Taming financial markets is a must for achieving stability – why the Bretton Woods spirit and logic need to be rediscovered

Daniel Dăianu is Professor of Economics at the National School of Political and Administrative Studies, Bucharest, and former Finance Minister of Romania, former MEP and a CASE fellow.

Fears are mounting about emerging markets being hit by the US Fed ending its monetary stimulus. Ironically, these fears are a replica of worries produced when the Fed resorted to its monetary stimulus, which put upward pressure on emerging market currencies. And some voices talked about a currency war against the backdrop of the financial crisis and rising protectionism. Whichever way the US central bank moves, the impact is severe on emerging markets. And the impact would be severe on Europe too, in view of the negative feedback loops between sovereign and bank strains in the eurozone. All this is further evidence that we are lacking a proper international economic regime and makes us envy the Bretton Woods arrangements.

Those arrangements could be seen as an epitome of Pax Americana, of a hegemonic shaping of the international economic regime after the end of the Second World War. But such a view would be questionable for two reasons, at least. One, because there is always a need for an effective international regime, which should foster peaceful interactions among sovereign states. Secondly, the Bretton Woods arrangements were rooted in the lessons of a huge financial and economic crisis, the Great Depression, and tried to combine regulations applied to domestic affairs with rules covering international relations.

The logic of Glass Steagall (which separated investment banking from commercial operations) and Keynesian macroeconomics applied to domestic finance, whereas pegged, but adjustable exchange rates and capital controls were used for the sake of enhancing economic recovery and trade in the world. What is called the 'impossible trinity' (concomitant stable exchange rates, free flow of capital and independent monetary policy) was taken care of through those arrangements. However, once the USD was delinked from gold in the 70s, a dynamic was put in motion that gathered tremendous speed via waves of financial deregulation.

The Big Bang in the City of London in 1986, the rescinding of Glass Steagall in 1999 and the Commodity Futures Modernization Act of 2000 in the US, etc. have brought in a new era, a rapid growth of finance in the industrialized world, and fuelled deep financial integration in the EU. But darker sides of the new financial system were poorly understood and largely dismissed due to a blind belief in the virtues of market self-regulation and of derivatives. And we have, gradually, got into another huge financial and economic mess, which harms the social fabric of society, even democratic politics. Add to it the profound eurozone crisis.

Like almost 60 years ago, in order to create adequate policies one has to come to grips with the profound roots of the financial and the eurozone crises and, arguably, rediscover the Bretton Woods spirit and logic – which were imbued with concern for the fate of the free world, of helping economic recovery in an open international system.

Finance must be reined in. Let's get back Glass Steagall!

For economies to start to grow again on a sustainable basis and create jobs, a sound financial intermediation system is needed. There is need to bring the financial system 'back to reason', to make it shed, as much as possible, of its speculative and destabilizing nature, to downsize it. What intrigues is that, even now, not a few chiefs in the financial industry do not acknowledge the role it has played in bringing about a crisis that is matched by the Great Depression only, in living memory.

This is also one of the main conclusions of the British parliamentary commission on banking standards[1]. The gross abuse of securitization, the promotion of a wide range of exotic financial products that were hardly tradable and frequently of lousy value, the reckless short-termism in maximizing profits and a blatant neglect of risks, have turned major components of high finance into an in-built destabilizer. The role played by a paradigm which extols the virtues of self-equilibrating financial markets and which was embraced by major central banks is to be highlighted here. The Libor scandal, the growing information on the rigging of commodity and currency markets, give more salience to the wrongdoing in an industry which has, or is supposed to have, many features of public utilities.

The Larosiere and Liikanen reports, which were worked out at the behest of the European Commission, the Turner, Vickers and the Tyrie reports in the UK, the Dodd-Franck legislation and the Volcker proposals in the US, indicate a path of overall reform. And measures have been enacted in order to bolster

capital and liquidity requirements, reduce leverage, cap bonuses, enhance transparency and discourage excessive risk-taking, etc. But, arguably, more has to be done.

For example, dealing with the 'too big to fail' syndrome may require the application of anti-trust legislation, as it does happen in various industrial sectors; this would imply splitting big financial entities. A sort of Glass Steagall legislation should be restored, as after the Great Depression. Ring-fencing retail from trading activities is not sufficient for protecting tax-payers. The proposal made by the US senators John McCain and Elizabeth Warren should be supported in Europe too and the European Commission should consider it very seriously. As a *Financial Times* editorial stresses *"it would eradicate the testosterone-charged culture of investment banking from retail activities."*[2]

More should be done when it comes to diminishing the casino like activities and regulating the shadow baking sector, enforcing ethical standards, tackling the threats posed by rising electronic (algorithmic) trading. Regarding the nature of electronic trading and linkages between finance and economic numbers provide a lot of food for thought: for instance, the average holding period for a stock moved from 4 years at the end of the Second World War to 8 months in 2000, 2 months in 2008 and 22 seconds in 2011[3]. And a legitimate question arises: what justifies the rising share of financial institutions' profits in overall corporate profits in recent decades? In the US for example, this share was about 8% in 1947, it rose to above 20% over the years and a peak of c. 46% was reached in 2001.

Bailing-in creditors and share-holders is being pursued in the EU in view of the great burden-rescuing financial entities have put on public budgets. As the Liikanen report indicates, the public cost of avoiding a financial meltdown amounted to over 13% of the EU27 GDP during 2008-2011. And the figure goes much higher if other committed aid is added. But I wonder why banks, themselves, are not embedded in this process, in view of the enormous pay gap between banking and other sectors in the economy? Limiting remuneration of top managers is not sufficient. Bailing in large depositors is fraught with pitfalls; it would accentuate the fragmentation of eurozone banking and discourage capital flowing into the EU if the banking union gets into being very slowly.

Some highlight a 'financial cycle', which has much lower frequency than business cycles[4]. The observation that the financial cycle depends critically on policy regimes is of exceptional relevance. For, although cycles can hardly be precluded the amplitude of boom and bust dynamics is influenced by policies, as it is the size of the financial industry – which is currently oversized in not a few advanced economies (eg. UK, Ireland, Netherlands, Iceland, Cyprus, etc). The robustness and resilience of financial systems has been much diminished by inter-connectedness and the spreading use of derivatives. Via widespread securitization, banks have, arguably, relinquished their mission of due diligence in lending, have gone much beyond what is prudent business conduct. Large financial entities have turned into 'risk-spreaders' and this is why they should be closely monitored by the ECB.

"The US and the EU have the key role in reinventing the logic and spirit of Bretton Woods, in taming finance, for the sake of regaining economic stability and preserving democratic order"

In order to reduce its fragility, make it more robust, the financial (banking) system needs to be 'modularized', as Andrew Haldane, from the Bank of England, remarked. And there are ways to achieve it, in spite of stern opposition from the financial industry: by promoting more simple banking (finance), downsizing large groups, separating activities, prohibiting the use of certain financial products, regulation of the shadow banking sector (hedge funds and private equity funds included), forcing transactions on open venues and mandating reporting and transparency standards, punishing frauds and market rigging severely.

The eurozone needs its own Bretton Woods

The financial crisis unveiled congenital flaws of the eurozone design and has created a formidable challenge for policy makers. The EU, the eurozone in particular, have become an area of major concern to countries the world over. And this concern is not only because the EU is the largest trading bloc in the global economy, but, also, because it is the site of many globally operating banks, financial institutions, and, not least, since, together with the US, it has been behind the globalization drive of the past decades. A financial disaster in Europe would imperil the European project, would have wide ranging implications for the global economy.

Budget profligacy in some EU member states does not explain the depth of the crisis in the eurozone. A consistent implementation of the Stability and Growth Pact would have not prevented tensions rising in the eurozone. Ireland and Spain, with their prudent budget policies in the pre-crisis years but sky-rocketing private indebtedness, are quite illuminating in this regard. A flawed design and incomplete policy arrangements, which invited rising inter EU member states imbalances, are no less important in explaining the plight of and the disaffection in the eurozone.

The Bretton Woods logic and spirit provide lenses for interpreting the eurozone crisis and figuring out remedies. First is the issue of policy space, of adjusting imbalances in an area where member states no longer use exchange rate tools. Second is the issue whether the current policy coordination and policy arrangements are appropriate for a single currency area. Economists are fond of extolling the virtues of fiscal space and this is why the EC and the IMF keep prodding governments to build it up through buffers and counter-cyclical policies. But there is another, broader and not least important concept, eg. policy space. For economies to adjust smoothly to shocks they need to rely on highly flexible markets and be able to resort to an array

of adjustment tools – Jan Tinbergen got his Nobel Prize for highlighting just that tenet decades ago.

In a single currency area, where the monetary policy and exchange rate policy are gone, the tasks for policy makers can easily turn into a mission impossible. As matter of fact, the fathers of the eurozone were conscious that the design was inadequate, but they bet on a highly questionable assumption: that convergence will take place eventually and that EU funds would make a decisive contribution to this end.

The eurozone crisis is also one of economics having taken revenge on politics; and as deregulated finance has brought a disaster upon us, a flawed design of the eurozone has created a big mess of its own too. To claim that the introduction of the euro was a big success is an overstretched assertion, in my view. The way it does function now, the single currency area is more constraining than the gold standard regime from the inter war period of the last century. And it pays to remember what that policy regime has led into, apart from other events.

It is true that there are automatic stabilizers nowadays, which did not exist at that time, but they cannot compensate for precarious policy arrangements and the constraints imposed by the Fiscal Treaty. The single currency area is devoid of policy arrangements which should consider external imbalances and the need for a fair sharing of adjustment burden. To think that the way out of large external disequilibria is by internal devaluation in certain countries only is quite unrealistic. To disregard the huge unemployment in several countries and the rising social tension is to repeat historical mistakes and bring demons of the past back to life.

The banking union project might provide a solution to enhancing the cohesiveness of the eurozone. But there are important technicalities, of a fiscal nature in particular, and sequencing problems that need clarification. There is also need for a strong and timely financial backstop. And there are other needed policy arrangements, which go beyond the operations of a banking union, in order to make the eurozone, the EU function properly.

The bottom line is that fiscal rectitude is not sufficient for rescuing the eurozone. There is need of elements of fiscal integration (the issue of common bonds, eventually), of tools for dealing with asymmetric shocks (such as insurance for unemployed people) and of stronger means for fostering economic convergence. Fiscal capacity, as put forward by president Herman van Rompuy, encapsulates such requirements. It is justified to decry, as some do, the insufficient size of resources the EU budget assigns to R&D based activities, to innovation, as a means to help EU members states cope with the challenges posed by the emerging economic powers. But it is also wrong to underestimate the impact on the eurozone, on the EU in general, of growing economic cleavages among member states.

A 'mezzogiornification' of the southern fringe of the eurozone was anticipated years before its inception. But Paul Krugman put it in benign terms, with specialization taking place according to comparative advantages and Germany, in the main, at the centre of an industrial core of the EU[5]. Whereas, now, we see that unless institutional and policy arrangements are adequate rising imbalances among EU member states, especially in the eurozone, can bring about havoc. The eurozone needs its own Bretton Woods.

Democratic order demands taming financial markets

The financial and economic crisis is reinforcing a worrying tendency in Europe and the US: the erosion of middle class. This erosion can be linked with technological change (that has favoured highly skilled labour in advanced economies), Asia's phenomenal economic growth (that has eroded western countries' market shares), public policies that have underestimated the role manufacturing and, not least, an over-expansion of financial industry in several economies, at the expense of other sectors. The excessive growth of finance has entailed a marked change in profit distribution in the corporate world and in income distribution in society at large.

Peoples' capitalism cannot obscure the significant rise in income inequality in recent decades. OECD data make up a grim picture in this regard; between the mid 1980s and the late 2000s income inequality rose in 17 out of 22 industrialized countries. When the 'social pie' is rising income inequality may not cause alarm. But when the social pie stagnates, or even shrinks, its increasingly unequal distribution produces tension and can become dangerous. Anyhow, an uncontrolled rising income inequality harms the 'equal opportunities' policy, which was a huge achievement of a civilized, fair society. There is also a huge ethical problem involved here. Big companies are fond of speaking of corporate social responsibility. But where was it when investment banks sold to investors financial products which they sold at the same time on the future market? And examples of this nature are numerous.

Weakened economies and the erosion of middle class are bad for the functioning of checks and balances, for securing the social glue and the social capital which are underpinning a democratic order. The rise in intolerance (xenophobia and chauvinism), high political polarization are harbingers of worse things to come unless policies are formulated to counteract them.

Taming financial markets is, therefore, a must so that future deep crises be avoided, or better dealt with. The way financial markets have functioned in recent decades is not God given. Public policy can and should change it, as it did after the Great Depression and after the Second World War. The reform of the financial industry is badly needed in order to bring back a sense of fairness in society, which is critical for the functioning of democracy.

However brilliant practices used by European public and private entities might be the economic/business environment, as a structure, matters tremendously. Finance has to assist economies recover and prosper again, and not, instead, extract undue rents from and destabilize them. In the same vein one can reason when it comes to the eurozone design and policy arrangements; these condition

the functioning and performance of national policies, as the latter impact on the state of the eurozone in their turn.

Rediscovering the logic and spirit of Bretton Woods

We need to rediscover the Bretton Woods' logic and spirit for the sake of tackling three formidable crisis which blend each other: a deep financial crisis, the eurozone crisis, and the crisis of the international regime against the backdrop of shifting power in the world economy.

The future international economic system will, quite likely, be carved out amongst three major currency blocs, with the US, the EU and China providing the lynchpins. A reshaped international regime would involve rules for the realignment of major currencies and measures in order to mitigate destabilizing capital flows, including financial transactions taxes; rules for preserving an open trade regime, but that should consider the needs of the poorest countries at a time when ecological degradation and food safety are a rising global concern. The functioning of the IFIs would have to keep in mind the shifting power redistribution in the world and lessons of economic modernization. G20 has not been effective enough in this respect. A new international regime would have to combat tax evasion and avoidance, not least because of the heavy burden bank rescues operations have put on public budgets, on tax payers. In this respect, a legislation that should limit tax havens to the utmost would make sense economically, socially, and ethically.

In domestic finance the restoration of a sort of Glass Steagall legislation would be more than welcome, together with measures that deal with the too big to fail syndrome, limit over-risky activities (trading), downsize finance and bring it back to reason, make it more simple. The EU and the US have the key role in promoting uniform norms in the regulation and supervision of finance. The Financial Stability Board could help enforce this new framework. The main aim herein is not the avoidance of arbitrage attempts by firms, but the very function of finance in the service of economies.

The US and the EU have the key role in reinventing the logic and spirit of Bretton Woods, in taming finance, for the sake of regaining economic stability and preserving democratic order. ■

1. The UK Parliament Commission "laments the striking limitation on the sense of personal responsibility and accountability of the leaders within the industry for the widespread failings and abuses over which they preside" (cited by Financial Times, June 19, 2013, p.8)
2. Split the Banks, 13 July, 2013
3. Scott Patterson, Dark Pools, 2012, Random House, p.46
4. Claudio Borio, "The financial cycle and macroeconomics; what have we learned?", BIS Working Papers, No.395, December, 2012
5. Paul Krugman, Geography and Trade, MIT Press, p.80, 1991

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