Towards a global financial system fit for development

Regulate Finance for Development briefing
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Towards a global financial system fit for development.
Building awareness, mobilising opinion

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DIFFICULT TIMES, IMPORTANT RESPONSIBILITIES:
The economic crisis, which started with the financial collapse of 2008, has expanded across the world and it now has its epicentre in the Eurozone crisis. Some European countries are on the brink of bankruptcy and the Euro is under extreme pressure. The unfettered de-regulation of global financial markets in the past decades has resulted in a massive increase of uncontrolled capital flows and speculative investment just seeking high returns in the short term. This is the consequence of a crisis of capital accumulation which forces the creation of new financial assets in order to generate more profits than possible through productive investments.

These processes had severe impacts on the developing world in the last three decades. And today the financial and economic crises, far from being over, continues to generate impacts on developing countries, this shows how urgent is to fix global economic imbalances and global economic governance before it is too late.

So far, the measures put forward by EU decision-makers in response to the crisis fall short of what is needed. They are failing to drive Europe out of the crisis. But, more importantly, they are not living up to the needs, hopes and aspirations of European citizens, whilst falling short of Europe’s responsibility towards developing countries.

Issues like debt management and restructuring, as well as the impacts of neoliberal economic structural adjustments, which dominated the development agenda in the last three decades, have today become everyday news in advanced economies including in Europe. And at European level regional economic imbalances, primarily due to the biased creation of the European economic zone, are becoming similarly important for their negative implications as well as global economic imbalances.

Nevertheless, these difficult times also provide a golden opportunity to re-regulate the financial system and change the development model. European leaders, led by the European Parliament, should seize this chance to put people first and lead a global reform process that delivers a fair financial and economic system and sustainable development for all. Today, Europe not only faces a terrible crisis, but also a great historical responsibility.
INTRODUCTION

‘In order to appreciate the virtues of Moses, it was necessary for the people of Israel to first be slave to Egypt; and for the Persians to become aware of Cyrus’ great courage, to first be oppressed by the Midianites’

Machiavelli, The Prince

Global financial stability is a global public good which is essential to guarantee long term sustainable development. Unfortunately, the crisis has shown that the current financial and regulatory system failed to guarantee such stability. In fact, the economic literature links the capital flow surges and stops that define the current financial system, with the prevalence of financial and banking crises.

As we are witnessing, these crises have consequences that reach far beyond the financial realm. The problem is that four decades of financial liberalisation and deregulation have left countries defenceless against pernicious financial flows. For instance, highly variable flows of short term speculative capital can bring about economic instability, causing exchange and interest rate fluctuations and exposing the country to contagion effects. In addition, the liberalisation of the financial system has enabled practices that also have detrimental consequences, especially among the poor. Financial speculation on food and commodity prices is literally threatening the lives of millions of people, mainly in developing countries. Moreover, the free flow of capital has facilitated the movement of illicit capital, including the proceeds of tax evasion and avoidance, a practice used mainly by wealthy individuals and corporations and which every year prevents developed and developing countries from collecting billions of dollars in taxes. This is public money that cannot be used to fight poverty and inequality.

At the same time, poorly planned financial sector liberalisation and deregulation has shifted the balance of power from Governments to markets. Across Europe, governments are adopting polices to soothe financial markets while citizens are bearing the brunt of a crisis for which they are not responsible. Recent plans to deepen European integration through a fiscal union will also be counterproductive if austerity measures are adopted in an undemocratic manner without consulting the national and the European parliaments. There cannot be a solution, as long as the big casino is not shut down and the financial sector is regulated so that it is no longer able to dominate the entire economy.

A new approach is necessary to make the financial system work for development, ensure an equitable distribution of wealth, reduce the volatility of food prices and restore political space for sovereign nations. The outputs of this research project show what can be done to make the global financial system fit for development.

Developing countries and developed nations would benefit if a more hard-headed approach to macroeconomic policy and cross-border financial flows is adopted. It is time for a new consensus replacing the failing neoliberal ideology - in favour of pragmatic policies seeking to channel financial flows for the benefit of people, especially those in developing countries. Given the occurrences of the last few years, it is clear that while the hurdles may be high, achieving finance that works for development is not beyond our reach.
RETHINKING GLOBAL FINANCIAL REGULATIONS:

The lack of macroeconomic regulation has reduced the scope for national policies and earned big rewards for some, but others have had to pay a high price. The list of the winners is lead by the financial markets, whose development is based on its own agility, sophistication, and flexibility, as well as on its capacity to evade national regulations. The main losers are citizens, especially in developing countries.

The management of capital flows is much more than a technical economic issue. Due to its effect on financial stability it has wide ranging social implications. The way in which financial flows are managed impacts on wealth distribution, poverty, and unemployment, especially when crises materialise due to unregulated financial flows. Lack of management tools, extreme volatility, speculation and other ills associated with the liberalisation of capital flows can bring vulnerable economies to their knees with terrible consequences for citizens. For instance, the so called Tequila crisis in Mexico saw the instances of extreme poverty soar from 21 to 37 per cent of the population between 1994 and 1996 it was not until 2001-2002 that it fell back to pre-crisis levels.

In addition, the rise of a powerful and highly speculative financial sector -sustained by the already mentioned lack of financial regulation- has transformed the sovereignty of governments into a ‘conditioned sovereignty’ or ‘supervised sovereignty’, in which governments are forced to follow the path set by the financial markets. Through their influence over the economy, these markets –and not citizens- are the ones who currently approve or disapprove national economic policies. This has been made clear by the recent fall of the Greek and Italian governments. In other words, there is a complete divorce between the global economic space and the national political space. The Euro zone debt crisis highlights the need for adopting urgent and efficient measures in order to hold financial markets to account.

The current debt crisis in Europe is a result of the privatisation of profits and the socialisation of losses in the financial sector. This crisis is only a repetition of previous debt crises that many developing countries have gone through since the early 1980’s. An independent and fair debt work out mechanism is needed in order to deal with unsustainable and illegitimate debts that put the burden of irresponsible behaviour by creditor and debtor governments on the citizens. A coordinated and coherent global response is needed. Governments across the world should use this opportunity to regain control of the financial system and make it work for development, both in the North and the South. These lessons should be borne in mind to develop a new and effective macroeconomic global governance system. This financial system re-regulation must also change the development model so that benefits are more equally shared by all the citizens of the world.

WHAT SHOULD BE DONE In order to reach macroeconomic and financial stability in the EU and in the world?

1- The ECB should take the role central banks were created for: to be the lender of last resort.
2- Speculative actors such as Hedge Funds should be banned. Speculative trading should be stopped, starting with banning CDS and short selling. Investment banking has to be strictly separated from commercial banking.
3- A haircut on EU member states’ debts should be accompanied by mitigation measures for savings and small investors.
4- Credit rating agencies shouldn’t be allowed to rate sovereign states, rating should done by a public agency under democratic control.
5- Tax financial transactions (at a rate of at least 0,05%) on all classes of financial assets.
6- A green Marshall plan for all European economies under pressure should be set up.
5-In order to stimulate domestic demand in surplus countries wages should be raised above productivity for the next years, and social systems must be improved.
6-Strong progressive taxation must contribute to redistribution from top to bottom and from the private to the public sector.
7-Improve regional and international coordination on capital account regulation, particularly enforcement of rules. Ultimately, a more ambitious global framework agreement could reinforce mutually consistent management techniques across source and destination countries. Reinroduce capital controls in Europe in the context of the upcoming EU Treaty review.
8- An international independent and transparent debt work out mechanism is needed.
FOOD SPECULATION AS A CONSEQUENCE OF DEFICIENT GLOBAL FINANCE GOVERNANCE

As mentioned above, the lack of financial regulation has dramatic consequences for developing countries and, especially, their citizens. The most visible example of this issue is financial speculation on food prices. Commodity futures markets have become monstrous in size compared to the actual production of the traded commodities, thereby causing price volatility and speculative bubbles.

Food price rises and greater volatility, lead to insecurity for many people. Consequently, due to high levels of unpredictability, households’ consumption is reduced and a loss of savings occurred, which renders economic growth impossible. Even more dramatic is the fact that food speculation is often effectively a derivate on chronic nutritional deficiencies and on informal, dangerous and precarious labour –especially for women and children.

In order to avoid speculation on food prices, it is essential to reverse most of the de-regulation that has taken place over the last decades. Calls for better regulation of commodity futures markets to ensure stable and affordable food prices for the benefit of consumers, producers and businesses, have been supported by a range of experts, including the Head of the UN Food and Agriculture Organization, and the UN Special Rapporteur on the Right to Food. In addition, G20 governments have identified food security as a top priority.

At present, action to crack down on excessive speculation in commodity markets is being considered both in the US and EU. In both markets there are opportunities to implement reforms that would help stabilize food prices. The U.S. Dodd-Frank Act on financial market regulation included 'reducing excessive speculation on food' as one of its policy objectives. In Europe, the European Commission recently published its proposals for a revised Market in Financial Instruments Directive (MiFID II) and a new Regulation (MiFIR). As a first step in the right direction, new rules for improving transparency in commodity derivatives markets have been envisaged. However, serious omissions and loopholes are likely to prevail, enabling even the most prominent actors to dodge the regulatory framework. Caps on the size of the bets speculators can make (hard position limits) are essential to tackle excessive speculation. However, existing MiFID drafts leave this question open. Throughout 2012, the proposals will be subject to discussion and changes during the EU ordinary legislative process, providing an opportunity to test the real commitment of Europe to a fairer financial system.

Non-financial hedging methods for farmers and food producers should also be considered as an alternative of financial markets. Various different hedging methods have proven efficient, such as: warehouses; cooperatives; growing a wider variety of crops; etc. These alternative risk hedging methods fit into a concept of sustainable, small-scale agriculture, respecting the principle of food sovereignty, and providing for food safety and sufficient supplies world-wide. At European level the CAP reform process in 2012 offers an excellent opportunity to put these ideas into practice and support alternative and non-financial hedging practices for farmers.

WHAT SHOULD BE DONE IN ORDER TO STOP FOOD SPECULATION?

1- Move the trading of derivatives from deregulated ‘over-the-counter’ (OTC) markets onto well regulated public exchanges, similar to the stock market, and introduce ‘position reporting’ so that regulators and analysts can properly assess the functioning of the markets.
2- Ban of ‘massive passive’ speculators from food commodities. These are, for example, pension funds and big institutional investors that use commodity futures to diversify their portfolio. Similarly, products like commodity index funds and exchange traded funds and notes, as well as high frequency trading should be prohibited in food commodity markets.
3- Introduce strict limits on the market share that can be held by individual traders and by financial speculators as a whole (position limits), to prevent them from overwhelming the market.
4- Give authorities sufficient powers to act on both market abuse and excessive speculation. This must include ensuring full transparency and supervision of financial markets in food commodities, caps on the size of bets speculators can make, and banning harmful trading activities, such as purely passive speculation. In the long-run a specific European supervision agency on food commodities is needed along the model of the Commodity Trading Futures Committee in the US.
5- Large investment funds, including private equity funds, hedge funds and pension funds, must be subject to strict transparency rules and codes of conduct, regarding investments into agricultural land or leases that may lead directly or indirectly to agricultural land grabs (causing problems such as rainforest destruction).
6- Provide incentives to alternative and non-financial hedging practices for small farmers and family agriculture – warehouses, cooperatives, local supply chains and contracts – as well as consider the possibility to reintroduce food commodity prices support.
ILICIT FINANCIAL FLOWS AND TAX EVASION

The lack of regulation has made capital flows highly flexible and mobile. Together with the lack of global coordination on tax issues, this allows certain international corporations and individuals to shift the proceeds of illegal activities and/or cheat national taxation systems. Off-shore centres and tax havens have proliferated in the last few decades and currently facilitate an annual illicit outflow from developing countries of around USD 500-800 billion – five to seven times the size of ODA. Around 65% of this amount corresponds to transactions related to tax avoidance and tax evasion schemes.

Illicit flows and tax evasion impact on people’s lives mainly in two different ways. On the one hand, governments see tax revenues highly reduced. As a consequence public expenditure has to be cut back with extremely negative effects on education, health and other social policies. On the other hand, capital flight and tax evasion also fuel corruption, which undermines democratic and transparency standards.

Existing initiatives to curtail illicit financial flows and tax evasion have proven insufficient. For instance, the Arm’s length principle of the OECD, to prevent transfer mispricing, and the OECD model for tax information exchange upon request have been but a small contribution in terms of results. Several initiatives also exist to prevent multinational companies from engaging in tax dodging practices by improving financial reporting through what is known as country-by-country reporting. The EU has now made some progress in this area by proposing, in the review of the Transparency and the Accounting directives, the requirement for companies to report on a country-by-country and project-by-project basis in the extractive and forestry sectors. Yet disclosing payments alone will not shed light on corporate tax dodging practices. Disclosing information on the economic performance of multinationals in each country where they operate is required in order to address this problem.

Policy makers have repeatedly committed in international fora, such as the G-20, to bring illicit flows and tax evasion under control, but barely any progress has been made towards comprehensive and effective measures.

Yet, progress made has been poor and slow. The OECD blacklist was swiftly emptied only a few weeks after the London G20 summit, giving little credit to the criteria used. In only 2 years some 37 territories exited the black and grey lists. The latter only counts some 5 territories, which weight only a tiny 0.04% of the global offshore financial market. A Global Forum peer review process was launched to monitor jurisdictions’ commitments to improve transparency but progress has been very slow and weak until now: Some 86% of the countries assessed are not respecting their transparency commitments. Moreover, CSOs estimate that only 3% of tax losses due to tax evasion have been recovered as a result of the Global Forum process.

A bolder and more strategic approach is therefore needed. CSOs are calling on the G20 and relevant financial institutions channelling funds to developing countries to target the users of tax havens. In doing so they would address the problem far more efficiently and swiftly. This is particularly crucial for Development Finance Institutions (such as the IFC; the EIB and national DFIs such as BIO and CDC) which channel public funds into private sector investments in developing countries. Having a development mandate these institutions should play a leading role on the fight against tax dodging and tax havens that undermine development finance.

WHAT SHOULD BE DONE in order to curb illicit financial flows facilitated by tax havens?

1- Promote a standardization of the legal definition of tax evasion
2- Require multinationals to publish their accounts on a country-by-country basis. The EU Transparency and Accounting directives currently under review provide a unique opportunity to extend this obligation to all listed companies at the European level
3- Put an end to shell companies and keep a register of trusts and other secretive legal entities existing under national laws, and their beneficial owners.
4- Reinforcing sanctions against economic and financial crime through a multilateral agreement to ensure automatic exchange of tax information, and to ensure that overseas territories and secrecy jurisdictions enter into the same agreement. The EU Savings tax directive currently under review provides an opportunity to make progress in the right direction.
5- Disclosure of beneficial ownership of all banking and securities accounts
6- DFIs should implement more stringent guidelines to prevent corporate tax dodging and other illicit practices. Beneficiaries of these institutions should publish their accounts on a country-by-country basis and should disclose the beneficial owners of financial intermediaries and investment vehicles involved in their activities.
USEFUL LITERATURE

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