

**Indian Council for Research on
International Economic Relations
15 September 2009,
New Delhi**

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

*Andrew Sheng,
Adjunct Professor,
Tsinghua University and University of Malaya*

Opinions are personal to author

Key Issues - Why didn't we see this?

1. **Davos WEF Chairman Klaus Schwab** *“What we are currently experiencing with the financial crisis and its consequences is the birth of a new era – a wake-up call to overhaul the institutions, our systems and above all, our thinking.”*
2. **Queen Elizabeth II: Why had nobody noticed that the credit crunch was on its way?** *British Academy answer: “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.”*

Financial Crisis: Four Failures

1. **Failure to remember History** - we have a history of increasing volatility and financial crises
2. **Failure to see Macro-Systemic Issues** - Unsustainability of Global Imbalance, Low interest rates, Implications of Asset Bubbles and Excess
3. **Failure to understand systemic implications of micro-behaviour** - Embedded leverage in Financial Engineering, bad incentive schemes,
4. **Failure of Economic Thought** - Specialization of academic disciplines ignored the really important political economy issues of our times: social inequities, political capture by vested interests, global warming and complex factors that affect financial stability -

Paul Krugman - *much of the past 30 years of macroeconomics “was spectacularly useless at best, and positively harmful at worst.”* 3

Fritjof Capra: The Turning Point (1982):

1. **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**
- **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.”**

Fragmentation vs. System-wide view at Academic and Government Levels – it does not add up

- 1. Fragmentation of Academic Disciplines –**
Economics wants to be a science, but uses unrealistic assumptions about human behaviour that turned out to be false. Example, the assumption that default risk and liquidity risk are exclusive [externalities are zero], non-interdependent and can be measured using models
In reality, institutions and behavioural characteristics are interdependent, inter-connected and interact in non-linear manner.
- 2. Fragmentation of Governance**
We have One Global Market, but financial institutions are regulated under National laws [Fragmentation of enforcement] – race to bottom
At national level, different agencies are in charge of different institutions, so that there are overlaps, gaps, turf-fighting and non-cooperation to solve complex social issues

Mervyn King - Banking is Global in Life and National in Death [but regulated in parts].

Montek - Three Great Issues of G20– it does not add up

1. Trade –

Trade has been positive globally, but it is driven on an unsustainable “material consumption” rather than “service-knowledge sustainable consumption path.

2. Jobs - quality of jobs, not quantity

As He Fan mentioned yesterday, does it make sense to spend US\$250,000 to create a job that earns \$2,500 per year? We need new type of job creation.

3. Global Warming - Danger if last 30 years prosperity due to Positive side of Global Warming, but next 30 years could see Negative side of Global Warming.

- How can World Governance finance Global Warming structural adjustment costs?

G20 is first opportunity to have more representative global governance model that might work, not for national interest, but for Global Interest.

Quantity vs Qualitative Growth

Fritjof Capra and Hazel Henderson (2009):

- **GDP Fever is at root of current problems [all measurable monetary values are added up, but non-measured externalities are ignored]. Growth for growth's sake has become quantitative exploitation of natural resources without considering ecology, global warming and quality of life.**
- **Central challenge of our economic and ecological crisis: 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?"**
- **Gandhi - "Earth provides enough to satisfy every man's need, but not everyman's greed".**

Current crisis should be viewed as a Network Crisis.

- **Highly Concentrated** hubs (20-25 large complex financial institutions) accounting for over half of global turnover, particularly in derivatives, concentrated in London, New York.
- **Too Interconnected to Fail** – LCFIs are larger than countries
- **Highly interdependent** – LCFIs trade with hedge funds and key clients, dependent on AIG, government deposit guarantee and central bank liquidity provision;
- **Inter-Active** – Markets become pro-cyclical through momentum trading, but reversal becomes vicious circle – lower liquidity, lower prices, insolvency
- **Simultaneous** – failure of Lehmans led to almost instantaneous stoppage of global credit, which affected real economy
- **Complex** – no one understood complexity of financial derivatives

Richard Posner: Critique on US Reforming Blueprint

-- *Lombard Street, July and August 2009, finreg21.com.*

- **Premature** – advocates a specific course of treatment for a disease the cause or causes of which have not been determined.
- **Emphasis on the folly of private-sector actors—investors, consumers, credit-rating agencies, above all bankers and and defects in the regulatory structure, leaving out:**
 - 1) Errors of monetary policy;**
 - 2) Large budget deficits;**
 - 3) Deregulation in banking;**
 - 4) lax enforcement of existing regulations;**
 - 5) the complacency of and errors by the economics profession**

Lessons from US Financial Behaviour, 1974-2008

- US gross debt grew from \$2.1 trn in 1974 (1.6 times GDP) to \$52.5 trn, of which financial sector debt grew 66 times to become largest borrower (32.5% of total, compared with households, 26.3%, and business 21.2%)
- Financial sector debt was created because banks became financial engineers, moving from retail to wholesale banks, relying more on securitization and therefore funding from abroad.
- **Financial engineering financed partly US current account deficit, but through hidden leverage.**

Who is winner in financial crisis?

- Subprime losses of \$150 bn in 2007 required US Government aid of \$13.2 trn as of 19 June 2009
- Top 10 US banks accounted for 53.9% of total bank assets in 2008, vs 35.6% (higher concentration)
- In crisis year 2008, salaries of top 10 banks rose from \$31 bn in 1999 to \$75 bn, but cash dividends to shareholders was only \$17.5 bn.
- **Management took 4.3 times more than shareholders, when shareholders had to inject capital and government guaranteed the deposits.**

This is also a Governance Crisis

Public/Private Governance Typology

	Private	Public
Private	1 - Greed for self-interest	2 - Civil Society - NGO
Public	3 - Public for Bureaucratic interests	4 - Public for Public Interests

Benner, Reinicke and Witte (2004):

Multisectoral Networks In Global Governance

- Governance gaps both operationally and participatorily.

Four operational asymmetries :

- The **jurisdictional** gap arising from the fact that global public goods and disexternalities extend far beyond the legal constraints of nation-states;
- The **temporal** gap between need for timely action and 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;
- 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 two areas:

- The growing income and wealth inequality arising from globalization;
- The demand from NGOs to be heard on global issues, with increasingly moral, financial and knowledge resources.

Present Spending Increase/Tax decrease model is Leverage Machine

- **Leverage creates global Ponzi scheme to fund current consumption through future taxation - sustainable only through zero interest rates**
- **ZIRP is fixed interest rate (at zero) policy - puts huge volatility on other asset prices, capital flows and exchange rates**
- **“bubble thy neighbour” policy - all countries hostage to ZIRP - no country can increase interest rates, tax rates and regulation without huge capital flows and arbitrage.**

Key Question - Is present “Global Leverage Machine” sustainable? - Global Tragedy of Commons

- **Unwinding of Excess Consumption + Deleveraging [leading to accelerated Global Warming] will take time**
- **Gold-based monetary system not viable due to unpredictability of supply of gold**
- **Bretton Woods II = Triffin Dilemma for US - conflict of domestic vs global monetary policies**
- **If RoW growing faster than US, requires US to run current account deficit + funding**
- **Will Global Central Bank + Global Super-Regulator solve this?**
No! Because there is no Global Fiscal resources to fund Global Goods + compensation for disadvantages region or sectors

In 30 years, Global Warming will change Global Governance Model

- **This crisis is financial + global warming crisis**
- **Can Coasian Bargaining solve global non-cooperation issue?**
- **No! Some form of Global Taxation is necessary - huge change in Westphalian model of voluntary cooperation.**

Advantages of Turnover Tax

1. **Less regressive, voluntary “user-pay” tax that is easy to collect**
2. **Can be counter-cyclical, increased as turnover increases to risky levels and reduce when market is slow - complements Capital Adequacy rules**
3. **Used to finance global public goods where there is no global tax**
4. **Paid by financial institutions that are currently able to hide in tax free OFCs**
5. **Reduced profits means reduced risk-taking**
6. **Add Sand in Wheels, because Frictionless Financial System enables infinite derivation and Runaway Windmill**
7. **Tax collection mechanism means that financial markets can be monitored against money laundering, insider trading, market manipulation etc that is currently impossible in global markets**

How much can be collected?

1. At US\$900 trillion annual FX + stock market turnover, 0.1% would yield \$900 billion annually - in 3 years clean up banking losses
2. At 0.005% would yield \$90 billion, double pledged aid to Africa of \$50 billion
3. Recommend minimum of 0.005% as global standard, collected at national level and credited to special fund, part of which can be used to clean up domestic financial losses. trading, market manipulation etc that is currently impossible in global markets
4. Suggest also standardized Withholding Tax Rate, say 20%, so that we have tax equalization globally at minimum level.
5. Governments agree not to deal with countries that do not tax and withhold.

Implications For Reforming Regulatory Architecture

1. Regulators should appreciate that mass behavior is influenced more by a few clear and simple rules, firmly enforced, rather than multiple complex rules, lightly or under-enforced.
2. Reform on a modular basis.
3. If the regulation actually limits the level of leverage, the bonuses will be capped.
4. Asia is more rudimentary, bank-based, and therefore not so sophisticated. Suggest that:-
 - *We have simpler form of Basle and IFRS for Emerging Markets, with priorities for implementation*
 - *Have global fund for Education for All, to be broadened to uplifting standards.*