Indian Council for Research on International Economic Relations (ICRIER)
In conjunction with Brussels European and Global Economic Laboratory (Bruegel) and CEPII

International Cooperation in Times of Global Crisis: Views from G20 Countries

Keynote Address:

The Political Consequences of the Economics Profession: G20 and the Emerging Markets

By

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Your Excellency Governor Dr. Bimal Jalan,
Distinguished Guests,
Ladies and Gentlemen,

I am very honoured to be invited once again to New Delhi by ICRIER, Bruegel and CEPII to join this luminary conference on "International Cooperation at Times of Global Crisis: Views from the G20 Countries". When I was last here in February, the world was still deep in the throes of the financial crisis. Since then, the crisis has entered into the damage control and reform phase, with first signs of economic recovery and an intense debate about necessary policy and institutional reforms. My sincere thanks therefore to Isher and Montek Ahluwahlia and Rajiv Kumar for an irresistible invitation to New Delhi to express some personal views on what emerging markets should do in G20.

In the Third Lall Memorial Lecture[2], the causes of the current global crisis were attributed to four mega-trends of wage arbitrage, interest rate arbitrage, knowledge arbitrage and regulatory arbitrage that led to the four excesses of liquidity, leverage, risk-taking and greed.

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[2] Andrew Sheng, *From Asian to Global Financial Crisis*, Third Lall Memorial Lecture, ICRIER, New Delhi, February 2009.

On further reflection, our collective failure to prevent the global crisis had four blind spots – first, the failure to have a historical perspective that financial crises have become a hardy perennial, increasing with volatility and frequency. Second, we failed to have a macro-system-wide perspective that global imbalances, loose fiscal and monetary policies and lax financial regulation were unsustainable. Third, we failed to examine the micro-institutional incentive structures that drove financial leverage to generate profits for private greed at massive social costs. Fourthly, after looking in dismay at the hasty reforms and reflation packages introduced, I have realized that there is a deeper and darker cause to how we arrived at where we are today. Our academic and professional training have become so specialized and compartmentalized that we ignored the truly big political economy issues of our times: social inequities, political capture by vested interests, global warming and other complex factors that affect financial stability.

Finance is a derivative of the real economy that amplifies growth through leverage, accumulating unfortunately higher non-linear risks. In this lecture, I ask the political question of who benefited most from the mega-trend of rising leverage which has been evident in global finance since the 1980s from one time GDP to nearly four times, on the conventional measure[3], and 12 to 16 times if you include derivatives. What is clear is that the shareholders of the financial institutions lost, the taxpayer lost and the real sector employees of non-financial institutions have also lost through higher unemployment.

Who gained was the top management of the financial institutions, who took a larger and larger share of the profits on the pretext that they were creative financial engineers that helped society manage risks. They did this on the basis of a free market economic philosophy that allowed unfettered finance to brew the largest crisis in the last 70 years, intellectually supported by complex finance models that were blind to long-tail Black Swan risks. Openly and with tacit permission from that ideology, the agents have taken over much of the rights of the principals.

In other words, it is the political consequences of the economics profession striving to make economics a quantitative science that did not add up. Some of you may recall that I observed that the American dream, where everyone can have whatever they desire, might be true for a small group of Americans, but certainly our fragile world cannot sustain the resource demand if every Indian, Chinese, Asian, African and Latin American were to live at the same American per capita standard of consumption. We need to ask the right questions before we can come up with the right answers.

My intention today is not to take on the economics profession, because Nobel Laureate Paul Krugman has already stated much more authoritatively that "*much of the past 30 years of macroeconomics* "*was spectacularly useless at best, and positively harmful at worst.*" My intention is to look at what emerging markets should do for themselves within the remit of G20 and see whether collectively, the

[3] Total banking assets, stock market capitalization and bond market size, divided by GDP. See Appendix Table 3 of IMF Global Financial Stability Report, various issues for explanation. See Sheng (2009), Figure 13.1 on the unstable pyramid of global leverage.

world can address the important issues of our times, rather than pretending that some of us can still enjoy unfettered prosperity and pass the consequences to future generations.

Why didn't we see it coming?

In November 2008, Her Majesty Queen Elizabeth II asked the simple but obvious question: Why had nobody noticed that the credit crunch was on its way? The august British Academy replied in their letter of July 2009 as follows: "*the failure to see the timing, extent and severity of the crisis and to head it off, while it had many causes, was principally a failure of the collective imagination of many bright people, both in this country and internationally, to understand the risks to the system as a whole.*[4]"

There are three possible answers to these excuses of very bright people – first, it was truly an unknown unknown, but that ignores the obvious fact that recent history witnessed repeated financial crises and that Cassandras such as Nouriel Roubini and William White at BIS were warning in 2005/2006 about the unsustainability of the asset bubbles forming. No one in authority paid serious attention.

The second excuse was that the present methodology of analysis is faulty. But the physicists and other social science had been arguing for years that the economic profession was using outdated tools that ignored the human factor, again with little impact.

The third is the possibility that the whole regulatory system was captured by the financial industry, both in ideology and as custodians of public savings and pensions, holding society to ransom. By capture, I mean that everyone was so captivated by the heady brew of unending prosperity promised by the financial engineers that they forgot to take away the punch-bowl. It has never been easy for any individual leader to stake personal reputations on the line to stop the gravy train heading for the inevitable crash. Unfortunately, the dustbin of history contains many tarred reputations of leaders who acted conventionally with unconventional consequences.

In the last eight months of 2009, there has been a flurry of major studies on the crisis, recommendations and also national proposals for regulatory reform. These would include the G30, the Geneva, De Larosiere and the UN (Stiglitz) Reports[5]. At the national level, the US Treasury, the European Commission and UK have also

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[4] British Academy, Letter to Her Majesty the Queen, 22 July 2009, London.

[5] These include: Group of Thirty Report on Financial Reform, www.group30/pubs/reformreport.pdf, January 2009;
Geneva Report No. 11, Fundamental Principles of Financial Regulation, March 2009, www.voxeu.org/index.php?q=node/2796;
The de Larosiere Group, Report on Financial Supervision, February, 2009, www.ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf;
The Turner Report (March 2009) www.fsa.gov.uk; UN Commission of Experts (Stiglitz Report) on Reforms in International Monetary and Finance Systems, March 2009.
US Treasury, Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation, available at www.treas.gov.

issued major consultation reports for reform that are under varying stages of legislative approval. I find that the most perceptive critique of the proposals is that of Chicago Professor Richard Posner who made his reputation on the law and economics of regulatory capture, arguing that over time, regulatory agencies come to be dominated by the industries regulated. Professor Posner thought that the US Treasury's proposals for regulatory reform were premature, because "it advocates a specific course of treatment for a disease the cause or causes of which have not been determined[6]". Amongst the causes omitted include the errors of monetary policy, large annual fiscal deficits, deregulation movement in banking industry, "regulators were asleep at the switch", and "complacency of and errors by the economics profession."

Posner also thought that "plans for reorganizations are cheap and visible, and plans are the easy part; it is at the stage of implementation that government falls down...the reorganization usually fails, because of inertia, turf warfare, passive resistance and lack of follow through, leaving in its wake more bureaucracy."

In other words, this is not just a financial crisis, but also a crisis of governance. As the Growth Commission led by Nobel Laureate Michael Spence has noted, global governance is challenged by the growing magnitude and scope of interdependence versus our collective capacity to coordinate regulatory and policy responses. The challenge is not just of policy, but our ability to execute and implement global solutions, when the world is fragmented into national compartments, and national implementation is further divided into silos of departmental turf wars. At the heart of the problem is Bank of England Governor Mervyn King's lament, "global banking institutions are global in life, but national in death."

Finally, we have brought institutions into the centre-place of the on-going policy debate. All policy debates are intellectually interesting but effectively useless if they are badly implemented by the bureaucracy or unimplementable because of institutional deficiencies, such as vested interests. The reality is that we do not have as yet global bureaucracies that are effective, because most policies are implemented at the national or local level that are often contradictory and inconsistent at the global level.

The Crisis of Economic Thought

There is a common thread linking all post-mortem studies of the current crisis – that we lack a system-wide view, culminating in the new term "macro-prudential supervision", as if such a new cliché would help all financial regulators. Any single-dimensional solution obviously forgets that the problem with financial markets is that they are highly complex, concentrated, inter-connected, inter-dependent, interactive with complex feedback mechanisms and the distinctive feature is that all players are gaming the system[7]. Such gaming may lead, as we all know through the work of

[6] Richard Posner, The President's Blueprint for Reforming Financial Regulation: A Critique, Parts I and II, Lombard Street, July and August 2009, at http://www.finreg21.com/print/15439 and 16902.
[7] Andrew Sheng (2009), *The first Network Crisis of the Twenty First Century: A Regulatory Post-Mortem*, Economic and Political Weekly, India, Special Issue on Global Financial and Economic Crisis, March.

political scientist Mancur Olsen, into a "race to the bottom" or a collective "Tragedy of the Commons", where individual greed without the ability to arrive at collective public good solution, leads to the destruction of the common good. Unless G20 is able to come up with solutions to break this vicious circle, we may end up with the "beggar-thy-neighbour" policies of the Great Depression.

As early as 1982, University of California physicist and system scientist Frithof Capra had argued that current problems are "*systemic problems, which means that they are closely interconnected and interdependent. They cannot be understood within the fragmented methodology characteristic of our academic disciplines and government agencies….a resolution can be found only if the structure of the web itself is changed, and this will involve profound transformations of our social institutions, values and ideas. As we examine the sources of our cultural crisis, it will become apparent that most of our leading thinkers use outdated conceptual models and irrelevant variables*[8]."

Basically, Capra argues that the present Cartesian, logical, linear, Newtonian approach to analysis leads to a "mechanistic conception of the world" that "has led to the *well-known fragmentation in our academic disciplines and government agencies* and has served as a rationale for treating the natural environment as if it consisted of separate parts, to be exploited by different interest groups (my italics)."

More recently, Capra and Henderson has caricatured economists as those who measure development "to a single economic dimension, usually measured in terms of per capita GDP ... unlimited quantitative growth [on a finite planet], as promoted so vigorously by economists and politicians, is unsustainable ... Qualitative economic growth, by contrast, can be sustainable if it involves a dynamic balance between growth, decline, and recycling, and if it also includes development in terms of learning and maturing[9]."

GDP fever is at the root of many current problems in emerging markets because GDP statistically adds up all measurable monetary values, but ignores non-measured externalities. Hence, growth for growth's sake has become quantitative exploitation of natural resources without considering ecology, global warming and the quality of life. Many Asians are wakening up to the reality that the price of rapid GDP growth has been achieved at tremendous deterioration of their quality of life, growing social inequality and tremendous health concerns. Short-term prosperity has been bought at long-term social unsustainability in exchange for financial assets that may be devalued in the long-term.

Capra and Henderson argue that the central challenge of our economic and ecological crisis is: "How can we transform the global economy from a system striving for unlimited quantitative growth, which is manifestly unsustainable, to one that is ecologically sound without generating human hardship through more unemployment?" In Mahatma Gandhi words, for which I am grateful to Mrs. Lall for

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[8] Frithof Capra (1982), *The Turning Point: Science, Society, and the Rising Culture*, Simon and Schuster, Bantam Paperback, Chapter 1. I am grateful to Dr Lim Mah Hui for pointing out this reference.

[9] Frithof Capra and Hazel Henderson (2009), *Qualitative Growth*, The New Economy, Summer, available at www.dowbor.org/crise/09hazelcapraqualitativegrowth.doc

reminding me last February: “Earth provides enough to satisfy every man’s need, but not every man’s greed”.

Crisis of Global Governance

Before I proceed to what G20 could be doing, allow me to ponder on the current crisis of governance. In hindsight, the combination of the culture of growth for growth’s sake, greed and network concentration has resulted in a networked world that is dominated by 20-25 large complex financial institutions (LCFIs), which account for more than half of global financial turnover, concentrated in a handful of financial centres. Their power overwhelms governments and markets because the assets they command are larger than national economies and their alumni are spread throughout fund managers and national and global bureaucracies. They have become a financial version of the Asian Global Supply Chain or what I call the Financial Engineering Food Chain. Their version of financial innovation has been characterized by UK FSA Chairman Lord Turner as of “little social value” and in hindsight, the high profits of the financial sector has been achieved through growing (and hidden) leverage, in a classic case of moral hazard – private gain at social cost.

As a global citizen, I am frankly appalled by the fact that what was blamed on subprime borrowers in 2007 responsible for losses of around US$150 billion has ballooned to a rescue package that the US Government has spent, lent or committed to the rescue of financial institutions of US$13.2 trillion as of 19 June 2009[10]. The Federal Reserve Bank’s analysis of the US commercial banks profits from 1999 to 2008 is eye opening[11]. In 2008, the ten largest US banks increased their concentration from 35.6% of net consolidated assets of the US banking system in 1999 to 53.9%, growing their asset size by 3.2 times compared with 2.1 times for the banking system as a whole. Last year, when the banking system suffered hugely on profits and investors had to bail out many banks by injecting substantial capital, the amount of salaries and benefits for the top ten banks declined from 1.59% of net consolidated assets in 1999 to 1.27% in 2008[12], but in absolute terms increased 2.4 times over the same period from US$30.8 billion to US$74.9 billion. Note that cash dividends to shareholders declined from 0.79% to 0.28% of net consolidated assets during the same period, but increased marginally from $15.3 billion to $17.5 billion.

In other words, in the midst of the worst crisis of 2008, the employees in the top 10 banks took home 4.28 times more than shareholders did, when shareholders took most of the hit and the government guaranteed all the deposits. Although I have not had access to the data, I would not be surprised that the same trend may be present in many of the non-US global banks. To put it mildly, it was management that took a large chunk of gross profits, whereas the shareholders and the taxpayers bore the brunt of the risks and losses. In free market economies, most failed firms would have employees being sacked, laid-off or facing much reduced salaries. You tell me if this is equitable.

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[10] Bloomberg Markets, August 2009, “Now’s It’s $13.2 Trillion”, p.13

[11] Federal Reserve Bulletin, Profits and Balance Sheet Development at U.S. Commercial Banks in 2008, Board of Governors of Federal Reserve System, Washington DC June 2009, pages A57-97.

[12] Fed, op.cit. Table A.1, page A87-90. I am unclear whether share option values are included in salaries and compensation.

But this was not supposed to be how the moral philosopher Adam Smith envisaged the benefits of the Invisible Hand working through the market for the greater public good. If we were to construct a matrix of public/private sector type of governance (Table 1), we would see that there are four types. Adam Smith's ideal situation is Type 1, private sector for self-interest that is supported and kept in check by Type 4, a selfless public sector working solely for the public good. But in the real world, we have seen enough examples of Type 3 Governance, where the public sector is working mostly for bureaucratic interests, resulting in at best unending turf wars, gaps and overlaps in delivery of public services and at worst, corruption. Recently, we had an example of how frustrating it can become when the US Treasury Secretary had to tell his financial regulators at a stormy meeting that 'enough is enough' to end the turf wars and refusals to give up jurisdiction, including lobbying against the reform plans[13].

The worst type of situation is when Type 3 is captured by Type 1, which means that the only way to check such behaviour is to have countervailing power through civil society (Type 2) and appeal to the higher morality of public service (Type 4).

Table 1: Taxonomy of Private/Public Governance

Sector	Private	Public
Private	***1 – Private Greed for Self-Interest***	***2 – Private Action for Public Interest (civil society)***
Public	***3 – Public Sector for Bureaucratic Interest***	***4 – Public Sector for Public Interest***

Before discussing what G20 can do, we have to examine the issues confronting global governance. The World Economic Forum, which is engaged on a "Global Redesign Initiative", recognizes that the world has become much more complex and bottom-up, with a major power shift from North to South and from West to East. There is greater recognition that one needs a holistic approach, with multi-stakeholder engagement and awareness that you cannot solve complex global issues without ecological and social sustainability.

As European social scientists and policy analysts Benner, Reinicke and Witte recognized, "we are faced with on the one end the persistence of greater power politics, unilateralism or 'multilateralism á la carte' (Richard Haass) and outright state failure, on the other end the emergence of new forms of governance along the public-private frontier. International organizations are caught in the middle trying to reinvent themselves in a changing world[14]." Global institutions face four operational and participatory asymmetries. The operational gaps are the *jurisdictional* gap between global public goods (and needs) and disexternalities that extend beyond the legal powers of nation-states; the *temporal* gap between need for timely action and

[13] Damian Paletta and Deborah Solomon, Geithner Vents at Regulators as Overhaul Stumbles, Wall Street Journal, 4 August 2009.

[14] Thorsten Benner, Wolfgang H Reinicke and Jan Martin Witte, Multisectoral Networks in Global Governance: Towards a Pluralistic System of Accountability, Government and Opposition Ltd, 2004.

long-term inter-generational sustainability solutions; the *complexity* of public policy issues that have profound economic, ecological, political and security effects on a cross-border basis; and the *contradiction* between market-reinforcing agreements (e.g. WTO) that concentrate power versus equitable standards, such as human rights, environmental and labour issues.

The participatory gaps exist in the areas of growing income and wealth inequality arising from globalization; and also the demand from NGOs to be heard on global issues, with increasingly moral, financial and knowledge resources.

In short, G20 must confront all these issues of global governance fairly and squarely to have any meaningful impact.

What can G20 do?

In 2008, G-7 finally came to the realization that the global power shift required greater legitimacy and newer, multi-stakeholder solutions, so that the G20 came to assume its place from a mere talk-shop to a more serious forum for more effective collective action for global problems. There is no doubt that G20 accounted for a larger and more representative share of global economic power, since the members account for roughly 85-90% of world GDP either on market exchange rates or PPP basis. G20 also accounts for roughly two thirds of global population.

Although there was much fanfare and hope over the growing power of the emerging markets, particularly BRIC countries (a term coined by Goldman Sachs), the reality is the shift in terms of voting power in the Bretton Wood institutions broadly preserved the status quo. True, there is greater representation in the upgraded Financial Stability Board and participation in the regulatory standard bodies, such as the Basle Committee for Bank Supervision, IOSCO and IAIS. But my personal greatest worry is whether the Emerging Market members, after they become members of the Club, would simply rubber-stamp the proposals of G7. After all, G7 has superior experience in global governance, institutional research capacity and policy analysis. Some of us have not forgotten that the best indicator of financial crises in recent years has been membership of the OECD. Almost every new OECD member, Turkey, Mexico and South Korea, experienced financial crisis fairly shortly after joining, because they probably liberalized prematurely without fully preparing for the potential global shocks.

The major issue before G20 is what can be done to ensure that future financial crisis can be prevented? This requires good diagnosis before prognosis, something that Posner had earlier indicated as premature. The obvious problem is that all global issues are multi-generational, multi-disciplinary and are interconnected, interdependent and inter-active, with no "one-size fits all" solution for all time. The gaming nature of nation-states and private sector behaviour is such that there is a race to the bottom. No country is able to tighten monetary policy alone for fear of inviting a ton of hot money that negates that policy. No country is able to tighten financial regulation for fear of business migrating to other financial centres. No country is able to raise taxation for fear of massive tax arbitrage.

Since the orthodoxy of democratic free markets demands greater public welfare expenditure in a situation of rising fiscal deficits, the world is in "bubble trap", with loose monetary and fiscal policies financed through higher and higher leverage. The reverse side of the bubble trap is the Japanese liquidity trap. Basically, what the Japanese did to tackle the deflationary pressure from the bursting of the 1980s asset bubble was to replace banking and corporate losses in equity and real estate with a debt bubble – essentially replacing the bubble losses with a fiscal debt equivalent to twice the size of GDP. This debt bubble is sustainable only through zero interest rates. If inflation was to return and Japanese interest rate rises, the deflation in the debt bubble would result in massive losses to bond holders, which are mostly domestic retirees. In effect, instead of doing massive domestic restructuring, the problems of excess capacity were postponed to future generations.

Does this solution sound familiar?

Since the present rescue plans also involve massive pump priming to protect the banking system, annual fiscal deficits around 6-7% of GDP are replicating the Japanese dilemma, requiring the whole world to adopt zero interest rate policy (ZIRP), creating what I call the "bubble-thy-neighbour" problem. Instead of closing down zombie financial institutions, trying to keep them alive by giving them massive spreads causes huge distortions in the global real economy.

First, the bank management gets away with continued high salaries, since profits are subsidized through full deposit guarantees and government ownership. How much of current profits are due to management abilities? Secondly, it is impossible to price risks under ZIRP because the incentive structures are already distorted. Socially disadvantaged SMEs will face higher risk spreads and less access to credit, whereas state-owned enterprises and large multi-nationals will get privileged rates, if not further government aid. Third, to place the adjustments in the exchange rate alone will not help global adjustment materially, since the Japanese experience shows that despite huge revaluation, the economy still ran continuous large balance of payment surpluses. If the vibrant emerging markets also drift to slower growth due to exchange rate shocks as well as domestic bubbles ala the Japanese situation post-Plaza Accord, then global growth will further slow down.

What in effect the present rescue efforts are doing is to tax efficient real sector corporations and savers to subsidize zombie financial institutions on the presumed objective of keeping employment at socially acceptable levels. We need real sector solutions, not playing with funny money. In sum, a financial engineering crisis cannot be solved with more financial engineering. You need real sector surgery.

So what is the real problem?

If we agree that the problem began with excess consumption financed by excess leverage, then the realistic solution must be a gradual adjustment to more sustainable levels, with collective action agreement on the gradual transition to a more sustainable situation. Instant solutions tend to have long-drawn out poor outcomes.

Allow me to play the devil's advocate in posing the issues starkly. If the core defect of central planning is ignoring market prices, ineffective bureaucracies and having no hard budget constraint, free market fundamentalism also has a problem of ignoring non-market risks, ineffective bureaucracies, no hard fiscal constraint and funding through limitless financial engineering. Central banks with compartmentalized mentality acted solely on consumer prices by ignoring asset bubbles. Supervisors ignored liabilities below the line and in offshore, unregulated special purpose vehicles. The result was massive embedded and hidden leverage in the financial system, since smart bankers realized that they could increase profits through increasing leverage at huge moral hazard risks[15]. This crisis has proven them right – they were bailed out with fairly golden parachutes.

I can only agree with Lord Turner's assessment that much of recent financial innovation has been of little social value, hidden by increased leverage in multiple forms and apparently sophisticated math models[16]. Since increased risk-taking by financial institution is due to a distorted management compensation scheme, driven by the need to increase profits quarter by quarter, the management responded by embedding leverage in the system until it blew up in their face. Consequently, the simple answer to controlling excess compensation is to control excess leverage. This requires a profound change in regulatory policies and supervisory practices, beginning with the need to define what are overall leverage limits. For emerging markets, if in doubt, we can fall back on the historically accepted levels of 15 times net capital. Less profits, less bonuses and reduced risk-taking.

Putting together different components of the picture - the fragmentation of economic disciplines into silos that ignored disexternalities, the inability of fragmented national agencies to deal with global issues, a free market philosophy of growth for growth sake and the difficulties in getting collective action to arrive at a hard budget constraint, we are now able to piece together the global enigma.

In a nutshell, the Bretton Woods II regime of liberalized capital flows and flexible exchange rates does not quite add up in a small fragile interconnected and interdependent planet. Most advocates of free capital flows equated good long-term foreign direct investment (FDI) with foreign portfolio investment (FPI). What they ignored was the fact that increasingly, through financial engineering, FPI is short-term and highly leveraged, profiting from higher volatility and ensured if possible through market manipulation, especially in thinly traded markets. Indeed, the carry trade that arose from ZIRP following the Japanese deflation essentially subsidized hedge funds, investment banks and speculators to punt emerging markets. There was no way that emerging market central banks could defend their currencies because their reserves were very lowly leveraged (mostly through domestic savings or long-term debt), whereas the other side was hugely leveraged with massive momentum play. If the foreign exchange reserves were funded with short-term debt, then it was a no-brainer.

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15 At the end of 2008, the US banking system still had US$201.1 billion of notional value of derivatives with positive fair value of US$7.1 trillion, but net capital of $1.149 trillion. Since other liabilities comprised US$11.1 trillion, the banking system had leverage of either 17 times (10 + 7 times fair value of derivatives) capital or 185 times net capital (10 + 175 times notional value of derivatives). Perhaps using notional exposure may exaggerate the leverage, but the experience with Lehmans is that when derivatives unwind, it is the gross unwind that is the killer, not the net unwind (Fed, op. cit. Table 2, p.A73

16 Adair Turner, Speech at Turner Review Conference, Financial Services Authority, London, 27 March 2009.)

Moreover, if the locals also believe that the exchange rate was indefensible, then the game was over. The conventional solution was a devaluation and switch to flexible exchange rates, using exports to solve domestic gaps. But this assumes that the export engine will be forever.

In short, the logical consequence of a monoculture of flexible exchange rates is an unstable race to competitive devaluation that can only end up in tears.

After the Asian crisis, when G7 refused to regulate the currency markets, the only way for Asians to defend themselves was through self-insurance, building up their savings and cutting leverage. The recycling of excess savings into the global markets increased the liquidity of G7 markets and created the prosperity which G7 central banks were reluctant to stop, resulting in the current crisis. But leverage can only "prosper" with lower and lower interest rates, bringing us into the never-never land of massive price distortion under ZIRP. Unfortunately, ZIRP also perversely accelerates the quantitative consumption of scarce natural resources, on the pretext of getting back GDP to positive territory.

Is the solution therefore in increased financial regulation? This is where the second piece of the puzzle falls into place. Suppose that G20 has assumed the mantle of supreme global authority to create the global financial regulator and global central bank that some academics argue for, would the global problems be solved? The surprising answer is no. The reason is that as the EU experience has shown, no regional central bank and super financial regulator can resolve regional and sectoral disparities without some form of central fiscal adjustment. And since we do not even have the elements of a global fiscal mechanism, the discussions about global financial regulation and monetary policy are somewhat futile.

In other words, we cannot have global monetary policy and financial regulation without some form of global fiscal coordination. The present fiscal trend of rising expenditure increases and tax cuts to rebuild an excess consumption/excess leverage model with limited global resources is a race to another crisis.

To put it bluntly, we cannot have a partial solution to a total problem. If we have global banking in life, we need global taxation because the only two things that are certain in life are death and taxation. For global institutions to continue to create global public goods, some form of global taxation is necessary. Since the financial sector is currently the "perpetual prosperity machine" with massive moral hazard, I would whole-heartedly agree with Lord Turner that a global "Tobin Tax" is probably what is needed as the first step in global fiscal reform[17].

Firstly, a turnover tax is a user-pay tax that is less regressive than other forms of taxation. It is like a gambling tax to tax socially negative activities for global public goods. Secondly, the turnover tax can be counter-cyclical, being increased or decreased depending on the level of speculative fever in the markets, raising taxation if the risks of bubble collapsing rises to fund safety nets for crisis resolution. Third, the turnover tax can be used to finance global public goods that currently have no

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[17] *How to tame Global Finance*, Prospect Magazine, 27 August 2009, Issue 162;
George Parker, *FSA backs global tax on transactions*, 27 August 2009, FT.com.

other forms of financing. Fourthly, the tax will be paid by financial institutions which currently bear minimal transaction taxes, as stamp duty and other transaction fees were reduced almost to zero as part of the doctrine of creating frictionless financial markets. The reduced profits of financial institutions will reduce their capacity to pay excessive bonuses and compensation that promote risk-taking. Fifth, once turnover tax is collected, statistics on transactions would be tabulated that could monitor excessive speculation, market manipulation and insider trading that currently plagues effective global financial market supervision.

How much will the turnover tax raise? The global turnover in foreign exchange and derivatives according to the BIS Triennial Survey in 2007 was US$3.2 trillion daily. Assuming 250 trading days, the total annual value of FX turnover would be in the region of US$800 trillion. If we add to this the total value of share trading of US$101.2 trillion according to the World Federation of Exchanges statistics, then the total annual financial trading, excluding bonds and other OTC transactions, would be in the region of US$900 trillion. Using a turnover tax of 0.1% would yield an annual tax of US$900 billion, enough within three years to cover the global banking losses last estimated at US$2.8 trillion. Using a turnover tax of 0.005% would yield $90 billion, nearly double the aid to Africa required of US$50 billion annually[18].

What I am suggesting is not for individual countries to impose a Tobin Tax, but for G20 to agree for all members to impose a single, uniform rate of turnover tax of say, 0.005%. There can be no race to the bottom, if we all agree to impose the same rate of taxation. Since global bubbles are global problems, G20 can agree to change the tax counter-cyclically. National governments that collect the tax would credit the proceeds to a global fund, with a formula that would allow national governments to use part of the proceeds to resolve current crisis problems. A global turnover tax can fund non-controversial global public goods, such as Education for All initiatives, before moving to tackle other more controversial areas[19]. This measure would put into place the module of fiscal standardization that improves conditions for future coordination in monetary policy and financial regulation.

Another possible measure to standardize the global fiscal regime is to agree on standard withholding tax rates, which for the sake of a number is put at say 15 or 20%. The agreement to have a standard withholding tax would make global taxation systems more uniform, allowing convergence in global tax regimes to reduce global transaction costs. If offshore financial centres could not compete through zero taxation, the incentives to create regulatory and tax "black holes" would be limited. Emerging markets have much to gain from stopping the loss of tax revenue to offshore financial centres. Improvement in domestic tax regimes would enable emerging markets to deal with many of the funding problems that are currently financed through external borrowing or hot money.

Concluding Remarks

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[18] Tim Edwards, *The FSA chief Lord Turner says a Tobin Tax could stabilize the financial system – and fund Third World development*, 28 August 2009, www.thefirstpost.co.uk.

[19] I am grateful to Dr Homi Kharas of the Brookings Institution for helpful comments in this area.

What I have tried to do today is to have a total picture of what impedes global progress to effective global solutions for complex global issues. If the arguments are somewhat unclear, it is because we are all dealing with something very new and yet very old – going back towards ancient philosophies that had a holistic view of man on earth, of either man exploiting man or man exploiting nature. Man's success in pushing for relentless growth has partly been achieved through greater social inequality (disguised through leverage) but mostly at huge ecological damage. It is time for emerging markets and developed markets to stop shuffling deck chairs on the Titanic, and concentrate on what we need to do collectively to stop the Tragedy of Global Commons. If it means changing the definition of GDP to a green Quality of Life index, so be it. If it means getting global fiscal regimes in place, so be it. We cannot do this overnight, but we must begin the debate.

There are many things that individual emerging markets can do to achieve their own national goals, which may conflict with global goals. These would entail reforms to what used to be called "global best practices". The irony is that what we thought were "best practices" turned out to be very poor practices. Global regulatory standards therefore should be made much more simple, understandable and more important, implementable. If I may be impolite, much of what is being proposed is still too complex, too theoretical and impractical for implementation for many emerging markets. Indeed, it is arguable whether these new regulatory standards, which are very expensive to implement, may not even prevent the next crisis, nor identify the real risks. As former Chairman of the Technical Committee of IOSCO, I bear part of that blame. But this does not mean that we should continue this drive towards adding complexity to greater complexity as a solution to our woes.

There is an oft-quoted phrase that says that the Chinese word for crisis is a combination of the words, danger and opportunity 危机. Most users forget that the Chinese word for assumption is False Certainty 假定。 This is another contradiction in terms. The political consequences of the economics profession are that by assuming what is false to be certain, we swallowed it hook, line and sinker. Time to get real.

I apologize for this blunt but somewhat tortuous analysis. My only excuse and hope is that it stimulates sufficient debate on the way forward in this time of global crisis.

Penang,
2 September 2009.