THERE IS SOMETHING WRONG WITH OUR GLOBAL FINANCIAL SYSTEM...

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«The worst seems to be over,» according to the Bank for International Settlements, «but the world economy may not be out of the woods yet. The overhang of productive capacity raises the spectre of deflation while potentially worrisome divergences in economic performance remain among countries. Risks also hover round the financial markets, where large movements of funds generate the potential for violent downswings».
Given this climate of uncertainty, the need for policy initiatives towards both macroeconomic and financial stability becomes extremely urgent.

GLOBAL FINANCIAL CRISES

Since the collapse of the Bretton Woods system, increased global capital mobility has been accompanied by an increased frequency of financial crises in both developed and developing countries. These have taken various forms: domestic crises affecting the banking sector and/or the financial market, currency turmoil and external debt crises. Experience shows that in developing countries, domestic financial crises often translate into currency turmoil, payment difficulties and even external debt crises. Similarly, reversal of external capital flows or attacks on currencies almost invariably threaten domestic financial stability in developing countries. By contrast, currency turmoil in industrialised countries does not usually spill over into domestic financial markets, nor do domestic financial disruptions necessarily lead to currency and payment crises. External indebtedness, together with the dollarisation of the economies in the South, accounts for much of this difference.

Even if each crisis in the developing countries holds specific factors, there are some common lessons that we can draw:

- Financial deregulation and capital account liberalisation appear to be the best predictors of crises.
- All episodes of currency instability have been started by a sharp increase in capital inflows followed by an equally sharp

ANATOMY OF THE CURRENT INTERNATIONAL FINANCIAL SYSTEM

1. Modern financial markets are organised less to create wealth and employment than to extract rents by buying and selling existing assets, and the discipline that these markets exert on policy–makers reinforces the position of existing wealth holders.
2. Instability is a systematic feature of financial markets. A factor that has added to the intensity of financial crises is the rapid increase in the leverage of global finance. This has enhanced its potential to generate exaggerated boom–bust circles by creating destabilising linkages among various markets and adding to the herd behaviour of investors in lending as well as exiting.
3. Financial instability is a major reason for slow and erratic growth in the global economy. Slow growth, greater job insecurity and income inequality associated with financial instability could lead to political backlash, creating conflicts in international economic relations and encouraging *ad hoc* and irrational restrictions on global economic integration.

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reversal. Such swings in these flows are related to internal or external policy changes that produce large divergences in domestic financial conditions relative to those of the rest of the world. Reversals of capital flows are often, but not always, associated with a deterioration in the macroeconomic conditions of the recipient country. Such deterioration often results, however, from the effects of capital inflows themselves, as well as from external developments, rather than from shifts in domestic macroeconomic policies.

- Financial crises tend to be associated more closely with certain types of financial flows and certain classes of lenders and borrowers.

THE EAST ASIAN CRISIS AND THE WORLD ECONOMY

In less than a year from mid–1997 to mid–1998, the East Asian economies went from being examples of the most successful development experience in modern history to economic stagnation and decline. Economic growth rates that had averaged 8–10% *per annum* over many years turned negative; economies that had enjoyed high employment and experienced labour shortages suffered and still suffer from extensive and rapidly rising unemployment. Assets stock markets lost half their value and more. In much less time than it took the 1929 stock market crash to turn into the Great Depression of the 1930s, the Asian economies that were once reputed as having exemplary and sustainable economic policies, were transformed into systems incapable of formulating their own economic policies. Never has the economic outlook for such a large group of economies changed so radically and so rapidly.

The crisis that began in East Asia is yet another episode in a series of crises that have been occurring with increasing frequency (at roughly two–year intervals) since the breakdown of the Bretton Woods arrangements and the liberalisation of capital movements. Such crises have occurred under diverse macroeconomic and institutional set ups: with budget deficits (Russia) or without budget deficits (Mexico and East Asia); with private borrowing (East Asia) or public borrowing (Russia); or when exchange rate stability was part of a strategy of export promotion and attracting foreign capital (East Asia). ***They have occurred with or without prudential regulations, with or without high corporate leverage, and as much in countries organised under the Anglo–Saxon model as under the Asian or German model.***

The curtain rose on the first act of the East Asian crisis in early July 1997, when the bank of Thailand withdrew support for the baht (the country's national currency), allowing it to move outside its exchange rate band with the dollar, a step soon followed by the other countries in the region. Instead of creating expectations of improved competitiveness and payment adjustment needed to sustain rapid growth, however, the shift to floating exchange rates triggered massive out–flows of capital throughout the region, driving equity prices and currencies down to record low levels. Economic damage usually associated with war or natural disaster was caused when an exchange rate adjustment was transformed into a virulent disease that infected the entire region with financial panic.

CONSEQUENCES OF THE FINANCIAL CRISIS

The adverse effects of the East Asia crisis have so far been felt primarily by developing countries. Economic growth in the South in 1998 fell below that of the North for the first time in many years. Monetary tightening to maintain market confidence has been a major reason for slowdown in most emerging markets. But this has not prevented contamination; spreads on emerging–market bonds have risen to unprecedented levels. The crisis has also had a major impact on commodity prices, which have fallen to their lowest levels for more than two decades. Thus, the crisis has also hit the poorest developing countries that are typically by–passed by international capital flows.

The risk of a global recession cannot be underestimated; no country can remain an oasis in a contracting and unstable global economy. The combination of recession, financial instability, exchange rate misalignments and growing trade imbalances among the major industrial countries is a recipe for the disruption of free trade. This can be very damaging, particularly for developing countries. There are already signs that a trend towards protectionist pressure is building.

The fact that there is no simple solution represents a dangerous state of affairs. The backlog of financial difficulties cannot easily be tackled by macroeconomic policies alone. But policy inertia can allow the situation to worsen considerably. ***Averting the risk of a global recession depends on actions by the US and especially by the surplus countries, the EU and Japan. These are not normal times; conventional policies designed for fine–tuning may prove inadequate.*** Bold action is needed to avert the risk of global recession.

PREVENTION AND MANAGEMENT OF FINANCIAL CRISES

1. ***Transparency and information.*** There is some ambiguity as to who should know what and for what purpose. From one point of view, markets should know more about what governments are doing in order to avoid bad investment and lending. From another, governments need to know more about what the markets are doing in order to take action and prevent instability. According to a third view, the International Monetary Fund should know more about what both markets and governments are doing in order to carry out effective surveillance. Yet, from another view, IMF has to be reformed toward more transparency and democracy in its decisions, consultations and programmes.

   Certainly the value of information is what you make of it and how you act on it. Good information is useless if ignored or wrongly interpreted. The emphasis on the ignorance of lenders about the weaknesses of East Asian borrowers is grossly misplaced and exaggerated. Rather, there was inadequate evaluation of the available data, including that in the periodic reports of the Bank for International Settlements. Again, much of the increase in the external financial exposure to Russia took place during a period when the country was under an IMF programme and when information was widely available on the shortcomings of Russian macroeconomic policy and on the weaknesses of its banks, legal and regulatory framework and corporate governance. Some observers, including UNCTAD, could foresee the Mexican crisis not because they had access to better data, but because they interpreted differently the widely available information. The experience thus raises serious questions as to the effectiveness of enhanced transparency in influencing the behaviour of international lenders and investors, or improving multilateral surveillance, unless there is a fundamental change in the international approach to finance.

2. Given the degree of integration of financial markets, ***global surveillance*** of national policies is essential for the prevention of crises. It needs to be even–handed, however, recognising that financial crises are not always home–grown, and that they are typically connected with large shifts in foreign exchange rates and interest rates of the major industrial countries. But there is no effective surveillance in these areas and no way of preventing «beggar thy neighbour» policies affecting key monetary and financial variables. Moreover, there is no mechanism for dispute settlement for macroeconomic and financial policies, such as exists for trade policies. Addressing these issues requires a major reform of the global monetary and financial system, so to ensure a better governance and greater representation and participation of weaker countries.
3. ***Prudential regulations.*** Their strengthening can certainly contribute to greater financial stability, but on their own they are insufficient to prevent crises. Moreover, serious weaknesses exist not only in financial supervision in developing countries, but also in the regulatory framework for cross–border lending and investment in countries that are the source of such flows. There are various proposals for global regulation of international lenders and investors, but they have little chance of implementation because of lack of political will.
4. About ***the exchange rate system***, given the size and speed of financial capital flows, no system can ensure stability. Target zones between the dollar, yen and euro are impracticable unless currency trading is brought under control. It is unlikely that the US, EU and Japan could achieve the kind of convergence and monetary cooperation needed for such an arrangement to work: the 1992–93 EMS (European Monetary System) crisis holds valuable lessons in this respect. Thus the immediate question is not the exchange rate regime, but the international financial system as a whole.
5. With regard to ***capital controls,*** until appropriate global checks and balances are in place, the task of regulating capital flows must fall mainly on the recipient countries. There exist a number of proven techniques to control capital flows, which developing countries can use to protect their economies against international financial instability, such as Chile and Malaysia experienced.
6. With reference to ***crisis management,*** the international community faces a major dilemma in formulating policies towards international capital flows. In the absence of capital controls, financial crises are likely to be increasingly frequent, severe and extensive. When a crisis occurs, defaults are inevitable in the absence of bail–outs. But bail–outs are becoming increasingly problematic. First, they protect creditors from bearing the responsibility of poor lending decisions, thereby putting the burden entirely on debtors. Second, because they tend to encourage imprudential lending practices. More importantly, the funds required for bail–outs have been getting larger and are now reaching the limits of political acceptability.

A way out of this impasse would be to turn to the principles of orderly debt exercises along the lines of chapter 11 of the US Bankruptcy Code, in particular its principle of an «automatic standstill». A country facing an attack on its currency should have the right to impose a unilateral standstill. This would be similar to the safeguard action foreseen under the GATT (General Agreement on Trade and Tariffs) rules where a country has the right to impose restrictions on its external trade when this is damaging its economy. The unilateral standstill decision could be subject to an independent panel whose sanction would give it legitimacy.

Such a standstill mechanism should be written into the rules and conditions governing international contractors so that lenders and investors know in advance that they may be locked in, should a financial panic develop and a country's currency come under attack. This should promote a better assessment of risks, eliminate moral hazard, and reduce purely speculative short–term capital flows to emerging markets. It would also eliminate the need for large–scale bail–outs. It could be combined with the IMF lending into arrears to provide liquidity needed for the economy's functioning during the renegotiation of its debt. This mechanism would contribute to a more equitable allocation of the cost of a crisis between lenders and borrowers, and allow the country breathing space to design and negotiate an orderly debt re–organisation plan. Such an approach could help both lenders and borrowers, and also promote greater stability.

TOWARDS AN NGO AGENDA ON REGULATION OF FINANCIAL MARKETS

In recent years, we have witnessed increased interest in financial issues by civil society both in the South and in the North. A common request expressed by citizens is for governments to intervene in their economy in order to prevent crises and to limit their most devastating consequences. In addition, civil society asks governments to design and implement specific measures at national, regional and international levels to control negative phenomena occurring in the world economy, such as financial speculation.

The issue of financial speculation is often associated with financing development. In fact, those concerned with financial instability, speculation and financial crises are also concerned with the lack of resources for addressing the current global problems, such as poverty, social exclusion, environmental degradation, peace and security.

A Tobin–Type Tax

Since the Copenhagen Summit for Social Development and the G7 Summit in early 1995, the idea of the Tobin tax, developed during the 1970s as a tax on foreign–exchange transactions, has found its way back into the international policy debate. At both events, proposals were put forward to impose a tax on international short–term flows. The purpose of the tax is to prevent speculative transactions while at the same time providing a source of revenue.

A Tobin–type tax could:

- reduce short–term speculative currency and capital flows;
- enhance national policy autonomy;
- restore the taxation capacity of nation–states eroded by the internationalisation of markets;
- trace movements of capital.

In the 1990s, two additional facts sharpened interest in Tobin's proposal and its variants:

1. ***the huge growth in foreign exchange trading*** to about US$1.8 trillion per day and the corresponding increase in currency instability, such as the series of financial crises clearly show. Between 1975 and 1994, the global turnover in currency markets multiplied 80 times, compared with a world trade increase of two–and–a–half times.
2. ***the lack of resources in development cooperation,*** since the tax could generate substantial sums, the idea has attracted the attention of those concerned with financing development cooperation. Depending on the formula, the Tobin tax revenues could generate between $150–300 billion annually. The UN and the World Bank estimated in 1997 that the cost of wiping out the worst forms of poverty and providing basic environmental protection would be about $225 billion *per annum.*

What is a «Tobin–Type Tax»?

The tax is essentially a very small levy of 0.1–0.5% on all currency deals. The greater the frequency of transactions, the higher the effective tax rate. This reduces short–term transactions while not inhibiting international trade, long–term capital flows, or currency price adjustments based on changes in the real economy. The tax would help avoid the crises that have affected both industrialised and developing countries, with particularly acute social consequences in the latter, and will stimulate productive investment and therefore growth. It has the additional advantage of being a levy on a sector that is relatively under–taxed at present.

The advocates of the tax understand the complexity of the issue and the perfectibility of such a proposal, but the proposal itself has a great symbolic value. If a Tobin–type tax is put into operation, governments must of necessity take a more active role in the financial market system, acting not alone but also in a co–ordinated manner with other governments.

In addition, such a tax would give to national governments and to international bodies such as the United Nations, financial resources that could be used to address poverty eradication, along with other objectives at the core of the Copenhagen Plan of Action monitored by Social Watch.

Unfortunately, there is no single or simple answer to current economic problems. This is why the proposal of a Tobin–type tax should be seen as a first step in the framework of a set of recommendations for both policy and institutional reform. As in any other challenge, however, the first steps are always the most difficult.

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