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on Global governance, international monetary policy and tackling global imbalances (incl. the issue on tax havens)

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Contribution by Kay Swinburne
Thematic Co-Leader to the Rapporteur

Rapporteur: Pervenche Berès

It is understood that three of the main contributing factors to the current financial crisis are global imbalances, regulatory governance and monetary policy. The purpose of this report is to examine the effects of these factors and propose measures to bolster the financial system against a future shock of this magnitude.

The credit crisis of 2007/9 can be considered to be the first crisis of globalisation. It is worthwhile briefly considering the historical perspective from which this problem evolved.

1995 was the year that China joined the WTO, marking a major step forward in globalisation. Indeed from 1996 onwards China's current account surplus increased every year up to the crisis, with the exception of the 2001/2002 recession, reflecting rapid export growth and relocation of manufacturing via foreign direct investment.

Most major economies had also converged on the policy of using the overnight target rate as the sole control mechanism to combat inflation, typically measured on a basket of goods and services in each economy which continued until the current crisis, when emergency measures such as quantitative easing were employed. Monetary policy was therefore a strong contributory factor to the development of the crisis.

Late 1997 saw the ASEAN financial crisis which resulted in capital flight and currencies being forced to float; the effect was disastrous with GDP falling by over 30% in USD terms in 1998. The area witnessed collapsing currencies, widespread bankruptcies, plunging asset prices (particularly in real estate) and social unrest. By comparison China, which also pegged its currency to the USD, was largely insulated from the problems of its neighbours due to the Renminbi not being convertible and FDI into China being in manufacturing facilities rather than easily monetizable securities.

The launch of the Euro in Jan 1999 saw many member countries benefit from lower interest rates including Greece, Italy, Portugal, Spain and Ireland - precisely the countries in the EU who were most exposed by the financial crisis because of imbalances in their economies.

Other events which frame the crisis include: the LTCM crisis, the stock market collapse in 2000 (dot com bubble burst) and the effect of the events of 9/11. The Federal Reserve slashed interest rates making home affordability attractive, with the stock market out of vogue, much speculative money entered the housing market encouraged by skewed and existing fiscal policies.

Global Imbalances

Imbalances on a small scale are manifested by imperfections that exist in all markets and are arbitraged away by market participants. Their effects are therefore transitory and the arbitrage assumption is core to most mathematical pricing and risk models. Similarly, interest rate setting authorities' models assume that by fixing the overnight rate the entire term structure of interest rates will be efficiently priced by the market. There is no scope for a structural imbalance in these situations. However the combination of scale and statistical 'tail events' did lead to imbalances that had direct impact on the crisis.

On a larger scale we can consider imbalances within an economy including: the over-reliance on the financial sector (UK); over-reliance on the export sector at the expense on domestic consumption (Germany, China); consumer debt levels (UK, US); and large budget deficits/surpluses. Whilst these imbalances are not independent of the crisis, it is considered that they impact more strongly on the ability of member states and constituent countries to react to the crisis, unlike the China surplus/ US deficit and the accumulating surplus of oil exporting countries.

Key to the crisis was the combination of the China current account surplus and the US current account deficit. On a global level, the amount of savings and the amount of lending is by definition a zero sum situation. It is rational and desirable that savings flow to the best investment opportunities in terms of productivity and risk adjusted return. This would broadly characterise the nature of the US deficit in the 1990's. During the technology boom led by the US, productivity increased and corporate profits swelled. In a benign inflation environment and with open, liquid securities markets, the US witnessed large foreign capital inflows via portfolio investments and direct investment. This environment came to a halt with the dot-com bubble burst of early 2000.

During the last decade significant budget surpluses have continued to amalgamate in China and increasingly in the oil exporting countries. In China, fiscal policy is geared towards promoting export growth at the expense of domestic consumption. This involves domestic tax policy and a managed exchange rate regime. The provision of a social security system, rebalancing the tax burden between corporate and individuals and the enforcement of property and human rights would all contribute to greater domestic consumption while at the same time reducing the incentive to keep saving.

Similarly, it is argued that the Renmimbi is being kept artificially low and has a distorting effect on world trade. However a weaker Renmimbi would not balance world trade unless Chinese domestic consumption was to increase. Hence the effect of a weakening would be to make other manufacturers more competitive but the extent to which other countries could compete with the established manufacturing base and a workforce without collective representation is not clear.

Surplus has also developed in the oil exporting countries, attributable to the huge increase in the price of oil. In broad terms, these countries share the attributes of low domestic consumption, and underdeveloped societies welfare systems thus increasing the saving imperative. As the US dollar is the major reserve currency and the base price for oil, there is an incentive to hold savings in USD.

By 2000, the US deficit had changed from a benign to a problematic situation. Rather than portfolio and investment inflows, foreign savings inflows were used to fund government, corporate and personal borrowings. The US went from a balanced or short lived budget surplus to record deficits. The issuance of treasury debt to fund this deficit across the maturity spectrum did not result in an increase in interest rates as might be expected, but rather a *decrease*. This was largely attributable to Chinese and foreign purchases of treasuries. This mechanism had secondary effects on corporate and consumer debt with its effects spreading globally.

The US government debt market is the deepest and most liquid market in the world, denominated in the world's reserve currency, it becomes the 'natural' home for a risk adverse investor. The problem that arises is one of scale. An efficient market theory would assume that an investor would direct investments to the best risk adjusted return. Alternatively, in the situation where an asset class becomes expensive relative either to fundamentals or other securities, other market participants would be expected to arbitrage the difference.

The Chinese purchase of US debt was ongoing and on such a scale that the effect of these purchases was to push down interest rates across all maturities. In relative value, the interest rates of other issuers, both sovereign and corporate was pushed down. Effectively risk premium disappeared and funding became cheap.

In the US tax incentives, government policies aimed at increasing home ownership amongst the low paid and the loosening of the credit quality of mortgages exacerbated the boom. The lack of an appropriate risk premium in the government bond markets led investors to participate in riskier markets in the search for yield. This took the form of lending to borrowers of lower credit quality and at very high loan to value ratios and their global distribution via credit derivative structures maintained a steady source of funds to the mortgage origination market.

In normal market situations, one would expect the risk of a transaction to lie with the lender but China has largely been protected from the effects of the crisis and it is in both the US and China's interests to maintain orderly and stable treasury markets. Given the continuation of the flow of funds, discipline is required either through regulation or policy.

Monetary Policy

The monetary response of interest rate setting bodies to all of these developments has been central to events globally. It has been suggested that interest rates in many countries were kept too low but the main problem lies in the strict mandate of price stability. In the UK an inflation rate of 2% was targeted and measured with respect to the consumer price index (CPI). It is necessary to define the basket in terms of 'sticky' prices which have inertia in their response to the monetary climate so that policy does not erratically respond to short term movements in volatile prices such as energy.

However, up to 25% of the CPI basket is comprised of imported goods on which monetary policy would have little effect. Globalisation through lower prices of imported goods effectively imparted price deflation on the goods component of the basket. The policy response of low interest rates to maintain a 2% inflation target meant that services inflation was running too high and that the economy was therefore running faster than it should have been. This in turn contributed to the asset price, primarily real estate, inflation witnessed in the UK, which was not measured in the CPI.

The ECB by contrast has a two pillar strategy where it also assesses the risks to price stability. The ECB was consistently criticised during the last ten years for too hawkish a stance on monetary policy with higher than necessary interest rates. Although a tighter monetary policy was not in itself sufficient to prevent asset price booms in some member states, the conclusion

would be that monetary policy is necessary but not sufficient to ensure price stability, suggesting that new policies may be needed.

The econometric models used to establish the appropriate overnight interest rate do not explicitly use inputs such as asset prices in their calculations or indeed other indicators of imbalances specific to this crisis. Other important inputs such as the output gap (the difference between the actual and optimal economic output) are not observable. However, it is considered better to work with a well understood and simpler model, where the deficiencies are known and qualitatively accounted for, than a complex model with more and uncertain inputs.

A recent IMF paper suggests that a higher target inflation rate, provided it is well communicated and kept stable, would not affect the output gap but would mean higher average nominal interest rates. This would provide more room for manoeuvre in a crisis using only interest rates as a tool. It has been suggested for example that in the absence of a zero rate floor to interest rates, the correct policy rate in the US currently would be 3 to 5 percentage points lower.

The policy proposals that are being discussed in the EU institutions at the moment do not sufficiently scrutinise the reliance of the financial institutions and regulators on mathematical modelling. While it no doubt has a place and has contributed to the availability of new financing channels, it has proven deficient in crisis times.
(See annex 1)

Global Governance

The absence of global institutions is likely to have facilitated the prolongation of unsustainable events which led to the depth and breadth of the crisis. However, the coordination of corrective measures via the G20 forum has been beneficial and should enable the implementation of future financial sector reforms globally. The upgrading of the global Financial Stability Board and current focus on international bodies such as the IMF and World Bank should encourage the strengthening of current weaknesses.
(See annex 2)

The current Maastricht cap of 60% debt to GDP ratio of member states has been systematically flouted. It is not the absolute size of the deficit in the context of the European economy that is problematic but rather the size compared to the domestic economy. It is critical that member states create credible and sustainable deficit reduction plans and publish financial statements that are both accurate and transparent. Off balance sheet transactions, unfunded public liabilities, labelling government spending as ‘tax credits’ to manipulate the balance sheet are examples of so called financial engineering by governments. By contrast, New Zealand has a much more transparent policy towards public finance reporting and it is recommended that an approach such as this be adopted.

It should be acknowledged that whatever steps are taken as a result of this crisis, there will be future economic shocks. The state is the insurer of last resort and as such consideration should be given to the fiscal room for manoeuvre. Monetary policy within the EU is too blunt a tool, particularly in the wake of globalisation, to address problems such as asset bubbles and

financial sector imbalances. However in light of the destabilising effect of these factors in the ensuing crisis we need to identify the most effective areas to implement a policy to contain emerging financial imbalances. These would almost exclusively be contingent capital triggers on the balance sheet of lenders and would necessarily involve the consolidation of all subsidiaries, branches, SPEs and SPVs in the calculation.

Tax incentives may have contributed to increased consumer and corporate debt, with debt accounting and tax issues further encouraging corporate borrowings which, although strong in any case as a result of the low term structure of interest rates were more attractive as the servicing costs of the debt are allowable expenses against a tax liability. There is no 'balancing effect' in the issuance of equity funding.

The financial sector saw lower capital requirements based on inadequate risk models, buying back equity in the market and cancelling it as a means to improve earnings per share, and low tax efficient debt issuance to fund balance sheet leverage. A large proportion of earnings were used to purchase back shares in preference to using retained earnings for capital or distributing cash dividends to shareholders.

The cheap availability of debt also contributed to the explosive rise in the private equity industry with transaction levels in individual deals and funds in the industry reaching record levels each year. Any future policy must address not only a higher capital cushion but the asymmetry in the funding solutions available to the corporate sector.

It has been suggested that tax havens have had a part in the crisis although it is not obvious that there is any connection. Often SPEs, SPVs or funds will be domiciled in such locations as the entity itself is not taxed. However, any distributions to shareholders or owners in the structures are taxable in the investor's home tax jurisdiction. The benefit of a tax free domicile for the fund or vehicle maximises the potential investor base and while tax liabilities may be deferred they are not avoided.

It is not likely that the tax free domiciles of these vehicles was the driving force behind their creation and were not instrumental in the ensuing problem. Tax avoidance or tax fraud issues are not specific to the crisis and are better dealt with by enforcement.

It has been suggested that a financial transaction tax applied within the EU or more beneficially on a global basis would be a suitable response to the current crisis. However, evidence suggests that this would not deter behaviour in the financial markets. To modify trading activity would require a punitive rate of taxation which would be impractical and inoperable globally across asset classes.

Policy needs to consider (see annex 3 for further details):

- *The implementation of a pro-cyclical monetary policy with respect to interest rates;*
- *Whether a higher target inflation rate globally would be warranted;*
- *The role of subjective judgement by regulators and Directors at times of market stress and less reliance on mathematical modelling;*
- *The state of the oil market, imbalances in oil producing countries and OPEC;*

- *Closer co-ordination of taxation policies globally through G20 to minimise tax arbitrage opportunities;*
- *A ban on buying back and cancelling previously issued equity to limit organic growth in financial firms;*
- *Minimising tax incentives which favour debt financing over equity financing;*
- *An ex-post analysis of this crisis in the terms of the debt assumed by each member state, their ability to service and reduce it including determining an appropriate future debt to GDP ratio;*
- *A requirement by Member States to publish financial statements that are accurate and transparent;*

Annex 1 : Global Governance: Mathematical Modelling

The policy proposals that are being discussed in the EU institutions at the moment do not sufficiently scrutinise the reliance of the financial institutions and regulators on mathematical modelling. While it no doubt has a place and has contributed to the availability of new financing channels, it has proven deficient in crisis times. This should not be surprising for three reasons.

First, in a crisis we observe a herd mentality in financial market participants which results from a (usually relatively short lived in terms of an economic cycle) collapse in risk appetite. Efficient market principles such as arbitraging market dislocations fall by the wayside in the drive for principle safety. This would be challenging to model.

Secondly, a crisis is by definition a 'tail' event in the distribution of possible market reactions. Such tail events occur more frequently than expected by models, but are nevertheless infrequent enough that any meaningful statistical modelling information is insufficient to capture them. Indeed it is everyone's desire to avoid tail events thus making it *de facto* a rare event which cannot be modelled.

Finally, all financial institutions will use substantially the same models and where the risks on their balance sheet are aligned, these models will trigger the same hedging events at the same time which tests the liquidity of the underlying market and can lead to a self reinforcing downward spiral as happened with LTCM.

This is where the size of positions has a deleterious effect and needs to be constrained. It is not easy to imagine how a risk model can incorporate the market activities of your competitors in the analysis. The principal policy recommendations flowing from this would be

(i) increased capital held on holdings whose values are not directly observable in a liquid market and rely heavily on mathematical modelling;
(ii) calculate capital on *gross* exposures. This would entail a haircut for net positions but would recognise the effect of large exposures in unstable market conditions;
(iii) scenario analysis based on qualitative and industry/regulator agreed metrics as opposed model based VAR or Monte Carlo analysis;
(iv) a capital premium on mathematically valued products who have not been in existence for 2 economic cycles. One of the problems with credit derivatives is that they have not been in existence for long enough to assess their behaviour and the robustness of their valuation and risk management over a long period;

Annex 2 - Global Institutions and their future role

What has become apparent during the global financial crisis is that the interconnectedness of the world's financial markets must be reflected in the work of global institutions. Organisations need to communicate effectively in crisis times and normal times in order to ensure coordinated approaches towards regulation, monetary policy (where applicable) and financial accounting to ensure proactive measures can be taken when markets are overheating.

G20 The expansion of the forum from the G8 to the G20 is to be welcomed as the breadth of coverage reflects the global nature of the crisis and the required actions by governments. However, discussions need to take place to ensure that agreements reached at these summits are translated into actions agreed by all constituent members, otherwise it will become a meaningless entity very quickly. The G20 Pittsburgh summit adopted a framework for multilateral surveillance of macroeconomic policies, with the aim of making national policies consistent with balanced growth and including regular consultations on commonly agreed policies and objectives.

IMF During the crisis the IMF's resources were tripled, however, countries still view the available funds as a last resort and have an implied stigma attached. Proposed reforms of the body should be implemented including: improved governance; the method of accessing funds available and ways of building on the new crisis prevention instruments; such as the flexible credit line and other sources of contingent financing. Beyond assisting distressed member countries with funding and expertise during crisis situations and monitoring multilateral policy dialogue, it has been tasked with acting as secretariat to the G20 forum in achieving the framework detailed above by building on its existing surveillance analysis and reporting back to the G20.

WTO The nature of the global imbalances, particularly between the US and China would suggest that protectionist measures witnessed so far may escalate - for example the Chinese tyre ban by the US and the Chinese action on US poultry. The role of WTO needs to be strengthened as an ultimate arbitrator between competing members in arising trade disputes

IASB The convergence of global economies, with respect to accounting standards over the past decade, is welcomed; however, the US now needs to move permanently to adopt IAS and the EU needs to ensure that it does not waiver from IAS in the post-crisis era.

BIS The work of the BIS is respected and therefore supported by all major financial centres. The recommendations from the Basel Committee on Banking Supervision, particularly Basel II were implemented by most European Banks, although they were not fully implemented by their US counterparts ahead of the crisis. A commitment from regulators of all major financial centres needs to be made with respect to Basel III and its full implementation across all jurisdictions.

Annex 3: Resulting Policy Recommendations

One common thread permeating all of the recommendations outlined below is the issue of *size*. Size is a relative concept whether we are talking about budget deficits, balance sheet leverage, the impact of derivatives or any other aspect of a crisis. In general, the issue of size should be a primary consideration when assessing the risk to stability in any financial framework and will no doubt impact on other developments outside the scope of this report such as so called 'dark pools' and the impact of large hedge funds on market stability. In the recommendations that follow, the role of 'size' should be considered.

- Too often the regulatory framework has been viewed as a set of boundary conditions in which products and business are financially engineered to operate within. In such a rapidly changing industry, adherence to principles rather than rules is necessary but with penalties for non-compliance.
- A major deficiency in the oversight system has become evident as a result of this crisis and opportunities for regulatory arbitrage need to be minimised globally through firm agreement at the G20 level, and within the European member states they should where possible be abolished through the application of a common rule book for financial services.
- Loopholes which allow subsidiaries of foreign financial services to operate significant business in the EU unregulated need to be closed, whilst College of Supervisors for all global firms need to ensure close supervision across all markets.
- Risks from aligned financial sector exposures need to be identified early. The people best placed to identify an emergent risk are the financial institutions themselves. In an analogy of interest rate setting committees, it is proposed that the major European financial institutions produce a bi-annual report on the current state of financial market stability and the outlook for risks to that stability. The report would be signed by the CEOs and CFOs of the institutions for which they would be held accountable and delivered to the FSB and ESRB for consideration
- Tax incentives which favour debt financing over equity financing need to be minimised. The problems associated with over-reliance on debt financing have become evident, particularly for tax payers who have bailed the financial system out, and hence any tax incentive to the extent that it is desirable at all should be focused on equity financing.
- Tax policies, while still exclusively remaining the responsibility of member states, may benefit from a more coordinated approach in order to ensure the operation of an effective single market in financial services.
- The size of financial institutions and their respective balance sheets have introduced the concept of 'too big to fail'. Proposals already made to address this, and supported by this report are that banks are required to produce a "living will" to detail their orderly liquidation in the event of a crisis and are required to hold increased capital.
- Senior management and Board Members at financial institutions have demonstrated lax control and little understanding of the risk that they were dealing in. Although not all non-executive directors should necessarily be expected to understand the minutiae of complex financial mathematical models, they should be expected to understand the business model sufficiently so as to be able to provide a first stage of regulatory oversight, to question new products and their risk management and to assume responsibility for aligning investor

and employee interests with respect to compensation. Regulators should be tasked with monitoring knowledge and suitability of board appointments.

- A ban on buying back and cancelling previously issued equity needs to be investigated as a mechanism for limiting the organic growth in financial firms. The inability to buy back their own shares would ensure that banks have to find genuine growth opportunities to increase earnings per share, or else retain the earnings as an increased capital cushion. They might alternatively choose to distribute dividends which are historically low compared to the capital allocated to bonus payments. This would also ensure that liquidity is left in the market for other participants. Aside from takeover opportunities, which themselves are limited by competition rules, growth in financial firms needs to be self limiting.
- The failure to manage other monetary indicators such as M2/M3 monetary aggregates and exchange rate targeting suggest that targeted pro-cyclical interest rate policies may be needed to work alongside monetary policy. Research needs to be done to identify the most effective areas to implement this and would necessarily involve the consolidation of all subsidiaries, branches, special purpose entities and special purpose vehicles.
- Member states should be required to publish financial statements that are both credible and transparent. Off balance sheet transactions, unfunded public liabilities, labelling government spending as 'tax credits' to manipulate the balance sheet should no longer be allowed and investigation into the merits of operating a more transparent policy towards public finance reporting along the New Zealand model is recommended in order to maintain investor confidence, particularly in the euro region, and allow better assessment of a member state's ability to cope with a large magnitude shock.
- An *ex-post* analysis of this crisis in the terms of the debt assumed by each member state and their ability to service and reduce it needs to be carried out. Each member state should determine an appropriate debt to GDP ratio and avoid reliance on a pre-set "group" criteria.
- Consideration at a global level needs to be given to the state of the oil market which is very exposed to manipulation and large price movements. Research needs to be carried out into the imbalances caused by oil producing countries and the role of global bodies such as OPEC as it is proposed that the oil market may be too small to easily absorb speculative capital and is too important in global economic terms to be manipulated by speculative flows.
- Research should be carried out to determine whether a higher inflation rate target (as proposed by IMF paper 2010) would be warranted, including whether it would be practical and implementable without negative consequences to economic growth or investor confidence in the euro region.
- Recommend less reliance by financial institutions and regulators on mathematical modelling. While it no doubt has a place and has contributed to the availability of new and novel financing channels, it has proven deficient in crisis times. Regulators and Board Members should be required to apply subjective judgement at times of market stress.