

Global Financial Markets: Fairness and Justice

Summerschool : Boston College/DIW
Economic Policy from a European Perspective
28. May 2013

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Outline of the Talk

1. Background of the Paper: *Global Financial Markets. Fairness and Justice*, Dorothea Schäfer, DIW, and Brigitte Young, University of Münster
2. Why Fairness and Justice in Finance?
3. **Financial Stability** as a **Global Public Good**
4. Fair and Just reforms of the financial markets:
 - *Publicness of decisionmaking*
 - *Publicness in net benefits (distributed equitable)*
 - *Publicness in consumption*

Background of the Project

- ▶ The German Parliament has set up a Commission of Inquiry on the topic **Economic Growth, Living Standards and Quality of Life**
- Purpose: how to achieve sustainable economic growth with less (fossil) energy and resource input (*decoupling of resource/energy and economic growth*)
- How to come up with **new statistical measures of GDP** to measure socio-economic variables like economic growth, inflation, unemployment etc.
- Modelled after the so-called **Stiglitz Report** (with Amartya Sen, Jean-Paul Fitoussi) by the Commission on the Measurement of Economic Performance and Social Progress, which was set up by President Nicholas Sarkozy in Feb 2008.

Purpose of the Project

- ▶ Believe that there is a gap between statistical measurement of socio-economic phenomena and citizen perception of the same phenomena (GDP grows, but people feel less well off)
- ▶ In fact, the German economist *Friedrich List*, has already in the 19th century made this point about insufficient economic measurements. In his *Theory of Productive Power* he argued against Adam Smith that wealth is not produced through exchange value but rather through **increasing the productive power of a nation**. His examples: if somebody raises pigs, he increases value but not if somebody raises humans. The doctor, the lawyer, the musicians, artists are not calculated to produce goods, but the pharmacist who sells pills does. A Newton, Kepler, a Watt are not as productive as a donkey or a horse.
- ▶ Thus List in 1848 calls for a reversal, not to focus and use *exchange value (goods being traded) as real value, but to focus on productive powers (defined as science, research, art, education, child rearing etc) to create real wealth of a nation.*

What does this have to do with Finance?

- ▶ Stiglitz et al., suggest that **the financial crisis** took many by surprise since **the measurement system failed** and/or the market participant and policy makers did not focus on the right set of statistical indicators. For example, **neither public nor private accounting systems** were able to deliver an early warning between 2004–2007. It is also clear now that much of the growth during this time was a „mirage“, profits that were based on prices that had been inflated by a bubble.
- ▶ Belief that if we had been aware of the **limitations of the standard metrics**, such as GDP, there would have been less euphoria and irrational exuberance.

Why Fairness and Justice in Finance: Quality of Life needs a Different Financial System

- ▶ Discrepancy between the **rich and normal citizens** has widened since **financialization** started to dominate the real economy and aspects of everyday life (student loans, health costs, credit card debts etc).
- ▶ Financial crisis has **decreased the trust** in financial markets, in a functioning banking sector, and in the trust of citizens in our political leaders to resolve the crisis
- ▶ Believe that the present financial system ***privatizes the profits, but socializes the debts.***

Challenges

1. **Economic/Financial**: How to resolve the various interconnected crisis: Finance, banking, private and sovereign debt, deflation, imbalances between current account surplus (Germany, China, Japan) and deficit countries (USA, UK, Eurozone peripheral countries)
2. **Legitimacy Crisis**: Occupy Movements (on the Left) but also populist right-wing movements and new right-wing political parties
3. **Academic Crisis**: believe in the Efficient Market Hypothesis became the „truth“ (price provides all the information), that markets are rational and self-regulating, left out of the calculus: power, institutions, heterogeneity of expectations; how the real world works.

Financial Stability as a Global Public Good

- ▶ Global Public Goods: Inge Kaul et al. 1999, 2003; Charles Wyplosz (1999).
- ▶ Financial *Instability as a Public Bad*
- ▶ **Market Failures:** as a result of dealing with risks and uncertainties which cannot be priced
- ▶ Bank runs when depositors are alarmed
- ▶ Information asymmetries – lenders know less than the borrower; moral hazard; adverse selection – when credit markets dry up as is the case right now due to the collapse of the interbank lending system

Why we need Financial Stability as a Global Public Good

1. **International Spillover**, which is a case of externalities. Exchange rate markets, banks and other financial intermediaries operate across borders; financial contagion. Thus a crisis, like the subprime crisis in the US, set off a global financial crisis or the Asian crisis in 1997/98 led to Russian, Latin American crisis.
2. **Market failures**: Asymmetric information is more problematic in capital markets which are liberalized (CML) than in national economies, herd behavior in driving up asset prices but also in bank runs – Northern Rock; moral hazard – knowing that banks will be saved through the state will lead to riskier behavior; leveraging
3. **Race to the Bottom**: competition among regulatory systems as happened during the 1990s/2000s.

Why and What are (Global) Public Goods?

1. **Challenges of a web of crisis** such as financial crisis, global warming, new communicable diseases, energy crisis, international terrorism cannot be resolved by national governments, **since they are global.**
2. **Definition:** Public goods are those that are neither **non-excludable (street sign)** or **non-rival** (irrespective of how many people look at the street sign it cannot be used up (or consumed))

Finance as a Club Good

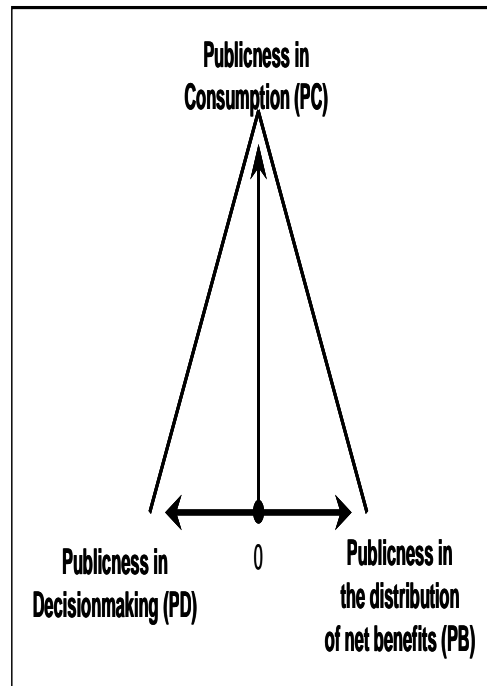
1. Financial products should be non-excludable (to be enjoyed by all)– but access has increasingly been restricted to **private actors** and negotiations are conducted behind closed doors – led to a privatized financial system
2. **Non-Rivalry – but there is rivalry in consumption.** Financial toxic innovations were sold to innocent bystanders, and safe products became increasingly polluted through CDOs, CDS, Mortgage Backed Obligations, Derivates multiple squared. Rivalry between those that are creditors and debtors.

Possible Reforms

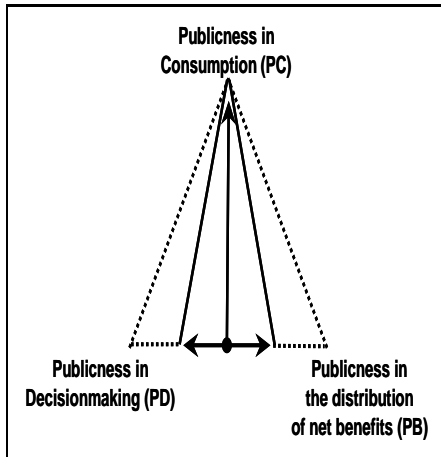
1. **Publicness in Decisionmaking:** who decides how and for whom the financial system is organized. This in effect speaks to the decision-making process of a new global financial architecture. It entails not only **output fairness**, but **process fairness** in negotiations
2. **Publicness in Net Benefits and Costs:** are they equitably distributed
3. **Publicness in Consumption:** to increase the non-rivalry of consumption through a certification process of financial products

Triangle of Publicness

- ▶
- ▶
- ▶



Triangle of Trade (WTO)



Publicness of Decisionmaking

- ▶ Financial market affect us all whether poor or rich thus the new **international norms (fairness, justice, democratic process)** need to be taken into account for the re-regulation of finance
- ▶ Joseph Stiglitz: those who are affected by the financial crisis should also have a say about its reforms. **Reality**: those who are affected by the failure of regulation do not have a voice.
- ▶ Albert Einstein: „We can't solve problems by using the same kind of thinking we used when we created them.“
- ▶ Need a **multilateral framework** in which there is **process fairness** among politics, business, and civil society
- ▶ This also means that **human rights, human security, ethnic and women rights** should play a role.
- ▶ Introduction of a **Financial Transaction Tax**
- ▶ From **national sovereignty** to **responsible sovereignty** (in which state have responsibilities towards their own citizens but also towards citizens of other nations).

Publicness in Net Benefits

- ▶ Despite the massive increase of international financial transactions since the 1990s, the distribution of net benefits has mostly gone to the **private actors**.
- ▶ Change: **Money is flowing** from emerging economies (such as China, Middle East) to developed countries (US)
- ▶ The global surpluses amounted to \$1.700 bill US of which the US alone imported 44 % in 2007.
- ▶ Need to re-balance the **imbalances between current account surplus countries** (China, Germany, Japan) and the **deficit countries** (US, UK, Spain, Greece, Portugal, Ireland). Balancing means that also surplus countries need to change their export models and stimulate domestic growth, and deficit countries need to decrease their dependence on imports and increase productivity.
- ▶ Need to develop **indicators** to measure the fair distribution of net benefits in finance. Model could be the **Human Development Report Index**. These indicators have to be transparent and publicly accessible.

Publicness of Consumption

- ▶ As the financial crisis has demonstrated, consumption (**non-rivalry**) was restricted by new financial products which normal citizens could not evaluate.
- ▶ **Non-excludability** has been violated by normal citizens, since they were excluded from safe products.
- ▶ Need a **Certification and Licensing Process** to test and evaluate any new financial product before it goes on the market (like the US Food and Drug Administration FDA – controls domestic and foreign products).

Conclusion

- ▶ *Finance is too important to leave it to financial experts*
- ▶ *Financial crisis demands a **reorientation of the rules of the game** of global governance of finance.*
- ▶ *Need to focus on **process fairness** and not only on output fairness.*
- ▶ ***Financial markets** are not private goods, which are excludable and rival, but part of the **public domain** to be used by all citizens.*
- ▶ *Finance has to be fair, just and democratic.*

Questions

1. Do the present reforms point to a fairer and more just financial governance system?
 2. Who could be the actors to implement such a system? What coalitions are necessary?
 3. How important are social movements/civil society (Occupy Movement)?
 4. Who are the winners of such a system, who are the losers?
 5. Why has the implementation of reforms been so slow or in some cases even stalled?
 6. What role for academia in this process?
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