastructure projects, such as bridges or dams. Governments also borrow to cover a temporary shortfall of tax revenues or when undertaking a "counter-cyclical" fiscal stimulus to fight off an economic recession. While banks and non-bank financial institutions provide much of this financing, a large amount involves issuance of securities such as bonds and equity shares. "Investment banks" traditionally advise companies seeking to issue bonds or shares of stock and underwrite them (bring them to market). However, most trading on securities markets is of already existing securities, as one attraction of buying them is the ability to sell them. Large numbers of traders are needed to make a securities market liquid, which is why the market managers must give convincing assurances that the prices are not manipulated and that the market is not prone to collapse. Investors (traditionally, insurance companies, pension funds, foundation or university endowments, banks and rich individuals) must feel confident that the markets are transparent and fair. Hence, violators go to jail. In addition, the financial system usually contains "brokerage firms" that specialize in representing buyers and sellers of securities (although today it is common for each class of financial institution to also offer the services traditionally offered by the others). While face-to-face trading and trading over telephone calls in some specialized markets are still common, human traders are increasingly being replaced by high-speed electronic platforms that match buy and sell orders in virtual markets.

Insurance: A fourth essential service is insurance, wherein a financial institution pays a promised sum on the occurrence of a specified event (e.g., fire, death, sickness). The insured pays a periodic "premium" for this service. Insurance can operate as a private business when the probability of the risk being insured against can be reliably estimated and is predictable (such as life insurance based on mortality tables), and when the number of clients is large enough that a reasonable premium charged to the insured will cover the cost of running the firm and paying the expected number of claims. Government involvement of some sort is required for other forms of insurance (e.g. flood damage). Because insurance companies collect premiums over time from customers to use when an insured event happens, they build up large funds for investment.

Savings instruments: People want a safe place to place their savings and they often appreciate the discipline of contractual savings plans, like pensions. Savings are also the essential counterpart to the credit that the financial system provides. The financial sector typically offers a range of saving and investment opportunities for individuals and firms that have funds in excess of current needs or are being put aside for longer term goals (weddings, funerals, children's education, retirement). Banks and financial institutions that are like banks (credit unions, building societies and savings banks) are meant to provide safe and convenient places to hold such surplus funds. The securities industry invented "mutual funds" as a way for investors of modest means to buy shares in a fund that itself invests in a portfolio of securities that individuals without great wealth could not match on their own. "Money market" mutual funds were introduced as a special category that is closest to bank accounts, although they have no government guarantee, unlike a bank deposit. They are issued by regulated securities companies and are invested in diversified and large pools of short-term credits. The money market funds heavily depended on investor confidence in their soundness, which was not challenged until the 2008 crisis. They are still popular, but it would be a stretch to call them essential.

Pension funds: Most financial sectors typically contain a specialized savings institution, the pension fund, which helps individuals save for retirement, usually complementing regular payments by employers. Pension funds receive contractual savings payments over a long period from clients, building to a substantial lump sum to convert to an "annuity" at retirement, which is a financial contract that would pay the client a particular amount per year for the rest of his or her life or for a preset number of years. Traditionally, pensions have been structured so that the payments over the employee's working life would build to a target sum sufficient to provide a promised retirement income, usually based on years of service and salary (often as a fraction of the earnings in the last few years before retirement). It has been the responsibility of the pension fund manager to invest the savings wisely and to arrange with the employer that sufficient payments are made into the fund over time to meet the promised retirement benefits. The shift from such "defined benefit" to "defined contribution" pensions in some developed countries transfers the risk of insufficient pension accumulation to the saver, a risk that was not theoretical, as the stock market collapse proved in 2009.