A realistic framework for international financial governance[1]

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"The current crisis obliges us to re-plan our journey, to set ourselves new rules and to discover new forms of commitment, to build on positive experiences and to reject negative ones. The crisis becomes an opportunity for discernment, in which to shape a new vision for the future."[2]

Introduction

The financial and economic crisis has highlighted the interdependence and interconnectedness brought about by globalisation. It has shown all too well that the collapse of one part of a single economy quickly can threaten the advanced economies as a chain-reaction across the globe was quickly triggered.

Although the world has become ever more interconnected and challenges are global in nature, governance remains to a large extent local. The international system of governance remains founded on the principles of national sovereignty, with the Westphalian order of 1648 remaining very much present in the international institutional architecture. In addition, we are faced with a multiple crisis of governance that transcends the economic and financial sector and which presents a number of specific challenges.

This paper will present some background to the financial crisis before focusing on the governance challenges that exist. A short critique of two main policy recommendations that were floated will follow before expanding on a framework that could contribute to restoring international financial governance.

The financial crisis and financial governance

In analysing the root causes of the economic and financial crisis one realises that there was a gaping hole in financial governance and regulation which allowed a massive increase in financial market trading that was in the main speculative and unrelated to any underlying real activity. Global trade in equity outstripped economic activity, until the reversal that occurred during the crisis. The spike in market transactions spiralled during the dot.com bubble around 2000, but this was significantly exceeded by the second spike during the run-up to the current crisis, around 2008. The same phenomenon can be seen in the foreign exchange market. In 2008, on the onset of the crisis, the

1 Draft for discussion, prepared for the Dublin conference of the Centesimus Annus Pro Pontifice Foundation to be held in Dublin 24-25 October 2014.

2 *Caritas in veritate*, Encyclical Letter of His Holiness Benedict XVI, Vatican, 2009.

daily global turnover in foreign exchange was forty-five times larger than the underlying foreign trade.

In addition, there has been a proliferation of new financial products that were in some instances unregulated. Financial innovation is supposed to contribute to risk mitigation but has instead, in some cases, led to speculative excess and heightened risk. Speculative trading has fuelled asset price bubbles, with dramatic consequences for the rest of the economy. In short, questionable banking practices and inadequate regulation have led to asset price bubbles.

An example is provided by the mortgage markets. Lenders enticed prospective home buyers with borrowing terms that often overlooked the credit quality of the borrower. This led to a spiral in outstanding mortgages and fuelled steady increases in house prices. Eventually, when the expectations of continuing price growth were not met, a large number of mortgaged households defaulted. Recovery from foreclosed property was insufficient to meet losses, and doubts emerged on the debt-based instruments.

These included securitized loans, where similar loans are bundled into securities which are then traded in their own right. Unfortunately during the packaging process and the subsequent selling and reselling of these bonds, information about the underlying mortgages was lost or possibly ignored. Credit rating agencies, in a number of cases, gave such instruments an excessively high rating based on low historical default rates on mortgages issued back at the time of greater prudence on the part of the original lenders. However, when the housing bubble stopped inflating and sub-prime mortgages started defaulting at a higher rate than the historical default rate, panic set in across financial markets, pulling down the whole pyramid of debt-based instruments. Dubious loan contracts in one part of the world ended up causing severe problems for cross-border banks who had invested in securitized loans. There was contagion on a massive scale.

Responses to these challenges

In response to these challenges, many policy recommendations were put forward, two of which merit a more profound assessment.

A 'True World Political Authority'

The claim for 'the urgent need of a true world political authority' was made by Pope Emeritus Benedict XVI in his encyclical *Caritas in Veritate* as well as in the note published by the Pontifical Council for Justice and Peace, "Towards Reforming the International Financial and Monetary Systems in the Context of a Global Public Authority." The world authority as proposed in the Note is seen as a supranational state-like power and will comprise a number of state institutions, such as a "world central bank" and a design that empowers this global political authority to achieve "a fair distribution of world wealth, which may also derive from unprecedented forms of global fiscal solidarity". This proposal is grounded in the common good and oriented by solidarity and subsidiarity.

Piketty's global tax on capital

Thomas Piketty's contribution to the debate to improving financial governances comes in the form of a proposal for a global tax on capital.[3] Although Piketty describes it as a 'useful utopia' and even believes that its implementation would be politically impossible, it is still worth considering. In his book *Capital,* Piketty shows the flaws of an inheritance-based system that favours those who do not need to work; this provides a justification for a tax on capital. Piketty also argues that the technical requirements for such a tax are easily met as values of investments are easily ascertainable and owners' identities are just as easily verified.

However, such a tax presents a major challenge. The application of such a tax by a single country or a small group of countries can lead to capital outflows, destabilising the financial system. Therefore, such a system requires international collaboration which in itself is unlikely to be forthcoming since each country would have an incentive to stay out and benefit from the resultant capital inflows. Piketty argues that a more modest proposal with a regional implementation could be feasible.

However the levy, as proposed is confiscatory and punitive in nature, with the proceeds ending up inconspicuously in the government's coffers. The proposal however can be adapted to a more positively oriented charge on financial turnover that would finance a solidarity fund. This would support meritorious causes. Ideally it can be targeted for educational or other projects focussed on providing remedies to communities that were negatively impacted by unacceptable practices by financial institutions.

A realistic framework

Although it may be unrealistic to expect the implementation of either proposal, both do offer pragmatic ideas for a possible way forward to bridge the financial and international governance deficit. In discussing these elements, I will be drawing from the European experience as a reminder that we have already embarked on this path, which is already achieving results.[4]

First, properly constructed **institutions** remain a central element in achieving financial and global governance. The crisis has shown that institutional deficits and failures do exist and institutional reform is needed. This was echoed at the G20 2009 Pittsburgh Summit, which spoke of the need to "reform the global architecture to meet the needs of the 21st century" and discussed the urgent need "to launch a framework that lays out the policies and the way we act together to generate strong, sustainable and balanced global growth."[5]

The crisis revealed the need for cross-border financial supervision that would address the problem of contagion. It would also reduce the risk of regulatory forbearance, further ensuring that all financial

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[3] Piketty, T. (2014), Capital in the Twenty-First Century, The Belknap Press of Harvard University Press, Cambridge.

[4] Speech delivered by the then WTO DG Pascal Lamy, "Global governance requires localising global issues", Oxford Martin School, Oxford University on 8 March 2012

[5] Leaders' Statement, The Pittsburgh Summit, 24-25 September 2009.

firms own up to their corporate responsibilities. In Europe, the existing institutional architecture was clearly unable to address the realities revealed by the crisis. The creation of essential centralized institutions should be tempered, however, by the principle of subsidiarity, to the extent that decisions that can be taken at the national level should be left up to the national authorities.

The goal of the proposed European banking union is to also cut the negative feedback loops between banks and sovereign debtors and to limit the increasing fragmentation of European financial markets. The institutional framework of the banking union comprises two key elements. The first is the Single Supervisory Mechanism (SSM). This is under the auspices of the ECB and is charged with the oversight of all euro area banks. The SSM will reduce regulatory forbearance at the national level. The second is the Single Resolution Mechanism, a European restructuring and resolution mechanism that would be responsible for the consolidation or winding up of non-viable banks. Unfortunately, another important element of the banking union, the deposit compensation scheme, has been delayed. Embodying solidarity with bank depositors, the deposit insurance scheme ensures that depositors are treated in a uniform way across countries, independently of their location or the location of the bank to which they entrusted their savings.

The financial crisis was a watershed in global financial governance. The European Union was one of the first key actors to recognise that the crisis required a globally coordinated response and proposed to convene meetings of the G20 at leaders' level. The importance of the G20 in response to the global crisis cannot be underestimated. It provided a critical forum for coordinating a global response which helped avoid a more severe financial meltdown. The G20 remains an important development partner in the international architecture of governance but ultimately it will be judged by how much its members stick to agreed commitments.

Secondly, **policy tools** can contribute effectively to enhancing international financial governance. Even here, Europe is leading the way. The Stability and Growth Pact has been strengthened by the so-called six-pack of economic measures, including the Macroeconomic Imbalance Procedure. The latter extends surveillance of national imbalances and needed corrective action to cover not only the fiscal dimension but also the broader economy.

In terms of monetary policy, the measures introduced by the European Central Bank over the course of the crisis and beyond show the effective use of policy tools. By providing extra liquidity at the onset of the crisis, the ECB was crucial in ensuring the functioning of not just the banking sector but of the whole economy. As the crisis deepened, the ECB implemented various measures to facilitate access to credit, preventing a meltdown in the financial system which would have had dire consequences right across the European Union and beyond. The ECB also implemented a number of so-called non-standard measures, including significant liquidity diffusion measures and increasing the number of counterparties eligible for refinancing. These measures were complemented by several cuts in policy interest rates and most recently through forward guidance. The ECB also launched Outright Monetary Transactions (OMTs) to provide a fully effective backstop in the sovereign bond market. Latest instruments launched such as the Targeted Long Term Refinancing Operations (TLTROs) are aimed to support a still fragile European recovery.

Thirdly, in order to build up global financial governance, **regionalism** might be an important contribution as the European project has shown. It represents an essential intermediate step between the national and the global governance level. Piketty (2014) argues that regionalism offers a feasible start towards achieving global financial governance, as it permits a progressive familiarisation with supra-nationality and with pooling national resources in order to address the common good of society as a whole. Regionalism also embodies the belief that the answer to such a global crisis is not found in retrenchment but rather in engagement.

In the case of the financial crisis, the region consists of the 18 nations in the euro area, or the 27 across the EU. As challenging as it has been to have a meeting of minds on this issue, achieving a similar consensus at a more global level would present an even bigger challenge.

Finally, greater attention needs to be given to **values.** Experience to date has shown, in a painful way, that institutions alone cannot guarantee good governance. A successful governance system does not only require the institutional framework as its basis, but it also requires adherence to a common set of values. It is today accepted that beyond an economic and political recovery, a moral recovery that re-establishes ethics and values at the heart of economic policy-making is necessary. Catholic Social Teaching provides a rich inspiration as we consider the kinds of institutions and governance mechanisms that need to be developed.

Inextricably linked to the discourse of ethics and values is the concept of rights and responsibilities, which is best described by the value of solidarity which is defined by Benedict XVI in his *Caritas in Veritate* as "first and foremost a sense of responsibility on the part of everyone with regard to everyone". Solidarity demands therefore that we work towards the common good*;* in other words, towards the creation of communities in which all people are able to flourish and achieve fulfilment. This is probably best described by Blessed John Paul II in his *Sollicitudo Rei Socialis* (1987):

> *When interdependence becomes recognized in this way, the correlative response as a moral and social attitude, as a 'virtue', is solidarity … not a feeling of vague compassion or shallow distress at the misfortunes of so many people, both near and far … [but] a firm and persevering determination to commit oneself to the common good; that is to say to the good of all and of each individual, because we are all really responsible for all.*

Solidarity therefore demands that we work beyond our individual interests and towards the common good. The European Union provided a degree of solidarity in its response to the crisis, although often in a hesitant manner. The various support mechanisms that have been launched by numerous European institutions represented solidarity in policy-making even if often the focus is mostly on the financial perspective rather than on the human dimension.

However, a balance needs to be found between public finance discipline and growth enhancing measures. The scourge of high unemployment and ensuing economic and social ramifications requires Europe to engage in growth-supporting and supply-side policies. In this case, true solidarity with our Member States who face such economic challenges demands us to be more supportive in terms of access to finance and funds to stimulate public and private investment.

Moreover, in a monetary union that encompasses one country, like the US, the monetary authority has a counterpart political and fiscal authority, allowing automatic and also discretionary government spending to alleviate hardship in distressed regions within the union. This is very different from the EU, with a very limited fiscal dimension, where the national contributions to the EU budget are capped at 1% of the EU's GDP. Limited funds constrain the ability of the EU to counter the impact of the crisis. Given the limitations on EU funds, the strongly performing Member States are in a position to make a more pronounced contribution to offset the scourge of high unemployment.

Closely linked to the concept of solidarity, one finds the principle of subsidiarity which places a duty on communities and institutions to ensure the participation of all stakeholders and to find the right balance between individual and the common good, and is closely related to solidarity. The subsidiarity principle is a European value which also echoes a central tenet of Catholic Social Doctrine as described by Pope Pius XI in his *Quadragesimo Anno* as "a fundamental principle that one should not withdraw from individuals and commit to the community what they can accomplish by their own enterprise and industry."

The blending of solidarity and subsidiarity can be observed, at times only to a limited extent, in the euro area, which is made up of nations rather than regions or provinces. This characteristic has influenced the mix of policy measures taken by the monetary union as well as by the EU to resolve the financial and economic crisis. In practice, the package of measures has combined monetary policy measures and bail-out programmes with the implementation at the national level, of structural reforms for the elimination of various macroeconomic imbalances and the restoration of competitiveness. This involves the application of the words from *Quadragesimo Anno* that I just quoted, and which can be paraphrased as follows: one should not withdraw from the Member States and relegate to the collective body what the Member States can accomplish by their own enterprise.

However, for subsidiarity to be effective, governments need to be aware of their responsibilities. In exercising their duty, civil servants, politicians and governments need to be guided by ethical and moral standards. By avoiding corruption, ensuring that the work ethic is maintained and that good governance prevails, politicians have a central role in ensuring that subsidiarity is effective.

It is perhaps relatively easy to identify the values and principles that should form the foundations of institutions and business models. What is far more difficult is to ensure that these values are applied in everyday life and dealings. This relies on us as individuals, professionals and policy makers.

Conclusion

In the face of these global challenges solutions will not emerge spontaneously but will be the result of numerous deliberations, research and reflections. The process of devising a realistic framework of international financial governance demands visionary leadership guided by a vision of the common good.

In searching for possible realistic solutions, Cardinal Turkson provides three principles to guide our work and reflection[6]. First, our thinking needs to be **radical** to not only tackle the real root causes of the current crisis but more importantly to identify the needed foundations for a lasting solution. Secondly, our proposals need to be **ambitious** to overcome the current state of affairs and to renew the international governance architecture. Thirdly, our strategy ought to be **modest** in planning realistic reforms in the right direction. A gradualist approach is needed to thoroughly reform the current architecture; in this context, progress in the EU has been generally slow if not glacial.

Although the challenges appear daunting we must not lose hope in our ability and capacity to mould a more resilient future. Our responsibility towards the common good should empower us to achieve a "financial reform along ethical lines that would produce in its turn an economic reform to benefit everyone."[7]

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6 Cardinal Peter K.A. Turkson, *Towards reforming the international financial and monetary systems,* speech delivered at the London School of Economics, 6 February 2014.

7 Pope Francis, address to new non-resident Ambassadors, 16 May 2013.