

EXIT THE MAIN STREAM ! OPTIONS TO RESTORE FINANCIAL MARKETS AT THE END OF THE NEOLIBERAL DISASTER

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ABSTRACT

In the context of the currently ongoing financial crisis some research work has been done to outline the major weaknesses of the deregulated and liberalized financial system architecture. A growing shadow-financial system, the abuse of investment techniques and the available financial instruments, accompanied by poorly performing and overestimated rating agencies, short term oriented financial behaviour and a poorly developed regulatory and supervisory environment led to a two-digit trillion Dollar damage. The system has in parts lost its function to efficiently intermediate between savers and borrowers and thus became a continuous threat to the value creating real economy. To restore the functionality of the financial system a set of measures is discussed. The Vietnamese financial system partially mirrors weaknesses of the current global financial system, although its particular strengths and weaknesses have to be considered separately as they are borne by the specific features of the Vietnamese economic system.

FINANCIAL MARKET INSTABILITY

The development of the financial system over the past 30 years can be characterized by two major interwoven features. Firstly the deregulation of international capital flows after the breakdown of the Bretton Woods System in 1973 and the switch to flexible exchange rates have created a source of shocks and uncertainties that have predominantly attracted speculative financial activities. Secondly the remaining regulations in the banking sector and the worldwide change of governance attitudes and risk behaviour led to an increasingly growing financial sector in the shadow of the regulated banking system. Investment funds, hedge

funds, private equity funds and other mostly dubious investment vehicles, operating in a legal and regulatory vacuum mostly located offshore are nowadays near to dominating the financial systems activities. It is estimated, that about 30% or 60 Trillion USD of the worldwide yearly financial flows are managed by those widely intransparent institutions. Due to what is called “financialization”, fuelled by financial market actors and protected by their academic sentinels once sheltered segments of the financial markets such as real estate financing became as well a playing field as those parts of the real economy that have never been in close touch with the financial markets (food, raw materials, public finance). Starting

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in 2008, the currently working financial system has been generating a total loss of estimated 10 Trillion USD.

Euro area government support for the financial sector between 10/2008 and 05/2010

	Committed (€ billion)	Implemented (€ billion)	In % of implemented
Capital injections	231	84.2	36
Liability guarantees	1,694	506.2	30
Asset protection	238	48.7	20

Only the Euro area government support for the financial sector between October 2008 and May 2010 mounted up to a total commitment of 2,15 Trillion Euro of which 550 Billion Euro have been effectively implemented (see table above)².

THE SHADOW SYSTEM

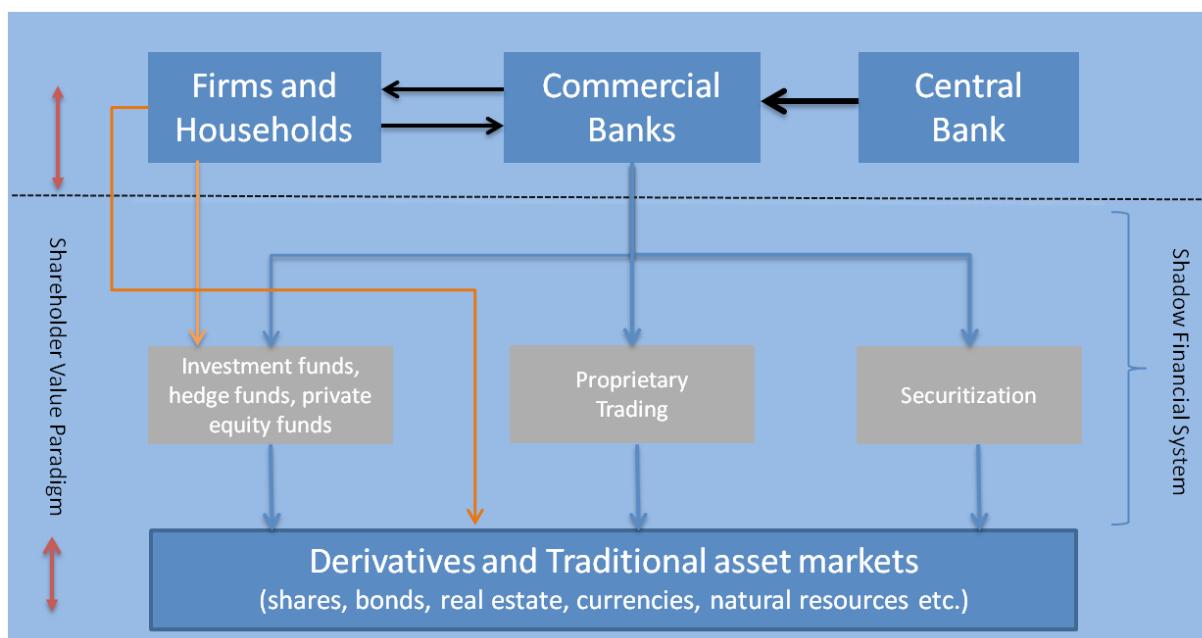
Along with fundamental changes in the functioning of the system and the motives of their agents the shadow financial system gained ground. Mostly located in offshore centres with minimal market regulations, facilitating money laundering, tax evasion and other internationally organized criminal activities, the shadow system primarily followed short term, risk oriented and often extremely leveraged strategic patterns. Driven by a change in the culture of finance, also publicly registered and supervised commercial banks adjusted to the behaviour of institutions in the shadow financial system to meet the new paradigm of corporate governance, the shareholder capitalism that subordinated the whole economy to the interest of

financial markets, enforcing higher profit mark-ups and an extremely short term oriented management. Shareholder capitalism also led to an explosion in earnings for management.

The way the system has been developing can be shown as follows: Generally central banks only interact with commercial banks, creating money “out of nothing” (Schumpeter, 1951). This capacity is vital to the stability of the financial system. Central banks as lenders of last resort guarantee the liquidity of the financial system and thereby of the whole economy. Traditionally, commercial banks used the money they lend from central banks to provide credit to firms and households, whereby the latter would keep most of their monetary wealth as deposits with commercial banks.

One of the most distinctive and finally most destabilizing features of the new, liberalized and deregulated financial system has been the newly growing linkage between the money creating central banks and the high risk shadow financial system:

²See Evans (2011), p. 99.

Figure 1. Commercial banks and the growing shadow-financial system.

Since now about ten years one can observe a growing direct relationship between the central bank, the commercial banks and the high risk shadow financial system. Figure 1 illustrates the channels of transmission.

Funding of nonbank financial institutions: Commercial banks are allowed to invest in nonbank financial institutions and thus indirectly finance their usually extremely leveraged risky investment activities. Those institutions carry out various short term oriented, high yield focused so called “Alternative Investments” (speculation against currencies or the share prices of selected listed companies, unfriendly takeovers and recapitalization of selected target companies, speculations on commodity markets, short term speculative trading positions using a broad range of complex derivatives) which all together most unlikely contributed to the wealth of the real economy but to excessive profits gained by a continuous interplay of bringing markets out of balance and earn from the resulting market processes. Interestingly those investment strategies claimed to be

necessary to adjust imperfect markets while the underlying business model was based upon creating imperfections by massive coordinated interventions. Ironically - due to their legal status as nonbanks - these type of funds never had to follow international accounting or disclosure regulations and thus contributed by their sheer volume in a significant way to informational market inefficiencies they were considered to fight against. To a certain extent the currently discussed so called “European debt crisis” can be seen as a result of investment mechanisms like this.

Proprietary trading: Triggered by unreasonable high growing yield expectations commercial banks are also directly involved in speculative and risky investment activities created and offered by the shadow financial system, financing themselves by the central bank and government-guaranteed bank deposits. Risky asset positions have been insured by especially created insurances (i.e. Credit default swaps) offered by non bank financial institutions and traded over the counter on unregulated markets³.

³Reliable sources indicate that the CDS market alone had grown to a value of more than USD 60 trillion by the end of 2007 – the equivalent of the annual global economic output (ISDA, 2010).

Securitization: Coming from a basically traditional banking objective (qualitative asset transformation), commercial banks also started to rearrange their credit portfolios, transformed them into tradable assets and sold it to institutions operating in the shadow financial system. Following this route, some commercial banks had almost no credit risk to bear and hereby could theoretically endlessly accelerate their credit business without expanding their provided equity positions. Credit portfolio securitization finally has broken the link between debtor and creditor by transferring the risk into the shadow system and caused an uncontrollable moral hazard situation. The melt down of the financial system in 2008 represented the climax of these kind of financial acrobatics.

All these channels together have contributed to the dramatically increasing fragility of the financial system. Transferring risks to outside of institutions outside of the regulated financial system gave the illusion, that default risks have disappeared from the market (Hellwig, 2008) just by trading. Bilateral, unregulated over the counter trading of high volumes of risky securities led to an almost complete lost of transparency and thus transformed huge parts of the financial markets into a big casino.

MONEY CREATION, CREDIT ALLOCATION AND FINANCIAL INSTABILITY

To briefly illustrate what basically went wrong we will refer to the very traditional but insightful interplay of money creation - credit allocation – investment and income creation. As mentioned above, deregulation and the growing impact of a deeply liberalized shadow financial system has fuelled the construction of direct links between a central banks money creation and speculative activities in asset markets.

Due to several changes, and a new fashion in the philosophy of central banking, interest rate policy became the only remaining tool available to central banks to govern price level changes, asset bubbles, excessive exchange rate volatilities and GDP growth. This confronted them with different dilemmas, however. Stopping price bubbles in a situation of low GDP growth and low goods market inflation by setting up high interest rates can push the real economy into deep recession. In contrast, low interest rates to fight a sluggish GDP growth can stimulate asset price bubbles. The problem behind these and other dilemmas is, that the central bank has no control over the allocation of credits. While in regulated types of financial systems central banks could be more or less sure that at least the lion s share of credit expansion and money creation would most likely flow into the productive sector (real economy excluding real estate sector) credit expansion in a deregulated financial system can directly feed speculative activities without substantially stimulating productive activities. Due to deregulation, misallocation of credits, asset price bubbles with nefarious economic outcomes have become more frequent and more harmful (internet stock market bubble in the late 1990s, the real estate bubbles in the 2000s which led to the subprime crisis in 2007, speculative price hikes in commodity and food markets as a result from excessive speculative attacks using commodity index futures etc.)

In parallel, liberalized and unstable international capital flows have led to unstable exchange rates and increasing current account imbalances adding to the instability of world financial markets. Monetary policy here would also possibly confronted with a dilemma: sudden capital outflows or even a sudden dry out of an inflow sources can force the central bank

to a restrictive monetary policy in spite of low growth and high unemployment.

All recent crisis scenarios share a basic mechanism: price bubbles have arisen with credit expansion that was only to a small degree financing productive activities. Thus the general picture does not surprise: Over the past 30 years of liberalized markets the indebtedness of all sectors have sharply increased.

The observable combination of high debt levels and asset price bubbles is another dangerous element of the deregulated capitalism. Credit driven asset bubbles may lead to an unavoidable phase of asset price deflation, which is turning into high levels of non performing loans and finally translates into a high rates depreciation, bankruptcies and rising levels of unemployment.

MISLEADING REGULATORY FRAMEWORKS

What has made things worse is, that the upcoming financial instability could not be compensated by appropriate regulatory frameworks.

Concerning banking regulation, the neoliberal period experienced a shift from a robust regulation concerning minimum equity requirements (Basel I, 1988) to its more fragile successor Basel II (2004). Whereas Basel I required the banks to classify their assets according to their credit risk into different categories, it required to hold on equity of 8% of the risk weighted assets. Although this framework had considerable weaknesses (all public debt of OECD countries were assumed to have a credit risk of zero and thus did not require any equity) it was robust and did not respond in a cyclical way on different states of the economy.

However, Basel II finally allowed banks to employ their own risk models in order to state the necessary regulatory

equity. This remarkable switch came along with two significant characteristics: First the use of simple mathematical models – the most common is the value-at-risk model - based upon a number of historical data served to justify the naive belief, that future can be calculated and that therefore financial markets could be kept in a stable condition. Besides this, all the individual models show strong pro-cyclical effects and thereby added to asset volatility and asset price bubbles. For example, during a period of asset price inflation defaults occur relatively seldom and historical data signal low default risks and low equity holdings, speeding up the volume of credits to be allocated in this sector and thus spiralling up the macroeconomic risk. Contrary to this, in a period of real estate crisis, default rates become high and thus the minimum equity levels jump to high levels thereby accelerating financial problems for the banking sector.

Secondly and as a result of individual risk models, the equity holdings after the introduction of Basel II became far lower than it was under Basel I. In fact, the intention of the banking sector when pledging for Basel II has always been to increase the debt-to-equity ratio and hence to increase the return on equity. Hellwig (2008) cited, that equity holdings of banks such as UBS or Deutsche Bank dropped from about 10% of their balance sheet in the 1990s to somewhere between 2 and 3% on the eve of the subprime crisis. At that time, the still growing number of institutions operating in the shadow financial system had almost no equity and contributed significantly to the damage caused by the subprime crisis.

Furthermore the long lasting discussion about suitable international accounting standards, primarily pursued by two private institutions (FASB in the

USA and the IASB in Europe) pushed for a procyclical mark-to-market valuation of asset valuation.

While in former times, assets in most European countries entered the books at historical values or at market prices, if market prices fell below historical values. As Basel II, fair value accounting adds to procyclical bias of asset markets: during a bubble, fair values led to a swelling of asset positions in the balance sheets and thus to higher profits, higher bonuses and dividend payments which did not reflect the operational profits but further stimulated the bubble. In contrast, during periods of asset price deflation a shrinking equity position leads to book losses, fuels fire sales of devaluated assets thereby resulting in a further collapse of asset pricing, credit crunches, liquidity and solvency problems.

OPTIONS TO RECOVER FROM THE FINANCIAL DISASTER ECONOMY

Financial systems should serve the real economy. Any reform programme must therefore aim to reduce the inherent instability of the currently established financial systems, to restore the financial system as a supportive tool for economic development, employment and wealth. It should be remembered, that it is not up to financial system to provide or guarantee high returns, those can at last only be earned by successful business operations in the real economy. Taleb (2010) has recently articulated the policy response to date: "You have a person, who has cancer and instead of removing the cancer, you give him tranquilizers. When you give tranquilizers to a cancer patient, they feel better, but the cancer gets worse." Policy after the subprime disaster has not radically cut back the dangerous and widely useless elements of the currently established financial systems. In contrary,

the opposite is the case: as the system has been fed by even more credit and liquidity, we will now have to step forward to guide the essential reform of the financial system.

SEPARATION OF TRADITIONAL BANKING BUSINESSES AND OTHER FINANCIAL INSTITUTIONS

Finally it was the re-establishment of a universal banking system in the United States that has led to a sharp growing investment banking sector, doing risky businesses using funds from deposits. By this strategy, the naturally higher risk from investment banking was covered/distributed to the customers in the credit business and finally, due to significantly extended securitization techniques and the application of credit derivative instruments transferred to the community of tax payers outside to the financial system.

As an indispensable consequence we require to severe all channels linking the commercial banks to the shadow financial system:

- a. Commercial banks would not be allowed to follow an unlimited business of proprietary trading.
- b. Commercial banks would not be allowed to own financial institutions outside the banking sector and vice versa.
- c. Commercial banks would not be allowed to give credit to non-bank financial institutions. Non-bank financial institutions would then have to tap the non-bank sector to get funded. This would firstly substantially lower the financial-leverage of their and secondly keep the risk of failure with the private sector involved thus preventing the financial system from a contagious systemic crisis.
- d. Commercial banks would be forced to keep a substantial part of their

loan portfolio, particularly the first loss piece in its own books. By this measure, securitization would be rehabilitated as a safe technique that efficiently supports the primary banking business. However, securitization should be limited to the extent required by banks to cover their core activities, that is, making a loan and keeping it until it is paid back.

Similar to commercial banks the customers of insurance companies should be protected by comprehensive system of regulations. In particular the investment behavior of insurance companies must be regulated to limit high-risk adventures, directly or indirectly by special investment vehicles founded outside of the core business.

Special businesses like real estate financing could be considered a special case of finance and permitted only by specialized, state licensed and state controlled institutions. The decades following the second world war in Europe have shown, that specially regulated financial markets for real estate investments added stability to asset prices while delivering sufficient and affordable housing providing social and financial stability to the population.

Reform steps that have been taken in the United States after the subprime crisis limit proprietary trading and the ownership of hedge funds and can be seen as a step into the right direction. Reforms in Europe do not go as far as those in the United States. Despite of these steps, in both areas the credit relations between the banking sector and the shadow-financial system have not been interrupted and continue to feed the financial ulcer.

THE FUTURE OF THE SHADOW FINANCIAL SYSTEM AND THE DERIVATIVE MARKETS

As mentioned above the links between the current commercial banks and the non-bank sector has significantly contributed to the tremendous growth of an widely unregulated and intransparent shadow financial system.

At first we propose to cut or at least control the links between commercial banks and the shadow system. This would automatically lead to a shrinking nonbank financial sector.

To maintain a levelled playing field we secondly recommend to enforce transparency concerning the activities of all financial institutions, from hedge funds to private equity funds and traditional investment funds or banks. Extending the regulatory and supervisory measures, implemented to keep the banking sector stable to those institutions would require them to inform the public about their activities (disclosure regulations), keep a certain amount of equity (Basel III) and to allow supervisory agencies to control the business of such institutions.

Thirdly we cannot find any reason to allow economic transactions between unregulated offshore centers and the regulated rest of the world. To ban these kind of businesses would mean to consequently fight money laundering, tax evasion and contribute to the activities against organized crime. To suspend the role of offshore centers does not have any negative impact on the economic development of the world.

Finally we think that derivatives should only be traded in regulated and controlled market thus we cannot see any viable future option to maintain over the counter markets. Derivative products should be standardized and need to be licensed by financial market supervision authorities, traders in specific markets should be required to provide a licence to

trade. We cannot see any need to participate the public in derivatives trading.

Some derivatives markets (like those dealing with commodities like oil, food or other natural resources) should be put under strict public control. To prevent excessive speculations position limits should be set and participants are required to be involved to a certain extent with the underlying spot market directly. The past abuse of commodity markets by financial investors has presumably directly impacted the living conditions of millions living in developing or least developed countries in a negative way.

To keep the financing of public budgets distant from speculative attacks we propose to install special regulations concerning the primary and secondary markets for governmental or any other public bonds. Guaranteed bonds need a stable trading environment which may at least require the registration of bondholders. Instruments to manage credit risks in this market segment should exclusively be developed, issued and traded under the control of the market supervision authority. Credit risk derivatives in general should also be subject to the regulations set up for the insurance sector.

EQUITY BUFFERS AND COMPLETING REGULATIONS

Contrary to the development until the implementation of Basel II the financial system again needs larger buffers to remain stable in the event of shocks. A recently recommended reform of Basel II has been accepted by the G20 in November 2010 and raises the requirement for high-quality equity⁴ positions from 2% to 4.5% of total bank assets. Furthermore a conservation buffer of 2.5% is added so that the minimum equity requirement will most

likely move up to 7% of bank assets. If a bank can not meet the requirements of the conservation buffer, dividend payments and management earnings must be curbed.

Despite this, central banks will be given discretionary power to set in place an additional counter-cyclical buffer that may be up to 2.5% of total assets and a generally higher equity requirement of 9% is being discussed at the last G20 summit in Cannes for those twenty banks that are assumed to be of systemic relevance. Beyond these equity related requirements banks are also required to keep a specified minimum liquidity. This measure has been taken as a response to the fact, that during the subprime crisis all liquidity suddenly evaporated when all financial institutions tried to sell their securities.

Finally also the Basel III is going to fix a ceiling on the allowed maximum leverage ratio of about 33. That means, that banks can give credit of around 33 times their equity.

Even the reform steps concerning Basel III are going into the right direction, we would like to address some serious shortcomings:

Following the reform agenda, Basel III will still allow banks to employ their disastrous pro cyclical risk models. Referring to this we see a clear contradiction to the anti-cyclical concept of implementing additional equity buffers. Therefore we strongly recommend to restore a modified standard model as it has been employed in the former Basel I concept.

As even more serious we see the fact, that Basel III still does not address financial institutions of the shadow financial system. We therefore expect a clear political decision until Basel III will be fully implemented (2018) to extend the

⁴High quality equity is defined as common capital plus retained earnings. Under Basel II other types of capital such as goodwill or deferred tax payments with only low loss-absorption capabilities played a significant role.

regulated and supervised sector and also include investment companies, hedge funds and other non-bank financial institutions – as far as they are not generally prohibited – to follow Basel III requirements. Otherwise higher standards set for commercial banks will stimulate a greater transfer of activities to the shadow system.

Finally we think, that regulations as proposed under Basel III will need the support of further comprehensive regulations to maintain financial stability: minimum equity holdings do not prevent a credit crunch when equity is destroyed by the depreciation of large parts of the total assets of a bank. In this case banks need to reduce their credit volume which may result in a serious breakdown of money supply needed to maintain the functionality of the real economy. Finally the still procyclical accounting regulations may turn the generally anti-cyclical direction of Basel III in a procyclical orientation too.

Definitely we do not follow arguments, that expect a reduced credit expansion and thus lower GDP growth if higher equity holdings will be required. There is no practical and theoretical argument to support this position. If the credit allocation process is running in an efficient way – what has not always been the case over the last decade when banks were more focusing the higher profitable investment banking business – banks will always have the opportunity to issue new shares at attractive conditions. The characteristics of financial markets (uncertainty and asymmetric information) in general set incentives to move into a more unstable state. Low equity rates create incentives to engage in high-risk strategies promising high profits because failure does not incur much loss of capital⁵.

The past development has shown, that the credit allocation provided by the banking sector does sometimes lead to macroeconomic instabilities, when for example too much credit went to the real estate sector. In many cases also credit expansion to private household for consumption or to developing countries were too high and not sustainable. To prevent such developments, central banks should be granted discretionary power to enforce potentially high equity holdings for special types of credits. Another route would be to set credit ceilings for certain types of credits or economic sectors.

OVERCOMING INFORMATION ASYMMETRIES: THE FUTURE OF RATING AGENCIES

In modern economies the question how to prevent market failures due to asymmetric distribution of information in combination with moral hazard in the principal agent relationship. Rating agencies and their assessments right now are the most prominent institutions to bridge the information gap to improve market efficiency. Actually it became questionable, if those agencies really contributed to improve the information efficiency of financial market transactions, or if they became part of the problem when considering their role in the near past.

The cartel of rating agencies failed to meet their objectives when it did not warn investors before 2007, that the financial system was moving into an increasingly fragile situation. Moreover they were actively involved in creating products and strategies that later brought the whole system to the brink. Rating agencies gave advice to the banking system how to bundle and unbundle their portfolios right for securitization which they later graded

⁵Even for neoclassical economists the highly appreciated Miller-Modigliani Theorem states that in perfect financial markets the financial structure of firms does not change investment decisions (Modigliani-Miller, 1958). In this case higher equity is not a problem at all.

to be A. The deep involvement of the rating agencies and their close contact to the US financial system raised questions concerning their independency.

Concerning the current so called “debt crisis”, rating agencies again responded very late and very selective to a development, that had been observable by everybody for a couple of years before. Still it is not very transparent, in whose interest rating agencies are playing their game, what are the methods they apply to assess for example a debtors future credibility and which mechanism of quality control guarantees the functionality of these institutions.

Finally these privately owned, cartelled and deeply in the financial system embedded rating agencies do not naturally nor legally deserve the right to call up for a change in governmental budget policy, corporate strategies or the organization of a worldwide financial system. Regarding their bad performance in the near past, their obvious lack of transparency and independency and the very complex task to restructure major parts of the financial sector, the role of rating agencies becomes questionable and raised numerous discussions for functional equivalencies to improve market efficiency.

However, despite the fact, that rating agencies do not have any legal mandate to put pressure on a government or even the board of directors of a bank or a company the methods, techniques and policy employed by credit rating agencies are seemingly procyclical, are technically intransparent and did not prove as an effectively working instrument of crisis management.

In general we agree, that information efficiency has to be improved significantly and that there is an urgent need for appropriate institutions and institutional

regulations to guide this process. We also consider that rating agencies will in future play an important role to smooth problems arising from asymmetric information and moral hazard behavior. We therefore propose to redefine the business models and the technologies applied when it comes to information management on financial markets.

Firstly we recommend, that the costs of rating should always be borne by the buyer of financial products, never by the seller of those products. This measure may contribute to an improved perception of their independency. Secondly we believe, that to guarantee the applicability and acceptability of techniques and procedures applied, rating agencies should be regularly supervised and licensed by the financial market supervision authorities, appointed by national governments or international organizations. This is to bring some kind of legitimacy to the agencies role. Thirdly we are convinced, that observing and rating the credibility of governmental, state, municipal or any other securities issued by public institutions should be dedicated to independently appointed and controlled state-run agencies. Ratings of products or investment strategies belong to the supervision authorities that are responsible for licensing financial products.

Finally we believe, that restoring the role of intermediation of financial institutions will perceivably add to the information efficiency of the financial market.

In addition to this we strongly propose, that the design, discussion and implementation of accounting standards should not any longer largely being designated to privately organized boards like the FASB or IASB that have been catering to the interests of financial institutions but should be recommended

and developed by internationally accepted politically legalized bodies that might be working close to organizations like the IMF, the BIS, the newly founded EFSF the G8 or other appropriate organizations that do have a legal political mandate.

GOOD GOVERNANCE AND DESTABILIZING INCENTIVE SYSTEMS

Following Alfred Rappaport's "Shareholder Value Concept" which tried to align management's objectives with the interest of shareholders, high bonus payments based on current profits or current asset prices were seen as the best measure to trigger management decision behaviour in line with the interest of the owners.

Since the late 1980s this widely misunderstood concept has led to an explosion of management earnings while creating incentives to maximize short term returns, even where the strategies behind were harmful to a long-term sustainable development. Workers, owners and finally the whole economy and its infrastructure suffered from this unwise approach.

While the current discussion is focussing on how to curb this type of bonus payments or how to extend the time period to measure management performance we recommend to set absolute limits to bonuses by law, at least in per cent of fixed salaries.

An even more attractive way to support long-term oriented management strategies would be to reinstall the stakeholder concept, that obliges management to always seek a compromise and outbalance various stakeholder interests. Inherent to this approach is, that business strategies implemented by the management will be controlled by stakeholders like owners, creditors, communities, workers and thus guarantee sustainable long-term strategies

without profit maximization at all costs. Galbraith (1967) has already presented such a model. He argued that in conditions, in which everyone was merely seeking high individual gain, the corporation would be a chaos of competitive avarice. Group decision making where the interests of each stakeholder are controlled by the others enforces a code of behaviour allowing all stakeholders to benefit.

TAX POLICY MEASURES

Tax policy measures to prevent extraordinary high volumes of short term financial transactions have been discussed since decades. Predominantly the overheated international foreign exchange markets has been under suspicion to be dominated by short term capital flows, mostly not in direct relation to the worldwide trading of goods and services.

In fact the turnover on worldwide financial markets in April 2010 reached up to an average of 3.98 Trillion USD per day. About 1.5 Trillion are related to spot transactions while 2.5 trillion USD refer to the derivatives markets. With a total percentage of about 70% the market is clearly dominated by hedge funds activities.

As it is out of question, that an average monthly turnover of far more than the global annual economic output (estimated at about 90 trillion USD) does not meet only the requirements of international trade but primarily serves speculative intentions it is recommendable, to break the habit of potentially dangerous, international high frequency trade by introducing a financial transaction tax, simply to suppress speculation and low margin day trading. Even from a systemic point of view, there is no reason not to tax this kind of transactions as they are clearly designed to create profits and thus systematically belong the category of economic activities

where value added taxes are applied to. Furthermore a financial transaction tax would be highly recommended to make sure, that the financial industry shares the burden of the costs caused by disturbances created by malfunctioning financial markets or abusive trading intentions or strategies but also in the interest of general public revenue creation.

However, considering for example the real estate markets, we think, that a transaction tax alone would not be resilient enough to stabilize financial markets. Regulations obliging investors to retain assets for a certain period of time may also reduce speculative intentions. For example, if a private equity firm were forced to hold a company for at least five years, there would be less incentives to pursue an unfriendly takeover of the company, divide it into pieces and sell the pieces for a quick profit. Another option would be to tax profits plus paid interest in companies. This would offer the advantage of not discriminating against higher equity holding in firms. To tax profits and paid interest in the same way would also make tax arbitrage more difficult. This would significantly curb typical investment strategies of buying firms substituting equity into the purchase company with debt and transferring interest to tax havens in an effort to reduce the total tax payments while increasing the profits without any operational background.

THE INTERNATIONAL CAPITAL FLOWS

To isolate a discrete financial system from being infected by risk prone elements from the rest of the global financial system requires capital controls. Obviously it does not make too much sense to regulate domestic banks and to dry out the shadow financial system when those domestic banks are allowed to go abroad to take out loans and finance risky adventures. That

is exactly what happened in the Asian countries before the Asian crisis broke out.

Due to the widely unregulated FX markets, the increased role of speculative oriented market participants, the availability of a wide range of complex derivatives and at least uncontrollable increasing trade imbalances international capital flows became increasingly unstable. A regulated system requires international capital controls, to afford central banks the instruments needed to control unstable international capital flows and to follow and – at least - a domestic oriented monetary policy. This is not possible, if capital flows are uncontrolled. In a new system current account imbalances should be kept as small as possible. This does not only imply the installation of capital controls but also a global mechanism to prevent countries from following a mercantilist policy for high and long term current account surpluses. The debates around the Bretton-Woods negotiations could be a starting point.

Central banks also should have the discretionary power to ban certain capital flows at certain times. It is important to point out, that today there is no legal restriction for such regulation and capital controls are compatible with membership in the International Monetary Fund and the World Trade Organization.

There is a variety of measures to implement and manage capital controls: One is to tax certain capital inflows and outflows. Much stronger and more applicable instruments include direct prohibition (i.e. flows to and from offshore centres) or quantity controls of certain capital flows, for example international portfolio investments, international credits or foreign direct investments. Legal regulations can compel pensions funds and insurance companies to invest only small amounts of their assets – or even

none at all – in specified markets. Certain banks such as savings banks or cooperative banking institutions can be prevented from pursuing international business to provide the wealth of their customers.

CONCLUSIONS

The global financial markets should be reformed to support sustainable economic development, low unemployment and with respect to a stable society without adding to income inequality.

- The financial system must provide sufficient credit for productive activities at low interest rates. In this it has to support a Schumpeterian-Keynesian credit-investment-income mechanism as a backbone of production and consumption. It would be misguided, to discriminate financial markets as a major problem of the economic system. The task is rather to regulate them in such a way that they provide necessary support to economic development.
- The currently destabilizing mechanisms working in the financial systems could be reduced if the commercial banking system as well as insurance companies and pension funds were strictly controlled, international capital flows regulated, risk-taking institutions such as investment banks isolated from the rest of the financial system, all non-bank financial institutions regulated, the shareholder value paradigm overcome and unions and other stakeholders able to influence management decisions. We do not see any need or useful functional role for offshore centres and tax heavens so that transactions with institutions located in these areas should be prohibited. For all this to occur, the non-bank financial sector must

shrink substantially. Also derivatives have to be kept quantitatively small, standardized and checked regarding functionality by state run or state controlled supervisory agencies. In such a system, commercial banks would be strongly encouraged to focus on anew on their core mission of providing loans to businesses and households.

In the near past, the financial system has siphoned an increasing share of income and has been significantly contributing to income inequality and long term inefficient factor allocation by forcing firms to just pursue high-profit mark-ups. Keynes once evoked the possible “euthanasia of the rentier, and, consequently, the euthanasia of the cumulative oppressive power of the capitalist ..” He envisioned a stage of capitalism in which real interest rates and normal profits would go down to around zero and only innovative entrepreneurs would earn a profit. So far his vision has not materialized. However, a reformed financial system could help to bring this about.

Indeed one option for a regulated financial system would be to set deposit rates by the central bank whereas real interest rates would be positive but low. Fixing deposit rates also adds to economic stability as competition between banks is reduced. In a highly regulated system, the central bank could fix interest rates and at the same time the amount of credit to be issued by the banks. Such a system would ration the credit volume. But credit rationing in all financial systems already exists, for even without such regulations not all credit subscribers paying the market interest rate will obtain credit. The advantage of simultaneously fixing interest rates and credit volumes is that real interest rates can be set at low levels and even restrictive monetary policy can be

implemented without increasing interest rates simply by reducing the credit volume of the commercial banking system.

Current regulations of financial markets and those that are now being considered may bring some improvement but will not be sufficient to guarantee stability. While many of the more radical

reforms recommended in this paper may not seem politically feasible to the time being, the fragility of the financial system will continue relentlessly, and history may well create new windows of opportunity for a meaningful change. If such an opportunity presents itself, we should be aware of which direction to take.

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