Observatoire de la Finance
Financial Monitoring Centre

Towards sustainable finance at the service of the common good

- Version 1 / original in French – preliminary translation -

Paul H. Dembinski

With the assistance of Fabiola Rüegg.

1. The background

The following text paints a general picture of the issues to be addressed at the 'Finance' discussion workshop of the Socio-economic Meeting of the Alliance for a Responsible and United World. As such, it is an introductory text.

The issue of 'finance and the common good' is an extensive one, arising at both an individual and global level. It concerns every category of player, and involves very diverse areas, from economic sociology to financial theory. To avoid repetition and an overly wide range of subjects in the talks, five lines of discussion have been identified, each of them a specific route into the overall issue. Thus we shall be addressing the following:

- Exclusion from and by finance; the exclusion both of people and of countries that are collapsing under the burden of debt.
- The responsibility of financial operators and how they are remunerated. The latter effects the decision-making process of the financiers, who at the end of the day are the ones who allocate the resources at the macro-economic level, which in turn determine the relative remuneration levels of labour and capital.
- The issue of ethical investment and the various options that savers have for directing/diverting their resource to uses and purposes in line with their own convictions and values.
- The issue of 'sustainable finance': how to bring long term perspectives into financial market considerations.
- And finally, the fifth point, where all the others converge: the governance structure and architecture of international finance. This will be addressed last of all, in order to make the most out of the contributions made during the four preceding workshops.

2. Some statements by way of introduction

- The growing specialisation in economic activities engenders efficiency (growth) but it also gives rise to fragility. Pressure to specialise increases mutual economic dependence thus it decreases autonomy.. Consequently, exchange and access to exchange becomes a matter of life and death for people, communities or countries. In other words, the monetary and financial system has become – willingly or unwillingly – the backbone of the economy and of contemporary society. So people, communities or countries depend more and more on their level of solvency in order to 'be accepted' into social life, which is clearly becoming increasingly the exclusive prerogative of economic considerations.
- The 'financiarisation' of economic activities has been constantly advancing on every level for at least twenty years now. This is manifested by continuous creation of new types of financial assets and by the multiplication of related transactions. This is then followed by the emergence of additional levels of dependency that result in the distancing of centres of financial decision-making from grass-roots economic activities. In real terms, this means that versatile and volatile financial decisions have violent and unmitigated repercussions on those who happen to be at the bottom of the pyramid.
- Financial globalisation brings in its wake the progressive merging of what were hitherto national financial systems into one emerging global system. From the way it looks on the horizon, this system is structured on two different layers: a global financial market dealing in assets where three to five thousand of the world's largest corporations seek funds. This market taps a growing share of the liquid assets and savings of the local financial reservoirs, which make up the bottom layer of the global system. This growing stratification creates two problems. Firstly, it is not clear that the global system's allocation of savings is efficient from a strictly economic point of view. Secondly, tapping savings from the local level and diverting them to the global level makes funding of local small and micro-enterprises more and more problematic.
- The sums of money that move around the financial markets are out of all proportion to their correlation in the real economy, and are the financial markets' main responsibility, both in normal times and in a recession. The stakes are huge, and the financial agents have to behave in such a way as to inspire confidence in the other economic agents, in order to help the economy flourish in ordinary times and not cause panic in times of crisis. But the responsibility of the financial system (both private operators and national and international public regulators) is not limited to short-term factors consisting in maintaining confidence and avoiding uncontrollable waves of panic. They are also responsible for long-term elements: if the financial markets disfunction, they must be reformed in any way necessary. Although the financial sector is not responsible for all the ups and downs of the economy, it is still largely responsible for the resource allocation process, both on the macro and the micro-economic level.
- Since 1971, the international monetary organisations have been out of step with the reality that was initially up to them to regulate. The search for a new governance framework for the international financial system has also been in progress now for over a quarter of a century, without any tangible breakthrough to date. Once again, the interests and aspirations of the weak, the ones who are not 'high achievers', is subordinated to the smooth functioning of the 'system' and its founding principles, which were formulated by the best – the high achievers – who still follow them unconditionally.

These five statements lay the ground for the questions and challenges that the 'Finance' forum aims to address. Unquestionably, the development of finance is one of the main drivers of an evolution with effects that go beyond the social sphere and actually reach the very heart of our civilisation. To focus the discussion, two methodological principles must be followed:

- Participants in the discussion must respect factual evidence, but without giving way to sterile academic doctrine. We are perfectly aware that many of the subjects we shall be discussing lie outside the scope of scientific argument – in the empirical sense of the word. But in no way does this diminish the need for accurate discourse.
- The goal of the discussion is to sketch lines of action or at least proposals that would allow us to correct or mitigate the more visible dysfunctional elements and the very worst effects of contemporary finance. Clearly, the proposals or assumptions made can be of greater or lesser scope, from the most radical to the most practical. To avoid falling into the trap of the "all we have to do is" and "we must" attitudes, we shall have to take into consideration first the pertinence of the proposals and then their feasibility.

3. A detached institutional framework

There is an ever-widening gap between the governance mechanisms laid down in Bretton Woods in 1944, and the contemporary state of international monetary and financial relations.

If by the term ‘system’ we are meant to understand a group of interacting elements acting towards a goal or objective, it would be wrong to call the current state of world financial and monetary relations a ‘system’. The challenge that is posed here boils down to the need to turn these currently anarchical relations into a system, in other words to give them a purpose that goes beyond them and that encloses them. Only thus can a framework allowing each party to take their own responsibility really be established or re-established. This is the price to pay for taking into account the common good.

3.1. The historical backdrop

The Bretton Woods system (henceforth BW) was conceived at a moment when the memory of the crash of 1929 – and also the tragedy of the war – was still present in everyone’s mind. So the mechanisms for regulating the international economy were designed and intended to prevent the emergence of a vicious circle that, from devaluation to protectionism, almost totally stamped out international exchanges in the thirties.

In light of this, intergovernmental consensus was the only form of governance one could envisage. This clearly demonstrates the division of responsibilities between the public and private sectors. Governance was meant to rest on three institutional pillars, which thereby became the very backbone of the international economic system:

- The International Monetary Fund, whose role was to ensure stability in change and help countries to face transitory and structural deficits in their balance of payments;
- The International Trade Organisation, which, built around the principles of reciprocity and the most favoured nation status, was to hold any protectionist tendencies at bay. Although it has taken almost fifty years to get the ITO up and running (in the meantime becoming the WTO), the principles it was to put into practice have become a reality since the late fifties.
- The International Bank for Reconstruction and Development (later the World Bank), which aimed to help war-torn countries initially and later underdeveloped countries to build the infrastructure necessary for balanced development, i.e., provide long-term funding.

3.2. The implicit relationship between currency and trade

The way the structure of the world’s economic system was designed in the aftermath of the war rested on an extremely clear vision of the relationship between the monetary and commercial dimensions of international economic relations. At the end of the war it was obvious that the world needed trade, and that free and smooth trading would be one of the most important steps towards reconstruction and growth.

So it is not surprising that the international order was designed on the basis of this goal. If growth meant expanding trade, it would be necessary to ensure that under no circumstances would monetary phenomena endanger the dynamics of trade. This viewpoint sees monetary disturbances as having considerable potential to inflict harm, as in fact proven by the monetary history of the period between the two world wars. In the eyes of the architects of BW it was also necessary to set up mechanisms for monetary governance to ensure that these kinds of problems were solved before they degenerated into protectionism. Two principles of governance were then laid down: on the one hand, intergovernmental consensus guaranteeing that any potential parity changes be made in an orderly manner; and on the other, implementation of procedures to separate trade and currency and provide the chance to regulate any potential problems within each of the spheres without running over into the other.

The institutional framework of BW bears the mark of the ideas of its time. Even if monetary phenomena were proven to be able to cause harm, they had to be controlled to open the way to trade. **Monetary phenomena were perceived to be the expression of national egotism, a potential risk to the common good, trade.** This view found its clearest expression in the IMF's statutes, in which its role is limited to managing monetary affairs linked to current transactions. The IMF is there to allow trade to develop.

3.3. The concept of convertibility

At the heart of the monetary apparatus of BW lies the notion of convertibility. Understood as the fact that any currency can be bought at a price known in advance, convertibility describes the situation all national currencies should reach once a state of equilibrium was regained after the war. The IMF statutes therefore foresee a transition period.

The convertibility referred to in the IMF's statutes has two characteristics: firstly, it is explicitly limited to current transactions, in other words, to commercial exchange and factor income transfer. This is perfectly compatible with the idea of the supremacy of trade. The importance of capital transactions is simply not taken into account.

The second feature of convertibility lies in the form of membership. The IMF's statutes explicitly state that a country can become a member without its currency being convertible. However, these same statutes impose convertibility as the goal to attain. But once this objective has been attained, in other words, once convertibility has been declared, the country cannot turn back.

3.4. Remedies for repayment difficulties

An order built around a regime of fixed change and anchored in convertibility should, to remain feasible and work in the legitimate interest of its member countries, include models for redressing potential imbalance of payments. The BW structure has three different models:

- In cases of temporary difficulties, the IMF can make the necessary financial resources available to the country in question;

- In cases of continuing difficulty, the IMF helps to draw up stabilisation policies, supported by ad hoc funding. These programmes are better known as conditionality;
- In cases of persistent difficulty : realignment of par values (under consensus).

3.5. The golden age of economic certainties

At the end of the war, during a period of euphoria that continued through the ‘glorious thirties’, it seemed that economic thinking was on the verge of providing the definitive explanation of international exchange. The work of Heckscher and Ohlin, later enriched by that of Meade, gave the impression that they had once and for all penetrated the methods of international specialisation and revealed the factors that determine the flows of trade.

With these solid theoretical foundations, at least in appearance, it was relatively natural and easy to obtain models that were tempting in their formality and general application. Since the late fifties, the monetary approach to balance of payments has imposed itself without opposition. According to this approach, the main cause of imbalance of payments lies in the overabundance of internal credit. This view has inspired the essence of the adjustment programmes implemented under the aegis of the IMF. It is still in line with the idea that monetary phenomena are potentially very harmful to trade and that any cases of disequilibrium must be treated at the source.

The structures and mechanisms of governance set up at BW helped to stabilise international economic relations for almost twenty years. But during this golden age of BW, deep-rooted changes were at work. They resulted in a dematerialisation of economic activity and the increasing importance of finance. Thus, the gap between the institutional framework and the economic processes gradually grew. In the end, the institutions were marginalised and lost their grip on the processes and situations that it was their main task to regulate and control.

4. Elements of the contemporary situation

4.1. Extraterritoriality – financial developments

States' sovereignty over their currency was at the core of the institutional order set up at BW. From the fifties, the inventiveness of private financial operators really took advantage of this by turning to good account an important shift in the distribution of roles. In effect, as long as the banks located in a certain country exclusively used the currency of that nation in their operations, sovereignty over that currency naturally fell under their national banking supervision systems. The limitations of this modus operandi appear when the national banks start transacting in or adopting positions on foreign currency and when the non-local banks manipulate the national currency. Until the late eighties, the supervisory authorities' control over these activities was incomplete. It was in the midst of this legal ambiguity that the eurodollar started emerging back in the fifties. The eurodollar has opened the way to private creation of international liquid assets beyond reach of national regulators. This development was made possible by the internationalisation of banks, particularly US banks, without a parallel extension of the scope of the supervisory bodies. This gives rise to international private finance and monetary policy makers have their work cut out for them; in the end, the BW system is toppled.

The euromarkets, which then became the 'international capital markets', provided a considerable supply of liquid assets that could be used to feed the very rapid spread of international loans taken out by both public and private borrowers. Although the extraterritoriality gaps could be filled during the eighties, this does not take away from the fact that the problem of supervising banking corporations in a consolidated manner still exists. The risk that the gaps in this area could take their toll on world finance still haunts the regulators.

Financial developments have also gone in other directions, notably the creation and exchange of financial assets that affect conditional or future events (financial futures, options, swaps). Due to all these developments, the traditional meaning of a financial institution's 'solvency' has been completely lost. In effect, the condition of both the assets and the liabilities of any institution can be dependent upon conditional loan agreements or financial futures. Because of these commodities, the figures on the balance sheet are exposed to precise, specific risks. This situation completely throws awry any idea of solvency that may derive from a traditional reading of the balance sheet.

4.2. Capital flows

On an international scale, capital flows have the upper hand over commercial transactions. International debt, direct investment and all kinds of transfers are increasing more rapidly than commercial transactions. This goes back to the time when the BW structure was overtaken by events.

In 1971, the United States suspended convertibility of the dollar into gold at a price of $35 an ounce. By doing this, the central pillar of the BW system gave way. The main reason for this decision was the USA's inability to face up to international capital flows.

4.3. The boom in financial transactions

Post-war growth brought with it an enormous monetisation of western societies. Recourse to credit also came a very long way. Parallel to this, the volume of financial assets that could be the basis for the extension of lines of credit also increased. From that moment on, western societies became clearly more finance-based, in other words, sensitive to price variations for financial assets. Two other more specific developments occurred alongside this trend.

Financial innovation took place against a background of a profound transformation of economic activity: goods production activity lost ground to service activities. So the share of added value obtained through handling materials drops, for any goods, while the share for services rises. Subsequently, the final price of the apple or the car incorporates a growing percentage for service activities such as marketing, advertising or even transport. Aside from this, the growing share taken by services also means continuing recourse to the intangible assets that have given rise to a whole army of ad hoc assets, also subject to financialisation.

The pension fund boom, by way of capitalisation and then asset holding, feeds a large demand and helps to increase the volume of financial operations.

4.4. Money becomes finance

Developments in the world of finance are reflected in the ever-increasing complexity of instruments used by the banks, whether in mutual or in client relationships. This facet of financial innovation was quick to defy the central banks to draw a dividing line between what was money and what was not. In effect, a continuously growing part of the liquid assets put into circulation by the central bank is still confined to the banking sector, which through the intermediary and in the shape of ad hoc instruments (financial assets), puts these liquid assets at the disposal of the public – at a price, of course.

Due to the growing importance of financial intermediaries, the clear dividing line between the concepts of money and finance becomes blurred. Between perfectly liquid credit – the best example being a bank note – and a government bond, there lies a whole continuum of degrees and grades that make it impossible to provide a clear demarcation between money and finance. This merging has extremely far-ranging consequences because it blurs the border between the public and the private sectors.

4.5. The growing role of banking regulations

The importance gained by the banks in national economic distribution in payment systems, together with the complexity of international interdependency, also make the supervisory authorities of the financial industry ever more important. The role of the central bank, traditionally limited to managing the national currency, also grows naturally to encompass supervision of national finance. This is even truer if the merging of money and finance is encouraged.

4.6. Markets and governments

The move from fixed to flexible exchange rate regimes that took place during the decade following suspension the gold standard in the US brought with it a gradual development of foreign exchange markets. In this way, the choices and decisions of governments in terms of economic policy were directly subjected to the verdicts of private operators. Traditionally, a currency's exchange rate is above all influenced by all the supply and demand factors that are brought to bear on it, which are indirectly linked to trade prospects. Today, also because of the importance of flows of capital, exchange rates are seen through the prism of the prospects of economic growth and how attractive it may be.

Put another way, the move to flexible exchange has greatly limited the economic sovereignty of countries, by directly subjecting their choices to sanctioning by the market.

4.7. The doubts of economic theory

Economic theory is less solid and self-absorbed today than it was just over ten years ago, at the end of the eighties. This is particularly true of its international dimension. Classic theory is finding it hard to incorporate the new reality; in particular multi-nationalisation of corporations and globalisation.

The Washington consensus is under great pressure, even though there doesn't seem to be it on the horizon any other consensus to replace.

5. The challenges – in search of solutions

The current debate on 'the new international monetary structures' is a heated one. It tends to crystallise around institutional issues linked to the reform of the IMF and is silent on the system aspect, in which the institutions are just one of many components. As was pointed out at the beginning of this text, as it stands, world finance doesn't deserve the name 'system'. If the overall objective is to create mechanisms for orderly problem-solving, the first challenge for governance of the world economy is to set the goals for the system of the future.

5.1. Towards global allocation of resources

In half a century, the specifications of the international monetary system have changed, moving from a system of payments (Bretton Woods) to a set of mechanisms that aim to take on the crucial task of globally allocating capital. This way, one of the basic functions of any national financial system, to grant (optimum) credit efficiently, moves from the local (national) level to the global level. When the borders enclosing a national financial system become porous, or even disappear, the parameters of efficient credit allocation also change. And this then raises the issue of the connections between the place in which the credit is generated and the place in which it is invested.

One of the first tasks is to find out if this shift is a conscious one, and if it is desired by all players, especially those that have particularly weak national credit.

The second issue concerns the mechanisms governing a certain grant and the parameters used. Two models can be pictured here. In the first one, the financial system, through its credit and deposit institutions, allocate these funds. In the second, the credit, globally, is made available to international groups who then proceed to invest it on the basis of their business strategy. If the second method seems to be more and more highly valued today, the issue of responsibilities clearly raises its head, particularly the relationship between intermediaries, governments and industrial corporations. Because of the new rules, transnational companies are becoming the real dispensers of capital on a global level, now taking a degree of responsibility that goes beyond the limited scope of their own interests. Is persuasion enough? Is not pressure, especially on investors but also on consumers, a factor that encourages a greater degree of awareness?

5.2. The relationship between public and private

During the BW era, the world of finance, on the one hand, and that of currency, on the other, seemed fairly clearly separated. The former had public responsibilities, with its institutions, its guidelines and also its duties. Today the finance/currency mishmash looks inextricable, with the added ingredient of the financial institutions' big temptation – just like any private enterprise – to 'nationalise' or share their losses, because of the effects on the currency, and privatise their profits.

This situation requires a redressing of the balance of responsibilities both in terms of currency – the big currencies – and of private operators.

If the BW system has succeeded in protecting trade from monetary disturbances, can one envisage a similar disconnection between the trouble a country might encounter in its balance of trade and the state of its capital account? Could one envisage an ad hoc institution – for example funded by the private and public sectors – that would come to the aid of countries with capital account difficulties? This would involve alterations in the exchange mechanisms and the founding of a debt renegotiation authority.

5.3. Is exclusion inevitable? And how to fight it

Globalised finance is trapped in a paradox: on the one hand, it cannot exclude countries or continents forever, but on the other hand, to uphold the rules and bring conduct under control, it must constantly bear in mind the threat of this marginalisation.

The dilemma of international debt, particularly of developing countries, is posed exactly in these terms. It is also essential to encourage private operators to be more aware of the risks of non-repayment, as is usually the case with national bankruptcy. Achieving the highest degree of caution depends on exercising some control over both the borrowers and the lenders. Various discussions are currently under way, ranging from the idea of fifty-year debt remission periods to an arbitration procedure that would have the authority to lighten or remove the burden of debt, if it is unbearable.

The relationship between poor countries' external debt and political corruption should also be looked at. One of the ways to lessen the chances of impunity in the medium term would be to include a clause in the debt contracts stating that if the debt is renegotiated, the creditor has the right to prosecute persons who have misappropriated the funds that were made available. Under this system, which leaves a lot to be desired, rulers would at least have been warned that if they abuse their authority, it is in their personal interests to have a sense of proportion so that this national debt does not become unbearable.

5.4. Common good – the responsibility of each and every one of us

The search for common good is exceptionally applicable to the context of globalised finance. It refers to the simultaneous quest for the good of individuals and the community. In the context of the monetary and financial system, it could mean that the solidity of the loans system is put in touch with the well-assimilated interests of each of its members. I believe the BW system attempted to connect these two layers: that of the exchange rate regimes, which was a political and shared responsibility, and that of countries in difficulties, with means and methods to improve the various situations.

In the floating exchange rate regime, shared public responsibility is exercised case by case on the basis of national interests, while the activities of the financial operators remain paramount. But these operators need change and volatility to survive, because they are paid in commissions and margins. And it isn't surprising that they mobilise huge masses of liquid assets to 'test out' now and again the stability of the institutional structures, without worrying about the consequences. The ways in which the financial players are remunerated shouldtherefore be given more attention by regulators. In order to limit excessive risk volatility, this must be a method of proven efficiency.

By implementing safety stops to force the biggest operators to take risks more in proportion to their position, one assumes that the professionals are more au fait with the system and its mechanisms than are the very small operators.

5.5. Intermediation called into question

The logic of contemporary financial intermediation can be concisely summarised as follows: the costs involved in setting up a credit are fixed (for the sake of simplification) at every level of the system, so remuneration for the intermediaries is based on the volume raised. This logic, when applied to every layer in the financial system, leads to outbidding in terms of credit size, with the corresponding, and growing, discrimination of the smaller players. In economic terms, discrimination in capital supply is expressed as limiting access to finance and as the cost of capital.

These developments evidently create problems of fairness. In fact, once again it's the intermediaries' remuneration structure and not the project's economic performance that makes it sink or swim. This development is unfair and even dangerous. It would also be useful to think about restraining measures that could push the middlemen into channelling part of their resources towards those that they would instinctively exclude for reasons of intermediation costs. This is another path that ethical investment could explore.

* * * * * * *

This, then, is the context for the issues that we shall attempt to address within the framework of the 'Finance' forum. We believe that the main elements of these issues are crucial, if one accepts – as we openly do here – that finance has a social function and use that goes beyond simply contributing to the Gross Domestic Product.

In order to kick off the discussion in the best way possible, we ask all the participants who so wish to put forward any aspects of the financial system that may have escaped us and that they believe should be included within the scope of our discussion.

As we said at the start of the text – each of the sub-themes will be introduced with a short text to put the issues in context.

SEE YOU AGAIN SOON.

For any information - Contact:

Observatoire de la Finance – Foundation under swiss law

32 rue de l'Athénée, 1205 Geneva.

Tel.:+41-22-346 30 35 / Fax.: +41-22-789 14 22 / E-mail: office@obsfin.ch

Web site: http: // www.obsfin.ch