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Rethinking Global Economic Governance and the G-20?

Global rules for trade, diverging rules for finance

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Content

1. Introduction 3

2. Sovereignty in the 21st century 5

3. Financial crises and the collateral damage caused by globalized finance 8
3.1. Building regulation on false assumptions 8
3.2. The consequences of scrapping capital controls 10
3.3. Crises revisited: What can be learned? 12

4. Consequences for financial regulation 14
4.1. The limits of global regulation 14
4.2. Policy recommendations 16
4.3. A step further: Is a tax on cross-border flows essential? 17

5. The utility of global rules in trade 20

6. Conclusions 21

References 22

1. Introduction

At its inception, the G-20 provided important *crisis management* and a co-ordinated response to the subprime crisis of 2007-9. It has as yet however, prior to and up to the latest Cannes Summit, failed to establish itself as an agent of *crisis prevention*. In contrast to the majority of analysts that lament the inability of the G-20 to come forward with global rules for global finance, I advance the heretical suggestion that this represents an opportunity rather than a problem. Diversity in financial regulation and what the Warwick Commission (2009) identified as the benefits of an 'unlevel playing field' would enhance, rather than weaken, the longer term stability of the international financial system. Financial regulation should and will remain principally the preserve of states.

By contrast, the failure of further development of the multilateral trade regime is a major failure of international co-operation. The global regulation of trade is an area where global rules can continue to provide significant welfare gains for hundreds of millions of people the world over. The current push for global financial regulation, whether in the G-20 or by the Basle Committee, provides a sharp contrast to the stalemate in the negotiations for a further development of the multilateral trading system. In trade, the trend is for preferential trade agreements, which are second-best solutions. In a rare moment of unity, trade economists agree with each other on the superiority of global rules. Consequently, I suggest a reversal of the current trend in economic governance in favour of one that accepts diversity in financial regulation, but renewed support for the WTO. In short: Global rules for trade, and national rules for finance.

Rhetorical commitments to the completion of the Doha Round notwithstanding, all major players in the WTO have sidelined the conclusion of the Doha Round in favour of the pursuit of preferential trade agreements. In the financial domain, however, state policy makers and regulators have all too often permitted the financial sector to dominate the debate and pursue its own, interest driven agenda. The high level of influence of the financial sector has contributed to a weakened support not just for market economies, but even for the concept of democracy. Societies have experienced that under-regulated financial sectors can cause enormous cost to taxpayers. Island, Switzerland and the United Kingdom are examples for the high costs that occur to societies that permit the unfettered growth of their financial industries. In order to both reduce the risk of global financial crises and to re-embed responsibility for regulation in the national political sphere, the search for global regulation of finance should be replaced by national or regional approaches.

In the aftermath of the subprime crisis, policy makers in Europe and the USA have been searching for answers to the pressing need for enhanced financial stability. The crises in the USA and in Europe have led to a search for greater financial stability. Big, systemic crises that threaten the stability of entire economies should not recur in the future. Universal rules for all major economies are supposed to provide the solution to this problem.

However, this approach is misleading. If policy makers wish to make banking a less volatile, less risky sector of an economy, putting the majority of their eggs in the global

regulatory basket probably is the wrong venture. In the G-20, since the first summit more than three years ago we have seen little meaningful progress with regard to the prevention of future crises. G-20 indications that it intends to toughen up regulation continue to lack credibility. Success on this count is always likely to be mitigated by the diverging interests of the participating economies and the prevailing high level of influence of the financial sector. The most recent G-20 Summit in Cannes was of course dominated by the European Sovereign debt crisis and very little was achieved with regard to crisis prevention. However, even without the turmoil in Greece and other Southern European countries I assume that the G-20 would not have produced a blueprint for re-regulating finance. Thus, nation states could and should move on and implement their own, tailor-made reforms.

The explanation for this approach, developed in section one of the paper, is to be found in the impact of globalisation in general, and financial crises in particular, in shaping attitudes towards the state and what we understanding by the concept of sovereignty in the modern era. The political dimension of regulation and the importance of the domestic polity, primarily for legitimizing regulatory issues, are yet to be fully acknowledged in the current reform debate, which is largely driven by a group of financial experts, including central bankers, that do not seem to feel accountable to democratic institutions.

Section two follows with a brief analysis of the evolution of past crises. One reason for the growing frequency and depth of crises has been the comprehensive dismantling of restrictions on capital flows and the globalization of finance. The third section addresses what might be called the 'structural limits' to economic regulation of finance. Whilst critical of the global approach to financial regulation, I am very much in favour of a functioning multilateral trade regime, which I discuss briefly in section four. Whilst not without faults, the existing trade regime has been indeed been beneficial for the poor, and the current trend of segmenting markets for trade in goods is both reducing aggregate welfare and socially unjust.

2. Sovereignty in the 21st century

Since the end of the Cold war in the early 1990s, some observers have suggested that nation states have lost importance and are increasingly irrelevant in today's globalizing world. David Held for instance has argued that supranational structures are co-existing together with national sovereignty and have essentially eroded the sovereignty of states:
"National sovereignty and autonomy are now embedded within broader frameworks of governance and law in which states are increasingly but one site for the exercise of political power and authority" (Held 2003: 172).
In a similar manner, Georg Sørensen has argued that in a postmodern global economy, sovereignty may have shifted to a number of venues and may no longer be exclusive to the nation state:
"Postmodern states are characterized by transnationally integrated, globalized economies; by multi-level governance, and by identities that are no longer exclusive to that nation-state" (Sørensen 1999: 602).
In addition, Held suggested that supranational governance – financial regulation being part of this exercise – has helped to close the gap between national and transnational life:
"... the growth of regional and global governance, with responsibility for areas of increasing transborder concern from pollution to health to trade and financial matters, has helped close the gap between the types of organization thought relevant to national and transnational life" (Held 2003: 172).
Writing before the financial crises that started to hit from 2007 on, Sørensen and Held have been expressing views that was widely shared: Globalization has led to the emergence of a level of governance above the nation state that is both necessary and efficient. Necessary, because the increasing level of, say, capital flows across borders result in the functional need for supranational regulation, and efficient because only global approaches were considered to close loopholes that inevitably arise as a result of national regulation.
To this day, academic observers and policy makers continue to use this approach when they try to explain the need for global financial governance. National approaches, for example a financial transaction tax, are considered impossible because they would only result in the relocation of financial transactions to other, less regulated financial centers. In essence, globalization results in the need to globalize decision making.
But the recent crises have resulted in a renewed debate on sovereignty – primarily because of the costs of the crises. Both in the USA and in Europe, domestic taxpayers have been confronted with enormous bills for the rescue operations. In Iceland and elsewhere, citizens have had to accept responsibility for their country's reckless bankers. The increase of cross-border financial transactions has not resulted in risk being transferred to the global level: In the end, risk ends up in a sovereign state.
Similarly, in Europe citizens of economies that have been implementing sustainable fiscal policies are asked to bear responsibility for irresponsible governance elsewhere.
Supranational governance has often not resulted in sustainable development. In Europe, the Greek borrowing binge was ignored by the European Commission and the European Central Bank for years. Supranational governance did not result in a

reduction of risk, but instead permitted the unchecked rise of debt in Greece, Ireland, Spain and other economies that are now faced with the need to adjust their economies quickly.

Sovereignty in the 21st century has therefore become a surprisingly asymmetric concept. It is suggested that societies have lost the ability to regulate, but they continue to be held liable if supranational regulation – whether regional or global – fails. Not surprisingly, policy makers struggle to explain the utility of asymmetric sovereignty to their constituencies.

Given this dilemma, the debate in Europe has oscillated around the need to further reduce sovereignty. Greek society is of course already exposed to this new approach, although the conditionality that the International Monetary Fund, the European Commission and the European Central Bank have been impose on Greece have not resulted in any improvement of the economic situation of the Greek economy yet. [1] But the call for further integration is in essence a call for the transfer of sovereignty to supra-national authorities that will implement the appropriate policies. Deep integration of fiscal policy in the European Union beyond the fiscal pact would reduce the sovereignty of participating nation states.

Nevertheless, what kind of accountability does the supranational authority command? One yet to be fully explored issue of the recent crises is the weak level of accountability of institutions above the nation state. The European Central Bank, for instance, for been implementing a type of crisis management that exposes societies to enormous risks, but the accountability of the European central bankers is limited. The failure of the European Commission in the run-up to the debt crisis is acknowledged, and the oft-criticized re-nationalization of the European crisis management is probably the inevitable consequence of this failure.

However, even in Europe sovereignty remains national. The ability and right to legislate remains the core issue here, and state policy makers justly insist on exercising this right. Europe continues to be a society of states, not an emerging state. As Robert Jackson suggested, the European Union is the child, not the parent or even the sibling of its member states (Jackson 1999: 452). The EU continues to be a "union of sovereign states" (Jackson 1999: 451). Any transfer of sovereignty in the EU is – perhaps temporarily – granted by a member state and can be withdrawn at the discretion of the member state. This right of member states is acknowledged in article 50 of the Treaty of Lisbon: Ultimately, sovereign member countries of the EU can decide to leave the European Union. The level and intensity of international co-operation may change, but the nation state continues to be the authority that decides whether to participate or to withdraw.[2]

If one accepts that liberalizing capital flows and financial deregulation have not resulted in the ultimate transfer of risk away from sovereign societies, the consequence is that nation states have to be much more prudent in their approach to regulation. Of course, supporters of a global approach to regulation would not deny the need for

[1] Despite the comprehensive conditionality of the Troika, Greece continues to be a state that exercises paramount authority. When Greece defaulted in March 2012, it changed the conditions for bond-holders ex-post and added so-called collective action causes. Of course, only a sovereign country can unilaterally alter contracts.

[2] Daniel Philpott has suggested that while states may accept certain obligations – whether at the regional or at the global level – the basic authorities do not change: Policies are monitored and enforced at the national level (Philpott 1995: 368).

prudent regulation, but they would suggest that the most promising avenue for regulation is a uniform, global approach. In the following section I will analyze the short history of global financial regulation and will particularly examine its failures.

3. Financial crises and the collateral damage caused by globalized finance

3.1. Building regulation on false assumptions

With hindsight, the development of global standards in finance has not resulted in a more stable international financial system. For example, the main standard, Basel II, has not prevented the two most recent crises—the sub-prime crisis and the crisis in Europe. Rather, both crises were fuelled by ill-designed rules. For instance, whilst Basel II required banks to set aside capital according to pre-defined risk criteria, it failed to consider the potential need to have liquidity available in the event of panic. Thus, after the Lehman shock in September 2008, solvent banks fund themselves in an illiquid position due to their inability to sell assets into collapsing markets (Levinson 2010: 81). In addition, Basel II was rather lenient towards mortgage lending. Before 2007, lending to home owners had been a low-risk business. Regulators around the world were assuming that lending to medium-sized and large corporations was riskier. With hindsight, the regulators' judgment was of course inaccurate. Furthermore, regulators were not discouraging the so-called securitization of loans, i.e. the bundling of individual loans into tradeable securities. In many countries, this process was actively encouraged. In the end, many financial institutions choose to opt for securitization rather than following prudent banking procedures and setting aside additional capital for new loans.

Basel II and III specifically try to develop a rule-book that ensures a global level playing field. But the drawback has been that all players followed the same, or at least similar, strategies. Haldane suggest this amplified the crisis.

"The level playing field resulted in everyone playing the same game at the same time, often with the same ball. Through these channels, financial sector balance sheets became homogenised. Finance became a monoculture. In consequence, the financial system became, like plants, animals and oceans before it, less disease-resistant" (Haldane 2009, p. 18).

Whilst the failures of regulation prior to the US crisis are now by and large acknowledged, there appears to be too little reflection on the appropriate path of future regulation. Time and again, in the aftermath of financial crises policy makers vow to get it right this time. This is a well-known pattern. The idea that the next crisis will be avoided by "better" regulation is as inevitable as financial crises themselves. As Carmen Reinhart and Kenneth Rogoff have observed in their seminal book "This time is different" (2009), there is a reoccurring pattern of hubris in financial markets. But that sense of overconfidence is not limited to market participants, it affects regulators as well. New regulation is put in place in the hope that this time will be different, and after a certain fermentation period the financial sector time and again has been successfully exploring new avenues to circumvent regulation. The G-20 efforts to introduce new regulation are also following this course.

Two main factors account for these repeated failures. First, financial regulation by definition is based on past experience. Reform is an exercise in shutting the stable door after the horse has bolted. New regulation invariably fails to envisage, or is pre-empted

by, new developments in finance. Whilst the utility of so-called innovation in finance is not always obvious, new instruments certainly create new challenges to supervisors, and they regularly fail.

Second, global rules can be, indeed frequently are, traduced by financial sector lobbying. Time and again bankers have succeeded in pressuring policy makers to accede to what Gordon Brown famously called "light touch regulation". The financial sector's lobbying efforts have often been effective and have resulted in a race-to-the-bottom by policy makers. The concern to miss out and to loose business to other financial sectors has often (mis-)guided policies. The most commonly used tactic is the reference to the level field. The argument is that unless the rest of the world, or at least the rest of the G-20, implements certain rules, any tightening of regulation at the national level will loose in the deterioration of the competitive position of that country's financial sector. Of course, this rhetoric has been exploited not just by the financial sector, but indeed also by policymakers, who have quite too often given the interests of banks preference over the interests of wider society. In short, Wall Street dominated, Main Street had to bear the consequences. Policy makers have joined the choir and have embraced the reasoning that those benefitting from unrestricted finance have been providing.

Globalization, narrowly defined as the increase of economic transactions between nations due to the lowering of hurdles for trade and finance, has been said to reduce the policy space of individual societies. The force of ever increasing interdependence, it has been argued, compels policy makers to deregulate economies and to reduce the level of regulatory restrictions. For instance, the liberalization of capital flows has been labelled as inevitable and an absolute must. It was argued that there is, to paraphrase Margaret Thatcher, no alternative to dismantling restriction on cross-border capital flows. From the end of the regime of Bretton Woods in the 1970s more and more OECD countries have been scrapping restrictions on capital flows and have thus embraced neo-classical doctrines. In most cases, this decision to liberalize capital flows has not been discussed in the polity of the affected societies, let alone having been subject to a wider democratic debate.

In the European Union, supporters of unrestricted capital flows were hardly confronted with opposition. Integration enjoyed widespread political support, and there was no differentiation between the integration of markets for goods and labour and capital markets. Economies like Spain and Ireland were joining the monetary union and at the same time were unable to protect themselves against unwanted capital inflows. In the event, both economies were subject to a boom in real estate and the national authorities had hardly any instrument to fight the overheating.

Consider the specific situation in Spain, for example. Roughly a decade after Spain emerged from years of authoritarian rule, the country joined the European Union. Until it joined the eurozone in 1999, authorities were able to manage developments in the financial sector pretty well. The combination of membership in the eurozone, which resulted in a dramatic reduction of the level of both nominal and real interest rates, and unrestricted capital flows resulted in an unsustainable boom in real estate. Capital flows to Spain reached unprecedented levels. Between 2006 and 2008, the current account deficits of Spain – reflecting capital inflows of the same magnitude – were between 9.0 and 10.0 percent of GDP.[3] Evidently, capital inflows of that magnitude pose a risk to an economy, and being locked inside the eurozone and its emphasis

[3] OECD, Economic Outlook 89 database.

on neo-classical thinking, Spanish policy makers were forced to observe the unfolding drama without being able to do anything about it.
The drawbacks of multilateral rules have become evident in the European crisis from 2009 on. The eurozone left participating economies with too few instruments to fight a credit boom. In Ireland and Spain in particular, authorities were unable to fight the obvious bubbles in real estate. They had no tools at their disposal: Interest rates were set at a uniform level by the ECB in Frankfurt, and robust other restrictions were not permitted due to European rules. Both countries had no instrument whatsoever to slow the inflow of foreign capital which fuelled the existing booms. Neither taxes on inflows nor other restrictions were permitted, thus exposing these two economies to market failure of enormous dimensions. Even the attempts of Spanish authorities to tighten supervision of local banks could not be very strict: Bypassing these national rules by borrowing elsewhere in the eurozone was relatively straightforward and did not even entail currency risk.

3.2. The consequences of scrapping capital controls

However, this perceived need for unrestricted capital flows essentially reflected the interests of not too many members of individual societies. In particular, internationally operating financial firms have displayed a profound interest in lowering restrictions on capital flows. As Jagdish Bhagwati observed way back in 1998:
"Wall Street's financial firms have obvious self-interest in a world of free capital mobility since it only enlarges the arena in which to make money" (Bhagwati 1998, p. 11)
For most members of a society, the issue of restrictions on capital flows is a marginal issue. Apart from holidays and the occasional transfer for one's nephew's birthday, cross-border capital flows are not affecting wider society. However, stable or volatile exchange rates are much more important. Volatility of exchange rates affects all sectors of the economy that are either exporting or competing with imports. In fact, when considering the 1963 observation of Robert Mundell that an impossible trinity exists in monetary policy, we would suggest that the policies of recent years reflect the growing political influence of those parts of societies that benefit from unrestricted capital flows at the expense of those that would benefit from stable exchange rates. What do we mean by this?
Essentially, Mundell suggested that of the three goals that monetary policy aims to achieve (stable exchange rates, unrestricted capital flows, independence of domestic monetary policy) only two are achievable at the same time (Mundell 1963, for a discussion of the trinity on exchange rate policy see Obstfeld et al. 2005). In democratic societies, the independence of domestic monetary policy, i.e. the ability of a central bank to raise or lower interest rates according to domestic economic developments, is an indispensable goal.[4] Thus, there is a simple political choice: Either unrestricted capital flows or stable exchange rates. In the era of Bretton Woods, capital flows were restricted, which reflected the weak position of the financial sector and the relative importance of manufacturing industry. The turn to unrestricted flows has clearly

[4] Under the gold standard, the political climate was of course different. Trade unions were non-existent or much weaker, and policy makers had more freedom to set interest rates according to external economic conditions.

demonstrated that the financial sector is back to its former position of influence on domestic policy makers.

Since the end of Bretton Woods, capital flows have risen dramatically. But we note that there has been a particularly sharp rise of flows in the decade before the US crisis. World current account imbalances (the half-sum of all deficits and surpluses of the 181 countries in the database of the IMF) had been relatively stable between the early 1970s and 1997; in that period, they oscillated around 1.2 percent of global GDP. Between 1997 and 2007, they grew to about 3 percent of global GDP (Brender/Pisani 2010: 24). The current account deficits of capital importing countries (notably the USA) and the surpluses of capital exporting countries (notably, but not only, China, Japan, Germany) rose dramatically. But we consider this to be a dangerous development that requires regulatory responses (Dieter/Higgott 2010).

A key issue here is the utility of capital inflows for an economy. In the 1970s, when restrictions on capital flows were still widely applied, liberal economists have suggested that unrestricted flows would benefit the poor. Capital, it was argued, would flow from capital-rich economies to countries were capital is scarce, primarily developing economies.[5] Why would that happen? The underlying theory is the efficient-market hypothesis, essentially arguing that financial markets process all available information efficiently. Thus, markets will realize that the more efficient use of capital will be in developing economies, rather than in established, developed markets. Of course, some capital has flown to developing countries, but in the first decade of the 21st century capital has been flowing upstream, from poorer economies to the United States of America. In the USA, the capital inflow was not used wisely, i.e. financing investment, but instead it financed unsustainable levels of consumption.

Recent research has confirmed the strongly diverging utility of different types of capital inflows. Aizenman, Jinjarak and Park have analysed capital flows to about 100 countries in two different time periods, 2000-2005 and 2006-2010. Whilst they confirm the positive contribution that foreign direct investment can make to economic development, they have not fund evidence both for portfolio investment and short-term debt. The later can even have negative effects on growth, particularly in phases of financial turmoil (Aizenman et al. 2011, p. 18).

The diverging effects of different types of capital inflows are hardly surprising. The key factor that determines the utility capital inflows is their use: Are they used for financing investment or for financing consumption? With regard to economic development, inflows that finance consumption (or failed investments) are most problematic. FDI is therefore better placed than other types of inflows to generate income for debt service. Portfolio inflows can generate income for debt service, but this is more difficult for foreign debt. Obviously, inflows into the USA, Spain or Greece have often financed consumption rather than investment. With hindsight, restrictions on certain kinds of inflows would have helped to keep these economies on a sustainable track.

Today, it is quite obvious that these failures now result in a severe penalty for the countries that have failed to consider the negative effects of capital flows. This of course is a failure of politics, not economics. Policy makers have to consider and defend the interest of society at large, not just those of the financial sector.

[5] For a discussion of the effects of liberalization see Eatwell 1997.

In particular the dramatic developments in Iceland have underlined the need for an approach that considers the effects of loose financial regulation. The small North Atlantic country – having a population of a mere 320.000 people – has become the victim of an ill-fated expansionist strategy of a few people in its financial sector. For a few years, ambitious Icelandic bankers attempted to conquer international markets, but they failed badly. No other country has demonstrated the validity of the aphorism that 'banks grow abroad but die at home' more clearly than Iceland.
Many market participants had the illusion that the Icelandic government had the ability to back the operations of Iceland's internationally operating banks. The (wrong) assumption was that this conventional approach to banking supervision was appropriate. This standard approach in banking regulation is called home-country regulation. Banks are supervised by national authorities, and in the event of trouble the national government and the country's central bank come to the rescue. However, this turned out to be impossible when the three banks operating out of Iceland required liquidity. Of course, the Icelandic government could only provide them with unlimited amounts of krona, but not with foreign currency. In effect, this combination of borrowing abroad in foreign currency by Icelandic banks is identical to a pattern frequently observed in developing countries and labelled "original sin". The national authorities could not provide sufficient support when liquidity dried up on international markets and the business models of Icelandic banks were no longer viable.
When Iceland's three bigger (hardly big) banks started their aggressive expansion, they used short-term liquidity from international financial markets to provide for their financing needs. Policy makers had permitted the Icelandic financial sector to grow relentlessly. By 2008, the banks' assets equalled about 1000 percent of the country's GDP, i.e. ten years of economic activity. Needless to say the Icelandic government had no choice but to permit the collapse of the country's financial sector. However, other countries sporting equally inflated financial sectors may be faced with similar choices at some stage in the future. The banks in the United Kingdom, for instance, had assets equalling 450 percent of British GDP in 2008 (Buiter 2008, p. 280), and the collapse of one or two major banks would have brought the UK's finances to the brink. The Swiss authorities are confronted with an even more problematic situation because the assets of UBS and Credit Suisse are as high as 660 Percent of Swiss GDP (Buiter 2008, p. 280). Their response has been to discipline their two biggest banks. Swiss authorities are asking for a "Swiss finish", a whopping six percent of additional core capital for the two largest banks, UBS and Credit Suisse. Effectively, these two banks will have to set aside 19 percent capital for their operations from 2018 on. Effectively, Switzerland has been departing from a uniform approach at the global level because policy makers considered global rules in finance too lenient for their own purposes.

3.3. Crises revisited: What can be learned?

Occasionally, one gets the impression that societies get used to financial crises as inevitable events, which is of course true. Hyman Minsky has suggested in 1977 - when financial were occurring, but at a much lower frequency and intensity than today – that financial crises are systemic, rather than accidental events (Minsky 1977, p. 10). His

core argument is that economic booms change the behaviour and the expectations of market participants. When a boom develops, standards change and risks are ignored:
"The tendency to transform doing well into a speculative boom is the basic instability in a capitalist economy" (Minsky 1977, p. 13).
Needless to say that this pattern of overconfidence in the boom has been observable many times since Minsky made his observation. A key example is the Japanese twin bubble – in real estate and share prices – in the 1980s. Consider what Minsky had suggested:
"Increased availability of finance bids up the prices of assets relative to the prices of current output, and this leads to increases in investment" (Minsky 1977, p. 13).
Exactly this happened in Japan, and the rise of asset prices relative to current output was reflected in the ever increasing number of years an employee in Japan would have had to work for his or her dwelling. The bubble burst in 1990, but is certainly was not the last financial crisis.
Minsky developed a minority position that was of course disregarded by the neoclassical mainstream, who continued to believe in the superior rationality of financial markets and their ability to process information efficiently. By contrast, Minsky suggested that financial stability cannot be achieved:
" There is, in the financial instability hypothesis, a theory of how a capitalist economy endogenously generates a financial structure which is susceptible to financial crises, and how the normal functioning of financial markets in the resulting boom economy will trigger a financial crisis" (Minsky 1977, p. 15).
Developments since the 1970s have obviously confirmed Minsky's financial instability hypothesis. His plea sounds very contemporary. He advocated a *'good financial society'*, in which the tendency of business and bankers to engage in speculative activity is constrained (Minsky 1977, p. 16). What he did, however, not provide was an idea how this goal could be achieved.

4. Consequences for financial regulation

4.1. The limits of global regulation

For more than two decades, the dominant view in the debate on financial regulation has suggested that global rules, and only those, can make the financial system safer and more stable. As indicated above, our contrasting view would give preference to tailor-made national and/or regional level solutions. A diverse regulatory landscape would be the result. While such an approach would not automatically prevent financial crises, the effects of turmoil might be mitigated because, as we know from biology, diversity stabilises complex systems, whereas monocultures transmit and more easily exacerbate shocks.

Of course, if the record of both regulators and academic observers in identifying future risks were better than history tells us then the case for diversity would be weaker. But as numerous financial crises have demonstrated, the widespread assumption that authorities are able to learn from past mistakes has time and again led to hubris and turbulence. Global rules may eventually result in global crises. There is no evidence that our ability to predict future risk is so well developed that the implementation of more global standards in finance will contain it. Simplifying is not axiomatically stabilising.

Andrew Haldane, Executive Director for Financial Stability at the Bank of England, has been interpreting the financial system as 'complex adaptive system' (2009, p. 3). He suggests that four mechanisms influence the stability of the network: *connectivity, feedback, uncertainty and innovation* (Haldane 2009, p. 8). All four of them have the potential to turn a hitherto stable system into an unstable one. Let us look at them in turn.

Connectivity of participants in financial markets – facilitated by cross-border capital flows – can serve as a shock absorber, but only within a certain range. Past a certain, hart-to-predict point, connectivity turns into contagion:

"But beyond a certain range, the system can flip the wrong side of the knife-edge. Interconnections serve as shock-amplifiers, not dampeners, as losses cascade. The system acts not as a mutual insurance device but as a mutual incendiary device. ... Even a modest piece of news might be sufficient to take the system beyond its tipping point." (Haldane 2009, p. 9).

We have seen numerous examples of the Janus-headed dimension of connectivity. At first benign and not problematic, cross-border financial flows suddenly turn from sources of relatively cheap finance into unmanageable liabilities. For instance, for many years the financial flows into Asian economies prior to the 1997 crisis appeared to be a blessing, only to become a liability when the tide turned. Similarly, before subprime connectivity, hailed by Alan Greenspan as a new era in finance, for years was considered to be unproblematic, but when the tipping point was reached the American virus infected financial systems all over the globe.

For the definition of feedback, Haldane refers to epidemiology. The speed with which crises, or diseases, spread, very much depends on the perception of market participants. Their views 'construct' the crisis. The reaction of market participants to crises thus determines the rate of transmission of the financial crisis (Haldane 2009, p. 12). And as

we know, financial markets have a tendency to be characterized by herd behaviour: First greed, than panic (Wood 1988). Both work as feedback loops.
Uncertainty is the third factor in Haldane's analysis. Networks generate chains of claims, and whilst in boom times the question of counterparty exposure is often ignored, in the event uncertainty creeps in. Is Bernhard Madoff or Warren Buffet at the end of the chain? (Haldane 2009, p. 14).
Modern finance has of course done at lot to conceal counterparty exposure and thus increased uncertainty. The widespread use of over-the counter derivatives, in essence private contracts between two parties without authorities or other market participants knowing about them, has been a key factor. Consider, for example, the surprise that hit many, including the US government, when the full exposure of American International Group AIG, the world's largest insurer, to credit default swaps became clear the day after Lehman Brothers collapsed. Haldane suggests that *"Counterparty risk is not just unknown, it is almost unknowable"* (Haldane 2009, p. 14).
Finally, innovation is a factor that contributes to the stability or fragility of financial systems. In fact, we think that innovation in finance has to be sharply separated from the real economy. In finance, innovation is associated with increased complexity and less transparency. The utility of innovation in fiancé remains to be demonstrated. Take, for example, some of the 'innovations' that contributed to the 2007/2008 crisis in the USA. One particularly opaque and dangerous instrument has been the squared collateralized debt obligation, or CDO^2. An investor in a CDO^2 would have had to read in excess of one billion (!) pages to understand the product. Haldane points to the impenetrability of that kind of financial product:
"With a PhD in mathematics under one arm and a Diploma in speed-reading under the other, this task would have tried the patience of even the most diligent investor" (Haldane 2009, p. 16).
Against this background, we suggest an agnostic view of banking regulation. We will never be able to know what the risks of future developments will be, and even if tough rules would be implemented, we can safely assume that the financial sector will find innovative ways around them. For example, the current proposal to require extra amounts of capital from so-called systemically relevant banks creates an incentive to carve up big financial firms into smaller units. While many observers currently appear to hope that big, to-big-to-fail banks will obey and implement new regulatory measures that would make them less profitable than their smaller peers, past experience does not provide sufficient evidence for this claim. It is plausible to expect that there will be a departure from large, integrated banks into smaller units. Yet this may not result in the lowering of risk, unless the newly created smaller banks follow diverging strategies *or* regulators would be willing to permit the simultaneous bankruptcy of several medium-sized banks.
As mentioned before, previous global initiatives for stricter regulation of the financial sector have not contributed to the stability of the international financial system. Basle I, introduced in the late 1980s when Japanese banks were the rising stars in finance, was not preventing any of the crises of the 1990s. Neither the Mexican crisis of 1994/95 nor, more importantly, the Asian crisis in 1997/98 were prevented. Particularly the crisis in Asia could have been a reminder for policy makers in the OECD, for it represented a textbook example of hubris in the financial markets that went unchecked. Not one single major market participant spotted the emerging crisis. Rating agencies started to worry when the situation had already visibly deteriorated and then contributed to the deepening of the crisis by frequently downgrading the affected economies. The parallels

to the American and European crises are all too obvious. But then, Americans and Europeans enjoyed their short-lived moment of schadenfreude, rather than returning to more prudent banking at home.

4.2. Policy recommendations

Our proposal to reverse current emphasis in global economic governance needs to be specified and put into context. Three key messages emerge from the financial crises of the last decades. First, financial innovation in most cases is modern alchemy and pretends to being able to create wealth with financial engineering. It can, but only for a short period of time and, more importantly, only for a limited group of people. Financial innovation has not contributed meaningfully to improving conditions for investment and thus not contributed to higher welfare. Moreover, as in particular subprime has demonstrated clearly, the gains of some people in the financial sector accrued prior to the crisis subsequently had to be covered by taxpayers.

Second, the increase of cross-border capital flows since the late 1990s has not contributed to a more sustainable financial system, but has instead opened new avenues for the transmission of financial shocks from one country to another. Compare, say, the Savings & Loans crisis in the 1980s with subprime. Both were the result of ill-constructed financial regulation in the USA, but the effects were extremely different. The S &L crisis was a domestic affair that did not affect the rest of the world in a significant way. Subprime, however, did. The key transmission mechanism was the capital inflows into the USA prior to the 2007/2008 crisis.

Third, attempts to regulate more prudently will always be exposed to powerful campaigns by the financial sector - often supported by academic economists that all too often are personally benefiting from the policy recommendations they give. Time and again, there will be crusades against proposals for tight regulation of the financial sector, and past experience suggests that today's world is no different.

So what are the benefits from a greater segmentation of financial markets as suggested by us? For instance, financial innovation that would have to be explained to a domestic audience would most probably receive less support. Financial institutions that have to explain to a domestic regulator what the benefits of a CDO^2 – a very exotic instrument that required documentation of one billion (!) pages – would most probably struggle to get their message across (Haldane 2009, p. 16). Using developments in global finance as a means for documenting the importance of financial innovation worked in the past, but departing from a global approach would enable regulators to investigate the pros and cons much more thoroughly. We are suggesting that the regulation of finance ought to be put back into the national polity. Since societies have to bear the consequences of failed regulation of the financial sector, they should be provided with direct ownership of the regulatory process.

In addition, the segmentation of markets from one another would help to contain national financial crises from having contagion effects. A crisis in one country would not have devastating effects on other economies, apart of course from slowing demand from the affected economy. Crisis would of course still occur, but more in isolation. The attempts of the financial sector, or parts of it to be precise, to lower regulatory standards would also be more difficult in a national context. If decision makers will be

confronted with the potential fallout of too lax regulation in the domestic political domain, chances are that liberalisation would be implemented more cautiously, if all.
In essence, we endorse the recommendations of the 2009 Warwick Commission. Their proposal to switch from home-country regulation to host-country regulation has been endorsed by some commentators (e.g. Levinson 2010: 87). As long as business cycles are structurally diverging between economies, national approaches to regulation would provide more stability than uniform, global approaches.
Our recommendation to improve diversity of regulation has two dimensions. First, in line with the recommendations of the 2009 Warwick Commission on International Financial Reform we are suggesting a departure from the principle of home country regulation and the introduction of host country regulation. In essence, this would enable regulators to require both national and international banks to provide local minimum capital requirements for local risks (Warwick Commission 2009, p.8). This shift to national regulation would make the activities of big international financial firms more difficult and would favour the development of national financial systems.
In this regard, we share John Maynard Keynes' observation that "above all, let finance be primarily national" (Keynes 1933, p. 758).

4.3. A step further: Is a tax on cross-border flows essential?

But we are of course aware that any attempt of regulators to implement a host country approach will also be subject to the financial sector attempting to circumvent regulation. Thus, the proposal for host country regulation has to answer the following question: What response are regulators willing to implement if their rules are bypassed? Assume, for example, that in a country the authorities notice a steep increase in real estate prices as well as lending for real estate. If they tighten regulatory standards, this will make borrowing at home less attractive and will entice borrower to turn to foreign lenders. In such a situation, authorities ought to be willing to implement temporary taxes on capital flows, e.g. at the level originally envisaged by James Tobin, i.e. one percentage point. Whilst taxation of cross-border flows may not be necessary outside credit booms, in some cases they appear necessary in order to ensure the stability of the domestic financial system.
Tobin's aim was not the creation of regulatory divergence, but instead the stabilization of exchange rates (Tobin 1978). Our goal is somewhat different. Whilst a tax on cross-border flows could potentially stabilize exchange rates, partly because a significant tax would constitute a de-facto restriction on capital flows, our main goal is to provide regulatory sovereignty, not stable exchange rates.
Of course, our critics will argue that taxes on cross-border flows will make borrowing more expensive. Our response is: This indeed is the intention. Given the numerous credit booms that went unchecked in since the liberalisation of finance, we do think it is not necessary to prove the efficacy of more restricted lending practices. After all, credit booms signal quite accurately the advent of financial crises (Schularick/Taylor 2009, p. 26).
Jagdish Bhagwati, a hard-nosed free trader, has suggested long before the most recent crises that unrestricted capital flows contribute to crises.

"But only an untutored economist will argue that ... free trade in widgets and life insurance policies is the same as free capital mobility. Capital flows are characterized, as the economic historian Charles Kindleberger ... has famously noted, by panics and manias" (Bhagwati 1998, p. 8).
Is there any evidence that restrictions on capital flows would provide greater financial stability? Bordo et al. have examined 21 countries over a 120-year period and have found interesting results.[6] The only period that was characterized by a co-operative international climate (if one ignores the economies of the Warsaw Pact for a moment) and restrictions on capital flows, the era of Bretton Woods, banking crises were almost non-existent. From 1945 to 1971, not a single banking crisis was recorded in any of the 21 countries in the sample (Bordo et al. 2001, p. 59). Currency crisis continued to occur, which is not surprising since fixed exchange rates tend to require adjustment in regular intervals. But for us, the absence of banking crises in the era of Bretton Woods is a feature of finance we should not dismiss light-heartedly.
A study by Schularick and Taylor further supports our plea for national regulation. They have analysed data for 14 developed economies in the span of 140 years. Following earlier work of Hyman Minsky (1977) and Charles Kindleberger (1978), Schularick and Taylor test whether the financial system is prone to crisis due to endogenous credit bubbles (Schularick/Taylor 2009, p. 3). The pattern is quite known: Phases of greed and euphoria alternate with periods of anxiety and panic. The result of their quantitative analysis is clear: Credit booms matter, and they usually precede financial crises:
"Our key finding is that all forms of the model show that a credit boom over the previous five years is indicative of a heightened risk of a financial crisis" (Schularick/Taylor 2009, p. 20).
It has to be added that many credit booms would not have occurred without substantial capital inflows, as we have demonstrated above for Spain.
These findings have severe repercussions for the evaluation of monetary policy. The mainstream school of thought, primarily, but not exclusively promoted by Alan Greenspan and the American Federal Reserve Bank, has been that monetary policy's exclusive focus should be on price stability and the promotion of economic growth. Financial stability, defined as the absence of unsustainable asset price inflations, was not an issue for the Fed. In the early years of the 21st century, Greenspan defended his deliberate ignorance of asset price inflations in a debate with the European Central Bank's then Chief Economist Otmar Issing (Issing 2003). Greenspan's position, shared by prominent American economists Alan Blinder and Frederic Mishkin, has been labelled the "Jackson Hole Consensus" named after the annual gathering of central bankers and academic economist in Wyoming's Jackson Hole (Issing 2008, p. 3).
Like the dismantling of capital controls, this mainstream position is based on the neo-classical efficient market hypothesis. Efficient markets correctly reflect all available information at the time of pricing the assets, and asset price inflations essentially either do not occur at all - the most radical position – or cannot be addressed by monetary policy at reasonable cost – the more nuanced variety. Of course, a coherent monetary policy would then have to ignore asset markets all together. However, the American approach was regularly asymmetric: Banks and other market participants were bail-out after the event, which did damage market discipline and contributed to weakening risk management in the market (Issing 2008, p. 4).

[6] The countries in the sample are Argentina, Australia, Belgium, Brazil, Canada, Chile, Denmark, Finland, France, Germany, Great Britain, Greece, Italy, Japan, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the USA, i.e. the leading economies in that 120 years time span.

After the collapse of Lehman Brothers, Otmar Issing underlined his call for intervention by suggesting that *"... an impressive number of empirical studies have demonstrated that hardly any asset price bubble has not been accompanied if not preceded by strong growth of credit and/or money"* (Issing 2008, p. 6). Prior to the bursting of the US bubble, the then Chief Economist of the Bank for International Settlements, the Canadian William White, raised the same issue in a 2006 BIS working paper.

Assuming that Schularick and Taylor's findings are correct, credit booms and asset price inflations are indeed a second key factor that central banks should pay attention to. Monetary policymaking should consider price stability *and* financial stability (Schularick/Taylor 2009, p. 26). Central banks could and should no longer pretend that credit booms are a private sector phenomenon that central banks can well and truly ignore.

But what are the consequences for our proposal of a return to national rules in finance? The answer is that central banks can control credit booms at home, but not abroad. Their ability to monitor developments in foreign financial markets is limited. Central banks and national bank supervisors may be able to limit unsustainable asset price inflations and credit booms at home, but they cannot be entrusted with doing the same task in other countries. For instance, would OECD central bankers and banking supervisors capable of deciding at the end of 2011 whether lending for real estate investment in China would constitute lending into an asset price bubble or aren't they?[7] Almost inevitably, central bankers and national supervisors will be put under pressure by the domestic financial sector to be more generous with international lending operations. Since this could easily lead to future cases of the types of crisis Icelandic style, we suggest that the segmentation of financial markets is a radical, but the more sustainable policy choice.

[7] Of course, China does not permit borrowing abroad, so the case is hypothetical. Today, anecdotal evidence suggests that 34 million dwellings are unoccupied in China and this surely constitutes a real estate bubble. The point is that from London and Frankfurt, an assessment of the sustainability of a boom will always be more difficult than for domestic central bankers and supervisors.

5. The utility of global rules in trade

Our proposal to abandon the attempts to make finance safer by developing more global rules could be interpreted as a recipe for reversing globalisation – it is not. Rather, we suggest that in the light of our discussion above, there are sufficient reasons for a sharp distinction between global rules in trade and those in finance. We are staunch advocates of further liberalisation of trade. As Jagdish Bhagwati suggested in 1998, after the Asian crisis, trade in widgets and trade in dollars differ from one another (Bhagwati 1998). In this regard, we differ from John Maynard Keynes approach, who advocated in 1933 "let goods should be homespun whenever it is reasonably and conveniently possible" (Keynes 1993, p. 758).

In contrast to the yet to be measured positive economic effects of unrestricted capital flows, trade economists have shown time and again the benefits of fewer restrictions in trade. Whilst trade may have negative effects for some parts of a country's population, the overall benefits far outweigh the negative dimensions. Trade has enabled countries like China, India and Vietnam to contribute to and benefit from a deeper international division of labour. Hundreds of millions of workers in developing economies have worked their way out of poverty by producing for global markets. At the risk of generalisation, it is fair to say that we observe the worst cases of poverty in countries that continue to try to protect their citizens from a more liberal approach to trade. And of course the industrialised societies benefit as well. Consumers would not enjoy the same range of goods and services if there were significantly less trade. Central bankers would have had a much harder job in controlling inflation if China and other emerging economies would not have provided cheap manufactured products. All these are tangible benefits of relatively free trade.

Thus, we would argue that in the other domain of global economic relations—as both economic theory and the history of the trade regime tell us—global rules are appropriate and do indeed provide additional benefits to the global economy. It is thus ironic and regrettable that we have observed a declining commitment to the norms and practices of the multilateral trading system and a proliferation of bilateral and regional trading arrangements. The World Trade Organisation is in dire straits, primarily because of the unwillingness of the United States of America and other key players to support the conclusion of the Doha Round. Whilst the WTO continues to be attractive for some countries – the Russian Federation will be joining as its 154th in early 2012 – the organisation has lost support from its previous core constituency. All OECD-countries are defecting to presumably useful alternatives, i.e. preferential trade agreements. These agreements, however, are making international trade more complex and will not facilitate deeper international division of labour.[8]

Global rules in trade continue to be the first-best solution as all acknowledge. This is less is obvious both historically and contemporaneously in the financial domain where diversity in regulation stakes a stronger claim to optimality.

[8] For a detailed discussion of the motives for and the disadvantages of preferential agreements see the report of the Warwick Commission (2007), pp. 45-53.

6. Conclusions

We are suggesting a radical departure in global economic governance. In contrast to the current approach we advocate global rules in trade, national or regional rules in finance. To achieve this gaol, we are suggesting the taxation of capital flows in order to provide polities with the necessary 'policy space' in which they can develop tailor-made solutions.

Needless to say the financial sector, supported by academic economists often closely intertwined with Wall Street, will argue that taxing cross-border flows is (an?) anathema. This is neither new nor a surprise. Bhagwati noted long before subprime and the various crises in Europe:

"And despite the evidence of the inherent risks of free capital flows, the Wall Street-Treasury complex is currently proceeding on the self-serving assumption that the ideal world is indeed one of free capital flows ... It is time to shift the burden of proof from those who oppose to those who favour liberated capital" (Bhagwati 1998, p. 12).

At the very least, global rules should not discourage the introduction of additional regulatory measures at the national level.

But we are not naive. We are under no illusion as to the limitations of this approach. Tougher regulation at the national or regional level will also be exposed to intensive lobbying. Players will relocate to less restricted market places. It was ever thus. But the benefits of a soundly regulated national financial sector outstrip the costs.

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