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# Signposts for a New Financial Architecture

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***The São Paulo Statement on International Financial Transformation for the Economy of Life**[1] proposes several elements of a new financial architecture. This Briefing Paper describes the background to these proposals. It complements Briefing Paper No. 32 which elaborates on the taxation measures contained in the São Paulo Statement.*

## Introduction

The São Paulo Statement begins with a recognition that: *"The 2008 global financial and economic crash increased poverty and unemployment among millions in the global North and worsened and deepened poverty, hunger and malnutrition among even larger numbers in the global South, already experiencing decades of poverty and deprivation caused by injustices in international financial and economic relations. A system of speculation, competition and inadequate regulation has failed to serve the people and instead has denied a decent standard of life to the majority of the world's population. The situation is urgent."*

Explicit in the São Paulo Statement is a recognition that reforms undertaken to date are inadequate. It laments: *"The manner in which economic and financial legislation and controls are biased in favour of the wealthy. We therefore affirm the God of justice for all those who are oppressed (Ps. 103:6). We call for a system of just legislation and controls that facilitate the redistribution of wealth and power for all of God's creation ...*

*"We are called to find a new and just international financial architecture oriented towards satisfying the needs of people and the realisation of all economic, social and cultural rights and human dignity. Such architecture must be focused on reducing the intolerable chasm between the rich and the poor and on preventing ecological destruction. This requires a system which does not serve greed but which embraces alternative economies that foster a spirituality of enough and a lifestyle of simplicity, solidarity, social inclusion and justice."*

In this Briefing Paper we shall describe the background for 10 of the key elements contained in the São Paulo plan of action for establishing a new international financial and economic architecture.

## A. Regulate the Banking Sector; Separate Retail Banking from Investment Banking

The São Paulo plan of action calls for: *"A comprehensive regulation of the entire financial sector, including the lightly regulated shadow banking sector (which in the U.S. and Europe is larger than the banking sector) ... Basic banking activities of deposit taking and lending to enterprises and households should be tightly regulated and separated from more risky activity (as in the United States in the 1930s with the Glass-Steagall Act)."*

After the turmoil unleashed by the 1929 stock market crash, the U.S. Congress passed the Glass-Steagall Act in 1933 to impose a strict separation between commercial banks and investment banks. Commercial banks are deemed to be low-risk insofar as their customers' deposits are substantially safeguarded by government-mandated insurance programs. They make loans to individuals or businesses within the limits set by requirements to keep reserves available to cover bad loans or depositors' withdrawals.

Investment banks, on the other hand, are not obliged to hold reserves and can engage in riskier activities such as underwriting equity issues and trading in securities. In their early days, investment brokers were often partnerships that exercised a degree of caution because their own money was at risk. However, once they became public companies whose managers invested shareholders' money rather than their own, they began to engage in riskier behaviour.

By the 1980s, this strict division of mandates was breaking down as commercial banks invented new kinds of accounts allowing customers to invest in riskier activities for higher returns. Debts were repackaged into tradable securities and sold off to investors, enabling banks to make new loans. A shadow banking system emerged where enormous amounts of assets were held outside the regulated system that required banks to hold reserves and pay for deposit insurance.[2] In 2008 the shadow banking system in the U.S. may have held somewhere between US$15 trillion and US$25 trillion.[3] The globalization of finance facilitated trading through lightly regulated offshore affiliates.

In 1999, the U.S. Congress repealed major provisions of the Glass-Steagall Act with the blessing of then Treasury Secretary Lawrence Summers and President Bill Clinton, a move that Clinton subsequently regretted. As financial consultant Satyajit Das explains: "The repeal paved the way for financial supermarkets – one-stop money shops taking deposits, making loans, providing advice, underwriting and trading securities, managing investments and providing insurance."[4] Canada also allowed traditional banks to integrate with brokerage companies and trust companies during the 1990s.

In the wake of the 2008 crisis, former U.S. Federal Reserve Chairman Paul Volcker became the most visible advocate of restoring the banking industry's historical division between commercial and investment banks. Volcker said a bank should act as "a service organization to take care of the basic needs for ... clients ... providing some place for their money, transferring funds around the country, making loans, helping with investments."[5] Volcker did not object to allowing hedge funds (private investment funds for wealthy individuals) to "go off and pretty much do their own thing, unless they get so big that they can mess everything up."[6]

President Obama announced his intention to implement what he called the "Volcker rule" on January 21, 2010. With Paul Volcker standing behind him, the president declared emphatically: "Banks will no longer be allowed to own, invest or sponsor hedge funds, private equity funds or proprietary trading operations for their own profit unrelated to serving their customers."[7] Proprietary trading refers to the practice where banks used their own money, augmented by substantial amounts borrowed from other banks, to invest in securities.

The Volcker rule restoring the distinction between commercial banking and investment banking was touted as a cornerstone of the Dodd-Frank Wall Street Reform and Consumer Protection Act. However when the Dodd-Frank Act was finally passed by Congress later in 2010, it was riddled with loopholes. The provisions that supposedly banned financial firms' proprietary trading contained exemptions for mutual funds, insurers and trusts and "an arbitrary rule that allows banks to gamble up to three percent of their 'Tier 1' capital, a number that for the big banks stretches to the billions."[8]

The law also allowed banks to engage in some types of non-proprietary trading such as "market making" where they would hold a sufficient number of shares to facilitate transactions for clients. By not distinguishing adequately between the two kinds of trade, "The proposed regulations could allow banks to engage in proprietary trades under the guise of market making."[9] This is just what happened as financial firms shifted traders from the desks where they traded securities on behalf of the firm to "client-related services." As one financial consultant explained: "You can use client activity as a cover for basically anything you are doing."[10]

## B. Ensure Banks Have Adequate Capital

The São Paulo plan of action states: *"There is a need to ensure that banks have adequate capital to absorb losses. Regulations on permitted leverage and minimum liquidity must be rigorous; likewise, counter-cyclical prudential regulation can assist in macroeconomic management."*

Since 1988, international guidelines for bank reserve requirements have been set through the Basel accords negotiated at the Bank for International Settlements, the central bankers' institution located in Basel, Switzerland. A set of non-binding guidelines, known as Basel II, was issued in 2004 but implemented by only 21 of the 27 members of the Basel Committee on Banking Supervision.

In response to the 2007-08 crisis, central bankers and regulators produced an updated version known as Basel III. Essentially these new rules aim at requiring banks to hold more capital relative to the risks they face, including from securitized loans and off-balance sheet exposures. Banks are also expected to submit to tighter supervision by national authorities. Financial institutions deemed "too big to fail" because of the damage their collapse would do to the whole financial system are expected to submit to even higher capital requirements.[11]

After analyzing the 440 pages of its complicated rules, financial consultant Satyajit Das declared that the guidelines under Basel III are "as susceptible to being manipulated" as earlier versions. [12] The convoluted definitions of what constitutes a bank's own capital are subject to different interpretations. When national regulators began to draft rules on how to apply the Basel III accord, banks hired lobbyists to weaken the regulations.

Some analysts calculated that if the Basel III rules were fully implemented, in conjunction with new taxes on bank holdings, they would reduce "a typical bank's return on equity from 20% to 5%."[13] Bank lobbyists succeeded in delaying the implementation of higher capital and liquidity requirements until 2019 in the name of aiding economic recovery.

Are the capital requirements high enough to prevent future crises? Martin Wolf, the *Financial Times'* chief economics analyst, is sceptical. Basel III, he explains, sets a "risk-weighted capital ratio of 4.5 per cent, more than double the current level of 2 per cent, plus a new buffer of 2.5 per cent ... [an] effective floor of 7 per cent." [14] But since implementation is delayed for several years, Wolf expects the world will probably experience "another financial crisis or two" in the meantime. Wolf says the equity standard "is far below levels markets would impose if investors did not continue to expect governments to bail out creditors in a crisis." He concludes that "equity requirements need to be very much higher, perhaps as high as 20 to 30 percent."[15]

If, as Das and Wolf suggest, the Basel III requirements have not substantially reduced risks of future crises, then more profound reforms are needed.

## C. Break Up Banks Deemed "Too Big to Fail"; Limit Bankers' Remuneration

The São Paulo plan of action states: *"Banks that are 'too big to fail' should be broken up ... Public policy should be directed to the reform of bankers' remuneration systems, to link them to long term social and environmental performance rather than short-term results. For example, bonuses could be set at a maximum of 100% of fixed remuneration (as demanded by the European Parliament). Commission should be forbidden when selling financial products to retail investors."*

Nobel laureate economist Joseph Stiglitz and his colleagues on the UN Commission on Reforms of the International Monetary and Financial System point to the urgency of limiting the size of banks deemed "too big to fail" lest their demise bring down the whole financial system. They observe: "When banks become too big to fail they have a perverse incentive for excessive risk-taking" because they know they will be bailed out. Hence "it is imperative that governments impose strong antitrust policies."[16]

While much discussed in the U.S., measures to break-up large financial firms have yet to be implemented. In his January 21, 2010, speech President Obama declared: "Never again will the American taxpayer be held hostage by a bank that is too big to fail."[17] But the U.S. Senate later rejected by a vote of 61 to 33 an amendment by Democratic Senators Ted Kaufman and Sherrod Brown that would have put strict limits on the size and risk profiles of financial corporations. Their SAFE Banking Act would have ensured that no bank holding company could hold more that 10% of all insured deposits and imposed a leverage limit of 6%. Simon Johnson, a former chief economist at the IMF, notes that the Obama administration fought hard against the Brown-Kaufman amendment.[18]

Private financial institutions have won time for themselves by delaying action on reforms as well as hiding discussions from public debate. Johnson describes how those with a vested interest in the current system orchestrate sophisticated delaying actions. While they agree there is a problem, they send the job of formulating solutions to committees of experts who produce reports of mind-numbing detail, which few really understand. By the time the experts report back, the public no longer remembers what caused the crisis in the first place.[19]

While the fallout from the financial crisis continues to cause hardship for millions, the financial firms most responsible recovered quickly, due in no small part to government bailouts. Goldman Sachs survived largely because it was allowed to reinvent itself as a commercial bank, thus becoming eligible for payments under the U.S. Treasury's Troubled Asset Relief Program. In 2009, Goldman reported a record US$13.4 billion profit.[20] The six largest U.S. banks paid their executives US$140 billion in 2009, "only slightly less than the $164 billion they paid themselves in the pre-crash year of 2007."[21] In 2009, the 25 highest paid hedge fund managers earned a combined US$25.3 billion.[22]

## D. Give Regulators Power to Curb Speculation

The São Paulo plan of action states: *"Speculative activity should be restricted so that the counterpart to real economy hedging needs is met without overwhelming enterprise on a 'sea of speculation.' Regulators should set 'position limits' on commodity traders in all globally relevant markets, especially those of foodstuffs, to limit unnecessary price volatility. Regulators should also require that market participants are capable of accepting delivery of the actual commodities. Further Credit Default Swaps, which have played a harmful role in the recent financial crisis, should be banned."*

Secretive, non-transparent markets for new financial instruments played a significant role in the build up to the crisis. Mortgages of dubious quality were bundled together into collateralized debt obligations (CDOs) and sold to banks, pension funds or hedge funds located anywhere in the world. Some hedge funds borrowed up to 100 times as much as their own capital to invest in innovative financial instruments. CDOs were sold to banks off-balance-sheet entities known as conduits or Strategic Investment Vehicles (SIVs). The prices of these derivatives were not transparent as they were set by banks based on opaque calculations.

One new financial practice that proved to be particularly problematic was the use of Credit Default Swaps (CDSs) to back up CDOs containing subprime mortgages. CDSs are a type of derivative that is similar to an insurance policy. Sellers of CDSs collect fees for taking on the risk that a loan will not be repaid. Creditors can buy them to protect themselves against the risk of default. But investors with no ownership interest in the securities can also buy CDSs and make windfall gains if they do go into default.

What brought down the trillion-dollar insurance firm AIG (American International Group) was the US$447 billion in CDSs sold by its subsidiary AIG Financial Products on assets such as subprime mortgages. As an AAA rated company, AIG Financial Products put up little or no collateral on the CDSs it issued. However, when the value of the underlying assets fell, AIG was unable to raise the money needed to pay investors in the CDSs. When AIG was bailed out by the U.S. Federal Reserve, the main beneficiaries were investment banks that had bought the CDSs it had issued. The biggest beneficiary was Goldman Sachs which collected US$12.9 billion of the bailout funds that nominally went to rescue AIG despite the fact that it was embroiled in a scandal involving its own misuse of CDSs.

Goldman Sachs was indicted by the U.S. Securities and Exchange Commission (SEC) for selling packages of high-risk mortgages as sound investments and then betting against them itself by buying CDSs. Goldman eventually negotiated a settlement with the SEC in July of 2010 paying a US$550 million fine, worth around four percent of its annual earnings. Journalist Matt Taibbi sums up the ploy with this analogy: "Goldman was like a car dealership that realized it had a whole lot full of cars with faulty brakes. Instead of announcing a recall, it surged ahead with a two-fold plan to make a fortune: first by dumping the dangerous products on other people and then taking out life insurance against the fools who bought the deadly cars."[23]

Professors Michael Lim Mah-Lui and Lim Chin criticize CDSs for allowing speculators who purchase them to "exercise as much influence over a company as its creditor." They cite David Einhorn, a hedge fund investor in the CDS market, as saying "I think that trying to make safer credit default swaps is like trying to make safer asbestos."[24]

In the wake of the crisis, reformers demanded that derivatives be sold on open exchanges where prices would be posted before sales were made. The Dodd-Frank Act included a requirement that most derivatives be posted on open exchanges. The U.S. Commodity Futures Trading Commission (CFTC) began to develop a system where offers to buy or sell contracts for future deliveries of commodities such as oil, grains or metals, would be posted electronically and widely accessible.

A *New York Times* editorial explains how the industry fought back: "In response, industry lobbyists ... made the absurd argument that open trading would hurt banks' flexibility to continue doing business as usual. ... Republican lawmakers, with some Democratic support ... proposed legislation to roll back the rules on open trading even before regulators have finalized them. Rules that have been finalized are increasingly subject to protracted legal challenges by the financial industry. And regulators are routinely reduced to pleading with Congressional appropriators for chump change to carry out their duties."[25]

Another tactic the industry used to avoid strict regulation was to establish their own trading mechanisms. For example, firms involved in trading derivative contracts set up private "central counterparty clearing houses" in an effort to avoid being forced to use publicly regulated exchanges.[26]

Industry lobbyists persuaded friendly members of Congress to sponsor bills that introduced other loopholes into provisions of the Dodd-Frank Act. For example, one bill would exempt the foreign affiliates of U.S. swaps dealers from oversight. Transnational firms could then channel deals through their overseas offices without being subject to U.S. laws.

Some critics called for putting strict limits on how derivatives could be sold. At one point U.S. Senator Blanche Lincoln, in the midst of a primary election fight to retain her Senate seat against a candidate who accused her of being soft on Wall Street, proposed an amendment requiring that all derivative trading be removed from banks entirely so that taxpayers would not be obliged to bail out banks when huge deals failed.[27] Lobbyists for the financial industry fought back. Later, after winning her primary battle, Lincoln backed off allowing a series of amendments to her proposal. Banks were allowed "to move their derivatives operations into 'subsidiary units,' rather than spin them off."[28] As a result "about 90 percent of the derivatives market was exempted" from meaningful regulation, according to Michael Greenberger, an expert in derivatives trading.[29]

## Case Study: Speculation on Food Drives Up Prices

In 2008, one of the manifestations of the crisis was a sharp increase in the prices of basic foods. According to Olivier de Schutter, United Nations special rapporteur on the right to food, “At least 40 million people around the world were driven into hunger and privation as a result of the 2008 food price crisis.”[30] His study of the causes of the price increases led him to conclude: “While the food price crisis may have been sparked ... [by] developments affecting demand and supply, its effects were exacerbated by excessive and insufficiently regulated speculation in commodity derivatives.”[31]

Following the passage of the U.S. Commodity Futures Modernization Act in 2000, speculators were able to buy and sell commodity-based derivatives “without any position limits, disclosure requirements or regulatory oversight.”[32] As a result the value of trades in commodity derivatives increased almost one hundred-fold between 2002 and 2008, growing from US$77 billion to US$7.5 trillion worth of contracts. After the collapse of the U.S. housing bubble, traders turned to buying commodity futures for food and oil products assuming that these were safe investments since people still needed to eat and wanted to drive.

A derivative known as a commodity index pioneered by Goldman Sachs had a particularly important effect on food prices. As de Schutter explains: “The strategy evolved by the Goldman Sachs managers ... was to have nothing but ‘long’ positions, to keep on acquiring them, and to roll them over as they expired, no matter how high the price of those futures climbed.”[33]

In other words, the Goldman traders kept on betting the prices would continue to rise. This upward movement in futures prices then had an effect on prices in the spot market where commodities are actually bought and sold as “sellers delayed sales in anticipation of more price increases; and buyers increased their purchases to put in stock for fear of even greater future price increases."[34]

Initially de Schutter was hopeful that the Dodd-Frank Act would put an end to excessive speculation in food. He welcomed provisions that would require the Commodity Futures Trading Commission (CFTC) to limit the aggregate number or amount of positions in specific agricultural or energy-related contracts that could be held by any one trader. Moreover, access to commodities derivatives was to be restricted to qualified and knowledgeable investors and traders who are genuinely concerned about the underlying agricultural commodities.

The purpose of the Dodd-Frank provisions was to allow traditional hedging to continue while curbing speculative excesses. Traditional hedging allows farmers or food processors to sell or buy contracts for future deliveries to offset price fluctuations that might occur in actual markets for delivery of the product. For example, a bakery can lock in prices for sugar by buying a contract for future delivery at a predictable price, thus avoiding losses that would occur if prices on the cash market rose unexpectedly. Traditionally, genuine hedging was facilitated by speculators holding as many futures contracts as were needed to offset the contracts held by farmers or food processors.

However, the actual rules the CFTC drafted for commodity contracts were soon watered down. The Dodd-Frank Act allows a significant exemption on position limits for hedging. The purpose of position limits is to prevent price manipulation by restricting the percentage of a commodity contract that any one entity can hold over a given time period. If the limit is too high big traders can manipulate prices. In their battle against position limits, financial firms launched law suits to delay their imposition while they turned their attention to influencing how the law would be implemented.

The hedging exemption in the Dodd-Frank Act grew wider and less enforceable when it was revealed that proposed CFTC rules “would expand the exemption to allow major financial players to qualify for this exemption by making a ‘good faith’ claim that they were trading on the other side of a commercial hedge.”[35]

When the position limit rules were announced in October 2011, the non-partisan Institute for Agriculture and Trade Policy found that the allowable limits were too high to be effective. Moreover they failed “to incorporate provisions allowing for an emergency review of position limits if they fail to prevent excessive speculation, and [did] not account for aggregate positions held by one entity across several trading venues.”[36]

## E. Regulating Financial Flows for Sustainability

The São Paulo plan of action calls for *"Regulating financial flows for sustainability: Governments should be encouraged to manage capital flows so that surges or flows in or out of a country do not destabilise the economy, including through instruments such as capital controls. Capital controls could curb the entry of volatile short-term flows as well as prevent capital flight from already beleaguered economies."*

At the 1944 Bretton Woods conference, both U.S. negotiator Harry Dexter White and Britain's John Maynard Keynes insisted on permitting the use of capital controls as an integral part of the international monetary system. In 1941, Keynes had declared: "Nothing is more certain than that the movement of capital must be regulated."[37]

As economist Marie-Aimée Tourres has explained, volatile and destabilizing capital flows are very dangerous, especially for developing countries. [38] They can cause undue appreciation in exchange rates and also limit the ability of nations to pursue independent monetary policies. In 2010, volatile capital movements in and out of developing countries amounted to more than US$1 trillion. Countries like Malaysia and China that used capital controls avoided the worst of the Asian financial crisis of 1997-98.

Although the International Monetary Fund's own Articles of Agreement authorize members to put controls on inflows and outflows of financial payments, IMF economists came to oppose any such controls. In the late 1990s, the IMF managing director, Michel Camdessus, even tried to amend the Articles of Agreement to allow the Fund to demand the liberalization of capital account transactions.

But as Gallagher, Griffith-Jones and Ocampo have shown, "The 2008 global crisis ... opened a new chapter in the debate over the proper policy responses to pro-cyclical capital flows."[39] A 2010 IMF staff paper found that capital controls on the inflows of capital had been effective over the previous 15 years and that nations that used them were "among the least hard hit during the world crisis."[40]

However, despite the evidence published in its staff paper, the IMF approves the use of capital controls only as a last resort and as a temporary measure. In contrast Gallagher, Griffith-Jones and Ocampo maintain that capital account regulations on both inflows and outflows should not be seen as temporary measures but as "permanent mechanisms to be used to smooth booms and busts."[41]

Among the types of capital account regulations that have been deployed successfully by countries such as Chile, Colombia and Thailand are requirements that a portion of inflows be kept in central banks; taxes on inflows or outflows; minimum stay requirements; and restrictions on the amount of capital that investors can send abroad.

Gallagher, Griffith-Jones and Ocampo conclude:"The global community should start a conversation regarding the extent to which there should be coordination among national governments regarding [capital account regulations]."[42]

## F. Sovereign Debt Restructuring Mechanism

The São Paulo plan of action calls for a *"Sovereign debt restructuring mechanism: A comprehensive, fair and transparent international debt restructuring mechanism to address sovereign insolvency on a timely basis should be established. Such a mechanism must be empowered to audit sovereign debts and cancel those debts found to be odious because they were contracted by despotic regimes without public consent for use against the population, or are illegitimate due to other factors such as usurious interest charges, fraud, and repayment obligations that would cause unacceptable privation."*

A global debt audit tribunal would establish a legal mechanism for determining the legitimacy of external debts. In 1927 Russian jurist Alexander Sack defined odious debts as those contracted by despotic regimes for their own benefit without public consent and with the knowledge of the lender. Precedents exist for cancelling odious debts. For example, in 1923 U.S. Supreme Court Justice William Howard Taft ruled that the government of Costa Rica was not obliged to pay a debt to the Royal Bank of Canada that had been incurred by former dictator Federico Tinoco on the grounds that it was for his own enrichment and not for the benefit of the people. Currently, however, there is no international court with the jurisdiction to oblige creditors to write off illegitimate debts.

In November 2000 the Canadian Ecumenical Jubilee Initiative invited partners from the global South to participate in an international forum to explore the varieties of illegitimate debts. In addition to citing the category of odious debt, the forum identified a number of other ways in which debt can be deemed illegitimate. These include:

- debts which cannot be serviced without causing harm to people and communities;
- debts owed for money stolen through corruption;
- debts for projects that were never implemented or never benefitted the people;
- debts for projects that were destructive for communities or the environment;
- debts contracted for fraudulent purposes;
- debts incurred at usurious interest rates;
- debts rendered unpayable due to factors beyond debtors control;
- private loans converted into public debt under duress.[43]

Debts held by vulture funds constitute an additional category of illegitimate debts. These private entities buy up sovereign debt on secondary markets at low prices from creditors who don't expect to collect full payment. Vulture funds then take debtor governments to court demanding payments many times larger than what the vultures actually spent to acquire the debt.[44] While the United Kingdom passed a law in 2010 preventing vulture funds from using British courts to enforce payments on low-income countries' debts, other jurisdictions continue to recognize their claims as legitimate.[45]

A New York court, on the other hand, recently ordered Argentina to pay US$1.3 billion to two holdout bondholding firms that refused to participate in debt restructurings in 2005 and 2010. As Beverly Keene writes on behalf of Jubilee South Argentina: "The decision seeks to legitimize debt claims that are illegitimate and illicit. The bonds now held by the highly aggressive 'vulture funds' that have been pursuing their Argentine prey for 10 years now, in courts all over the world, are direct descendants of the debt accumulated in Argentina at a cost of 30,000 disappeared, in order to sustain the civilian-military dictatorship that ruled the country between 1976 and 1983, and force the country into the neoliberal strait jacket. That debt has been the subject of extensive judicial investigation in Argentina, and in July, 2000, Federal Judge Jorge Ballester ruled that it was the result of at least 477 fraudulent and arbitrary acts."[46]

### G. Gender-just Fiscal Stimulus and Social Protection

The São Paulo plan of action calls for, *"Gender-just fiscal stimulus and social protection: Public investment and spending on small-scale agriculture, renewable energy, infrastructure, health and education sectors, and gender-just social protection programmes must be safeguarded and expanded even during periods of painful austerity measures in debt-burdened nations. Austerity often falls heavily on the most vulnerable sectors of society and results in a vicious circle of economic decline, hampering recovery by dampening domestic demand and eroding national tax revenues."*

An examination of the social consequences of austerity programs recently imposed in Europe reveals that they have disproportionately affected the poorest and most vulnerable populations, especially women. Christine Vanden Daelen has shown how increased unemployment and loss of public services have particularly penalized women who make up two-thirds of the employees in public services and bear more of the costs of providing food, health care and education for their families through unpaid work.[47]

While news media have concentrated on reporting on austerity in Northern countries, the South Centre reminds us: "The untold story is the scope and depth of austerity that is taking place among developing countries, which have contracted at nearly double the rate [of] their developed counterparts."[48] The South Centre cites evidence that public sector wages have been reduced or capped in 73 developing countries while subsidies for food have been cut in another 73 at a time when food prices are at all time highs. Moreover social protection programs have been cut in 55 developing countries while fiscal policies that could increase prices on goods and services principally consumed by the poor are planned in 71 countries.

Publicly owned financial institutions can play an important role in financing small-scale agriculture and infrastructure projects. For example, the Bank of North Dakota, established by the state legislature in 1919, is still serving its population. Its original purpose was "to free farmers and small businesses from indebtedness to out-of-state banks and railroad companies. By law, the state deposits all its funds in the bank, and deposits are guaranteed by the state. ... [It partners] with private banks to loan money to farmers, real estate developers, schools, and small businesses. It also purchases municipal bonds."[49]

Recently the Bank of North Dakota made 20 year loans at 1% interest to assist state residents to rebuild after a flood. Richard Heinberg summarizes the advantage of a state-owned bank: "If a state owns its bank, it need not worry about shareholders or profits, so it could lend to itself or to its municipal governments at zero percent interest. If these loans were rolled over indefinitely, they would be essentially the same as creating debt-free money."[50]

### H. Replace IMF with a New International Monetary Organization

The São Paulo plan of action states: *"The International Financial Institutions (IFIs) are not based on a democratic system. Rather, their decision-making structures reflect the relative economic and financial power of nation states. In order to address these inequalities, nothing less than a drastic overhaul of the governance of the world economy and the international financial system is needed. The main objective is to ensure that financial markets and the economy are brought under the primacy of democratic decision-making structures and that they function as good servants rather than bad masters in political and economic life.*

*"A new International Monetary Organisation (IMO) needs to be created and should be guided by universal principles of economic, social and ecological justice. The IMO would have oversight over monetary policies and transactions and would deploy funds without structural adjustment conditions to establish a globally effective, stable, fair and socially responsible global financial and economic architecture, bringing democratic accountability to financial markets. Its actions should not be dominated by policies of interest groups and its policies should be equitable and responsive to the social consequences of financial activities at financial sector and national levels."*

Soon after the 2008 crisis disrupted global markets there was talk of convening a new conference to transform or even replace the international financial institutions that emerged from the historic 1944 Bretton Woods conference. Many observers questioned the legitimacy of the International Monetary Fund and World Bank whose neoliberal policies had not only failed to prevent the crisis but actually prolonged it by continuing to dispense inappropriate policy advice.[51]

A UNICEF study examined IMF policy recommendations for 86 low- and middle-income countries and found that, as of 2010, the IMF was still advising governments to withdraw fiscal stimulus or cut public spending when counter-cyclical measures would have been more appropriate.[52]

Although there was much talk in the early days of the crisis about reforming these institutions little action followed. Minor reallocations of voting rights within the IMF gave the larger emerging countries six percent more of the voting rights. But some of these reallocated votes were taken from the already inadequate quotas allocated to smaller, weaker developing countries.

The changes did not alter the basic power structure as the United States retains more than 15% of the votes assuring its ability to veto major policy decisions. Despite much talk about merit-based appointments, the tradition of always choosing a European as IMF Executive Director and a U.S. citizen as World Bank president has continued.

Perhaps one of the most significant changes is that many countries have stopped borrowing from the IMF in order not to be subject to its conditions. Argentina, Brazil, Bolivia, Serbia, Indonesia, Uruguay, the Philippines, Russia, Thailand and Ecuador repaid loans to the IMF or stopped borrowing in order to escape its dictates.[53] Similarly several Latin American countries have withdrawn from World Bank programs such as pursuing the arbitration of investment disputes through the International Centre for Settlement of Investment Disputes (ICSID).

Instead of proposing bold reforms, the Group of Twenty actually attempted to reinforce the power of the IMF by trying to persuade its members, particularly the so-called emerging countries, to triple the Fund's lending capacity to US$750 billion.[54]

## I. A New International Reserve System

The São Paulo plan of action states: *"There is a need to design a new multicurrency reserve asset, similar to Special Drawing Rights, to create liquidity so that the 'seigniorage' currently enjoyed by those countries whose currencies are now used as reserves instead accrues to the international community. At present, the main commonly used international reserve currency is the US dollar. Almost everywhere in the world, the US dollar is accepted and convertible. This creates enormous advantages for the US economy as, contrary to other countries, the United States can pay for some of its imports with dollars instead of with exports, as long as the world considers the dollar a safe reserve currency. No other country in the world would survive with a level of current account deficits as high and as persistent as those of the US. This 'seigniorage' is an 'exorbitant privilege' which accrues to the US. It is a significant unjust feature of the present international financial system, coupled with the fact that there are often undesirable consequences for the world's economies, such as excessive capital flows, resulting from the monetary policies that the United States takes for purely domestic reasons.*

*"In order to make the world less dependent on US deficits (or gold reserves, for that matter) and in order to create global liquidity in a more rational way, the International Monetary Fund created in the 1960s a multilateral reserve asset called Special Drawing Rights. SDRs can be created as the objective need arises, for example as an instrument for anti-cyclical policies (as in2009), and as an alternative reserve asset which could eventually replace the US dollar and a few other reserve currencies. Besides SDRs, other proposals have been made such as International Currency Certificates. The common aim of these proposals is to search for ways and means to arrive at a system for the creation of liquidity based on global need in order to serve the real economy."*

The U.S. dollar is not only the most important world currency when it comes to financing international trade, it also serves as the principal international reserve asset. Billions of U.S. dollars circulate outside of the United States' borders.

For the U.S. dollar to continue to serve as the principal international reserve currency there must be no restraints on the creation of new dollars. Currently the world financial system depends on the existence of an excess of dollars circulating abroad. Around two-thirds of foreign reserves owned by other countries are held in U.S. dollar-denominated assets. (The rest are held in euros, yen or a handful of other hard currencies).

In 1960 Yale economist Robert Triffin identified a major problem inherent in a world monetary system dependent on a national currency. The "Triffin dilemma" occurs when the country supplying the world's principal reserve asset has to run large current account deficits (mainly by importing more than it exports) in order to ensure a sufficient supply of world liquidity. As that country becomes more indebted to foreigners, confidence in the value of its currency erodes over time.

In March 2011, University of California economist Barry Eichengreen wrote an opinion piece in the *Wall Street Journal* arguing that the dollar's reign as the world's major reserve currency is coming to an end.[55] He cites three reasons for the greenback's demise. First, new technologies allow traders to compare prices quickly and switch trades instantaneously between currencies. Secondly, the rise of rival currencies, especially the euro and eventually the Chinese *renminbi* (or *yuan* as it is also known) will give traders alternatives. Thirdly, and most importantly, the rise in U.S. indebtedness will cause foreigners to question whether the U.S. might "resort to inflating away" the real value of its currency.

Eichengreen is not alone in questioning whether assets denominated in U.S. dollars will remain a dependable store of value. Agustino Fontevecchia, an analyst at Forbes.com notes: "The U.S. dollar's role as the world's reserve currency has been called into question since the most recent financial crisis. A mounting deficit and a battered economy have led many to question why the U.S. was given the privilege of owning the world's printing press, giving it access to cheap financing, and ultimately causing extreme indebtedness."[56]

The Commission of Experts on Reforms of the International Monetary and Financial System, chaired by Joseph Stiglitz, noted several problems associated with the current global reserve system's dependence on the U.S. dollar. It said the system is beset by instability, noting that as far back as the 1960s, the international monetary system has "been plagued with cycles of diminished confidence in the U.S. dollar."[57] The commission noted that the current system has "an inflationary bias associated with excess dollar liquidity… [that leads to the] eventual erosion in the value of dollar assets."[58]

The Stiglitz Commission calls the current system inequitable because it results in developing countries having to accumulate large foreign exchange reserves as a defence against financial instability, "transferring resources, typically at low interest rates, to the developed countries … in particular to the United States."[59]

Developing countries loaned developed countries that issue reserve currencies US$3.7 trillion in 2007 at very low interest rates while they paid higher rates on the money they borrowed to invest in development projects. The difference between the interest payments received and those paid resulted in a transfer of resources from the South to the North greater than all the Official Development Assistance allocated that year.[60]

The current system also has costs for the United States. According to the Stiglitz Commission, when the U.S. runs large current account deficits in order to supply liquidity for other countries' reserves, there are "adverse effects on U.S. domestic demand; when dollars are held to meet increased demands for liquidity in surplus countries, they fail to produce any countervailing adjustment in foreign demand. This necessitates the U.S. running persistent fiscal deficits if it wishes to keep the economy at or near full employment."[61]

**Keynes plan for 'financial disarmament'**

Advocates of a cooperative international monetary system frequently invoke the proposals first put forward by John Maynard Keynes in his 1930 *Treatise on Money* and then refined in his pre-Bretton Woods proposals for what he then called "financial disarmament." Keynes proposed the creation of the *bancor*, an international reserve to be administered by an International Clearing Union, a type of global central bank.

Under this plan, each country would have an account at the Clearing Union. Central banks in countries with current account surpluses would deposit *bancors* in the clearing union and countries with deficits would be able to borrow them without restrictions. Since total surpluses would equal total deficits the Clearing Union would always remain solvent. As political economist Duncan Cameron explains: "Instead of countries being indebted to each other, each country [would be] a debtor or creditor with the Union. The difference [is] hugely important. Without access to *bancor* credit, indebted countries [are] forced to cut back spending, increase taxes, devalue their currencies and raise interest rates. With access to *bancor* ... they could spend on domestic priorities."[62]

A new reserve system could in theory use the IMF's Special Drawing Rights (SDRs) as a universal reserve asset. But this would require the IMF to undergo fundamental reforms. Alternatively, the Stiglitz Commission suggests that a new Global Reserve Bank could be created to oversee an international currency. They argue that a new international reserve system based on SDRs or a new international asset would benefit the U.S. itself allowing it to manage its own monetary and trade policies without having to constantly run current account deficits to supply dollars to the rest of the world.[63]

In the absence of universal agreement on the construction of a new monetary system, regional groups of countries can still launch independent entities under their own control. Several South American countries have created the Bank of the South as their regional development bank. While civil society organizations welcome this regional bank as an alternative to the Northern-dominated World Bank, they remain concerned lest it favour large-scale projects serving elite interests over loans to small-scale local initiatives.[64]

Similarly, civil society groups urge Southern governments to establish regional reserve funds or currency swap agreements as alternatives to borrowing from the IMF. Some South American countries have begun to use their own currencies instead of dollars or euros or yen for intra-regional trade. Eventually Southern countries may establish regional central banks and common currencies while avoiding the difficulties that have plagued the Eurozone.

Ecological economist Herman Daly asserts that if the international community did adopt a new international asset like the *bancor* proposed by John Maynard Keynes, "There would no longer be any need for the International Monetary Fund and the austerity its 'conditionality' imposes on weaker economies."[65]

### J. Create a UN Economic Social Ecological Security Council

The São Paulo plan of action calls for a, "*United Nations Economic Social Ecological Security Council. For all its deficiencies, the United Nations remains the most representative and inclusive forum for global cooperation and policy setting. Conceptually, it serves as a model on which to build a more effective and representative international financial and economic architecture. However, it is not adequately forging consensus on many issues at this time.*

*"A potential instrument for enhanced, effective and coherent global governance could be the establishment of a UN Economic, Social and Ecological Security Council (UNESESC). Civil society and churches have repeatedly called for such a body where pressing economic, social and ecological issues would be brought together to be discussed and acted upon in a coherent way.*

*"The report of the Stiglitz Commission, published in 2009, echoed this demand. As proposed by the Stiglitz Commission, the task of the UNESESC would be to assess developments and provide leadership in addressing economic issues that require global action while taking into account social and ecological factors.*

*"It should represent all regions of the world at the highest possible level and ensure the participation of the various global institutions (such as the IFIs, International Labour Organisation, United Nations Conference on Trade and Development, United Nations Women, World Health Organisation, United Nations Development Programme, United Nations Educational Scientific and Cultural Organisation, International Telecommunication Union, etc.), and cooperate closely with civil society to promulgate measures for the protection of the economic, social and ecological rights of nations and communities."*

The proposal of the Stiglitz Commission for a global council to coordinate economic, social and ecological policies is rooted in a larger debate on the future and purpose of the United Nations itself. In 1995, on the fiftieth anniversary of the UN, a Commission on Global Governance issued *Our Global Neighbourhood*. That report called for democratic oversight of international financial institutions including the IMF and the World Bank. The report proposed, "A new Economic Security Council [that] would … consist of 23 members who would have responsibilities for international financial and development activities. The IMF, World Bank and the World Trade Organization – virtually all finance and development activities – would be under the authority of this body. There would be no veto power by a nation, nor would there be any permanent member status for any nation."[66]

Unfortunately, the dominant industrial nations rejected this proposal in order to hold on to the influence they wield, particularly through the IMF and the World Bank. However, the Stiglitz Commission report kept this vision alive. The São Paulo Statement suggests that the churches should play a particular role by bringing, "interested stakeholders together to develop the proposal further in order to overcome the differences that impede reaching the consensus needed for implementation."

### Counteract lobbying by financial firms

The limited nature of reforms to the financial system undertaken since the 2008 crisis corresponds to the historical pattern described by Oxford University professors Walter Mattli and Ngaire Woods: "The longer politicians wait to implement reforms after a financial crisis, the greater the chance that financial industry lobbyists and other specialists take over the process and water down reforms."[67]

The financial lobby is very strong, especially in the United States. Journalist Matt Taibbi sums up his description of how members of Congress gutted the Dodd-Frank Act with a telling observation: "The name of the game isn't cleaning up Wall Street, it's cleaning out Wall Street – throwing a 'yes' vote at a bank-approved bill to get them to pony up in an election year."[68]

According to the Center for Responsive Politics, "The finance, insurance and real estate sector combined to spend US$6.8 billion on federal lobbying and campaign contributions from 1998 through 2011. ... [In addition] big banks' undisclosed contributions also underwrite powerful trade groups like the American Bankers Association, the U.S. Chamber of Commerce and the Business Roundtable."[69]

U.S. Senator Dick Durbin summed up the enormous influence of the financial lobbyists (who now outnumber Congress members and Senators by a ratio of 3.7 to one) when he observed: "The banks are still the most powerful lobby on Capitol Hill: they frankly own the place."[70]

### Conclusion

KAIROS regards the ***São Paulo Statement on International Financial Transformation for the Economy of Life*** as a sign of hope, especially given the commitment of the sponsoring churches to carry through with actions to educate and mobilize church members for the transformation of the global financial system.

*KAIROS: Canadian Ecumenical Justice Initiatives unites eleven churches and religious institutions in work for social justice in Canada and around the globe.*

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