De-financialization requires global economic governance reform

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Financialization has been described as the "process whereby financial markets, financial institutions and financial elites gain greater influence over economic policy and economic outcomes".[1] This means not only does the over-sized role of the financial sector in the global economy make us vulnerable to frequent crises, but also that the economy is not equipped to deliver the broad-based and sustainable prosperity that is needed to meet the SDGs. Instead, inequality is the defining feature of the age. According to Credit Suisse, over 85 percent of the world's wealth is owned by less than 10 percent of the adult population,[2] and according to IMF researchers, "the share held by the 1 percent wealthiest population is rising at the expense of the bottom 90 percent population".[3]

What can be done to rein in the power of finance and global elites and gear global, regional and national economies towards meeting the needs of all people? Some solutions will be outlined below, but first we need to understand the nature of the global financial system, and the global monetary system that underpins it.

Financial crisis management has not fixed underlying problems

The main thing to note about the financial sector reforms undertaken by the Financial Stability Board (FSB) and related institutions at the behest of the G20 after the 2007-2009 global financial crisis is that they have not fixed underlying problems, and the risk of further financial and economic crises remains high. Three key points are worth highlighting:

First, the non-bank financial sector – which is very lightly regulated – continues to grow. As the FSB notes, "non-bank financial intermediation, including by insurance companies and pension funds, has grown in several advanced economies .... and [Emerging Market and Developing Economies] since the crisis, and now represents more than 40% of total financial system assets."[4] The FSB's 'narrow measure' of shadow banking, focusing on activities "that may give rise to financial stability risks" grew "to $34 trillion in 2015 … equivalent to 69% of GDP" of the 27 jurisdictions studied.[5]

Second, efforts to fix 'too big to fail' banks have not focused on actually stopping bank failures from causing system-wide problems. Instead they have centred on reducing the risks of this by increasing their ability to shoulder losses, and by improving regulators' mechanisms for resolving insolvencies to prevent problems of one institution (or several) spreading around the system. However, IMF staff have estimated that "the balance sheet size of the world's largest banks at least doubled, and in some cases quadrupled, over the 10 years prior to the financial crisis… [and] their size has been relatively stable since".[6] This is problematic, as the same paper notes that large banks have "lower capital, fragile funding, more market-based activities, and more organizational complexity" than smaller banks.[7]

Third, private debt levels have risen to record levels: Global debt hit a new record high of US$ 164 trillion in 2016, the equivalent of 225 percent of

1 Palley (2007).
2 Credit Suisse Research Institute (2016).
3 Dabla-Norris et al. (2015), p. 15.
4 Financial Stability Board (2017b), p. 33.
5 Financial Stability Board (2017a), p. 3.
6 Laeven et al. (2014), p. 7.
7 Ibid., p. 8.

global GDP - 63 percent of which is nonfinancial private sector debt.[8]

In summary, ten years after the global financial crisis, we still live in a highly leveraged global economy backed by an under-regulated financial sector in which many institutions could still threaten the system's stability if they were to go under. Further global or major regional financial crises should therefore be expected: the question is when, rather than whether.

However, unlike the last crisis, it is possible that the next crises may hit developing countries first or hit them much harder than did the last crisis. As the FSB notes, "the financial crisis has slowed down, but not reversed, the long-term trend toward higher global financial integration",[9] and developing countries have become increasingly vulnerable to external financial markets and actors. Private capital flows to developing countries have been driven by the external economic situation and the policies of other countries, in particular low interest rates and quantitative easing policies in the developed world, which have encouraged capital to flow to developing countries in search of higher yields. At the same time, there has been a "significant increase in the presence of foreign investors and lenders in domestic financial markets of [developing countries] as well as the presence of their residents in international financial markets, rendering them highly vulnerable to global boom-bust cycles generated by policy shifts in major financial centres".[10]

8 See: https://blogs.imf.org/2018/04/18/bringing-down-high-debt/.

9 Financial Stability Board (2017b), p. 34.

Structural problems in the global monetary system

It is important to understand, however, that these problems of the global financial system do not just arise because the financial sector is under-regulated and has in many cases escaped the bounds of national or regional regulation; they are also rooted in problems of the global monetary system.

15 August 1971 marks the day of the 'Nixon shock' – the day the US President unilaterally announced that dollars were no longer convertible into gold, effectively ending the Bretton Woods system of international monetary cooperation that had, after World War II, helped ensure the longest and most equitable sustained period of global growth in human history. The Bretton Woods system had been creaking long before that date, of course. Built around the US dollar, it became increasingly untenable as the USA's enormous post-war current account surplus crumbled and it became a major deficit country. One key feature of the Bretton Woods system, however, was that it required cross-border flows of finance to be heavily regulated by governments, in order for them to manage their exchange rates within tight bounds. Gradually it was replaced by a new way of thinking that favoured exchange rate flexibility, which would suggest the reverse: governments should not attempt to control, restrict or influence the 'free' movement of international capital.

10 Akyüz/Yu (2017), p. 17.

Since the collapse of the Bretton Woods system in the 1970s, the international monetary system has been prone to significant swings in exchange rates. The current international monetary framework is not really a 'system' at all; it has evolved haphazardly since the early 1970s. Though exchange rates are often described as 'freely floating' there are in practice a wide variety of different arrangements in place. Some countries peg their currencies to a hard currency such as the dollar or a basket of currencies, but this means of course that their macroeconomic frameworks follow that of another country, which can build up significant problems, as Argentina discovered at the beginning of this century. In reality, the size of the foreign exchange market, which dwarfs global GDP, means that government efforts to manage exchange rates can always come unstuck.

This has meant that exchange rates can be highly volatile, which can be very damaging for developing countries. This level of volatility creates significant risks, particularly for the poorest countries, making macroeconomic planning difficult, and adversely affecting investment, as investments which could be profitable with stable exchange rates may become unprofitable when risks are accounted for, or may be avoided by risk-averse investors. Exchange rate volatility also increases debt and balance of payments risks, as devaluations increase the cost of servicing foreign debt, and make imports more expensive.

Without controls on capital flows, persistent trade imbalances are a major feature of the system, making it more unstable. Risks have altered in recent years. The slowdown in world trade and the collapse in commodity prices have contributed to developing countries switching from a consistent current account surplus in recent years, to a deficit in 2015, which reached close to US$ 100 billion in 2016. This contributes to the rising debt levels that we have noted, as this deficit is normally financed by capital imports: by borrowed money.

The fact that the dollar is the global reserve currency exacerbates these problems. The dollar's central role allows the USA to borrow cheaply and to continue borrowing indefinitely, as it can always 'print more dollars'. This means that American monetary and fiscal policy decisions impact the rest of the world. For example, the value of the dollar has a significant impact on commodity exporters as "most commodities are priced in dollars and most commodity contracts are settled in dollars".[11] In addition, there can be enormous systemic risks arising from the dollar's position. The huge scale of borrowing by the US government, financed in large part by China and other emerging countries eager to buy US securities to build their reserves in the decade before the global crisis, allowed the US government to maintain low interest rates, fueling the disastrous private-sector borrowing bubble that was one of the key causes of the crisis.

The monetary policies used in response to the crisis have also created issues for financial markets that may cause significant problems in the future. For example, they have pushed the interest rate for government debts into negative territory, affecting pension funds that buy most of these assets. This may be one reason why so much attention has recently focused on how to help such actors invest more in developing countries, even though this strategy does not have a strong development rationale, particularly for low-income countries, and would connect developing countries even further to unstable international capital markets.

As a consequence of all these risks, developing countries have been transferring funds to developed countries on an enormous scale, to build reserves, to manage their exchange rates and to protect themselves against future crises arising from the global monetary and financial system. This has largely taken the form of buying assets in developed countries, and "in the first quarter of 2016, 64 percent of official reported reserves were held in assets denominated in US dollars".[12]

Ambitious reforms are needed

It is clear that efforts to reform the global monetary and financial system must have far higher ambitions if the risk of another major global or regional crisis is to be averted.

The system of global economic governance is not working well enough to deliver on the SDGs, in large part because developing countries often have a limited role in, or are excluded from, decision-making in this system. In the aftermath of the global financial crisis, there were numerous calls for a 'Bretton Woods 2' conference to redesign the system to prevent global crises in the future. This would still be merited, but the political will generated by the last crisis did not prove sufficient, and it may unfortunately take another crisis before sufficient momentum gathers behind an ambitious global redesign of the monetary and financial system.

In the meantime, supporting the G77 to lead a push for major

11 Akyüz (2017), p. 3.

12 United Nations (2017), p. 74.

reforms before or at the next UN Financing for Development conference will be critically important. A major programme of reform is needed, but it is worth highlighting two key recommendations that are of prime importance and give concrete examples of the kind of work that needs to be done.

First is the establishment of an intergovernmental tax body under the auspices of the UN, with the aim of ensuring that developing countries can participate equally in the global reform of international tax rules.

Second is the creation of a Debt Workout Institution within the UN system, independent of creditors and debtors, to facilitate debt restructuring processes. Only by (a) filling the major gaps in the international governance architecture, and (b) ensuring that developing countries have a major role within governance institutions, and that they are transparent and accountable, can we hope to undertake the major reforms to de-financialize the global economic and financial system necessary in order to prevent and resolve future crises.

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