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Pittsburgh: A Fresh Start or Cosmetic Tinkering?

The Chances for a Complete Overhaul of the International Financial Markets

Heribert Dieter

A good year after the collapse of Lehman Brothers, the heads of state and government of the G20 meet in Pittsburgh at the end of September 2009. Amidst signs of global economic recovery – astonishingly fast in the eyes of many observers – the focus is shifting away from acute crisis management and onto long-term reform of the international financial markets. For all the resolute rhetoric, there is no decisive progress to report here. Not even this financial crisis, it would appear, is enough to bring about comprehensive reordering of international finance. Crucial questions, such as countering global imbalances, are low down the agenda for the Pittsburgh summit.

This meeting of heads of state and government of the Group of 20 major industrialised and emerging market economies is the third in twelve months. The first took place on 15 November 2008 in Washington, D.C., at the very end of George W. Bush's presidency and without noticeable participation by President-elect Barack Obama. The second meeting followed on 2 April 2009 in London. Now the third summit will take its course on 24/25 September in the old US steel-making city of Pittsburgh.

The choice of venue is in itself a disappointment. If all the talk about giving new rising economies, especially in Asia, a greater say in efforts to redesign the financial architecture had been in earnest, then an Asian country should have staged the third summit. Holding the meeting in Singapore, Hong Kong or Seoul would have made it clear that the transatlantic powers were ready to make a new start on international finance policy. The chance to make a statement through the choice of venue was wasted.

Executive Pay

The omissions and contradictions in the actual agenda are graver still. Of course it makes sense to scrutinise incentive systems. Exorbitant salaries and bonuses paid to bank employees who neither risk their own capital nor bear any liability when losses occur has understandably provoked widespread popular anger in OECD states. But

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there are good reasons why it is not enough just to fight the symptoms of casino capitalism.

For one thing, there is more than one way to earn a fortune in the financial markets. Bonuses are just one of them; another is giving staff a direct share in the business and its profits. And one should not underestimate the dexterity of those involved. For example, restrictions on earnings within the G20 could be circumvented by paying out bonuses elsewhere. There is little sense in clamping down on the croupiers' pay but otherwise leaving the casino open and running.

An Incomplete Analysis

Although many countries have seen high-octane outrage over excesses in the finance sector, the debate about causes and consequences has often blown over pretty quickly. That was the case in the UK, which profited like no other European country from globalisation of the banking sector. Although a large part of the population are among the big losers of the crisis and the state will be carrying the burden of crisis management for years to come, the British public seems to have accepted its fate. Britain has no more of a broad protest movement than most other OECD countries.

So in many quarters the public is already a little weary of crisis analysis, even though the discussion about causes and consequences is still full of holes. Astonishingly, there are whole issues and groups that are not up for debate at all.

Central Banks and Monetary Policy

The central banks, above all the US Federal Reserve, bear great responsibility for making the great speculative bubbles possible in the first place. Alan Greenspan's expansive monetary policy, tailored much more to the interests of Wall Street than those of Main Street, was one of the central causes of today's financial crisis. But there is little sign that the central banks have changed their course in monetary policy. On the contrary, especially at the central banks there is hardly a whisper of a paradigm shift.

This is particularly true of the United States. Greenspan's successor Ben Bernanke is basically continuing his predecessor's policies, providing the financial sector with enormous funds at almost no cost. Massive provision of liquidity following turbulence in the markets was one of the central pillars of Greenspan's monetary policy. After the stock market crash of 1987 and again when the dot-com bubble burst in 2000, Greenspan flooded the markets with liquidity. Federal Reserve Chairman Bernanke is now applying the same cure, defending his policy with the financial sector's great importance for the US economy. Greenspan's justifications for his bubble-blowing policies were no different.

President Obama reappointed Bernanke to a second term in August 2009, on the grounds that he had managed the difficulties competently and the government could not afford to do without experienced operators in the midst of crisis.

In the private sector, by contrast, the chief executives of a number of major American and European banks have been forced out, and many staff at banks and insurance companies lost their jobs. At least in certain cases the private sector trusted the cleansing power of crisis.

But does Bernanke not epitomise an ominous continuity in US monetary policy? Before his appointment to the Federal Reserve he dismissed the idea that US economic and financial policy was responsible for the huge capital inflows, claiming instead that foreign actors had caused the crisis. The "savings glut" from abroad, he said, was what forced the United States to import so much capital (for a time the United States took more than two thirds of all global capital imports). From Bernanke's perspective the United States was an innocent victim and Alan Greenspan's monetary policy thus absolved of fault.

Even if it was the capital-exporting countries that made the excesses in the United States possible in the first place – at least in their current dimensions – the theory is unconvincing. The United States itself worked very actively to encourage capital inflows, for example exempting foreigners from having to pay tax on interest earned in the USA. And for decades US administrations have failed to increase the savings rate of American households. Americans relied on their wealth increasing through growth in the value of property and shares, and the illusion was supported by official policy. Only as the crisis took hold did American citizens begin to increase their private savings.

This worrying continuity and lack of change ("Change we can believe in"?) extends beyond questions of personnel. The US Federal Reserve steadfastly maintains policies that ignore the development of asset price bubbles; whereas the experience of the past decades tells us that a U-turn is needed. Central banks need to play an active role in dealing with the excesses of casino capitalism. The European Central Bank may have had little success in this field, but at least it has been pulling in the right direction for a long time – as reflected by the controversy between its chief economist Otmar Issing and Alan Greenspan at the beginning of the decade.

More Clout for Banking Regulators

There can be no doubt that regulators in many OECD countries failed to take sufficiently vigorous action to correct irregularities on the financial markets. Even where risks were identified, there was little in the way of decisive action. That applies equally to the United States and United Kingdom and to certain continental European economies.

The reform of banking regulation must not be restricted to tightening the capital requirements for banks. Many regulatory systems suffered from two design errors. Firstly, their primary purpose was not only to ensure stability but also – and in some cases above all – to strengthen the competitiveness of the national financial sector. Secondly, the work of the banking regulators was rarely subject to independent control. Parliaments, especially, played only a minor role in regulating the regulators.

Over recent years there has been an OECD-wide move to strengthen the independence of central banks. This was not an end in itself, but was intended to put the central banks in a position to ensure monetary stability without undue influenced from politicians sometimes pursuing shorter-term goals. Analogously, there should be a collective effort to free the regulators from political influence and strengthen their independence. It would also make sense to involve the parliaments more closely.

It is obvious that if banking regulators are to be effective they need powerful backing. Immediately after a financial crisis they will usually be able to count on that support. But in the medium and long term the enthusiasm for risk – one could also speak of greed – will return to the financial markets. The regulators need to be prepared for that moment, and that means visibly strengthening the institutions and their leaderships. Certain details of banking regulation will be discussed in Pittsburgh, but it would be equally important to have a proper fundamental reappraisal of the issue.

Global Imbalances

The proverbial elephant in the room at Pittsburgh summit is global imbalance. In recent years China, Japan, Russia, Saudi Arabia, and Germany too have exported huge amounts of capital and contributed to speculative excesses in other countries. But the role of the capital exporters played a minor role in previous G20 summits and is unlikely to be a central issue in Pittsburgh either.

In fact, from a German perspective there are good reasons to give a little more

thought to these imbalances. To start with, the whole business was a rotten deal. Germany sold machines and high-quality cars and received Lehman derivatives in return. Germany's enormous surpluses landed back in the United States where they helped fuel the dubious dealings of the US financial sector. Not a model to emulate. But at the international level there is still no earnest discussion about getting rid of the imbalances. And there are reasons for the silence.

For the economies involved the existing model offered advantages and satisfied particular preferences. That applies especially to the United States and China. The former is the economy with the biggest appetite for capital, whereas the latter is already the world's most important manufacturer of consumer goods of all kinds. A specific division of labour has emerged over the past decade: China manufactures goods and supplies the credit for their purchase; the United States buys Chinese and accumulates debt. Back in 2003 the Basle Bank for International Settlements was already describing this arrangement as "vendor finance".

So both countries share an interest in the model's survival. For the Chinese the division of labour is especially attractive. Export-led growth creates millions of new jobs and ensures the survival of the non-democratic regime. At the same time, China's enormous currency reserves represent a potent foreign economic policy instrument with which the country can finance a worldwide shopping spree. Thus the repercussions of Sino-American imbalances are by no means restricted to the protagonists themselves, but actually affect numerous other countries including Germany.

In recent years the Chinese state has stepped up its efforts to secure supplies of mineral and agricultural resources, causing concerns elsewhere including Germany. Because China's foreign trade is governed by politics rather than the laws of the market, it is an open question whether future supplies of raw materials will be acquired on the market or have to be bought from the (Chinese) state.

China's currency reserves could also be used to purchase established businesses. The Chinese state currently has access to liquid funds amounting to $2,200 billion, and the current market capitalisation of Germany's flagship companies BASF (the world's biggest chemicals company) and Daimler (renowned car manufacturer and the world's biggest commercial vehicle manufacturer) together corresponds to just 5 percent of current Chinese currency reserves. In other words, the world's biggest investor is emerging in Beijing and the Chinese strategy – unlike that of conventional private equity – does not even require the availability of cheap liquidity on the international financial markets.

In response demands have been raised in Europe in recent weeks for a strict set of rules to be developed for examining and approving foreign direct investment. This would be superfluous if the international community were able to agree on a shared regime including deterrents for lasting current account surpluses.

Back in 1944 – in his proposals for the Bretton Woods Conference – John Maynard Keynes already proposed a regime that would have punished long-term current account surpluses (i.e. capital exports). Keynes wanted deterrents against both deficits and surpluses. In Germany too, the goal of "equilibrium in external economic relations" was written into the Stability and Growth Act of 1967 (which is, incidentally, still in force). Today, however, the other three sides of the "magic square" – growth, employment and price stability – are granted almost all the economic policy attention.

So our current financial system knows no sanctions for countries running surpluses. For deficits the market, at least in theory, provides adequate controls. While capital-importing countries have to work to attract funds and remain attractive for

foreign investors, countries in surplus can export capital unhindered.

That applies especially strongly to China, which has disabled the strongest mechanism for bringing down surpluses. In a system of flexible exchange rates, changes in the rate balance out surpluses and deficits. A country with a deficit will sooner or later see a devaluation of its currency, increasing the competitiveness of its own products on the domestic and global markets. For surplus countries the mechanism functions exactly the other way round: their currencies should gain in value, which improves the competitive prospects of their economic rivals. But China prevents its currency, the renminbi, from appreciating, allowing it to run permanent high surpluses that massively boost its global influence through non-military means.

The motives and instruments of the four other surplus countries may differ from the Chinese, but they cause problems for their partners nonetheless. Germany's enormous surpluses have also led to tensions within the EU. Without the common European currency, the large German current account surplus (in 2007 more than $260 billion) would have driven up the exchange rate of the deutschmark. And absent an external stability pact (see SWP Comments 2009/C09, July 2009) this drives a dangerous wedge into the European Union. Ultimately, it was German capital exports that financed the bubbles in Spain, Ireland and a number of eastern European countries.

German capital exports were a pretty poor deal anyway. Despite their preference for safe investments, risk-shy German savers have been left carrying the can all the same – through the state budget – for the risks taken by financial intermediaries.

Sanctions for Surpluses?

Long-term surpluses could be brought under control by placing a surcharge on them, as proposed by the Keynes Plan of 1944. Economies that run large long-term surpluses should agree to pay a proportion to a body such as the International Monetary Fund. Surpluses could be categorised as "high" if they exceed 4 percent of GDP and "long-term" could mean "longer than two years". The surcharge could be set at 10 percent of the current account surplus starting in the third year.

Of course a number of objections can be raised against such a system. The proposed thresholds are arbitrary, with no basis in economic theory. But the same applies to the limits on state debt laid down in the Maastricht Treaty.

Also, capital export is generally a private-sector activity (although not in the case of China) so states cannot, it is objected, control the investment decisions of citizens and companies. But governments often work to influence the behaviour of companies abroad, for example by punishing bribe-giving. Governments can and should keep an eye on the volume of capital movements and take measures to stem surpluses where necessary.

Questions can also be raised about transferring funds to an international organisation such as the International Monetary Fund. But this is not a transfer that occurs automatically. The system creates incentives to avoid long-term surpluses in the first place.

Most of all, the proposed surcharge is designed to fill a regulatory gap. Flexible exchange rates correct surpluses, but when the state intervenes to prevent its currency appreciating the mechanism is put out of action. Japan and above all China have done exactly that often enough. As a member of the eurozone, Germany has been able to run large surpluses without this leading to a massive appreciation of the currency.

If one considers surpluses and deficits as two sides of a credit relationship, it becomes clear that the creditor side should be involved too. Today's asymmetrical order – where only the debtors are responsible for credits being repaid – has come in for repeated criticism in the past. During the debt crisis of the 1980s the then chairman of Deutsche Bank, Alfred Herrhausen,

called in 1989 for greater contribution of creditors (including his own bank) in overcoming the debt crisis. The same thing can basically be said in today's crisis: some of the creditors are protected, which appears unfair.

However, contemporary innovations in the financial markets make it harder to understand the effects of interactions. Capital exports to the United States, especially from Asia, have been characterised by a high level of risk aversion. In other words, Asian capital flowed primarily into low-risk American treasuries. Apart from exchange rate fluctuations – and even these have been controlled by the central banks – investors entered into no significant risk. German state banks and the IKB Deutsche Industriebank were basically also risk-shy and bought supposedly safe securities, but suffered the misfortune that their investments did not live up to their agency ratings.

Thus even though America's foreign creditors did not invest directly in risk business they still contributed to the creation of the speculative bubble. So-called innovations in the financial markets made risks tradable separately from one another (credit risk, interest risk, liquidity risk) and from the actual act of lending. This is how capital with a preference for low risks flowing into the United States made it possible for high risks to be taken in the financial sector. But, in the case of the Asian participants, the risks remained largely in the United States. One prominent example is the US insurer AIG, which sold billions of dollars of credit default swaps without actually making provisions for the possibility of default or setting aside capital.

All in all, the upshot is that because capital exporters contribute indirectly to the emergence of bubbles mechanisms are needed to restrict long-term capital export. This issue belongs on the agenda at the G20.

Tobin Tax and Stock Exchange Tax

As we have seen, large long-term surpluses lead to speculative bubbles on the financial markets. Alongside direct sanctions, transaction taxes such as the one proposed in 1971 by American economist James Tobin would be another means to rein in long-term surpluses. The goal of such a tax would not be – as Tobin originally proposed – to stabilise exchange rates, but to increase the general cost of international capital movements. The revenues from such a tax could be used to create a pool from which state support programmes could be funded when a crisis occurred. Then, unlike today, the financial sector would cover the cost rescuing itself, rather than the state. One drawback of the Tobin tax is that it taxes all international transactions alike, without distinguishing between those financing useful activities, such as direct investments, and international capital flows serving speculative purposes.

In view of the current massive crisis we must ask earnestly whether it would not make sense to increase the cost of transactions in the financial markets, in order to counteract some of the excesses that have only been able to arise on the basis of the low costs of such transactions. We are talking about a tax that serves two main goals: to take a little of the velocity out of the whole financial sector and to open up a new source of tax revenue, which could be rich depending on the configuration of the tax.

A distinct and different option is a stock exchange tax at the national level. This would tax transactions within a financial market, in a similar way to land transfer taxes. Here too, the goal would be to slow down the financial markets and hinder purely speculative transactions. A stock exchange tax, which has existed in the UK since the seventeenth century (stamp duty), would be an obvious proposal for discussion in the G20 framework. The danger of business shifting to other financial markets would be reduced if many countries were to introduce the tax jointly. The example of

London shows that the unilateral imposition of a stock exchange tax need not mean the end of a financial centre.

Rating Agencies

Global imbalances are not the only field where there is need to think about new incentive systems. Rating agencies contributed greatly to the current crisis and its predecessors. The incentives were misconceived: Firstly it was the seller, not the purchaser of a security who paid the agencies' fees. Secondly there was often no independent second assessment of the risks.

Neither the market nor regulation (registration of agencies) are likely to rectify this inconsistent structure, but the state can and should ensure that ratings are regularly verified.

To strengthen competition and modify the incentive structures it would be conceivable to set up a state rating authority to scrutinise the assessments of the private agencies. This institution should be funded not out of general tax revenues, but through a levy raised in the financial markets themselves. The charge could be based on the stamp duty that has been in place in London since 1694 (!), which comprises 0.5 percent of the value of the shares and securities traded on the exchange.

This model offers four advantages over the existing system. Firstly the work of the current rating agencies would be fine-tuned, rather than abolishing them. Secondly, the proposed two-stage system would strengthen competition, whereas in the past a race for the most generous rating was observed. Thirdly, the two-stage system could be implemented at the national level without any necessity to achieve a global consensus. And fourthly, such a system would be self-financing.

Exchange Rates

Finally, the issue of exchange rate stability is missing from the Pittsburgh agenda. Exchange rate turbulence was perhaps not at the heart of the tempest this time, as it was in many previous crises. But exchange rate fluctuations and management remain a financial hot potato – see China. Already today we are seeing signs of a significant weakening of the dollar, and the G20 states are ill-prepared for a dollar crisis.

Summary

The G20 process is fundamentally useful, but has worrying gaps. Concentrating on a few rather minor issues (such as bonus payments) while ignoring more important ones (such as global imbalances) is problematic. After the meltdown of the century the national and international financial markets need to be comprehensively and fundamentally reformed, and the proposals discussed to date do not go far enough. In particular, much more fundamental thought must be given to the role of monetary policy, to international capital flows and to strengthening banking supervision.

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