Towards a Global Finance System at the Service of Sustainable Development

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Assessing the development impact of European and global financial reforms

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Towards a Global Finance System at the Service of Sustainable Development

Assessing the development impact of European and global financial reforms

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Contents

Summary

The global debate over financial reform is still ongoing. In the European Union (EU), some reforms have now been implemented, but these frequently are only half-measures and, thus, do not offer adequate protection against future turbulence. However, EU financial reforms must facilitate progress towards global sustainable economic development. Furthermore, reforms will not only affect the EU; they will also strongly impact on developing countries. Consequently, the EU should prioritise the following goals:

- Considering sustainability and the precautionary principle in all reforms.
- Ensuring full transparency of EU financial operators and markets.
- Comprehensively regulating all financial actors to prevent shadow banking.
- Deleveraging the financial system, especially the banks.
- Introducing restrictions on speculators and speculative products, especially in commodities markets.
- Supervising European banks operating in developing countries.
- Permitting prudential capital controls in free trade and investment agreements.
- Tackling tax evasion and tax avoidance, and increasing progressive taxation of wealth.
- Facilitating innovative development financing via a Financial Transactions Tax.
- Pushing for greater international cooperation on exchange rates, trade imbalances and capital flows.
- Giving developing countries a greater say in international decision-making processes and in supervision.

1. Introduction

The financial crisis is truly global in scale. It will have a lasting impact on growth, jobs and debts, and will be a long-term burden for economies all over the world. Although it originated in the developed world, the subsequent fallout has been keenly felt in developing countries. For example, reduced lending, foreign direct investment and aid, along with weaker export revenues, have resulted in increased poverty, unemployment and indebtedness.

The crisis is a consequence of the global rise of neoliberalism. An unwavering belief that markets are efficient and banks are self-regulating, resulted in excessive privatisation, liberalisation and deregulation. Financial markets are now predominant, and traditional economic activities, such as classic production and services, are slowly being sidelined. This system engenders inequality, uncertainty and the concentration of power in the hands of the few. Short-term speculation and excessive risk-taking are rewarded, despite their destabilising effects on the wider economy. Furthermore, the current crisis is not an isolated event, as demonstrated by the 1997 Asian Financial Crisis. However, markets can facilitate development, provided sensible limits are imposed. It is simply unbridled capitalism that one must guard against.

Many countries are now taking steps to restructure the system and restore stability. However, the debate over which reform measures are most appropriate is still ongoing. In the European Union (EU), some reforms have now been implemented, but these frequently are only half-measures and, thus, do not offer adequate protection against future turbulence. Additionally, many important reforms have been completely omitted, or are only just at the concept phase. For example, the European Union is not scheduled to reach a conclusion on areas such as derivatives regulation until 2011, despite this having been a key issue for many years. Thus, whilst many existing EU reforms are promising, there is still much work to be done. The overall goal must be a global finance system that serves sustainable development, both in developing and developed countries.

This brochure, which is part of the EU-funded project "Towards a Global Finance system at the Service of Sustainable Development", first looks at the impact of the crisis on developing countries. It then gives an overview of several legislative proposals launched by the European Union since the financial crisis began. Where negative effects are identified, possible solutions are outlined and discussed. Without substantial, widespread financial reform, history will repeat itself. We have a responsibility to ensure the financial system aids, rather than hinders, sustainable development.

2. The financial crisis and developing countries

Developing countries have frequently been affected by financial crises over the last few decades. Such crises can directly affect an entire generation. At the beginning of the current crisis, some economists postulated that emerging economies might emerge unscathed, as speculative financial capitalism was far less prevalent and growth figures were initially robust. However, this "decoupling" did not materialise, and, when lending and trade declined, developing nations soon joined the global downturn.

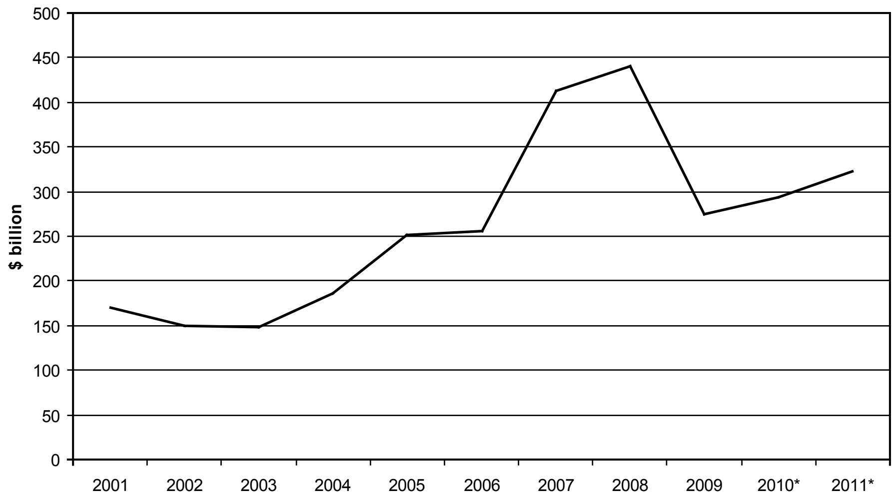
2.1 Capital flows

Private capital flows to both developed and developing economies, but particularly to the latter, greatly increased in the years preceding the financial crisis. However, 2008 saw a reversal of this trend, and the first fall in such investment since 1997. The largest component of this outflow consisted of portfolio investment. Portfolio investment involves the purchase of assets (such as shares, bonds and derivatives), without any intention of taking-on a long-term management role. This is distinct from foreign direct investment (FDI), in which the investor actively partakes in governance over time and, thus, often introduces new technology or expertise. However, there are also some unfavourable accompanying conditions, such as tax exemptions.

Portfolio investors generally hold assets for only a short period of time. Moreover, they often exhibit herding behaviour; i.e. trading decisions are often determined by how others are trading, rather than by market fundamentals. Frequently asset bubbles are created and then subsequently burst, as there is a collective rush to buy, followed by a collective rush to sell, that are both driven more by emotion than by rigorous financial analysis. Thus, portfolio investment can be highly volatile, and often does not facilitate stable economic growth. Consequently, its role in development should be questioned, and capital controls considered.

FDI has also dramatically increased in developing countries in recent decades. However, the current crisis has severely affected FDI capital flows to emerging markets (see figure 1), and, thus, European financial reform initiatives must support, not impair, recovery of sustainable FDI.

Figure 1: Foreign direct investment to emerging and developing economies



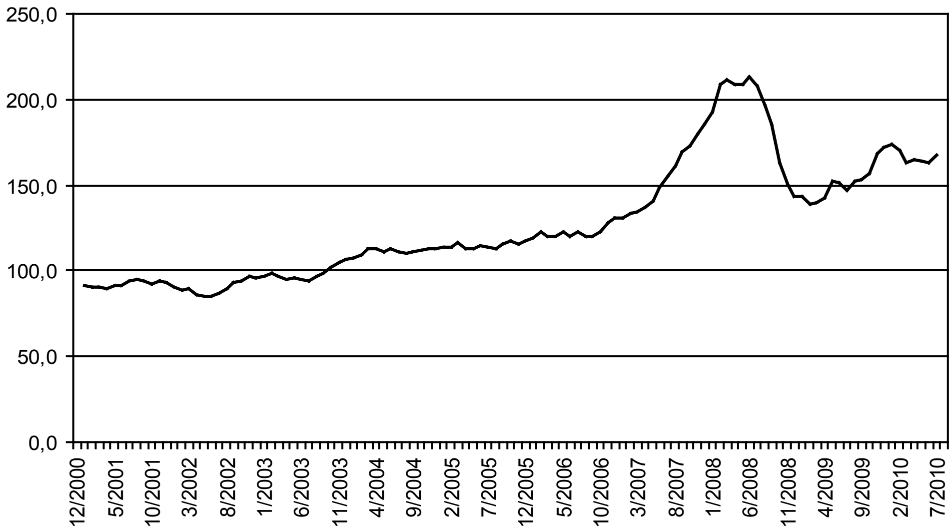
*Projection, source: IMF

Thankfully, the effect of the financial crisis on official development assistance (ODA) has hitherto been more restrained than one might have expected. However, whilst many donor countries have avoided cuts, a significant overall decrease has still been registered. Furthermore, as many developed countries are forced to implement widespread public spending cuts to combat large budget deficits, many may advocate downsizing ODA investment to mitigate domestic pain.

2.2. Financialisation of commodity markets

An additional result of neoliberalism was the food price spike of 2006 – 2008. This is a severe example of how modern financial markets can threaten the lives of millions of people in developing countries. Food prices rose dramatically around the world at the end of 2007 (see figure 2). According to UNO, between 109 million and 126 million people may have fallen below the $1 per day poverty line owing to this increase. Initially, all sorts of factors were put forward to explain the rise; for instance, increasing demand in emerging economies or the production of biofuels. But then from July 2008 onwards, prices collapsed again – and it turned out that these long-term factors were not fully responsible for the spike. Other forces were at work here, specifically the rise of extensive speculation via commodities futures by big banks and so-called index funds, especially in the years preceding the crisis. For example, trade in agricultural futures and other derivatives increased by 32% in 2007. Whilst there is an ongoing debate in the financial sector over the extent that speculation impacts on prices, a recent World Bank working paper acknowledged the relationship.

Figure 2: FAO Food Price Index



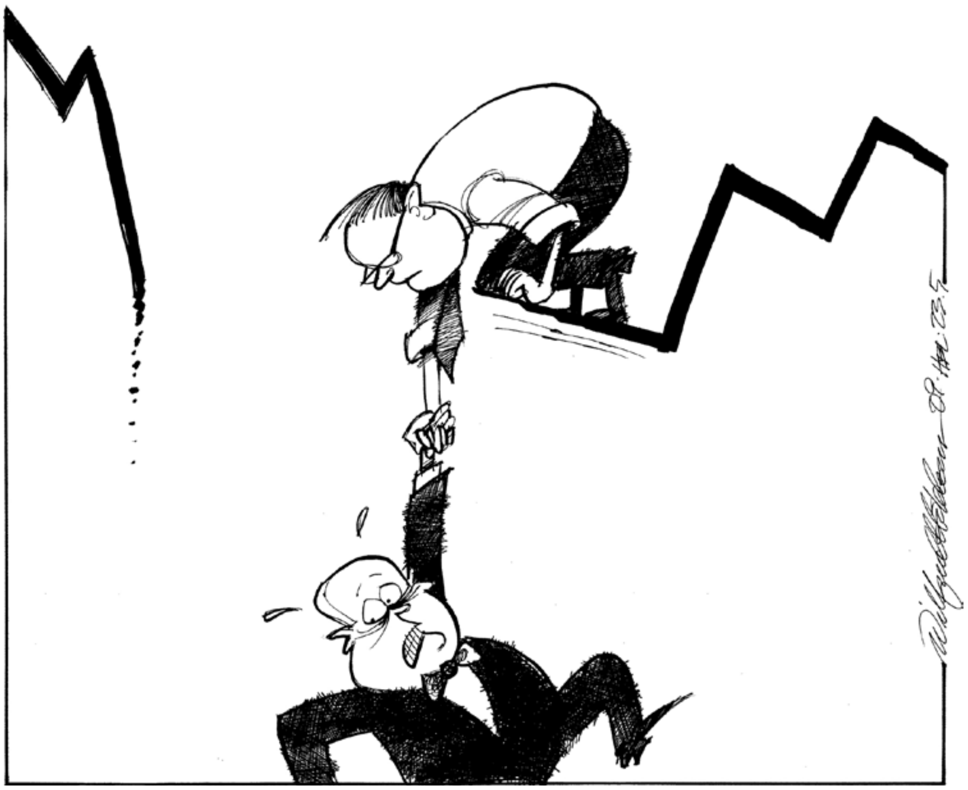
Source: Food and Agricultural Organisation

2.3. Real-economy channels: trade and remittances

The rapid rise in global trade in recent times has played a key role in development and poverty reduction. However, in 2009 global trade dropped nearly 13 percent. This is the largest decline since the 1930s, and is sorely felt throughout the developing world. Global imbalances, and any subsequent protectionist measures, pose an additional threat to the recovery of exports.
In a similar vein, remittances, i.e. transfers from labour migrants to their home countries, dramatically increased in the years immediately preceding the crisis: from \$83 billion in 2000 to \$338 billion in 2008. This revenue represented a substantial proportion of gross domestic product in many developing countries. However, pressure on wages and an increase in unemployment in the developed world have severely depressed these cash flows. A report by the World Bank notes that remittances fell by approximately 6 percent in 2009.

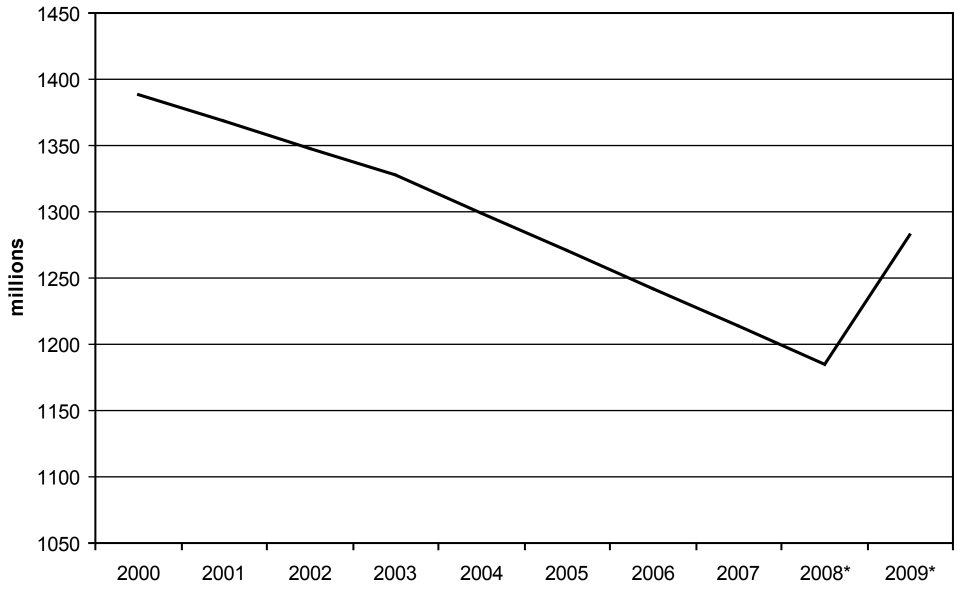
2.4. The social and economic effects of the crisis

Social developments achieved over the last ten years have been interrupted and frequently even reversed due to the crisis. Consequently, the Millennium Development Goals (MDGs) are now unattainable. According to the World Bank and the United Nations, 55-114 million additional people have become poor (surviving on less than 1.25 US dollars a day) as a result of the crisis; similar effects have been registered for people earning less than 2 dollars a day (see figure 3). Moreover, even these alarming statistics cannot fully convey the suffering and injustice experienced by the world's poor.



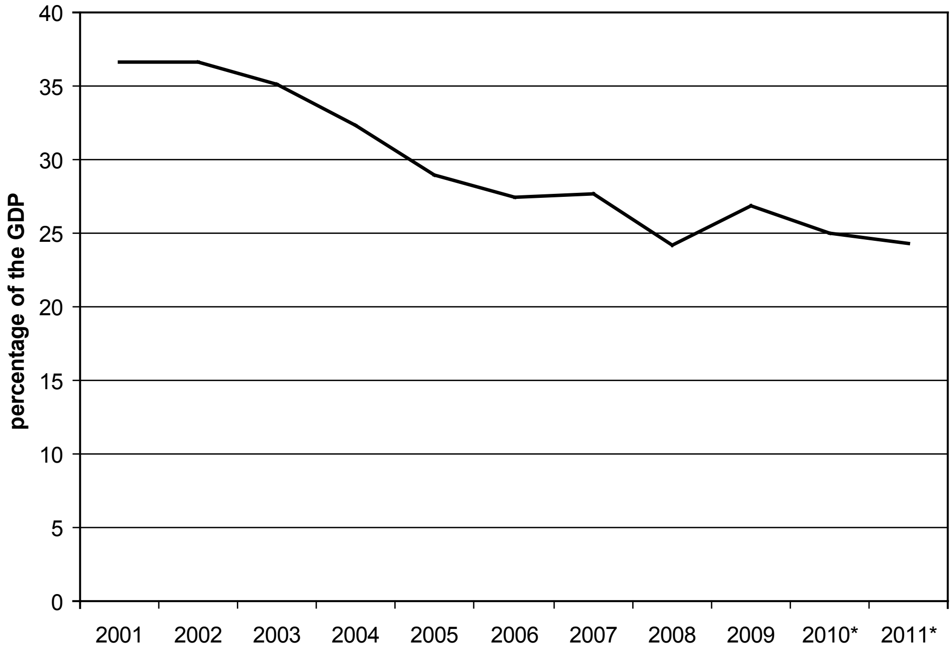
The crisis also risks derailing the progress achieved in reducing the debt burden of developing nations. Declining tax revenues, the need for increased social security payments (where they exist), and financial sector support or stimulus packages forced increased borrowing between 2008 and 2009 (see Figure 4), despite the already large budget deficits in many developing countries.

Figure 3: Number of people whose income is below 2 US dollars per day



*Estimates, source: ILO

Figure 4: External debts of emerging and developing countries



*Projection, source: IMF

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http://www2.weed-online.org/uploads/the_financial_crisis_and_the_developing_countries.pdf

3. EU financial reforms

The need for deep financial reform is unanimously accepted by all countries and politicians. However, strong lobbying from the financial sector has succeeded in checking progress. As a consequence, many proposals are half-measures at best. While the US has had a fairly ambitious reform act in force since July 2010, the EU has been more timid. Progress had been gradual, and many important regulatory changes, such as tightening controls on derivatives trading, are only just being discussed.

As one might expect, the focus of the reforms is the EU itself, rather than the impact of these reforms on developing countries. However, this approach is insufficient, given the interconnectedness of the global economy, the impact of the EU for global financial stability, and the various activities of EU companies, EU banks and EU funds in developing countries, as well as the importance of EU rules and EU-influenced rules in global standard setting.

In this section, the most important reform proposals and discussions will be analysed with respect to their impact on financial stability and sustainable development, i.e. their ability to help deliver higher standards of living in the developing world, along with more environmentally sustainable development globally.

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3.1. Reforming the banking sector

Banks are still the main provider of capital and financial services. They have been at the heart of the crisis, and their reform is the most important issue of all. A sustainable model is needed to ensure that banking works for the real economy.

Well-reasoned capital adequacy rules are a key component to stable banking. These limit the credit lines banks can extend, and also force banks to set-aside capital so that any losses from defaulting counterparties can be absorbed. Rules can apply to single activities, e.g. loans, or across all the activities a bank engages in, e.g. total loans extended in compassion to a bank's own capital base. The rules can be rather one-size-fits-all, or they can take into account different business models and transactions, e.g. traditional loans versus involvement with derivatives or securitized papers. As setting aside capital ties up funds that could be lent out or invested, banks generally lobby hard against any moves to increase requirements. In the recent age of light-touch regulation, banks successfully pressured governments into limiting capital adequacy rules – this was one of the primary causes of the current financial crisis.

The international capital requirements standards are set by the Basel Committee on Banking Supervision, an international body of supervisors. The current regulatory framework is called Basel II. It has been transformed by the EU into the Capital Requirements Directive (CRD) of 2008. Since the 2008 financial crisis has highlighted deep insufficiencies in CR rules and the Basel rules have been revised, the EU is now in the process of reviewing the CRD. One review from 2009 includes limiting securitization (loans and other previously illiquid assets packaged in new financial products and sold), mitigating risks from inter-bank lending, and supervision of all cross-border banks headquartered in the EU. Another revision agreed in July

2010 covered increased capital requirements for re-securitizations, trading across all asset classes, better transparency, improved risk assessment procedures, and strict rules on how to regulate and pay staff.
The EU process runs parallel to the current comprehensive reform of Basel II, which will result in the so-called Basel-III rules. The latter will include new standards on the quality and amount of capital and liquidity reserves, the build-up of counter-cyclical capital buffers, the level of indebtedness (leverage ratio), and systemically important institutions. The EU will implement these proposals after they have been agreed internationally.
The question now is whether the upcoming higher capital requirements will affect the availability of credit and financial services to (poorer) clients in developing countries in which EU-based banks operate (see table 1). Many banks have expressed this concern. Similarly, domestic banks in developing countries may struggle to stay afloat once they are required to set more capital aside.

Table 1:
Number of subsidiaries/branches of EU-based banks in developing countries

Bank	Number of subs/branches in developing countries
HSBC (UK)	38
BNP Paribas (F)	35
Credit Agricole (F)	33
Barclays (UK)	25
Deutsche Bank (Germ)	20
Unicredit (It)	18
ING (NL)	17
RBS (UK)	17
Santander (SP)	9
ABN Amro (NL)	7

Source: SOMO, based on the banks' annual reports and websites, March 2010

Proper risk assessment, which was insufficient before the crisis, is now crucial to prevent reckless and unsustainable banking. The CRD and Basel II rules prescribe how a bank's risks should be assessed. This is not only important for the banks' general performance, but also because capital requirements are related to this assessment. Basel II allows banks to conduct their own risk-assessment - a so-called "internal ratings-based approach". Not surprisingly, banks prescribed themselves minimal levels of "buffer capital", so that maximum capital was available for lending and investment. In contrast, banks from developing countries relied on external ratings, which resulted, on average, in higher capital requirements. Consequently, European banks had a competitive advantage, as they could provide cheaper credit. Thus, risk assessment procedures need to be reassessed and standardised. In addition, reforms should mandate that banks incorporate sustainability criteria into credit risk assessment.
Financial exclusion is another key issue that must be addressed. The current financial system frequently discriminates against poor and disadvantaged people, both in developing countries and within the European Union. For example, many low-income European citizens are denied access to a current account, because commercial banks profit from savings accounts and mortgage lending, which the impoverished are unlikely to ever need. Consequently, it is imperative that European reform proposals promote universal access to basic financial services.

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http://www.banktrack.org/download/close_the_gap/close_the_gap.pdf

3.2. Credit rating agencies (CRAs)

Credit rating agencies (CRAs) are institutions set up to measure the creditworthiness of banks, investors and states, and the risk-of-default on the financial products they issue. The market for CRAs is highly concentrated: two big CRAs (Moody's and Standard&Poor's) and a smaller CRA (Fitch) control about 90% of the global market. Their power is strengthened by the fact that their ratings are also obligatory for regulatory frameworks such as Basel II (see above, 3.1), and banks often depend on these ratings.
Time and again, such as during the Asian and the current crisis, CRAs have failed to adequately assess the creditworthiness of products and institutions. They were also heavily criticized by governments due to their ratings of states. Frequently countries were given healthy ratings, which were then swiftly downgraded during the financial crisis.

PIGS stands for Portugal, Italy, Greece and Spain

Such rapid changes imply that not enough consideration was put into the initial ratings, which clearly were inaccurate. This rapid downgrading occurred recently with Greece's rating, which had a major impact on Greece's capacity to finance its debt by issuing bonds.
The EU didn't regulate CRAs prior to the crisis, and regulatory reform is still currently ongoing. Since September 2010, CRAs have had to register, assess the risks of conflicts of interest, and meet transparency and due diligence requirements. An additional reform is on its way, which mainly deals with supervision at the European level, and rules for a CRA on disclosing its ratings to other CRAs, thus ensuring more transparency.
Rating agencies have an enormous impact on development, because their ratings determine the cost of funding for both governments and companies in the developing world. Frequently small companies cannot afford the high rating fees and, thus, do not get rated. Consequently, these companies are not able to

secure reasonable terms to access capital by credits, or by issuing bonds or stock. A major problem is the small number of well-established rating agencies, which results in severely substandard level of competition. The EC has expressed its concern about this, but has not yet proposed a solution to eliminate this problem. Also, concerns about conflicts of interests within rating agencies are not being dealt with sufficiently in the current EU proposals, and no viable alternative for assessing default risks is envisaged so far. Another problem not yet addressed, is how CRAs can adequately incorporate into their ratings the social and environmental risks that the borrowers and financial products they rate pose.

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3.3. EU regulation of investment funds

Funds play an important role in modern financial markets, channelling a considerable share of global capital. So-called "alternative investment funds" (AIFs) cover hedge funds, private equity funds, commodity funds, real estate funds, infrastructure funds and other types of institutional funds. These funds managed around EUR 5 trillion in assets at the end of 2008.

Hedge funds are the flagship of unbridled capitalism. These funds have thus far been free from supervision and most investment restrictions. They generate enormous profits for wealthy individuals and institutional investors. To give an example of their impact, one hedge fund purchased 7 percent of the global cocoa harvest in July 2010 in order to drive up prices. These funds also played a pivotal role in the current financial crisis, e.g. in the collapse of Bear Stearns. Furthermore, long before the current crash, the 1998 collapse of LTCM had already demonstrated that hedge funds had the ability to undermine the stability of the entire financial system. These funds also invest in developing countries, and they are part of the tax haven business (see 3.7) that channels a vast amount of money out of developing countries every year.

Private equity funds buy companies in order to restructure them and sell them on for a profit a few years later. While this might be a way of financing firms, business practices are often questionable. For example, funds often transfer the debts incurred when taking over a firm, to the firm itself. Moreover, the short-term interests private equity fund managers face when restructuring a firm, will often lead to decisions that are not in the firm's long-term interests. For example, they may neglect long-term investment, or sell off valuable property ("asset stripping").

In 2009, the European Commission published a proposal for a new directive on alternative investment fund managers (AIFM), which was heavily debated. In November 2010, an agreement has been reached. The main elements of the new AIFM are:

- Compulsory registration, oversight and potential intervention for all funds
- Regulation according to the type and size of the AIFs
- Limits can be placed on AIF debt leverage.
- More transparency through reporting requirements to the authorities
- Use of so-called depository banks to protect investors' money
- Remuneration policy to discourage risk taking

The EU's current regulatory proposals attempt to limit, or to a limited extend forbid, the most damaging and speculative activities. However, from the perspective of sustainable development, AIFs should have been regulated and limited much more. At the very least, they should be fully subject to the same rules as investment funds, banks, etc. Additionally, there should be strict rules, transparency and supervision (see also 3.5.) in order to prevent investment**,** or other financial market activities**,** and profits by hedge funds not being taxed according to the existing taxation regulations in the country of operation.

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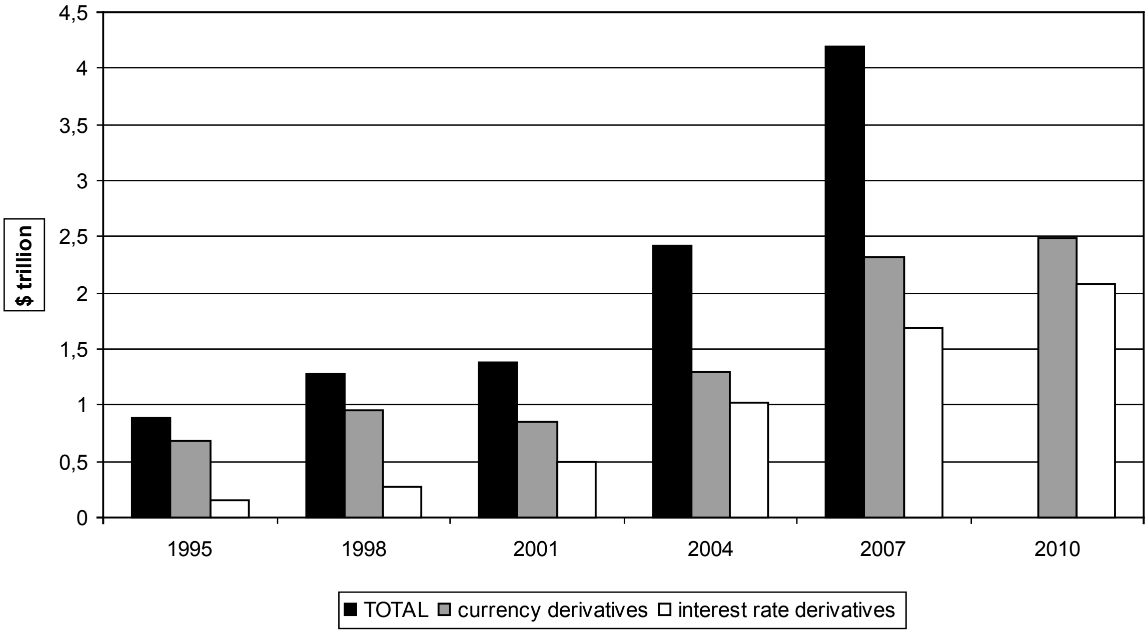
3.4. Derivative trading, and food and commodity speculation

Derivatives are financial instruments that derive their value from the expected trajectory of a given commodity, share, currency or other asset. They can be used for hedging existing risk; however, because they are also a source of leverage, they are frequently used in a highly speculative manner. For example, investors can speculate on the future price of a product, without having to buy the product itself, which would require a large upfront cash outlay. Financial derivatives developed in the 1970s and exploded in the 1990s (see figure 5).

The biggest rise occurred in unregulated and opaque over-the-counter (OTC) markets, where derivatives are traded directly between two counterparties and not publicly on exchanges. This boom in OTC business dramatically reduced the transparency of the market, and made monitoring systematic risk, and regulation in general, extremely difficult. Moreover, most OTC business is not "cleared" through clearinghouses. During clearing, collateral is posted according to the current market value of the product traded, which helps limit the fallout from counterparties defaulting.

Figure 5: OTC derivatives trade, global daily turnover



Source: Bank for International Settlements

The EU increasingly recognises that derivatives regulation must be strengthened if the financial system is to be stabilised. For example, the Directive on Markets in Financial Instruments (MiFID) is currently being reviewed. Proposed legislative changes include the mandatory use of clearinghouses for so-called "standardised" OTC derivative contracts. For "non-standardised" OTC transactions, counterparties would be required to come to a collateral-posting arrangement between themselves. To increase transparency, all trades would have to be reported in a "trade repository".

For developing countries, commodity derivatives are of particular importance (see section 2.2). This is also being seriously considered by the EU. In early 2010, Michel Barnier, the Commissioner for Internal Market and Services, said: "Speculation in basic foodstuffs is a scandal when there are a billion starving people in the world." The EU Ministers for Development Cooperation stated in May 2010 that to ensure food security, they would like to examine possibilities for dealing with price volatility. A July report by the European Parliament on "Derivatives markets: future policy actions" calls for banning purely speculative trading in commodities and agricultural products. In August, three French ministers pushed for the tighter regulation of commodity markets in a letter.

However, the EU's overall approach has hitherto been too cautious. Proposed legislation will not significantly reduce derivatives trading or prevent excessive speculation, nor will it end all opaque OTC trading. Consequently, developing countries will remain exposed to speculative attacks, systematic instability and highly volatile markets. Regulation that considers position limits, circuit-breakers, and possibly even banning outright speculation in certain markets, must be considered. In commodity derivative markets, all financial speculation by banks and funds that results in increasing prices should be tackled and banned, and a specialized regulatory body is needed. Finally, from a sustainable development perspective, the lack of special attention to the derivative trading markets based on carbon emission trading is worrying.

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3.5. The new supervisory architecture

Supervision includes the oversight of financial markets, financial institutions, like banks or insurance companies, and financial products, like derivatives. European supervision is of global importance, as European financial institutions have subsidiaries and branches all around the world, including in many developing countries (see 3.1.). The financial crisis has shown that former supervision was highly inadequate.
Following heavy debates between member states, the European Parliament (EP) voted on the creation of new EU-wide supervisory bodies in September 2010. In the now-approved European System of Financial Supervisors, three new European Supervisory Authorities will deal with supervision:

- European Bank Authority, EBA
- European Securities and Market Authority, ESMA
- European Insurance and Occupational Pensions Authority, EIOPA

Commodities Futures Trading in Chicago

While national supervisors hold substantial regulatory powers, the three new EU bodies will also be of importance. They will be allowed to intervene in cases of breaches of EU laws, in disputes between national authorities, and in emergency situations. However, the ESAs do not have the power to enforce any action that would have budgetary consequences. In addition, the recently created European Systemic Risk Board will warn, but not be able to act against, macro-economic risks, such as speculative bubbles on the stock market. All these supervisory bodies generally do not have a mandate to consider the importance of non-financial stability risks. For example, the EU has failed thus far to incorporate the risks posed by banking industry activities on civil society and the environment.

EU and EU member state supervision does not currently adequately take into consideration the direct effect poor financial supervision in Europe can have on developing countries and their supervisors. If a European bank goes bankrupt, this severely affects the financial system in all the countries where it has branches. There are currently no mechanisms in place for compensating developing countries for crises that emerge following the collapse of European banks.

When European banks have branches in developing countries, these are in principle supervised mainly by supervisory authorities of the European home country. When European banks have subsidiaries in developing countries, then both home and host countries are responsible for supervision. However, the extent to which developing countries can have insight and influence in practice remains to be seen. Similarly, concerns remain regarding whether a developing country has visibility of and influence on the funds active in their country, and the derivatives markets that affect their country.

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Bank in India – the EU is currently negotiating a free trade agreement with India

3.6. Trade and investment agreements

Trade and investment agreements cover financial issues in two respects: firstly, in relation to the flow of capital, and secondly, in relation to financial services. Both issues are very important for developing countries. There are both bilateral and multilateral agreements. In the World Trade Organisation, the General Agreement on Trade in Services (GATS) covers financial services and liberalizes financial services trade, financial products and investments in the financial sector. Similarly, regional or bilateral free trade and investment agreements (FTAs) can liberalize products, trade and foreign investments in the financial services sector.

How many financial services a (developing) country liberalizes under such rules depends on the so-called "commitments" a country decides to undertake. However, once commitments have been made, the free trade rules discipline governments very strictly. This is because countries can generally only reverse commitments if they pay compensation to those countries who request compensation for loss of profits to their financial industry.

The non-discrimination rules included in GATS and FTAs prohibit governments from selecting which foreign banks are allowed into their country, for instance when they would like to give priority to banks that are interested in promoting universal access for the poor. Even if there is a carve-out for prudential regulation, it does not permit a so-called "economic needs test" before admitting foreign financial service providers, nor limits on foreign ownership and restrictions on the size and value of their operations. Additionally, non-discrimination rules still apply when foreign banks have received support for survival from their home country, and now compete with domestic banks that have not received any support.

GATS, FTAs and investment agreements also contain rules that prohibit controls and restrictions on the free movement of capital in general; only in exceptional circumstances, such as when in the midst of a severe crisis, are such restrictions allowed. The ability to sometimes control and limit capital flows is crucial for developing economies, as shown by recent measures taken by countries such as Brazil, Indonesia and South Korea.

The EU is strongly in favour of easy access to financial markets in developing countries, because activity in these markets is a hugely profitable business for the EU's financial services industry. In bilateral and multilateral negotiations with developing countries, the EU has been pushing for liberalization, even if insufficient international or national supervision and regulation is in place. The most recent FTAs signed in 2010 did not show a change of direction.

The EU should fully and transparently assess the impact of free trade on the developing world before it continues to push for greater liberalisation. The EU should first clarify to what extent the prudential carve-out rule would allow all necessary financial reform measures. The EU should allow sufficient regulatory space for host governments to regulate foreign financial services investors, deal with speculative attacks, as well as with financial crises, and promote sustainable development.

Luxembourg is the EU's „biggest" tax haven

Further reading:

Vander Stichele, Myriam (2009): 'Free trade' agreements contribute to financial and other crises. SOMO. http://somo.nl/publications-en/Publication_3014

Vander Stichele, Myriam / Kavaljit Singh (2009): Rethinking Liberalisation of Banking Services under the India-EU Free Trade Agreement. SOMO. http://somo.nl/publications-en/Publication_3220

Seattle to Brussels Network (2010): EU Investment Agreements in the Lisbon Treaty Era: A Reader. http://somo.nl/publications-en/Publication_3558

3.7. Tax havens

Tax havens are countries or so-called jurisdictions that offer low or no taxation, little or no regulation and privacy protection to investors, companies and individuals. The resulting tax evasion and capital flight from developing countries pose a major obstacle to development. Estimates of illicit financial flows from developing countries range from 250-900 billion US dollars every year, and the trend is increasing. In addition to illegal outflows, tax competition between states, to attract investors through lower taxes, also causes problems for all governments, as do companies when they use loopholes to shift profits to low-tax jurisdictions. Capital flight leads to sever reductions in tax revenue and thus impedes the financing of public goods.

The EU has recently taken measures to tackle tax evasion and capital flight. The Commission released a "Communication on Tax and Development" in April 2010, calling for transparency and information exchange measures to stop tax evasion in developing countries. This communication was supported in June 2010 by the European Council's "Conclusions on tax and development". Furthermore, the European Parliament also put forward strong transparency recommendations in two recent reports, including so-called country-by-country reporting. Such reporting would require multinational companies to disclose financial information regarding their operations in third countries in their annual financial statements. This would prevent companies from shifting their profits between the countries in which they operate, in order to minimise their total tax bill.

Within the EU, the 2005 EU Savings Tax Directive (EUSTD) is an important tool in tackling tax evasion. It contains an automatic information exchange provision for EU member states, which is a prerequisite if governments are to identify tax fraud. The current review of this directive could be used to establish automatic information exchange mechanisms with developing countries.

In June 2010, ECOFIN adopted a resolution to coordinate anti-abuse provisions in member states' tax policies. This covered rules for controlled foreign corporations. Furthermore, the EU has officially committed itself to "tax governance", requiring the existing Code of Conduct Group on Business Taxation to be continued; the latter aims to stop measures that constitute harmful tax competition. Several issues, which civil society organisations have incessantly lobbied for as prerequisites to fighting tax evasion and capital flight, are reflected in the above-mentioned EU initiatives. However, there is still a long way to go and many proposals have yet to be implemented. Furthermore, important rules, such as mandatory disclosure of the beneficial ownership of all economic entities, including trusts and funds, still need to be included.

Further reading:

Kar, Dev / Devon Cartwright-Smith (2009): Illicit Financial Flows from Developing Countries 2002-2006. GFI, Washington. http://www.gfip.org/storage/gfip/economist%20-%20final%20version%201-2-09.pdf

Palan, Ronen / Richard Murphy / Christian Chavagneux (2010): Tax Havens: How Globalization Really Works. Cornell University Press.

3.8. The Financial Transaction Tax (FTT)

The need for financing development and climate change adaptation could be addressed by a Financial Transaction Tax (FTT). This measure would also penalise, and thus help depress, high-frequency trading by speculators and thus lessen volatility. The basic idea underlying the FTT is to tax the trading of all financial assets, e.g. shares, bonds, derivatives and currencies. Basic retails transactions, such as current account transactions, and central bank operations would be exempt from the tax. The tax rate would be set at a very small rate, so as to avoid dramatically reducing market liquidity. Estimates suggest that a FTT could generate two hundred billion to one trillion dollars globally, and approximately 118-178 billion dollars in the EU alone. Therefore, the FTT would become an important source of development financing. A growing number of influential economists, such as Nobel-laureates Paul Krugman and Joseph Stieglitz, have spoken out in favour of a FTT.

Political support for this idea has grown throughout Europe and beyond. At the EU summit in June 2010, the EU heads of state agreed that EU member states wanted the G-20 to further explore and develop the "introduction of a global financial transaction tax". EU institutions have been divided on the issue of the FTT, with the European Parliament supporting it and the European Commission rather opposed to it. In October 2010, the European Commission released a working paper rather critical of the FTT, both for economic and political reasons. However, the paper supports a FTT on a global level and calls for a so-called Financial Activities Tax on profits and remunerations. At their meetings in September 2010, the EU Finance Ministers could not agree on the implementation of a financial transaction tax or a bank levy. They will, however, continue to discuss the issue on the EU and G-20 level.

In October 2010, the IMF also released a staff paper on the FTT. The paper acknowledges that an FTT would be technically feasible to implement. This admission is a key development, as those opposed to the tax frequently claim that it would be impossible to administer. Moreover, incorporating the tax into settlement and clearing procedures, would mean that only minimal, rather than universal, international coordination would be necessary. This is because there are only a few institutions that provide such services, and banks will not boycott settlement and clearing simply to avoid the tax, because these processes dramatically reduce the risk of large losses from counterparties defaulting. The OTC product clearing industry is also a natural monopoly, which will limit new entry to this market.

On a global level, support for the FTT is equally divided. The Canadian government has voiced strong opposition to introducing a bank levy or a financial transaction tax, arguing this would punish its banks, which were sufficiently prudent and were not affected by the crisis. Countries such as India also argue that better regulation would be preferable over increased taxation. However, a FTT would not destabilise the markets, and would be a very progressive tax, with minimal global co-operation. When restructuring the financial system, it is imperative the EU ensure the new order is fairer.

Further reading:

Schulmeister, Stephan / Margit Schratzenstaller / Oliver Picek (2008): A General Financial Transaction Tax. Motives, Revenues, Feasibility and Effects. Vienna.

Schulmeister, Stephan (2010): Bank levy versus transactions tax: A critical analysis of the IMF and EC reports on financial sector taxation. Vienna.

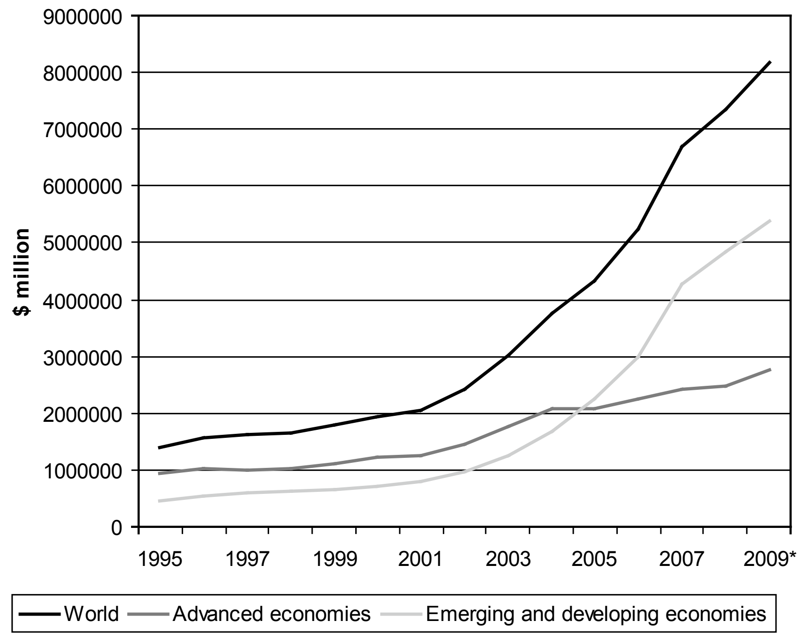
Leading group on innovative financing for development: http://leadinggroup.org

3.9. Currencies

The existence of different currencies has considerable effect on the relationship between the respective economic areas. Exchange rate volatility undermines investment in developing countries. It introduces uncertainty into domestic financial planning, and foreign investors additionally worry that the value of their assets may collapse due to hyperinflation. Exchange rates can be fixed via government intervention, or allowed to float freely. Both systems have their advantages and disadvantages. A fixed system can fail in reflecting economic fundamentals. But when exchange rates float freely, the accompanying volatility, which can be exacerbated by speculation, can also cause problems. Currency crises have become more frequent since the fixed exchange rate system set up after World War II was abandoned in the 1970s.

Developing countries generally peg their currencies to a stable, developed currency, usually the US dollar, in an attempt to prevent inflation. However, this system is vulnerable to speculative attacks, as speculators may aggressively drive down a currency in the hopes that the government will not be able to counter the move, and, thus, will allow the currency to devaluate. Consequently, developing countries build up large foreign exchange reserves (see figure 6), which they then use to buy, and thus support, their own currency when it is devaluating, either naturally or as a result of speculative attacks.

Figure 6: Official foreign exchange reserves



*Projection, source: IMF

After World War II, the US dollar was established as the world's leading currency. Consequently, most globally traded commodities, such as oil, are denominated in US dollars. In this respect, a leading currency helps facilitate international trade. However, this also means the world economy is dependent on the dollar, and problems in the U.S. economy are rapidly transmitted through to other countries. The supremacy of the dollar has been weakened by the establishment of the euro and, in recent years, by the rise of China and other emerging markets. This emerging multi-polar system reduces the problems introduced by dollar hegemony, but also leads to a more complex system. It could therefore also potentially be detrimental to the real economy, in particular in developing countries.

Since exchange rates are a problem for trade, investment and debt servicing, various means for dealing with them at the macro level have been attempted. One is the creation of a single currency, as advocated by Keynes in 1944. For example, the Euro was established for precisely this purpose. In regions of Asia and Latin America, similar regional currency unions are also being considered. However, it is also worth exploring the possibility of expanding the role of the IMF's "special drawing rights", a synthetic foreign exchange reserve derived from the value of a basket of currencies. Another possibility is a coordinated global exchange rate system, e.g. through inflation adjusting, as well as the use of capital controls (see also chapter 3.10).

Of course, any process of currency integration would take a long time. The main problems are the differences in the economic strength of various national economies. If a stronger economy and a weaker economy come under the same currency, the weaker one loses its competitiveness. As long as these differences persist, having a national currency allows devaluation of deficit countries' currencies and appreciation of surplus countries' currencies. However, within a common policy framework of cooperation, different economies could be harmonised over time

Further reading:

UNCTAD (2010): Global monetary chaos: Systemic failures need bold multilateral responses. Policy brief. http://www.unctad.org/en/docs/presspb20102_en.pdf

Ambrose, Soren / Bhumika Muchhala (2010): The problem of reserves in developing countries. http://www.twnside.org.sg/title2/resurgence/2010/234/cover04.htm

3.10. Capital controls

Free movement of capital is a core component of economic integration in alliances such as the European Union. However, the free flow of capital can also create problems, particularly for developing countries, as it can quickly reverse, or make countries dependent on foreign investors and global markets. Therefore, capital controls have been common since 1945. As Keynes noted during the war, "control of capital movements both inward and outward should be a permanent feature of the post-war system."

With the collapse of the Bretton Woods system in the 1970s, capital controls were considered to be backward or protectionist, and incompatible with a market economy. However, after the Asian crisis in 1997/1998, questions arose as to whether the liberalization of capital accounts was a sensible policy in all economic conditions. Malaysia, which imposed controls, was better off during the crisis than countries like Thailand, which did not. Other countries, such as China and to a certain extent also India, did not liberalize their financial markets. Hence, they were not or only indirectly affected by the Asian crises.

Capital controls are one of the best instruments to ensure that capital flows serve sustainable development. In a working paper from February 2010, even the IMF stated "that capital controls on certain types of inflows might usefully complement prudential regulations to limit financial fragility and can be part of the toolkit. In particular, by helping fuel credit booms, especially in foreign currency, debt liabilities, including debt recorded as financial FDI, seem to bring significant vulnerabilities to the economy." (see below, Ostry et al.)

Capital controls can also increase the amount of capital available to governments and companies in the developing world, by limiting the extent to which their domestic investors can invest overseas. Most importantly, capital controls help prevent large streams of capital suddenly flowing into a country, and then, at a later date, rapidly flowing out of the country. Such events are highly destabilising, and not conducive to sustainable development. Many countries are now implementing capital controls. For example, Brazil imposed a tax of 2% on capital inflows in October 2009, and

increased it to 6% in 2010, to deter carry trade activity. In 2010, South Korea and Indonesia introduced currency controls to protect themselves.
The goal should not be to stop all international capital flows. Capital movements should simply be monitored and regulated. The EU must learn from previous crises, and end its dogmatic dismissal of capital controls. At the moment, EU trade and investment agreements impose the EU's own rules of freedom of capital movement on developing countries, which only allow for temporary interventions to restrict cross-border capital movements and, even then, under strict conditions. Therefore, the EU should stop pushing for the liberalization of capital accounts in the GATS negotiations and in bilateral trade and investment agreements. Solely emerging and developing countries should be responsible for how far they want to liberalize their capital accounts.

Further reading:

Ostry, Jonathan D. / Atish R. Ghosh / Karl Habermeier / Marcos Chamon / Mahvash S. Qureshi / Dennis Reinhardt (2010): Capital Inflows: The Role of Controls. IMF staff paper. Washington. http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf

Singh, Kavaljit (2010): Fixing Global Finance. A Developing Country Perspective on Global Financial Reforms. New Delhi: Madhyam. http://www.madhyam.org.in/admin/tender/FGF2510.pdf

3.11. Trade imbalances

Global imbalances are often quoted as being one of the causes of the current financial crisis. One specific type of imbalance is the focus of attention: foreign trade imbalances, i.e. the fact that certain countries export much more than they import. Inversely, other countries import much more than they export. If such an imbalance continues over time, it leads to substantial current account surpluses on the one side and deficits on the other.

A country which has a permanent deficit accumulates debt, whereas the surplus countries become creditors of the deficit countries. Looking at the statistics, one can see that the major surplus countries are China, Germany and Japan, whereas the biggest deficit country is the US. The US financed this deficit through treasury bonds. The Chinese were the biggest purchaser of these bonds, accumulating an unprecedented sum of reserves: 2,998 trillion US dollars in 2009. These imbalances can affect other important economic parameters, such as exchange rates, currency reserves, interest rates and labour markets, and in the end, the economy as a whole.

Running a trade surplus can be attractive for a developing country in order to "catch up" with the industrialised world, as shown by China, where low wages and a high savings rate are used as a comparative advantage to fuel development. Nevertheless, surpluses – like deficits – can be a problem if they continue over time. Frequently, a surplus may be a sign of true economic performance, but the average citizen pays the price – with stagnating or even shrinking wages. Or, as the example of China shows, a huge surplus is mirrored by a huge deficit.

This issue of imbalance has to be dealt with at a global level, especially within the G-20. Mechanisms need to be put in place to eliminate this unsustainable situation. This is only possible through efforts centred on both trade and finance, including capital controls and currency measures. Of course, the EU is not the dominant player here, unlike the US and China. However, the EU can also make a difference, beginning with internal imbalances. At the international level, the US has proposed to limit the trade deficit to a certain percentage of GDP. Such initiatives should also be considered in the EU.

Containership

Further reading:

Flassbeck, Heiner / Massimiliano La Marca (2009): Global imbalances and destabilizing currency speculation. Journal of Business, Finance and Economics in Emerging Economies, Vol 4, No 1. http://vi.unctad.org/uwist08/sessions/tue0513/flassbeckglobimb.pdf

UNCTAD (2010): Trade and Development Report 2010. Geneva.

4. Conclusion: Towards a global finance system at the service of sustainable development

This brochure has outlined the most important effects of EU financial reform on sustainable development. Currently, reforms do not adequately mandate the financial sector to contribute towards the transition from an unequal, socially and environmentally destructive economic system, towards a new financial model that supports fairness and sustainability.

To summarize, the EU should take the following reform goals into account:

- Considering sustainability and the precautionary principle in all reforms.
- Ensuring full transparency of EU financial operators and markets.
- Comprehensively regulating all financial actors to prevent shadow banking.
- Deleveraging the financial system, especially the banks.
- Introducing restrictions on speculators and speculative products, especially in commodities markets.
- Supervising European banks operating in developing countries.
- Permitting prudential capital controls in free trade and investment agreements.
- Tackling tax evasion and tax avoidance, and increasing progressive taxation of wealth.
- Facilitating innovative development financing via a Financial Transactions Tax.
- Pushing for greater international cooperation on exchange rates, trade imbalances and capital flows.
- Giving developing countries a greater say in international decision-making processes and in supervision.

There is a long road to travel before a sustainable economy can be realised. However, given the vital importance of this goal, it is crucial that the European Union does not shy away from taking a leading role. The current financial crisis has engendered unprecedented political and public will for reform; this once-in-a-lifetime opportunity must be seized.

General resources and further information

27

This section provides general resources for following the debate on financial reforms.
An update on the ongoing reforms is provided in a **bi-monthly newsletter on EU financial reforms,** which can be subscribed to on the SOMO website **http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletters/subscribe or by emailing Myriam Vander Stichele: m.vanderstichele@somo.nl**.
Furthermore, there are several email list serves:

- On commodity speculation and derivatives reform globally: email to **food-spec-strat+subcribe@googlegroups.com**
- On commodity speculation and derivatives reform in the EU: email to **eu-food-spec+subcribe@googlegroups.com**
- On the Financial Transactions Tax (FTT): email to **transactions-tax+subcribe@googlegroups.com**

Official websites:

Bank for International Settlements: **http://www.bis.org**
Council of the EU: **http://www.consilium.europa.eu/showPage.aspx?id=&lang=en**
European Parliament (EP): **http://www.europarl.europa.eu**
European Commission (EC): **http://ec.europa.eu/index_en.htm**
Financial Stability Board: **http://www.financialstabilityboard.org**
International Monetary Fund: **http://www.imf.org,** UNCTAD: **http://www.unctad.org**,
World Bank: **http://www.worldbank.org**

The project members "Towards a Global Finance system at the Service of Sustainable Development":

Association Internationale de Techniciens, Experts et Chercheurs (AITEC): **http://aitec.reseau-ipam.org**
Centre for Research on Multinational Corporations (SOMO): **http://somo.nl**
Glopolis: **http://www.glopolis.org**
New economics foundation (Nef): **http://www.neweconomics.org**
Védegylet: **http://www.vedegylet.hu**
World Economy, Ecology & Development (WEED): **http://www.weed-online.org**

Other NGOs working on financial and sustainability issues:
Bretton Woods Project: **http://www.brettonwoodsproject.org**
Campagna per la riforma della banca mondiale (CRBM): **http://www.crbm.org**
Corporate Europe Observatory (CEO): **http://www.corporateeurope.org**
Friends of the Earth: **http://www.foe.org**
Re-Define: **http://www.re-define.org**
Word Development Movement (WDM): **http://www.wdm.org.uk**

Networks and campaigns:
European Network on Debt and Development (EURODAD): **http://www.eurodad.org**
Europeans for Financial Reforms: **http://europeansforfinancialreform.org**
Make Finance Work: **http://www.makefinancework.org**
Regulate Finance for Development: **http://regulatefinancefordevelopment.org/homepage**
Rethinking Finance: **http://rethinkingfinance.org**
Seattle to Brussels Network: **http://www.s2bnetwork.org**
Tax Justice Network: **http://www.taxjustice.net**

On US reforms:
Americans for Financial Reforms: **http://ourfinancialsecurity.org**
Institute for Agriculture and Trade Policy (IATP): **http://www.iatp.org**
Commodity Futures and Trading Commission: **http://www.cftc.gov**

Developing countries' views:
Focus on the Global South: **http://www.focusweb.org**
Madhyam: **http://www.madhyam.org.in**
South Centre: **http://www.southcentre.org**
Third World Network: **http://www.twnside.org.sg**

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