

What are the main risks of the liberalization of global financial system (economic crisis, excessive speculation, tax havens,..) ?

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**"What are the main risks of the liberalization of global financial system
(economic crisis, excessive speculation, tax havens,..) ?"**

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In 50 years, there have been more than 400 financial crises, 70 of which concern sovereign debt. Yet international finance continued to grow, today it dominates and directs the globalized economy, but it is increasingly out of control of states and citizens. The banks have benefited from the liberalization of the economy following the collapse of the Soviet Union to convince states and their citizens of their ability to promote and accelerate the economic development of market economies. Due to the international opening of economic borders, banks have presented themselves as essential actors to optimize the realization of the famous "comparative advantages" of Ricardian thought.

However, the Adam Smith's "invisible hand" does not work in modern globalized societies. Historically, there were 5 crisis causes :

- First, the balance of payments crisis is characterized by a rapid depreciation of the currency and the loss of foreign exchange reserves that increased distrust of international operators towards a national economy and speeds up speculation.
- Secondly, the financial bubble occurs when speculators invest in financial assets above their real (basic) price in order to obtain profits in the very short term. The collapse is predictable, but before its realization it is possible for speculator to obtain more and more profits.

- Third, the financial panic is the result of both rapid withdrawals from loans to creditworthy borrowers and when there is no strong lender of last resort
- Fourth, bankruptcy expresses the insolvency or insufficient liquidity of a borrower unable to meet his debt. If this is a state, these bad debts lead to drastic recessionary policies
- Fifth, the moral hazard crisis concerns financial operations benefiting from implicit or explicit public guarantees. In this case, banks may engage in risky transactions, with high potential for profit. If the operation fails, States have to pay, which can lead to a political and economic crisis within the country.

The history of crisis and the responsibility of States

With the globalization process, multinational enterprises and banks asked for less States financial regulations and control. The world leadership of USA was clearly established after the end of Soviet Union. US government then progressively agreed with the liberty requirement of private sector, and then all States and international financial organization followed this policy due to the dollar importance into the international monetary and financial system.

In 1999, the separation between commercial and investment banks was removed in ISA. The predatory lending was encouraged by the laissez faire system organized by the George W. Bush administration.

The application of the "3D rule" (deregulation, disintermediation and decompartmentalisation), organized with the support of States, was presented by financial operators as a required and sufficient condition for economic development. This situation allowed speculators to engage dangerous operations for the entire system. A lot of financial crisis took place in Mexico, Russia, Asia or Argentina. In 2008, with the bad bank loans ("subprime" and securitization) and the bankruptcy of hedge funds and investment banks, the crisis spread throughout the world. Unsupervised freedom never leads to viable or stable solutions in the long term, given the rapid emergence of perverse effects. Then, State action to combat this collapse has been claimed in order to remedy the huge systemic risks.

After 2008, what happen for the International financial and monetary system ?

Many banking reforms were mentioned, announced, but never completely applied. Due to the action of States, the crisis was reduced, but the private debts became public debts, a modern application of the moral hazard system. Banks have again speculated against the most indebted countries, notably Greece and Ireland. In 2010, President Obama proposed the Dodd-Frank Act, mainly in order « to promote the financial stability of the United States by improving

accountability and transparency in the financial system, to end the application of the principle "too big to fail", to protect the American taxpayer by ending bailouts and to protect consumers from abusive financial services practices. Regulators must supervise more strongly significant financial institutions.

- It introduced stronger regulatory tools and defined stronger oversight.
- In order to increase transparency, the derivatives were supposed to work inside central clearinghouses.
- In principle, it created the Consumer Financial Protection Bureau (CFPB), an independent federal agency primarily focused on protecting consumer right against rip-offs of financial intermediaries.
- The Volcker Rule restricted some financial operations to the depository banks, concerning mainly the speculative use for their own accounts of the deposits of savers.
- Finally, an "orderly liquidation authority" for insolvent firms was proposed.

However, Dodd-Frank Act did not restore the separation between commercial and investment banking. The big banks are not controlled at all because they are very useful for the dominant world financial role of USA. Some of Dodd-Frank's rulemaking requirements have not been finalized, such as the multi-agency rule on executive compensation, which would discourage excessive risk-taking and encourage the reduction of bonuses for the Bank staffs.

At the same time, The European Commission proposed the introduction of a uniform regulation for all financial actors in the 28 Member States, with a centralized supervision of banks by the European Central Bank, introducing stricter prudential standards, improving protection for depositors and establishing rules for the management of failed banks. The separation between commercial banks and investment banks still was evoked, despite the strong reticence of the banking world.

In order to reduce the financial crisis effects, the European Commission estimated the public funds made available to European banks at 4.5 trillion euros, usually in the form of unconditional guarantees, ie 37% of the EU's GDP. Doing that, paradoxically, it encouraged speculation by the securities it grants to some public financial assets. Indeed, big banks find very interesting advantages with this policy, including governmental protection when the economic situation directly affects depositors, small shareholders and citizens. This security is an implicit form of subsidy, free insurance. For the IMF, these implicit subsidies amount to US \$ 70 billion in the US and US \$ 300 billion to the euro zone. The European Central Bank calls for austerity, but it gives unlimited loans to banks at attractive interest rates without questioning their usefulness to the economy.

However, banks often operate with financial players that escape any collective control. Indirectly, they continue to take risks with depositors' money. Banks are no longer interested primarily in the economic actors of goods and services. Without financial control, financial innovations can sometimes constitute weapons of mass destruction of national economies.

What are the perspectives of the Donald Trump financial policy?

Donald Trump promised to “dismantle” Dodd-Frank financial reform. Republicans want to eliminate designations of “systemically important financial institutions”, to weaken or lay off antitrust enforcement of mergers and acquisitions, to cut the corporate income tax, as well as the tax on corporate partnerships in favour of hedge funds.

For Donald Trump, financial regulators have to organize more technical and less “political” or “partisan,” policymaking, for better or worse. Governments have less and less instruments available to control monetary and financial flows, but they seem to be less accountable to citizens. The FED does not have a huge influence on the American national economy. However, it has a major role giving confidence to the market economy and the dominant economic and financial agents.

With this top liberalization of financial system, the probability of new financial crisis is still higher.

- 1) Speculation is based on uncertainty that is expanded by the growth of "derivatives markets" with an insufficient control of economic, financial and accounting information.** Derivatives accounted for \$ 700 trillion in 2016, it represents 8 to 10 times the world's GDP. Finance is at least partially disconnected from the economy. Between 2000 and 2008, EU GDP grew by 12% compared with the 90% growth of the banking system. A lot of sophisticated products invented by banks include public debt, real estate, energy, food, ecology, and so on and they encouraged erratic fluctuations, particularly with regard to foreign exchange and credit risks. Any producer can protect himself against climatic or geopolitical hazards. OTC contracts (Over the Counter) are off-balance sheet and are not subject to control, they relate to currencies, interest rates, government securities or mortgages. Financial innovations are infinite, with forwards, swaps, futures, call, put and so on. Banks can develop their own funds, but have an incentive to transfer their risks to the shadow banking system. The development of derivatives markets may lead to serious financial crises, according to two modalities, the domino

and snow ball effects and the drying up of market for real securities by the surge in derivative transactions.

- 2) The excessive technicality of banking is a strategy that deletes democratic control. The speculative process is accelerated with the appearance of "High Frequency Trading" (THF), capable of settling stock market transactions in microseconds. THF represents 40% of the volume of equity markets in Europe and 60% in the USA, thanks to powerful algorithms. Today, algorithms determine the value of the euro and the dollar, the amount of pensions or the value of financial assets.
- 3) **Pension funds play an increasingly important role in the functioning of international finance.** By 2015, pension funds accounted for \$ 14 trillion, almost one-fifth of the gross world product. Financial institutions and States support them, but they are at the origin of several "perverse effects", such as the rejection of intergenerational and societal solidarity. The speculative play of pension funds does not reflect any state of mind on the economic and social consequences of their decisions and they do not feel any social responsibility. They want to diversify the assets in order to arbitrate between risk, liquidity and profitability. Pension funds exert strong pressure to achieve high short-term profitability in order to earn high income from profit.
- 4) Islamic Banks respect the rules defined by the Muslim religion. Then, Allah has judged the lawful trade, and illicit interest rate (Quran, Sura II, verse 275). Islamic banks have to produce some management services, such as a passive financing with participation to profits and losses, a purchase of firm's shares or the goods and services exchange for a profit fixed at the signature of contract. However, the operations are not transparent. Islamic banks become very influent especially in the Gulf countries and in Asia. They are accused of financing sometime terrorist operations.
- 5) **Regulators** take time to punish unlawful activities, and the financial lobbyists influence them. In USA, the pro-bank leaders sit on the same board, the Financial Stability Oversight Council, which monitors financial institutions against systemic risk. They are able to legalize their own behaviours.
- 6) Tax evasion. Multinational firms and banks report their income and invest in tax-privileged countries that allow cascading arrangements to optimize corporate taxation. It is one of the causes of the growing public debts, which explain the recession policies and unemployment in the market

economies. Tax heavens are specialized. For insurance, you have to go through Bermuda, for financial services through Luxembourg, for holding companies through the Netherlands and for income from the brand through Ireland. Banks are very active in Tax heavens countries, they participate to the corruption circuits and these financial resources are often unknown. When some financial problems arise in the world, these unknown operations and deposit intervene inside the world economy without any control and for the sole interest of the banks and financial operators. OECD tries to reduce the international financial secrecy, with the principle of the generalization of the Foreign Account Tax Compliance Act, but it is not still operational.

- 7) **In conclusion, in this endless race between more complex financial operations and more complex rules to target them guarantees, the regulators will always remain behind the capacity of financial firms to construct more esoteric instruments to conceal risk, or use complexity as a cloak to get their way. The world economic development at stake. However, for Saule Omarova, “Financial reform is like a big onion. The more layers you peel off, the harder you cry.**