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The Economic and Legal Implications of Speculative Capital Flows

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From an international macro-economic and legal perspective, this thesis investigates the nature, causes and effects of unregulated cross-border capital transfers. It provides evidence that speculative capital flows are both disruptive to the global economy and at odds with the intent and purpose of international monetary law. The thesis examines options for limiting the negative effects of those flows to help improve the efficiency of the international monetary and financial system.

The Economic and Legal Implications of Speculative Capital Flows

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In fulfilment of the requirements for the
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James Cook University, Townsville.

Exchange rate misalignments have become a major source of disruption for the world economy. They make it unsafe to make long-term investments, they endanger the value of investments already made ….The market mechanism fails to bring currencies back into alignment … speculation tends to exaggerate currency moves … the system of freely floating currencies is cumulatively destabilising.

George Soros[1]

[1] Soros, G. (2003) *The Alchemy of Finance*, 3rd ed., John Wiley and Sons Inc., New Jersey, at p 337.

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30th August 2013

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Abstract

This thesis employs the disciplines of Law and Economics to analyse the effects and implications of speculative capital flows (SCF). Using descriptive analysis as part of its methodology, it covers matters relating to: globalisation, macroeconomics, the international monetary and financial system (IMS), the international monetary market (IMM), foreign exchange trading, financial stability, international monetary law, prudential regulation, case law and legal and economic philosophy.

The global financial crisis of 2008 (GFC) demonstrated that there are several areas of weakness within the international monetary and financial system. Notwithstanding the variety of problems, this dissertation focuses primarily on the practise of moving speculative capital around the world to gain a profit and examines what effect that has on national economies and what should be done to reduce the impact of those practices. The thesis uses the *Efficient Market Hypothesis*, the *Balance of Payments Equation* and the *Mundell Fleming IS-LM-BP Model* to highlight the effects of speculative capital flows on national economies.

The legal argument advanced in the thesis is that: for several decades speculative capital flows have become increasingly destabilising to the global economy, and that *State Responsibility* and the doctrine of *due diligence* imposed by the mandates of international monetary law can, and should, be employed to help rectify this problem.

The thesis evaluates several options to minimise exchange rate volatility and shows how financial instability attributed to current practises might be curtailed through enhanced regulation. The thesis argues that enforcing the provisions already contained within international monetary law would help reform the framework through which the international monetary market operates; it is both economically warranted and legally justifiable. Not only might reform

help stabilise the international monetary system, it could also create a more equitable and robust environment in which the global economy could flourish.

The dissertation revisits the *Social Contract* theories prescribed by John Locke, Charles-Louis de Secondat and Adam Smith. The work of Vilfredo Pareto and his theory of *Optimality*, Nicholas Kaldor's and John Hicks's modified version of *Cost Benefit Efficiency* and Richard Posner's *Economic Analysis of Law* are applied to speculative capital flows. The philosophical and rational expectation arguments support the need for more control over financial markets and that legislators must be pro-active in pursuing that goal.

The discourse examines what alternatives are available for reducing the destabilising effects of speculative capital flows. The thesis analyses capital controls, the adoption of Tobin type taxes, more currency unions, and a single world currency. It describes how the regulatory requirements for international finance are lagging behind market advancements and identifies deficiencies within global prudential regulation. Henceforth, the laws (both international and domestic) must catch up to current market practises. The thesis applies three theories for regulatory reform, these being: Ian Ayres' and John Braithwaite's *Regulatory Pyramid*, Stuart Umpleby's application of *Requisite Variety*, and Anne-Marie Slaughter's concept of a *New World Order*. The combination of those propositions guides the research towards the necessary components for an effective regulatory framework suitable for addressing the issue of speculative capital flows and financial stability within the global economy. The thesis makes recommendations but concludes that while international dialogue has increased since the global financial crisis and prudential supervision of global markets has become an agenda item for discussion in G20 countries, any proposals or strategies for improving financial stability, reducing foreign exchange volatility and transaction costs within the global economy remain typically at the discretion of G7 leaders.

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Abbreviations

AARMR	American Association of Residential Mortgage Regulators
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Managers
AIG	American International Group Inc.
APRA	Australian Prudential Regulation Authority
ASEAN	Association of South East Asian Nations (Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Burma (Myanmar), Cambodia, Laos and Vietnam)
ASEAN+3	ASEAN plus China, Japan and South Korea
ASIC	Australian Securities and Investments Commission
ATTAC	Association for the Taxation of Financial Transactions to Aid Citizens
AU	African Union
AUD	Australian Dollar
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht ~ the German Federal Financial Supervisory Authority
BIS	Bank for International Settlements (Basel Switzerland)
BOP	Balance of Payments (aggregate of what one country owes other countries)
BRIC	Brazil, Russia, India and China (all rapidly developing market economies)
BRICS	BRIC plus South Africa
BWI	Bretton Woods Institutions (IMF and the World Bank)
CAPM	Capital Asset Pricing Model (an investment tool)
CEO	Chief Executive Officer
CFR	Council on Foreign Relations
CFTC	Commodity Futures Trading Commission
CGFS	Committee on the Global Financial System (BIS)

CIA	Central Intelligence Agency (US)
CME	Chicago Mercantile Exchange
CNY	Chinese Yuan, currency (元) often called *ren minbi* meaning *peoples' money*
CTT	Currency Transaction Tax
ECB	European Central Bank
ECU	European Currency Unit
EEC	European Economic Community
EMH	Efficient Market Hypothesis
EMS	European Monetary System (1979-94)
EMU	European Monetary Union
EPU	European Payments Union (1950-58)
ERM	Exchange Rate Mechanism (EU)
EU	European Union
EUR	Euro (€) the currency within the Eurozone
FDI	Foreign Direct Investment
FDIC	Federal Deposit Insurance Corporation (US)
Fed	Federal Reserve System of Banks (US)
Forex	Foreign exchange
FS&M Act	*Financial Services and Markets Act* 2000 (UK)
FSA	Financial Service Authority (UK)
FSB	Financial Stability Board (BIS)
FSF	Financial Stability Forum (superseded by the FSB)
FSFDI	Financial Sector Foreign Direct Investment
FSOB	Financial Stability Oversight Board (US)
G6	Group of 6 industrialised countries France, Germany, Italy, Japan, UK and US

G7	Group of 7 (G6 plus Canada)
G10	Group of 10 (actually has 11 members: G7 plus Belgium, the Netherlands, Sweden, and Switzerland)
G20	Group of 20 (23 countries plus the EU ~ made up of G10 plus Argentina, Australia, Brazil, China, Turkey, Russia, India, Indonesia, Mexico, Saudi Arabia, South Africa and South Korea)
GBP	British Pound (£)
GDP	Gross Domestic Product
GE	General Electric Corporation Inc.
GFC	Global Financial Crisis (2008 – 2009)
GNP	Gross National Product
HSBC	Hong Kong and Shanghai Banking Corporation (a British bank)
ICESCR	International Covenant on Economic, Social and Cultural Rights (UN)
ICJ	International Court of Justice (UN)
ICMBS	International Centre for Monetary and Banking Studies
ICSID	International Centre for Settlement of Investment Disputes (UN)
IMF	International Monetary Fund (UN)
IMM	International Monetary Market
IMS	International Monetary and Financial System
IOSC	International Organisation of Securities Commissions
LIBOR	London Inter-Bank Offered Rate
LIFFE	London International Financial Futures Exchange
LTCM	Long Term Capital Management Inc. (Deregistered)
MATIF	Marché à Terme International de France (the futures exchange in Paris)
MFI	Multilateral Financial Institutions
NYSE	New York Stock Exchange Group
OAPEC	Organisation of Arabic Petroleum Exporting Countries

OAU	Organisation for African Unity
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of Petrol Exporting Countries
OTC	Over-the-Counter (reference to a type of financial transaction)
PCIJ	Permanent Court of International Justice
PIPES	Private Investment in Public Equity
RBA	Reserve Bank of Australia
ROI	Return on Investment
RTGS	Real time gross settlements
SCF	Speculative Capital Flows
SDR	Special Drawing Rights
SEC	Securities and Exchange Commission (US)
TARP	Troubled Asset Relief Program (*Emergency Economic Stabilization Act* of 2008)
TIFFE	Tokyo International Financial Futures Exchange
TWI	Trade Weighted Index
UK	United Kingdom
UN	United Nations
US	United States (of America)
USD	United States Dollar
USSR	Union of Soviet Socialist Republics

Chapter 1

Introduction to Speculative Capital Flows

Chapter Abstract

This Chapter introduces the topic to be addressed in this thesis and describes the general layout of the research. It starts by presenting an introduction to the topic which outlines the aims of the thesis and several questions which the author will endeavour to resolve. It defines the meaning of 'economically detrimental'; provides a brief explanation of speculative forex trading; and describes several problems associated with the movement of speculative capital in the global arena. This Chapter also articulates how the thesis design follows a descriptive model of academic research and explains the type of economic and legal methodology used within the thesis. It also describes how the thesis will contribute to the existing body of knowledge and expresses the limitations of this research.

Note: both the in text referencing (American Psychological Association, 2010) and footnotes[1] used throughout this thesis follow the *Publication manual of the American Psychological Association*.

[1] American Psychological Association (2010) *Publication manual of the American Psychological Association* (6th ed.), Washington, DC.

1.1 Introduction

As the global financial crisis (GFC) of 2008 proved, there are several areas of weakness within the international monetary and financial system (IMS), however this thesis will only focus on one, that being the practice of moving speculative capital around the world and the impact that currency trading has on the global economy. The thesis examines the legal and economic implications on how to improve efficiency[2] in the IMS by exploring options that might reduce the negative impact of speculative capital flows (SCF).

Many investment funds, as well as individuals, use currency speculation as an alternative form of investment. Currency speculation goes under several different names. It is often referred to as *currency trading*, *foreign exchange trading* and more commonly within the industry as *forex trading*. Currency speculation is the practice of forecasting the change in the value of a currency and profiting from any movement in the value. It is frequently used to diversify an investor's portfolio and is carried out by selling one currency and buying another currency. Compared to share/stock portfolios, and commodities, forex trading provides a good opportunity to realise large profits due mainly to the high degree of leverage that is available in money markets and the endless variation in currency values. It also allows for proportionately higher losses. As with most sales mechanisms these days, revolutionary innovations in technology employing web-based applications, integrating real-time monetary transfers and analytic management software are enticing not only private equity/hedge funds into this multi-trillion dollar arena but also amateur investors. A market that was once an exclusive domain of central and commercial banks, has opened its doors to would-be currency traders from all walks of life from all corners of the earth.

[2] For a full explanation of the use of the word 'efficiency' in this thesis, see section 1.4. Generally, efficiency refers to the best use of scarce resources so as to maximise social benefit and minimise waste by reducing dead weight losses and unnecessary transactions costs.

It will be demonstrated that this practice can be financially and socially detrimental to national economies which are exposed to such activity. Not only do speculative capital flows have a tendency to erode the wealth from a domestic economy, they also cause significant disruptions to the global economy as a whole.

The thesis investigates some economic strategies and legal options to maximise the stability of exchange rates. It analyses the process of SCF within the international monetary market (IMM) and examines what effect that activity has on national economies. It reports on, and describes the disruption caused by speculators in the IMM and then contemplates the argument that law makers could perhaps provide a more stable environment under which the IMS should operate. To those ends, the thesis addresses these questions:

1. What are the effects of speculative capital flows and to what extent do they affect the wealth and stability of national economies.

2. Has international monetary law kept pace with market forces or has globalisation and technological progress surpassed the rule of law and compromised international monetary and financial stability?

3. Can the philosophical, economic and legal doctrines and principles which shape the nature and spirit of international law be employed to improve the efficiency of the global monetary and financial system?

4. If there are imperfections in the present system, what economic strategies and regulatory mechanisms are available to enhance financial stability and how can reforms be implemented?

1.2 Aims of Thesis

The intention is to evaluate some economic and legal options for reducing the negative effects of speculative capital flows so as to improve efficiency in the IMS. The argument advanced is that: the movement of speculative capital in the international monetary market (IMM) has been economically detrimental to the international community at large, and that international monetary law[3], the doctrines of *State Responsibility*[4], *due diligence* and international co-operation can, and should, be employed to help rectify this problem.

The thesis argues that enforcing the provisions already contained in international monetary law would help reform the framework through which the IMM operates. The thesis demonstrates how it is economically warranted and legally justifiable. Not only will reform help stabilise the international monetary system by eliminating the disruption caused by speculative capital flows, it would also create a more efficient environment in which the global economy could flourish.

Employing internationally accepted legal principles and enforcing the mandates of international law could reduce the level of exploitation provided by the intrinsic weakness of the current system. As will be demonstrated, it is a case of applying those existing laws in the context of international co-operation on economic and monetary affairs and ensuring some form of standardised regulation based on efficient and equitable principles is met. Alternatively, there are other options available that could radically change the existing financial architecture which are also discussed.

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[3] International treaties such as the *Charter of the United Nations*, the *International Covenant on Economic, Social and Cultural Rights* as well as the IMF and World Bank *Articles of Agreement*.

[4] *State Responsibility* refers to the obligations imposed on a sovereign State if it has signed an international treaty. The State henceforth owes a duty to the international community under international law. For a full description see Chapter 6.

1.3 Defining 'Economically Detrimental'

At the outset it is important to clarify the meaning of 'economically detrimental'. The *Oxford Dictionary*[5] describes 'detrimental' as a harmful act causing loss. It could be argued that a detrimental act extends to subjecting a person to a material disadvantage in comparison with other people in similar circumstances or that the act could also include some form of prejudice. Under the umbrella of human rights law the meaning of detrimental could also extend to humiliation and denigration. The *International Covenant on Economic, Social and Cultural Rights*[6] (ICESCR) in accordance with the principles proclaimed in the *Charter of the United Nations*, recognises the inherent dignity and equal and inalienable rights of all members of the human family as a foundation of freedom, justice and peace. It proclaims the ideal of human beings enjoying life free from fear and want, whereby everyone may enjoy his or her economic, social and cultural rights. By virtue of self-determination, people may freely determine their political status and freely pursue their economic, social and cultural development[7]. People may freely dispose of their natural wealth and resources without prejudice to any obligations arising out of international economic co-operation, based upon the principle of mutual benefit and international law. In no case may people be deprived of their own means of subsistence[8]. Article 5 of the ICESCR says no State, group or person has the right to engage in any activity or to perform any act aimed at the destruction of any of the rights or freedoms recognised in the present Covenant. Similarly the United Nations' *Charter of Economic Rights and Duties*[9] seeks the attainment of wider prosperity among all countries

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[5] The Australian Concise Oxford Dictionary, 2nd Ed. (1996) Oxford University Press, Oxford, UK.

[6] United Nations' General Assembly Resolution 2200A (XXI) of 16th December 1966, entered into force 23rd March 1976.

[7] ICESCR Article 1.

[8] ICESCR Article 2.

[9] United Nations' General Assembly Resolution 3037 (XXVII) of 19th December 1972. The *Charter of Economic Rights and Duties* was adopted by the General Assembly, at its twenty-ninth session on 12th

and higher standards of living for all people by promoting economic and social progress based on co-operation, mutual advantage and equitable benefits. Thus any act by a person or entity which undermines economic and social prosperity or deprives people of their economic wealth without their consent must be regarded as being economically detrimental. A full explanation of the processes and effects of speculative currency trading are discussed in the Chapters that follow to highlight the economic detriment caused by SCF.

1.4 Explaining the Use of 'Efficiency' in this Thesis

According to the 1969 *Vienna Convention on the Law of Treaties*, unless a word has a special legal meaning imposed upon it, the word should have its ordinary every day meaning applied to it. In law that is the case but in economics there are several uses and interpretations of the word 'efficiency'. Seeking efficiency is one of many competing goals in social systems. Withstanding the different perceptions and applications of the word 'efficiency' in economic theory[10], the application of 'economic efficiency' used in this thesis shall refer to the best use of scarce resources so as to maximise social benefit and minimise waste by diminishing the existence of dead weight losses and reducing transactions costs in the foreign exchange market.

In standard supply and demand theory, an economy operates at its most efficient level when supply meets demand[11]. This can be represented in graph form where the lineal equations

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December 1974. It reaffirmed the fundamental purposes of the United Nations, in particular the maintenance of international peace and security, the development of friendly relations among nations and the achievement of international co-operation in solving international problems in the economic and social fields.

[10] Examples include: Pareto efficiency, Kaldor-Hicks efficiency, the Efficient Market Hypothesis, X-efficiency, Allocative efficiency, Productive efficiency, Distributive efficiency, Dynamic efficiency, Optimisation of a social welfare and Utility maximisation.

[11] Marshall, A. (1895) *Principles of Economics*, Macmillan and Co., Ltd. London; See Book V. General Relations of Demand, Supply and Value, particularly V.III Equilibrium of Normal Demand and Supply, p 281.

intersect at the point known as equilibrium. Movements away from the point of equilibrium signify a less efficient position within the economy. When social costs exceed the price that suppliers charge for an extra unit of a good or service, the marginal cost of supplying that product generates an overall reduction in efficiency to the economy. Additionally when artificial demand forces are exerted within the market, that also pushes the economy away from true equilibrium. Applying those concepts to speculative capital movements, this thesis elaborates how unregulated market forces may distort the value of a currency thus pushing it away from its true equilibrium position resulting in economic inefficiencies.

Following in the tradition of Adam Smith (1776)[12], Ludwig von Mises (1912)[13] and Friedrich von Hayek (1944)[14], a mainstream view is that free market economies are generally more efficient in allocating scarce resources than command economies, but despite that, government involvement is still necessary at the macroeconomic level (via fiscal and monetary policy strategies) to manage the economic cycle. To complicate matters further and ensure the economy functions at its optimum level, prudential supervision and regulatory controls must also be added into the equation. Consequently, there is heated debate about how to maximise efficiency, with some theorists advocating *laissez faire* freedom to remove government intervention, while others advocate for enhanced regulation to reduce market failures and imperfections. Both views are expanded upon in Chapter 3 which then establishes a starting point as to what ought to be done to improve economic efficiency in the

[12] Smith, A. (1776) *An Inquiry into the Nature and Causes of the Wealth of Nations*, Andrew Skinner Ed. (1999), Penguin Books, London; Book IV: Of Systems of Political Economy, Ch 1 The Principle of the Commercial or Mercantile System, p 5.

[13] von Mises, L. (1912) *The Theory of Money and Credit*, translated by H.E. Batson, (1953) Yale University Press, USA; see for instance Part 1, Ch VI The Enemies of Money ~ Money in the Socialist Community, p 91.

[14] von Hayek, F.A. (1944) *The Road to Serfdom*, Routledge Press, UK; see particularly Ch 7 Economic Control and Totalitarianism, p 91.

international monetary and financial system. Those findings validate the rationale for pursuing economic efficiency in the IMS as a worthy goal for this thesis.

1.5 A Brief Explanation of Speculative Forex Trading

The *Oxford Dictionary* describes the word 'speculate' as 'a theory or conjecture that has no firm conclusion or factual basis'. It implies that there is the likelihood of an unpredictable outcome based on the facts known at a given time. Business speculation is a method of investment in some form of property, in which the investor hopes to realise a financial gain. The dictionary goes on to describe 'speculative business transactions' as an 'investment involving the risk of loss'. With speculative transactions, although an investor wishes to realise a financial gain there is a distinct possibility that the investor could equally realise a financial loss. If an investment does not carry such a risk as to the possibility of loss, then the investment should not be considered speculative as such, but rather it could be labelled a 'sure bet'.

Currency arbitrage is the practice of buying a currency at one point in time and selling it [hopefully] at a profit at some other time. The international monetary market (IMM) is the global dimension where participants conduct monetary transactions on a range of different financial products. The foreign exchange (forex) market more specifically facilitates the conversion of one national currency into another and is by far the world's largest financial market. Practically every international transaction or investment requires a forex trade to be made. Whether engaging in international trade, imports or exports, investing in a foreign stock market, or in futures and options, or any other financial product, the currency market comes into play. While there are many reasons for participating in the forex market ~ like facilitating commercial transactions or hedging against future price drops on longer term

international contracts, ~ speculation for profit has become the most popular motive for forex trading for both big and small participants alike[15].

For most of the twentieth century forex trading was the domain of central banks, commercial banks, investment banks, financial intermediaries and a very limited number of wealthy investors who pursued the money-making opportunities associated with changing currency values. However, as globalisation evolved and corporations expanded to multi-national levels, they too became caught up in the macrocosm of global finance and more interested in currency differentials; smaller investors followed. With the advances in internet technology and the introduction of real time gross settlements[16], plus the financial industry's ability to devise new products and unique leveraging options, more and more traders are participating in the forex market for the purposes of making money.

The rise of global electronic trading has made this process much faster and easier, enabling speculators to transfer huge sums of money between continents in seconds in an attempt to capitalise on small differences in the buy and sell prices of various currencies. The attraction of the forex market is that an investor does not have to rely on any one particular economy to make money. Whether or not his home economy is flourishing or falling into a recession is irrelevant, a trader can earn money by simply moving his liquid wealth into another currency.

The value of a currency is influenced by a variety of economic and political conditions. Within floating exchange rate regimes there are many fundamental influences on a currency's

[15] The evidence to back that assertion is presented in Chapter 1 section 6.

[16] Real time gross settlements (RTGS) is a financial mechanism whereby monetary transfers take place from one bank to another on a 'real time gross' basis. It means payment transactions are no longer subject to any 3 – 5 day waiting period before funds can be accessed.

value, but ultimately it rests with supply and demand. The next most important factors are national income, interest rates, inflation and political stability. If there is a significant gap in interest rates between countries, the country with the higher interest rate will normally attract a higher portion of foreign investment capital. The foreign investor will first have to buy the local currency in order to make his investment and this will in turn increase demand for that currency. The process is similar when corporations import and export goods and services to other countries. In floating currency economies, *ceteris paribus*, any migration of money into or out of an economy affects supply and demand and therefore the value of its currency.

Sometimes central banks participate in the open forex market to influence the value of their nation's currency. The central bank intervention usually seeks to stabilise the country's currency in relation to other world currencies by either releasing its own domestic currency into the market in an attempt to lower the price, or conversely, buying it to raise the price. Economic forecasts, central bank intervention and large market orders can contribute to high volatility in currency prices, however the sheer size of the forex market makes it virtually impossible for any one entity to drive the market for any length of time. But when animal instincts and herd-like-behaviour drives the market, devastating economic consequences may be realised which may in turn have a contagious effect on other national economies.

1.6 Global Movement of Capital

Since the 1970s, international monetary flows have experienced enormous expansion. In the early 1970s, the daily turnover in foreign exchange markets was US$18 billion[17]. Transaction volume increased more than fourfold between 1977 and 1980 and fourfold again between

[17] The financial figures in this section are derived from the Bank for International Settlements' *Triennial Foreign Exchange and Derivatives Market Activity Reports* 1995, 1998, 2001, 2004, 2007 and 2010. Available at: http://www.bis.org/publ/

1980 and 1983. Trading doubled between 1983 and 1986, and tripled between 1986 and 1989, when it reached the sum of US$590 billion per day. It increased again by almost 40 percent between 1989 and 1992, reaching $820 billion a day. In April 1995, the average daily turnover associated with foreign exchange contracts was $1.2 trillion, an increase of 45 percent on that of 1992. In April 1998 this figure reached $1.49 trillion turnover per day[18]. That was more than double the size of the market in 1989, and more than 82 times the size in 1973.

To comprehend the extent of this increase, one need only compare the figures for the volume of world trade, which revealed no equivalent increase. In 1995 the average daily turnover in foreign exchange activity was US$1.2 trillion, compared to global turnover in trade for goods and services at only $21 billion. The annual global trade in merchandise exports and commercial services in 1998 was $6.5 trillion, equivalent to a mere 4.3 days of trading in the foreign exchange market[19]. Total foreign exchange trading in 1998, approximately $360 trillion, amounted to approximately 55 times the world trade in merchandise exports and commercial services. According to Bank for International Settlements (BIS), the world's total official foreign reserves in 1998 amounted only to $1.6 trillion, or just over a day's trading on the traditional foreign exchange markets. On the London Stock Exchange in the financial year 1998-99, equities to the value of $5.7 trillion were traded in contrast to the $152.8 trillion in foreign exchange that changed hands[20].

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[18] Bank for International Settlements (1999) *Triennial Central bank Survey of Foreign Exchange and Derivatives Market Activity 1998*. Available at: http://www.bis.org/publ/r_fx98.htm

[19] *Id*.

[20] Excelsior Worldwide Corp. (2006) *Foreign Exchange Market Overview*.
Available at: http://www.worldwidetimes.com/overview.htm

The 2001 BIS Triennial Report on forex trading[21] indicated that turnover in foreign exchange markets had declined substantially between 1998 and 2001. In April 2001, average daily turnover had returned to the 1995 level of $1.2 trillion, compared to $1.49 trillion in 1998, equating to a 14 percent fall when volumes were measured at constant exchange rates. Turnover did not decline uniformly across instruments. Trading volumes fell sharply in spot markets and, to a lesser extent, foreign exchange swaps. By contrast, trading in outright forward exchange contracts increased slightly.

The reduction in turnover for the 1998 - 2001 period can be attributed to several things: the decrease in risk tolerance that followed the financial market turbulence in 1998 (ie the Asian Meltdown); the ability of central banks to maintain price stability and therefore ease pressure on exchange rate differentials; more countries adopting floating exchange rate regimes ~ thereby allowing incremental changes instead of radical adjustments in currency values; the introduction of the euro; and to some extent the pressure from the international community ~ governments and non-government organisations (NGOs) alike pushing to regulate the free movement of capital. All those variables would have had a small effect on the market.

Although it is impossible to attribute the exact cause for the decline in speculative transactions within the forex market during that period, market confidence and reduced returns to investors would have been a major contributing factor. The introduction of the euro would logically be a large influence as well. In January 1999 all currencies within the European Monetary Union (EMU) were, in accordance to the *Maastricht Treaty*[22], irrevocably locked into one another. This meant that there was no longer any variation in the currency

[21] Bank for International Settlements (2002) *Central bank Survey of Foreign Exchange and Derivatives Market Activity in 2001*, released 18th March 2002. Available at: http://www.bis.org/publ/rpfx02t.pdf

[22] Officially titled, the *Treaty on European Union*, signed 7th February 1992 in Maastricht, the Netherlands.

prices within the euro zone. As the combined EU eurozone represented the world's second largest economy at the time, it is reasonably safe to argue that shoring up a major proportion of the global economy by implementing the single currency reduced the domain for speculative practices. Removing the opportunity for speculators to take advantage of the inherent weakness of the system to realise profits on currency differentials is an effective tactic and an obvious solution to overcoming the problems caused by speculative currency flows.

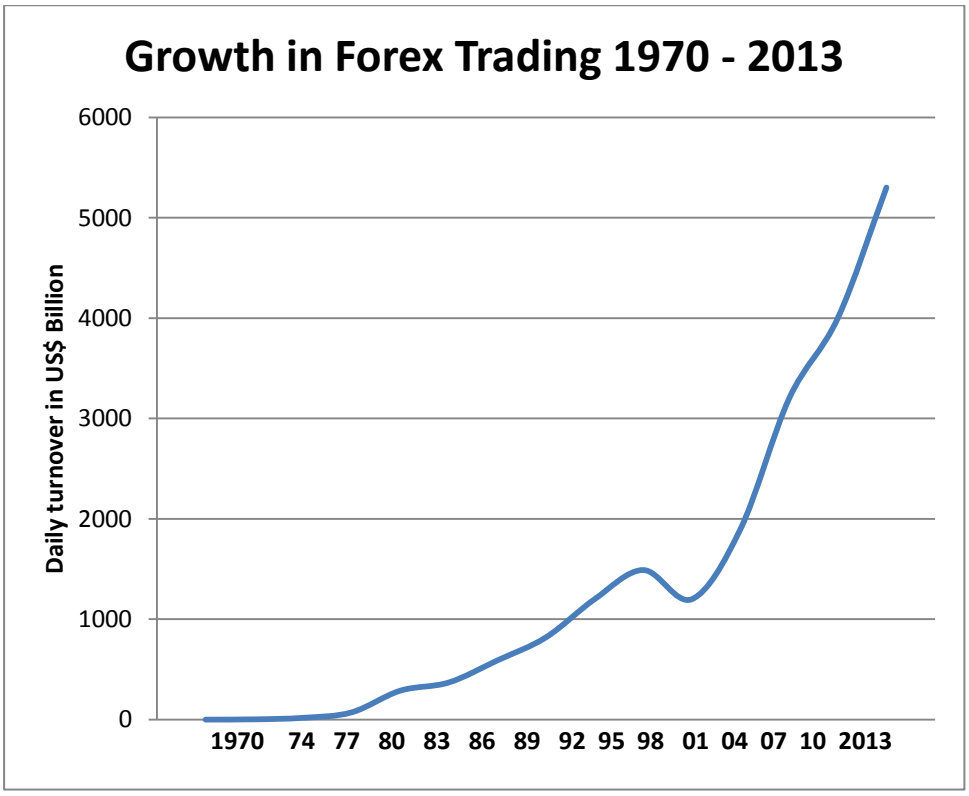
Despite the fall in trading levels between 1998 and 2001, the BIS 2004 Survey[23] on foreign exchange and derivatives market activity highlighted several important changes compared to the previous survey conducted in 2001. The 2004 survey showed a large increase in activity raising the average daily turnover to $1.9 trillion ~ a 36 percent rise when volumes were measured at constant exchange rates. This reversed the fall in global trading volumes as measured between the 1998 and 2001 period, and proved significantly that the IMM was alive and well and in no mood to give up on the lucrative benefits attributed to currency trading.

In the early part of 2013, 53 central banks and 42 monetary authorities participated in the Bank for International Settlements' ninth Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity. The survey collected data on turnover in traditional foreign exchange markets ~ those for spot transactions, outright forwards and foreign exchange swaps ~ and in over-the-counter currency and interest rate derivatives. According to previous BIS surveys, turnover in forex instruments increased by an unprecedented 71 percent between

[23] Bank for International Settlements (2004) *Triennial Central bank Survey of Foreign Exchange and Derivatives Market Activity 2004*, p1. Press & Communications Basel, Switzerland.

2004 and 2007 to $3.2 trillion per day. While stock prices fell during the GFC[24], international currency transfers actually increased; up 20 percent higher in April 2010 than in April 2007. With banks, hedge funds, mutual funds, pension funds and sovereign wealth funds participating heavily in the market, turnover in forex trading and other foreign exchange instruments averaged $5.3 trillion per day (as at April 2013). Figure 1.1 shows the growth in forex trading since 1970.

Figure 1.1 Growth of Forex Trading



Source: BIS Triennial Reports 1989 – 2013

Extrapolating the current trend forward, it might be envisioned that by 2016, turnover in forex trading could be in excess of US$6.5 trillion per day. In terms of daily turnover at US$5.3 trillion in 2013, the forex market is approximately 57 times larger than the total of all

[24] As of July 2010 the US S&P500 index was 31 percent off its high reached on 9th October 2007. Similarly the Australian share-market was 36 percent below its peak of 6828 in November 2007.

international share trading and over 100 times greater than the payments for all internationally traded goods and services[25].

If, as it is argued in this thesis, speculative currency trading adds to financial instability and decreased efficiency, then the increase in daily turnover will have a compounding effect on the current problem. It is one of the reasons why this topic requires immediate attention by legislators and policy makers the world over. The literature review which supports the need for this particular research is presented in Chapter 2.

1.7 A Starting Point for an Enquiry

Cohen (1956) noted:

> … every enquirer must begin not with a tabula rasa for the recording of fresh facts, but with a fund of information. Discoveries in nature are not made by those who follow Bacon's precept and rid themselves of all anticipations of nature. The man who knows nothing about the subject may be free of bias but he will not discover anything. The facts of human nature do not stream into empty minds[26].

Creswell (2007) wrote: 'The qualitative researcher today faces a baffling array of options for conducting qualitative research. Numerous inquiry strategies, inquiry traditions, qualitative approaches and design types are available for selection'[27].

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[25] The dollar value of world merchandise exports in 2012 was $18.3 trillion, equating to a little over US$50 billion per day. Cf: WTO Press Release/688, 10 April 2013. World exports of merchandise and commercial services, 2005-12. At http://www.wto.org/english/news_e/pres13_e/pr688_e.htm

[26] Cohen, M. (1956) *A preface to logic*, Meridian Books, Inc. New York, p 170.

[27] Creswell, J. et al (2007) Qualitative Research Designs: Selection and Implementation, *The Counselling Psychologist*, Vol 35, p 236.

Camp (2001) advises:

> For a quantitative study to have an acceptable theoretical framework it must provide adequate discipline-related and research-based literature to produce a set of theoretical assumptions that lead directly to the research question or questions.

He continues:

> The theoretical assumptions provide a premise for the study so that a coherent argument can be made for the research questions. A problem establishes the reason for the study. The literature provides the background and knowledge base related to the study. The theoretical framework provides a premise for the study. The premiss leads directly to the research questions.
>
> As a minimum, for a qualitative study to have an adequate theoretical framework, the basic assumptions of the researcher must be elucidated to provide an intellectual context for the research. If the study will begin with specific research questions, a study-specific theoretical framework should provide the rationale by which the research questions were derived…[28]

1.8 Thesis Design ~ A Descriptive Model

Peters (2009) reports that critical analysis is a central process in all academic work. It involves critically applying rational logic to thought processes. He says it means being open to other points of view and not being blinded by our own biases; it can include asking questions, identifying problems, describing, predicting, analysing, categorising and establishing causes and effects[29].

[28] Camp, W.G. (2001) *Supra*.

[29] Peters , M. (2009) *Academic Writing, Philosophy and Genre*, Wiley-Blackwell , Chichester, West Sussex, p 1-13.

Sloman (2010) explains that descriptive analyses allows for direct observation of behaviour and environmental events in naturalistic contexts[30]. In the field of economic writing empirical studies tend to dominate academic work yet research using descriptive analysis methodology is common in other disciplines. From a legal perspective, a descriptive analysis can form the basis of legal discourse without reverting to rigid processes normally associated with legal reasoning.

The thesis uses the descriptive model of academic writing to emphasise the cause and effect of variables within a system[31]. The challenge therefore, is to solve a problem found in existing practices by considering viable options that might resolve the critical situation. Analysis conducted under the descriptive model provides the factual position and pinpoints where problems arise and how those manifestations relate to other aspects (Kaufman and Lamb,1967)[32] ~ in this instance; aspects of the International Monetary System. A descriptive analysis presents ~ as much as space allows ~ a holistic view to help determine which deficiencies detract from the sum of the whole (Grether, 1980)[33].

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[30] Sloman, K. (2010) Research Trends in Descriptive Analysis, *The Behavior Analyst Today*, Vol. 11, Issue 1, p 20.

[31] Kaufman, H. and Lamb, J. (1967) An empirical test of game theory as a descriptive model, *Perceptual and Motor Skills*, Vol. 24, p 951.

Grether, D.M. (1980) Bayes' rule as a descriptive model: The presentativeness heuristic, *Quarterly Journal of Economics*, Vol. 95 , p 537.

Creswell, J. (1994) *Research design: Qualitative and quantitative approaches*, Sage Publications, Thousand Oaks, CA, p 82-83.

Creswell, J. et al (2007) Qualitative Research Designs: Selection and Implementation, *The Counselling Psychologist*, Vol 35, p 236.

Camp, W.G. (2001) Formulating and Evaluating Theoretical Frameworks for Career and Technical Education Research, *Journal of Vocational Education Research*, Vol. 26, Issue 1.

[32] Kaufman, H. and Lamb, J. (1967) An empirical test of game theory as a descriptive model, *Perceptual and Motor Skills*, Vol. 24, p 951.

[33] Grether, D.M. (1980) *Supra.*

Descriptive research does not fit neatly into the definition of either quantitative or qualitative research methodologies, but: 'Because descriptive research spans both quantitative and qualitative methodologies, it brings the ability to describe events in greater or less depth as needed, to focus on various elements of different research and organise information in meaningful ways'[34]. A descriptive analysis may be defined as heuristic research where a hypothesis does not form part of the academic investigation but nevertheless maintains a formal series of structured research questions. It can operate within the macro-scale and its application is usually of a discourse. Similar to policy analysis and systems analysis[35], a descriptive analysis employs a discovery approach by which an investigation is carried out to explain strategies and their development. Although there is no formally recognised procedure, a descriptive analysis aims to explain the contextual framework in which political, economic, legal and socio-cultural forces influence events and outcomes. One common methodology is to define the problem and evaluation criteria; identify all alternatives; evaluate them; and recommend the best policy[36].

Because the topic in this research covers both economics and law it requires a slightly longer process. In this thesis the analysis will follow this agenda.

1. Introduce the topic and describe the general layout of the thesis
2. Verify, define and detail an economic problem via the literature review
3. Consider arguments for and against changing the existing norms using economic models
4. Provide an historical background to identify why the present situation arose

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[34] The Association for Educational Communications and Technology (2001) *What Is Descriptive Research?*, Bloomington, IN. Available at: http://www.aect.org/edtech/ed1/41/41-01.html

[35] Radin, B. (2000) *Beyond Machiavelli : Policy Analysis Comes of Age*, Georgetown University Press.

[36] Simon, H. (1976) *Administrative Behavior*, The Free Press, New York; Wiktorowicz, M. and Deber, R. (1997) Regulating biotechnology: a rational-political model of policy development, *Health Policy* Vol. 40(2), p 115-38; Thomas, I. (ed.) (2007) *Environmental Policy: Australian Practice in the Context of Theory*, Federation Press, Sydney.

5. Describe the legal framework under which the international monetary system operates
6. Assess possible legal remedies to mitigate losses caused by speculative capital flows
7. Identify institutional mechanisms which could help minimise exchange rate volatility
8. Evaluate the major alternative policies/strategies in terms of economic efficiency
9. Determine the most efficient course of action for regulatory reform of global financial markets
10. Discuss the likely hurdles of implementing new policies/strategies at the global level
11. Provide an analysis of the thesis findings and make recommendations

Each Chapter covers a separate agenda item which is explained in more detail below as well as at the beginning of each Chapter in the form of a Chapter abstract.

Because this thesis is multi-disciplinary, it must adopt two procedures for tackling this particular investigation; one employing methodology pertaining to economic and financial management, and another to law and regulation. To those ends, the thesis reviews the existing literature to identify an economic problem. It uses economic models and theory to show the consequences of that problem; which in turn subsequently demonstrates the need for a remedy through law and enforceable regulations.

The legal analysis identifies the regulatory failings which have allowed the present situation to arise. It examines the causes and consequences of ineffective laws and identifies available means for rectifying those failings through effective, enforceable regulation. Within that paradigm the thesis discusses the barriers (both legal and practical) to implementing an effective and enforceable international regulatory regime. It also examines alternatives to the existing international monetary framework. The respective research methods are expanded on below.

1.9 Economic Methodology

The thesis uses the *Efficient Market Hypothesis* (EMH) to demonstrate that the currency market is anything but efficient. Published in 1965 by Eugene Fama[37], the EMH proposes that markets are characterised by multiple participants acting in a rational manner in an effort to earn profit. Fama contemplated that in an efficient market, competition among the participants leads to a situation where the actual prices of financial assets already reflects the combined total of all known information ~ hence the market price settles at its equilibrium and is therefore at its optimum efficiency. The thesis explains why the EMH cannot apply to the IMM in the presence of SCF.

The thesis also uses the *Balance of Payments Equation* [38] and the *Mundell Fleming IS-LM-BP Model* to highlight the negative effects of speculative currency trading on national economies. Developed independently from each other by economists Robert Mundell[39] and Marcus Fleming[40], Dornbusch (1976,1980)[41] synthesised Mundell's model and Fleming's model into one which he called the 'Mundell-Fleming Model'. The Mundell-Fleming model was first known as the *IS-LM-FE* model, emphasising the three markets and equilibrium curves involved: *IS* for the goods market, *LM* for the money market, and *FE* for the foreign

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[37] Fama, E. (1965) The Behaviour of Stock Market Prices, *Journal of Business*, Vol. 38, No.1, p 34–105.

[38] The New Palgrave: A Dictionary of Economics (1987) The Macmillan Press Limited, London.

[39] Mundell, R. (1960) The Monetary Dynamics of International Adjustment under Fixed and Flexible Exchange Rates, *Quarterly Journal of Economics*, Vol. 74, p 227-57.

Mundell, R. (1963) Capital Mobility and Stabilisation Policy under Fixed and Flexible Exchange Rates, *Canadian Journal of Economics and Political Science*, Vol. 29, No. 4, p 475-85.

[40] Fleming J.M. (1962) Domestic Financial Policies Under Fixed and Under Floating Exchange Rates, *International Monetary Fund Staff Papers*, Vol. 9, p 369-79.

[41] Dornbusch, R. (1976) Exchange Rate Expectations and Monetary Policy. *Journal of International Economics*, Vol. 6, p 231-244.

Dornbusch, R. (1980) *Open Economy Macroeconomics*, Basic Books, New York, p 194.

exchange market. However the model's third label can be substituted to the *IS-LM-BP* model which showcases the balance of payments instead of the foreign exchange market. In this research, the *IS-LM-BP* model is used to demonstrate that an economy cannot simultaneously hold exchange rates steady and maintain an independent monetary policy when unregulated capital movements are present. The descriptive analysis of how all three economic theories support the argument for minimising speculative capital flows and promoting regulatory reform is presented in Chapter 3.

1.10 Legal Methodology

Theories and philosophies of legal research comprise several different traditions including comparative, historical and doctrinal methods as well socio-legal and critical legal studies.

The University of Edinburgh describes the changing nature of legal reasoning as such:

> Legal concepts change through time as a result of reflection on the appropriateness of conceptual structures to help regulate and shape the social world. That reflection is carried out in different forms and at a different pace by courts, legal doctrine and legal theorists. Theoretical reflection and historical research are, therefore, intertwined as complementary aspects of any investigation on the foundations of any given legal concept, including the concept of law. The idea of legal traditions of rational inquiry brings that connection between legal theory and legal history home[42].

The Faculty of Law at the University of Copenhagen provides an insight to this process:

> The research-related interest of a PhD project will often be due to the fact that it analyses legal problems which have not previously been taken up scientifically - the project has news value. This may be due to the fact that previous scientific treatment of the subject was not sufficiently detailed, or that the PhD project can contribute

[42]University of Edinburgh (2008) *History and Philosophy of Law*, School of Law web site: Traditions of legal enquiry. At: http://www.law.ed.ac.uk/pg/taught/courseoptions.aspx

further knowledge, for example a new or significantly changed formation of a theory[43].

This thesis employs a rational inquiry into the practice and effects of unrestricted capital flows. It is a descriptive endeavour covering traditional doctrinal research in context of socio-legal and empirical legal studies, together with theoretical and philosophical legal reasoning in the realm of international monetary law. The thesis identifies the factual situation and then applies fundamental legal concepts to provide a normative proposition for solving the problem (Greenberg, 2005)[44]. Combining economic evidence with legal reasoning, the thesis verifies the causal connection between the free and unregulated movement of speculative capital with that of the sophisticated and intentional erosion of national wealth.

A core theme advanced throughout the thesis is that the principles of economic efficiency and legal equality must be a benchmark by which the rules and regulations of global economics are formulated. Universal principles such as fairness, justice and sovereign equality ought to be guiding forces behind regulating and maintaining the efficiency of the IMS. To reinforce that theme, the thesis revisits the *Social Contract* theories prescribed by John Locke, Baron de Montesquieu and Adam Smith. The work of Vilfredo Pareto and his theory of *Optimality*, Nicholas Kaldor's and John Hicks's modified version of cost benefit *Efficiency*, and Richard Posner's *Economic Analysis of Law* are also discussed. The work of those authors is presented in Chapter 5 which explains the viable philosophical, economic and legal arguments in support of regulating speculative currency flows. The thesis then offers a normative proposition for solving the problem, but what must be taken into consideration is

[43] University of Copenhagen, (2005) *Writing a Ph.D. Thesis*. Faculty of Law, web site. Research related interests and productiveness. At: http://jura.ku.dk/phd/english/project_description/

[44] Greenberg, M. (2005) Reasons Without Values?, *Social, Political, and Legal Philosophy*, Vol. 2, UCLA School of Law Research Paper No. 05-27.

the fact that this is a global problem requiring a global solution. It is under those circumstances that the thesis will focus on the regulatory aspects of the IMS.

1.11 Finding a Solution

Descriptive facts alone cannot determine the content of the law; normative propositions must also help determine why particular legal principles should apply. By conducting a descriptive based analysis, the existing international legal framework and its laws are used to demonstrate what ought be done to solve the problem. It is here that the thesis demonstrates how regulatory reform would be in line with the directives of the UN *Charter*, the *Articles of Agreement* of the Bretton Woods Institutions (BWI) and the sovereign State's own national interests. However being an international problem, any proposed solution would necessarily have to fit within a State's Constitutional guidelines and perhaps require the modification of central bank mandates to enhance transparency at an international level as well as increasing the scope and power of the State's prudential regulatory institutions.

The thesis considers what alternatives are available for rectifying the problem. Several propositions are put forward and a discussion of the merits and disadvantages of each proposition is presented. These include: capital controls; the adoption of Tobin type taxes; reverting to a system of fixed currencies; creating more currency unions; and even the possibility of a single world currency. While these propositions may be rudimentary, easy to say but difficult to implement, their simplicity will nevertheless make it apparent whether or not the basic precepts would fit within or be suited to the existing international regulatory framework ~ and herein lies the greatest challenge.

Because speculative capital flows can be shown to cause inefficiencies within the IMS, the solution must therefore be tackled from an international standpoint. Getting the governments of major economies to agree on the monetary arrangements for financial stability will no doubt present numerous points of view and practical problems. First some form of consensus would need to be established, then there would be the matter of implementing consistent reporting standards and practices, which would in turn require regulatory supervision on a global scale.

The thesis examines the current international regulatory framework to determine what mechanisms and institutions are best suited to implement the desired reforms. It determines the regulatory requirements for international finance are lagging behind market advancements. Therefore the laws must somehow catch up to current practices. Regardless of whether the law-makers agree to restrict SCF or adopt a Tobin tax, create more currency unions or initiate a world currency, some form of effective regulation is still required. The thesis applies three theories for regulatory reform, these being: Ian Ayres' and John Braithwaite's *Regulatory Pyramid* [45], Stuart Umpleby's application of *Requisite Variety*[46] and; Anne-Marie Slaughter's concept for a *New World Order* [47]. The combination of those propositions guides us towards the necessary components for an effective regulatory framework suitable for addressing the issue of speculative capital flows. The intrinsic components of the theoretical framework synergistically build the argument towards

[45] Ayres, I. and Braithwaite, J. (1997) *Responsive Regulation: Transcending The Deregulation Debate*, Oxford University Press, Oxford, UK.

[46] Umpleby, S.(1990) Strategies for Regulating the Global Economy, *Cybernetics and Systems*, Vol. 21, No. 1, p 99-108.

Umpleby, S. (2001) What Comes after Second Order Cybernetics?, *Cybernetics and Human Knowing*, Vol. 8, No. 3, p 87-89.

[47] Slaughter, A-M. (2004) *A New World Order*, Princeton University Press, New Jersey.

improving the scope and authority of international financial regulation. Simultaneously, the proposed regulatory framework for minimising disruptive capital flows could also be applied to the existing IMS structure to enhance financial stability in general.

1.12 General Structure of Thesis

As part of the descriptive process, the thesis summarises the historical events that gave rise to the current problem. Employing this procedure helps identify where and how the inefficiencies permeated the IMS. Included in the descriptive analysis is evidence of the economic disturbances caused by SCF. Economic models are used to highlight the problems. The economic analysis demonstrates how national economies are affected and what that means for the people of those economies. Proving the correlation between the currency traders' activities and the effects on national prosperity will demonstrate the causal link of how economic inefficiencies have occurred. The nexus between the traders' activities and the economy's loss[48] provides the necessary justification to support the argument for tighter regulation of existing international laws and perhaps the introduction of new ones.

The thesis argues that what ought be done, is that the current practice of electronically transferring vast amounts of capital around the world with the intention to turn a profit on currency differentials at the expense of national economies, should be some-how restricted, or at a minimum, their negative effects reduced and that national governments acting collaboratively, have the power to make that happen. While the author recognises that capital controls imposed by stand-alone economies such as China, South Korea, Brazil and India are

[48] Please note that not all speculators are successful. The possibility of loss being incurred by the speculator is mentioned throughout the thesis; see for instance pages 2, 8, 34, 60, 85, 93, 116, 126, 138, 217, 222, 230, 282, 321,380 and 390.

an effective tool in protecting the value of their individual currency[49], financial instability is still prolific throughout the global economy. The fact that the contagious effects of currency speculation originating in one country can spill over into other semi-protected economies still warrants the need for a co-ordinated global solution.

To support that argument, the thesis will: analyse the existing legal framework and operations of the international monetary and financial system; clarify the philosophical principles behind the existing laws; apply the law to the actual situation; determine whether there is a valid reason for concern; review the current challenges facing the IMS; report what influence the unregulated market has had on the international community; investigate current agenda and policy considerations; question the effectiveness of the International Monetary Fund's (IMF) rules; examine economic doctrines; cross reference the collective principles of the *Charter of the United Nations* and IMF *Articles of Agreement* with that of economic reality; define the legal obligations of sovereign States and explain how their operations fit within the IMS; identify any breaches or omissions of international law; examine national interests and their effect on the IMS; review the available options for reform and summarise the findings.

1.13 Limitations of this Research

Statistical data relating to the exact costs on economies which have been subject to speculative attacks has not been presented in this study. While such information is important to determine the precise effect on gross national product (GNP) it was not included because of the relative complexity with collecting that type of data. The nature and diversity of collecting that information rests heavily with central banks and international bodies like the Bank for International Settlements and its agencies as well as the more widely known

[49] Notwithstanding that in some instances, limits on private outflows are poorly enforced, capital controls are explored further in Chapter 2, Section 5.3 and Appendix E. In depth analysis of capital controls is outside the scope of the thesis.

institutions ~ the World Bank and the IMF. Therefore the quantitative approach of calculating precise costs to national economies was beyond the scope of this research.

To explain why this research by-passed the above mentioned econometric modelling, the Bank of England and the British Treasury calculated Britain's economic losses after its speculative attack experience in 1992. It took the British institutions several years to gather the information and process the data. Six years after the event, the British Treasury was in a position to determine the net effect on GNP and the cost to the British economy. Chris Giles from the *Financial Times* used the *Freedom of Information Ac*t 2000 (UK) to investigate British Treasury records and reported in 2005 that the speculative attack of 1992 cost the British economy £3.3bn [50]. While this study does not process such data or calculate individual countries losses, it does show via a theoretical approach, how an economy is affected and supports that proposition using the three economic models outlined above[51].

A hurdle for any research project is to ensure that the information is relevant and up-to-date. Changing circumstances within the global economy made in response to the 2008 economic crisis have provided a catalyst for greater international co-operation and regulatory reform. While this area of international monetary law is in an evolutionary phase, unforseen events and exogenous forces may alter the architecture of the current system and hence steer the transformation in an unanticipated direction. The changing dynamics within the global economy with countries like Brazil, Russia, India, China and South Africa (BRICS) exerting more influence on the Western dominance of global finance may have significant

[50] Giles, C. (2005) Black Wednesday Documents: Losses on currency markets cost more than £3bn, *Financial Times*, National News, 10th February 2005.

[51] The *Efficient Market Hypothesis*, the *Balance of Payments Equation* and the *Mundell Fleming IS-LM-BP Model*.

implications for present financial arrangements. Without access to the intentions and strategies being planned by various players in the global economy, this thesis can only provide comment on the situation as it presently stands. The thesis does however provide discussion on several options which could come to fruition under existing circumstances, *vis-à-vis*, the creation of a North American economic and monetary union or alternative international financial arrangements instigated by BRICS or the European Union.

While a disaggregated analysis may be helpful to identify the purely speculative movements and to consider the effects of suggested interventions on other non-speculative activities, given the multiple motives for capital movements, a disaggregated analysis is beyond the scope of this thesis.

Another limitation of this thesis can be attributed to the magnitude of the IMS. Financial regulation encompasses a wide range of activities including: accounting standards; capital adequacy requirements; corporate and prudential administration; investor protection; insurance and money laundering. Each dimension of regulatory supervision warrants a dedicated study in itself. Therefore this thesis examines but one aspect of financial market oversight. Because the scope of the topic is extremely broad, the thesis does not delve into areas of financial regulation relating to different tax regimes, corporate affairs or cross-border insolvency matters, but rather it focuses on the inefficiencies of speculative capital transfers and the remedies contained within international monetary law which might help solve that particular problem.

The next chapter presents the literature review which supports the need for undertaking this research.

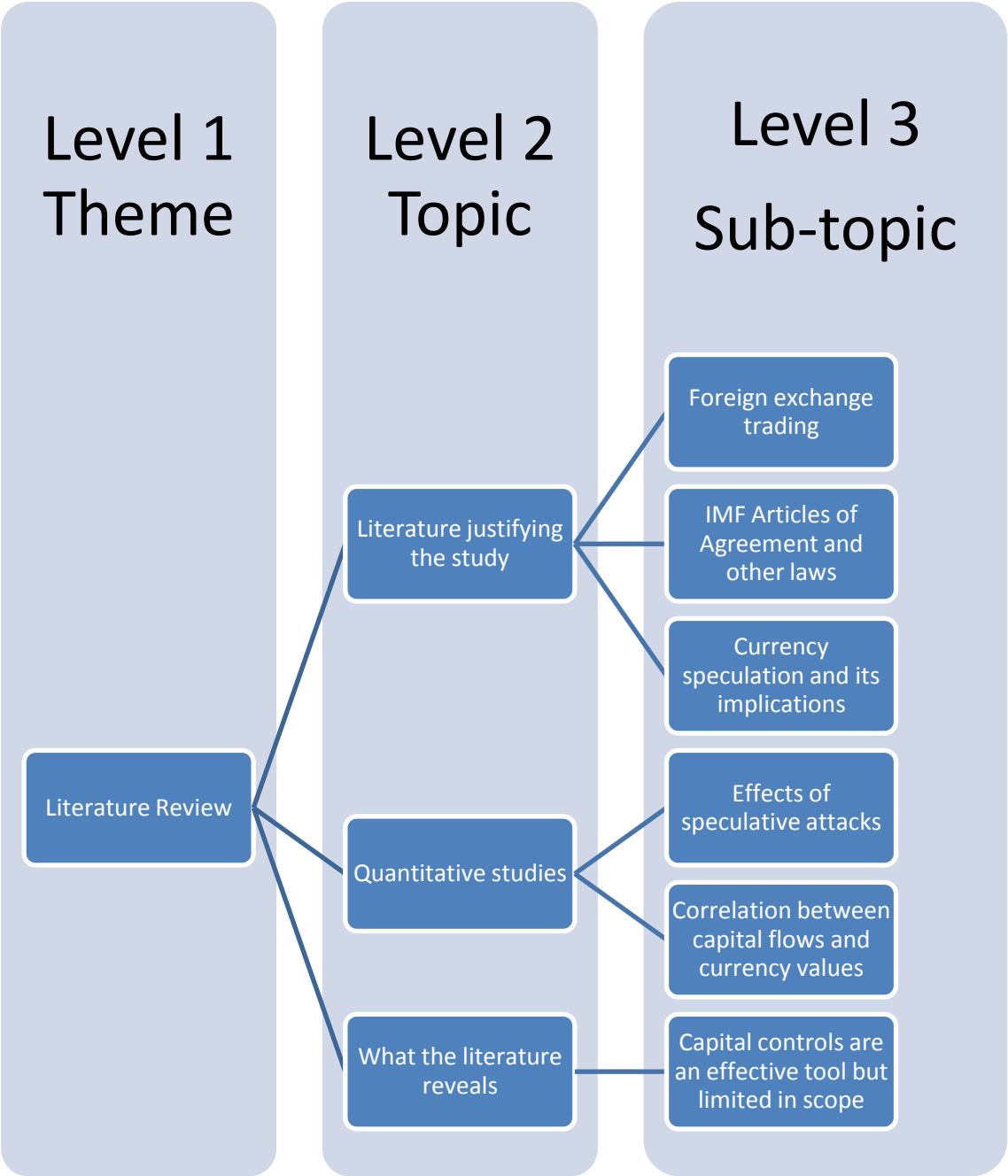
Summary of Chapter 1

This Chapter:

- introduced the topic of speculative capital flows
- outlined the aims of this thesis and identified the four thesis questions
- defined the meaning of 'economically detrimental' and explained what the term 'economic efficiency' would mean within the context of this thesis
- provided a brief explanation of forex trading and how that related to the global movement of capital and how it is used for speculative purposes
- explained how this economics and legal thesis would employ descriptive analysis as the suitable method for conducting this research
- introduced the economic theoretical models and the legal doctrines that would be used throughout the thesis to support each argument
- outlined the general structure of the thesis and expressed the limitations of this research

Chapter 2

Literature Review



Chapter 2

Literature Review

Chapter Abstract

This Chapter verifies, defines and details the economic problem addressed in this thesis. The Chapter examines the existing literature and establishes the significance of the research. As a starting point to understanding the intricacies of foreign exchange trading and currency volatility, the Chapter takes a brief look at the IMF *Articles of Agreement* and the expectations sovereign States have within the international setting. Financial crises, speculative attacks and the correlations between capital flows and currency values are examined to establish the major implications associated with speculative currency trading. The Chapter re-visits the Asian Meltdown and provides an Australian perspective to clarify the negative effects volatile currencies have on an economy. It then conducts a review of recent quantitative studies. The literature reveals that speculative capital flows do have a significant negative impact on national economies; the effects of which may develop into a full-blown financial crisis. In addition, the increased volatility in exchange rates allows speculators to capitalise on extra profit opportunities, which in turn creates a self-perpetuating cycle of fluctuations. Those fluctuations generate uncertainty in financial markets which produce economic inefficiencies including contagious flow-on effects to other nations thus destabilising the global economy even further.

The literature also reveals how tighter government controls on capital flows can have positive effects in maintaining economic stability within the national setting. Realising that inefficiencies do exist with the present arrangements, if we are to develop the full potential of a globalised financial system to benefit well-developed and underdeveloped economies alike,

it becomes necessary to focus research into this very important area of global financial governance. Conclusively, there seems little benefit in allowing these destabilising capital flows to continue without exploring possible remedies to improve economic efficiency within the global financial and monetary system.

2.1 Literature Justifying the Study

This literature review provides the context for undertaking this project. Although the research problem was briefly alluded to in the first Chapter, this review not only gives a summary of previous research but it also uses the literature to explain why this area of economic and legal understanding is so important. By examining the work that has already been done with respect to speculative capital flows, this Chapter expresses the relationships between the previous studies and determines the precise nature of the problem to be addressed in this thesis.

The literature review: summarises what we already know; introduces relevant legislation and outlines present treaty obligations; explains what the immediate concerns are; describes the key concepts and variables; shows the correlation between speculative capital flows and financial instability; and identifies the contribution this present study will make to the existing body of knowledge.

2.2 Foreign Exchange Trading

Unlike other financial markets which close at the end of the day, the forex market has no locality or time restrictions. It is an over-the-counter or internet market where buyers and sellers including banks, corporations, and private investors conduct business. Foreign exchange trading takes place in financial trading centres all over the world, but

predominantly in Chicago, Frankfurt, London, New York, Sydney, Tokyo and Zurich creating one cohesive, international market. The huge number and diversity of players involved makes it impossible for even governments to control the direction of the market. The unmatched liquidity and around-the-clock global access makes foreign exchange trading the ideal activity for speculators who seek profit opportunities in minimally regulated markets.

The foreign exchange market is one of the most popular markets for speculation, due to its enormous size, liquidity, and tendency for currencies to move in strong trends. An enticing aspect of trading currencies is the high degree of leverage available. Most foreign exchange brokers allow positions to be leveraged at 1:100, with some even higher. Because the forex market is incredibly huge, rightly no individual can manipulate prices, but private individuals who correctly identify and anticipate price trends can make large profits by making only a 1 percent deposit upfront. When expectations are ripe and herd-like behaviour comes into play, *en masse* movements with high leverage can have detrimental effects on the value of a targeted currency.

Throughout the 1990s there evolved a growing interest in the causes of speculative pressures on currencies. This became evident, stimulated by the attack on the exchange rate mechanism (ERM) of the European Monetary System in September 1992, followed by the devaluation and float of the Mexican peso in December 1994, and continued with the Asian meltdown through 1997-98. In international debate it was argued that short-term capital movements were at the root of financial and economic crises, hampering development and nourishing poverty in many developing countries. While it is true that weaker economies feel the

pressure more intently, this practice had never been restricted to just the developing economies. In 1992 the British pound was targeted causing billions in losses[1].

While reactive trading involves the buying or selling of currencies in response to economic or political events, speculative trading is based on an investor anticipating particular events happening to improve his position. The problem with either type of trading is that an investor may have to monitor the economic environment constantly and move assets quickly in order to minimise losses should an event prove unfavourable. Speculative trading on the other hand requires the trader ~ whether big or small ~ to be more pro-active, and hence there are numerous software based analytical tools available to help speculators reduce the level of risk. Because computer programs have helped improve their profits, speculation in currencies has proven to be a major windfall for many of the world's top market traders.

We need only examine what the highest paid hedge fund managers are earning to determine that they are taking full advantage of the weaknesses within the IMS. For instance, in 2009 the top 25 hedge fund earners were paid a collective $25.3 billion. Fund managers like: Steve Cohen, Carl Icahn, Edward Lampert, Kenneth Griffin, John Arnold and Philip Falcone earnt around a billion dollars each. Three managers among the top 10, George Soros (No. 2), James Simons (No. 3) and John Paulson (No. 4) were each $3 billion plus winners with David Tepper coming outright winner with personal earnings for 2009 of almost $4 billion[2] equalling just under US$11 million per day. To give an indication of how their personal incomes have increased over the past several years, in 2006, the top 25 hedge fund managers

[1] Information about the British experience is expanded upon in Chapter 3 section 3.8.

[2] Schwartz, N. and Story, L. (2010) Pay of Hedge Fund Managers Roared Back Last Year, *New York Times*, 31st March 2010, p B1.

earnt a combined total of just over US$14.25 billion. Their average personal income was $570 million each, compared with US$362 million in 2005 and US$251 million in 2004[3].

The flip-side to the windfall of successful currency traders is that the financial instability and economic hardship caused by SCF on national economies can no longer be ignored and needs to be addressed at both national and international levels. Of course there are always two sides to an argument. This Chapter examines the literature which provides evidence that speculative capital flows are detrimental to economic efficiency. Those studies clarify the precise nature of the problem and enhance the argument in favour of regulating speculative capital flows. However an alternative ideological belief exists where some market participants support unrestrained capital movements; that view is examined and counter argued in Chapter 3. This Chapter also introduces some of the laws relating to the IMS, which subsequently highlights the necessity to undertake this area of research.

2.3 Trade and Currencies

Tew (1985) [4] noted that, speculative capital movements were not a new phenomenon[5]. Banks and governments had been involved in the buying and selling of national currencies for centuries, but this was a cumbersome enterprise ~ unlike the instantaneous transactions that are the norm today. Reserves of foreign exchange were generally accumulated over long

[3] Taub, S. (2007) The Top 25 Moneymakers: The New Tycoons, *Institutional Investor Magazine*, 20th April 2007.

[4] Brian Tew actively monitored the events of the global monetary system over a forty year period and studied extensively in Australia, England and the US. He worked in the field of monetary theory, banking, finance and international exchange arrangements and, amongst others, regularly consulted with US Federal Reserve Chairman Paul Volcker and the Bank of England's John Kirbyshire. His in-depth studies of international monetary practices provide a comprehensive record of the events which led to floating exchange rates after the collapse of the Bretton Woods *Agreements* and the way the current IMS evolved.

[5] Tew, B. (1985) *The Evolution of the International Monetary System*, Hutchinson & Co., London, at p 52, 82-83.

periods of time as a result of trade between nations. So while one country "A" may have been accumulating a trading partner "B's" currency, there was also the likelihood that trading partner "B" was accumulating "A's" currency. If the bilateral trading arrangement was not balanced, meaning that one country imported more than it exported, then there would have been a net uni-directional flow of capital, thus giving one country a surplus and the other a deficit. Depending on the arrangement between the countries, generally there was a limit to the amount of credit one country would extend to another with the imminent prospect that either country could set a limit on how much of the other country's currency it would be willing to accept. Once that limit was reached, the receiving country could insist on payment in its own currency or that of a totally different currency. Hence there arose opportunities to trade or accumulate another country's currency and dispose of those credits as and when fixed parities changed between currency values. The critical point to note is that currency values did not fluctuate as much as they do today under the movable peg or fully floating exchange rate systems. Up until the 1970s, most currency values were fixed via the international gold standard or by bilateral and multilateral agreements between nations. Nevertheless there were still flexible rates, black market rates, parallel rates, grey rates and compensation rates[6], but in most circumstances the official rate stayed relatively stable once its value was pegged to a major currency or basket of currencies. Therefore the opportunity to capitalise on variations in currency values only arose on a limited basis.

If however a change in value was to occur, the change in value was usually initiated by the country that governed the currency and in most cases, it was carried out with the intention of regulating import spending and maintaining a static balance of payments. For example, leading up to the 1950s, the evolution of European monetary arrangements accelerated due to

[6] *Ibid*, p 17.

a spate of adjustments to official par exchange rates, touched off by the devaluation of the pound sterling in September 1949. Between then and March 1950, the US dollar parity of almost all other currencies devalued as well but some with very unequal percentages[7]. It was during a process of adjustment that the speculator could capitalise on the differentials between exchange rate values, but such investments rarely happened due to the lack of timely information.

In the 1950s information travelled much slower than it does today. The general public did not have access to up to the minute information, nor was there any way of knowing what was happening in a foreign country unless there were operatives or reporters in situ with access to an appropriate wire service. Thus the game of capitalising on changing currency values was carried out not so much by private investors or financial institutions, but by governments and their central banks. A candid admission by the former head of the French Secret Service, Count de Marenches, tells the reality of government involvement in international monetary practices. In his book *The Evil Empire*[8], Marenches describes how on several occasions he obtained classified information that, when acted upon, produced very favourable economic benefits for France. He said:

> When, for instance, we knew for certain beforehand that the Americans were going to devalue the dollar on 18 December 1971 – when we saw the date and the extent, I notified President Pompidou … Thus the Bank of France was able to put into effect a series of operations which were highly successful. The figures involved, in fact taken on their own, would have financed the Service for years. … Spying in the proper sense is becoming increasingly focused on business and the economy, science and industry – and very profitable it is … In any Intelligence Service worthy of the name

[7] *Ibid*, p 33.

[8] de Marenches, Count A. (1986) *The Evil Empire*, Sidgwick & Jackson, London.

you would easily come across cases where the whole year's budget has been paid for in full by a single operation. Naturally, Intelligence does not receive actual payment, but the country's industry profits[9].

The essential purpose of the international monetary and financial system (IMS) is to provide a framework that facilitates the exchange of goods, services and capital among countries under orderly conditions[10]. International co-operation between nations is facilitated by treaties. The IMS has two treaties stemming back to the 1940s which were designed to promote international monetary co-operation, these being the *Articles of Agreement* of both the World Bank and the IMF.

2.4 The Articles of Agreement and Other Laws

Article I section 1 of the IMF *Articles of Agreement* sets out the purposes of the International Monetary Fund:

(i) To promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them

[9] *Ibid*, p 40 - 41.

[10] IMF *Articles of Agreement*, Article 1, Section 1.

with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

The International Monetary Fund is guided in all its policies and decisions by the purposes set forth in Article 1. Under Article IV, (expanded upon in Ch 5) each signatory nation to the Bretton Woods treaties is obliged to fulfil the purposes of the *Articles of Agreement* and collaborate with the IMF and other members to ensure orderly exchange arrangements and to promote a stable system of exchange rates.

Unassumingly, the *Articles of Agreement* did not restrict espionage or other questionable practices by signatory members to gain an economic advantage when currency values change[11]. Nor is there a suitable policing mechanism in place, as yet, to deter disruptive

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[11] Those ethical issues were never contemplated, and for whatever reason, seem not to be raised or even mentioned in institutions like the UN, IMF or World Bank. Typically, these institutions have ignored such practices occur, but as de Marenches reveals:

> The United Nations has the reputation of being a veritable Gruyère cheese for the various Intelligence Services, and with some pretty big rodents inside … Naturally, I have known of highly placed French agents in certain international organisations … I would say that Allied agents have occupied certain diplomatic posts*.

de Marenches identifies numerous names, dates, places and examples where economic espionage has taken place, not only from a French position, but a truly global one**. We can draw from this that while the UN promotes itself as a: 'global association of governments facilitating co-operation in international law, security, economic development, and social equity'***, it also serves as a platform for promoting national self-interests.

* de Marenches, A. (1986) *The Evil Empire*, Sidgwick & Jackson, London, p 49 - 50.

**US economist, John Perkins provides substantial evidence of how America gained economic advantages over other countries through State sponsored fraud. See: Perkins, J. (2005) *Confessions of an Economic Hit man*, Ebury Press, Great Britain.

In November 2010, after WikiLeaks published US diplomatic cables, Reuters reported that: "There is nothing new about espionage at the United Nations, but it's always embarrassing when classified documents proving it happens surface in the media". Cf: Reuters (2010) WikiLeaks Scandal: Is the United Nations a Den of Spies? *Reuters*, 29th Nov 2010, available at: http://blogs.reuters.com/global/2010/11/29/wikileaks-scandal-is-the-united-nations-a-den-of-spies/

***http://www.un.org/Welcome to the UN. It's your world.

currency practices at the international level. Clearly the purposes of IMF Article I section 1(iii) are not being met. Nevertheless, if the world is to accept the credibility of the UN, then it would not be unreasonable to expect that the basic tenets of the *UN Charter* and its off-shoot treaties [12] should be implemented and enforced through appropriate international regulation.

Any practices that manipulate exchange rates or produce erratic disruptions within the IMS to gain an unfair competitive advantage over other members are at odds with the intent and purposes of the international monetary treaties. Yet while the IMF *Articles* expressly discourage disruptive currency practices between member States, national mandates on the other hand call for practices which provide benefits for their constituents. It is here that conflicts of interest arise between international obligations and domestic policies. The IMF *Articles of Agreement* promote economic growth and price stability, as do most central bank mandates, however domestic legislation also prescribe obligations such as maintaining full employment and national economic prosperity[13].

Those policies in terms of economic prosperity and full employment in the domestic setting can be at odds with the requirements of international obligations or even economically detrimental to other nations. One need only observe the determination of China to maintain the low value of its currency against the demands of the US and the European Union to revalue the yuan to a point that makes Chinese exports into the US and Europe less

[12]Such as the *IMF and World Bank Articles of Agreement*.

[13] The US version is found in the *Federal Reserve Act* 1913 (US) of which section 2A outlines the monetary policy objectives of the US central bank. The British version is found in section 11 of the *Bank of England Act* 1946 (UK). The *Statute of the European System of Central Banks* describes the objectives of the European Central Bank. The Australian version is found in section 10 of the *Reserve Bank Act* 1959 (Cth).

competitive[14]. But as Article 2.1 of the UN *Charter* states: the Organisation is based on the principle of the sovereign equality of all its members. Determining the value of one's own currency is well within the rights of the sovereign State. Under Article 4.1, membership in the United Nations is open to all peace-loving States which accept the obligations contained in the *Charter* and are willing and able to carry out those obligations. Maintaining a low currency value to stay competitive is not in violation to the UN *Charter*, but imposing on the rights of another State is. Manipulating currency exchange rates or producing erratic disruptions to gain an unfair competitive advantage over another sovereign State is arguably an imposition upon the other State's rights. This thesis describes how those rights are affected through the practices of speculative currency trading.

2.5 Financial Crises and Speculative Attacks

Underhill and Zhang (2003) wrote:

> Persistent episodes of global financial crises have placed the existing system of international monetary and financial governance under stress. The resulting economic turmoil provides a focal point for rethinking the norms and institutions of global financial architecture and the policy options of public and private authorities at national, regional and transnational levels[15].

Although there are fully floating currencies in existence which also suffer the afflictions of disruptive capital flows, the literature on speculative flows in multiple pegged systems identifies four main causes for a currency crisis. A currency crisis may be defined as a collapse in or an abandonment of maintaining the value of a currency. The crisis arises when

[14] Zou, H-R. (2006) Dichotomy of a re-valued reminbi, *China Daily*, 28th July 2006.

[15] Underhill, G.R.D and Zhang, X. Ed. (2003) *International Financial Governance under Stress: Global Structures versus National Imperatives*, Global Economic Institutions (No. 4), Cambridge University Press, UK. p i Front matter.

market forces become so powerful that the central bank of a particular country can no longer maintain stable currency values. The result leads to volatility in the exchange rate, usually accompanied with a drop in value, higher international debt and domestic economic instability. Social and political stability can also be compromised during such times as was evident in the case of Indonesia during its economic crisis in 1997[16]. When such events occur the cause can often be attributed to what economists term a speculative attack. A speculative attack is characterised by a large fall in foreign exchange reserves held by the targeted country. The technical qualification was deduced by US Federal Reserve economist Ramon Moreno[17] in 1995 when he described an attack as a fall greater than the mean change minus 1.5 times the standard error of the change in reserves[18]. When attacks occur, the affected country invariably becomes worse off while the speculators reap considerable benefits.

A crisis may arise from diverging fundamentals[19]. For example, a country with a nominal exchange rate target and inflation that is higher than its trading partners will become increasingly uncompetitive leading to expectations of a re-alignment[20]. Here uncertainty in

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[16] Poppele, J., Sumarto, S. and Pritchett, L. (1998) *Social Impacts of the Indonesian Crisis - New Data and Policy Implications*, Development Economics Working paper number 81, East Asian Bureau of Economic Research.

[17] Moreno, R. (1995) Macroeconomic Behaviour during Periods of Speculative Pressure or Realignment: evidence from Pacific Basin countries, *Federal Reserve Bank of San Francisco*, *Economic Review*, p 3-16. The explanatory variables include; relative money supply growth rates, CPI inflation rates or unit labour cost growth, the current account deficit and GDP growth rate.

[18] There are several methodological approaches to modelling speculative attacks. The *stylised facts approach* simply examines the behaviour of certain macroeconomic variables. The *time series approach* uses interest rate differentials to estimate the probability of realignment for a country at each point in time and this estimated probability is then related to various macroeconomic variables which are hypothesised to affect the probability of an attack. The *multivariate analysis* uses either logit or probit estimations. And the *hazard function*, which estimates the instantaneous probability of a speculative attack occurring at time t, conditional upon there having been no speculative attack up to period t - 1.

[19] Economic fundamentals include such things as: GDP out-put, GDP growth, inflation, interest rates and employment levels.

[20] Dornbusch, R. (1982) *Stabilisation policies in Latin America: what have we learnt?*, World Development. World Bank Publication. See also Flood, R.P. and Garber, P. (1984) Collapsing exchange rate regimes: some linear examples, *Journal of International Economics*, Vol. 17, p 1-13.

the minds of market participants and small deviations from the pre-announced targets could trigger speculative capital flows.

Secondly, outflows may become unmanageable because of perceived policy differences which market participants consider to be unsustainable[21]. Here for example, if the exchange rate commitment implies that one country has to follow a policy which is unsuited to its economic conditions, this can call into question the credibility of exchange rate targets.

If GDP output is below expectations and unemployment is rising, the costs of maintaining the peg may exceed the benefits and the authorities may decide to adjust it. Market participants realising this may happen put the peg under extra pressure by acting in expectation of a devaluation or an adjustment of the peg.

Thirdly, exchange rate pressure can come about as a result of self-fulfilling attacks influenced by multiple equilibria[22]. Economic fundamentals (such as GDP growth, interest rates, level of savings, fiscal spending, balance of payments, taxation etc) could suggest that the economy is under-performing with respect to the targeting policy but other internal deficiencies like political unrest or a weak banking system could compromise the level of stability if an attack

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[21] Eichengreen, B. (1993) European Monetary Unification, *Journal of Economic Literature*, Vol. 31, p 1321-57. See also: Ozkan, F.G. and Sutherland, A. (1995) Policy measures to avoid currency crisis, *Economic Journal*, Vol. 105, p 510-19.

[22] *Multiple equilibria* refers to a mathematical model in which there is more than one equilibrium position caused by the existence of multiple variables. In a supply/demand model it can be represented as backward bending supply curve that crosses a demand curve more than once at prices each of which is a market clearing price.

occurs. Hence self-fulfilling attacks can be induced by a country's internal economic mismanagement[23].

Finally, there is the issue of contagion[24] as disturbances in international markets spread over into other countries. Self-fulfilling attacks may be triggered by contagion via its effect on fundamentals. Here depreciation or a fall in demand in one country may lead to speculative attacks in another country because the expected loss of competitiveness or reduced demand for exports lead markets to question the sustainability of the peg[25]. Such events were commonplace during the 1990s.

The 1992 crisis in the old European exchange rate mechanism (ERM) began with problems specific to Sweden which caused financial markets to question the sustainability of other central rates which had not previously been in doubt[26]. Mexico had similar problems in 1994 when its currency was attacked which set off a substantial fall in its foreign reserves[27]. Inevitably the Mexican government was forced to allow the peso to float and from late 1994

[23] Obstfeld, M. (1996) Models of currency crisis with self-fulfilling features, *European Economic Review*, Vol. 40, p 1037-47.

[24] *Contagion* is the inoffensive way of saying it was a domino effect where one collapsed economy leads to the collapse of another economy. In the instance of the Asian meltdown of 1997 the economic evidence derived through forensic accounting would probably demonstrate it was a well orchestrated and systematic attack on each economy where each collapse had consequent spill-over effects onto other economies.

[25] Gibson, H.D. (2003) Realignment probabilities and reputation effects in the EMS, *Oxford Economic Papers*, Vol. 55, p 314-55.

[26] Cobham, D. (1994) *European Monetary Upheavals*, Manchester University Press, UK.

[27] At the behest of the IMF and as a pre-condition leading to the North American Free Trade Agreement, the liberalisation of trade restrictions and capital controls introduced in the late 1980s by Mexico gave rise to the problems of 1994. The sharp increase in portfolio investments into Mexico had brought with it an explosion of imports as businesses geared up to supply the American market. This adversely affected the country's Current Account balance and after the initial rush, the inflow of capital stopped flowing. Soon afterwards the outflow began as foreign speculators moved their money out of the economy. Mexico's foreign reserves dwindled as the government tried to support the value of its currency but by the end of 1994, the government was forced to devalue the peso by 15 percent. The devaluation triggered more instability which eventually led to the floating of the peso.

to early 1995 the peso depreciated by almost 80 percent. With the effects of economic contagion, Mexico's financial woes permeated into other South American economies.

Similar problems were experienced in Asia. In 1997 contagion moved systematically from Thailand, Malaysia, South Korea, Indonesia and the Philippines in what became known as the Asian meltdown. Hence it becomes appropriate not only to investigate the determinants of capital flows but also to focus on the probability of a country experiencing a speculative attack and the net effect on the national economy.

2.6 Correlation between Capital Flows and Currency Values

Gibson and Tsakalotos (2003)[28] examined the implications of capital flows upon countries with transition economies which were seeking admission into the EU. In order to qualify for membership each country[29] had to comply with the requirements of the *Maastricht Treaty* and the administrative procedures set down by the European Central Bank. The conditions involved a commitment by each country to peg the value of their currency to that of the euro for a period of two years prior to admission. In that period the respective governments had to maintain budget surpluses and maintain inflation within specified bands. These measures would determine how effective each government was in stabilising its own currency.

Gibson and Tsakalotos sought to shed light on the likely problems those countries would encounter with exchange rate policy in the run up to EU membership. Using two separate econometric models, they showed that most of the original euro-zone member countries had experienced fairly sizeable capital flows from the early 1990s. In explaining those flows, they

[28] Gibson, H. D. and Tsakalotos, E. (2003) *Capital Flows and Speculative Attacks in Prospective EU Member States*, Bank of Greece Working Paper, No.6, October 2003.

[29] The countries wishing to join the EU's Enlargement Program were Bulgaria, Czechoslovakia, Czech Republic, Estonia, Hungary, Lithuania, Malta, Poland, Romania, Slovak Republic and Slovenia.

found that their level and size had a direct correlation to downward pressure on currency values. The impact of domestic factors on capital flows was relatively weak with only inflation and economic growth proving moderately significant. Their results suggested that increases in inflation had a negative impact on capital inflows. The elasticity revealed that a one tenth increase in the existing inflation level led to a 1.4 percent decline in capital flows. Economic growth, by contrast had a small positive effect on capital inflows[30]. The results also revealed that while domestic factors had limited impact on the value of each country's currency there was clear evidence of contagion effects, meaning that in spite of successful domestic policies, the maintenance of the exchange rate peg was complicated by spill-over effects caused by developments in other countries within the region.

They suggested such flows can complicate the conduct of monetary and exchange rate policies. Large inflows, for instance, can undermine a tight monetary policy as the necessity for the central bank to sterilise the impact of the inflows on the domestic money supply becomes increasingly difficult. In this instance the central bank must withdraw cash from the economy in order to maintain a limited supply otherwise inflation could set in. On the other hand, large outflows can put pressure on an exchange rate peg because the central bank has to use its reserves either to defend the currency or inject money back into circulation. The trouble with this situation is that the country's foreign reserves may be rapidly depleted.

Gibson and Tsakalotos's study showed how speculative attacks not only affected the country to which they were directed, but also how neighbouring trading partners were significantly affected as well. The jeopardy caused by speculators has far-reaching effects into the economies of multiple nations. Therefore it would seem reasonable and in the best interest of

[30] Gibson and Tsakalotos (2003) *supra*, p 13.

most nations to unite to combat or eliminate the negative effects of such attacks. One of the factors motivating the European countries to unite under a single currency was that the original euro-zone members were acutely aware that forming a large economic bloc would dramatically reduce their exposure to speculative attacks[31]. In forming a robust economy to match that of the US's, the Europeans not only protected their own national interest but, as a united collective, challenged the supremacy of the US dollar as the world's preferred trading currency[32].

2.7 Currency Speculation and its Implications

The problems attributed to speculative currency flows have been discussed for decades, yet nothing constructive has been done to minimise the disruption. In his 1988 book[33], George Soros outlined the weaknesses he saw in the international monetary system. Yet no one in power did anything about it leaving the way open for him to capitalise on the inherent inefficiencies of the IMS which consequently earnt his hedge fund, and many others, hundreds of billions of dollars over the following decades.

Fifteen years after the release of the first edition of Soros's *Alchemy of Finance*, Paul Volcker, writing in the foreword to the third edition, expressed his concerns about currency trading saying:

> Soros has from his unique perspective brought clarity to deep-seated problems of international finance that have been too little recognised in either the world of academia or that of policy makers. Approaches that would ignore the systemic

[31] See the *Report on Economic and Monetary Union in the European Community*, submitted to the European Council by Jacques Delors, President of the European Commission on 12th April 1989.

[32] With the admission of Lithuania in January 2010 it now totals 17 out of 27 EU member States which are reaping the benefits of the single currency. Denmark, England, Norway and Sweden, although they are members of the EU still maintain their own national currency. Six other countries are in the process of adopting the euro.

[33] Soros, G. (1988) *The Alchemy of Finance*, Simon & Schuster, New York.

> implications of his observations will, in my judgement, fail to develop the full potential of globalised finance for well-developed and underdeveloped economies alike[34].

In the third edition of the *Alchemy of Finance*, George Soros wrote:

> Exchange rate misalignments have become a major source of disruption for the world economy. They make it unsafe to make long-term investments, they endanger the value of investments already made, and they are at the root of protectionist sentiment in the United States. The market mechanism fails to bring currencies back into alignment. On the contrary, speculation tends to exaggerate currency moves. As we have seen, the system of freely floating currencies is cumulatively destabilising[35].

In 1997 at an international forum on globalisation, Bernard Lietaer[36] focused on the alarming increase in global currency speculation. He said the potential implications were: 'truly explosive, threatening global power arrangements, the sovereignty of nation-states, and the abilities of ordinary people to survive'[37]. After giving empirical evidence about the dramatic increase of foreign exchange transactions which occurred between the 1970s and the 1990s he went on to discuss how the changing environment of international finances had induced structural changes within business and governments. He said typical First World banks which once relied on lending money to customers to earn a return now actively participate in foreign exchange markets. In some instances he said, 20 to 50 percent of bank revenues can be attributed to profits gained from foreign exchange transactions. The consequence of this is

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[34] Volcker, P. (2003) *Forward*, to Soros, G. (2003) *The Alchemy of Finance*, 3rd ed., John Wiley and Sons Inc., New Jersey, at p xiii.

[35] Soros, G. (2003) *The Alchemy of Finance*, 3rd ed., John Wiley and Sons Inc., New Jersey, at p 337.

[36] Professor of International Finance at the University of Louvain in Belgium and Research Fellow at the Centre for Sustainable Resources at the University of California.

[37] Lietaer, B. (1997) Global currency speculation and its implications, International Forum on Globalisation, *IFG News*, Issue Two, Summer 1997, reproduced in Third World Resurgence, Vol. 87/88 (1997), p 15-17.

that banks are no longer the big players in terms of supplying credit to domestic markets. He said since the 1970s, banks, as a source of financing in America, have dropped from 75 percent of the total supply of credit to 26.5 percent. He reasoned that if a bank can earn higher returns from currency speculation, it is easy to comprehend why it would not allocate its resources to earning lower rates of return through lending. This means that there is a lot less traditionally cheap money available to clients who wish to borrow money for normal business expansion programs. The resultant effect of this situation, he says, is that the First World manufacturing base has now migrated to the developing economies, taking capital, technology, jobs and prosperity with it.

Lietaer (1997) also referred to another structural change that occurred because of the new financial framework. The dropping of the gold standard and the floating of currencies created windows of volatility whereby foreign exchange risk has by far become the largest risk in international business surpassing both market risk and political risk. He gave an example of a European company investing in a production plant in India. The initial investment could be in euro, the products sold locally from that plant would be purchased in rupees, if the value of the rupee then drops in terms of the euro the return on the original euro investment would drop as well. He said:

> … in short, the biggest risk of such investments is not whether Indians will buy the products (market risk) or whether the Indian government will nationalise the plant (political risk), but the changes in the values of the currencies involved (foreign exchange risk)[38].

[38] *Ibid*. p 16.

Lietaer focused on the consequences of increased currency speculation in circumstances where the nation State has little control over global capital and information technology. The first consequence of this, he said:

> … is that national governments are in the process of losing power. Currency traders are effectively 'policing' governments by selling off a nation's currency when they are dissatisfied with that government's policies. If enough traders act together, the value of a currency can plummet, creating a 'currency crisis'. These sudden large sell-offs are viewed by governments as 'attacks' on the value of their currencies[39].

Such was the case with the devaluation of the British pound in 1992, the Scandinavian currencies in 1992 and 1993, Mexico in 1994, the Asian countries in 1997 and 1998, Australia in 2001 and Argentina in 2002.

In fully floating exchange rate regimes and fixed pegged systems alike, central banks can intervene in the market when their currency is under attack, but the volumes of money now being traded are so vast that central banks find it near impossible to avert a crisis. Given that on average $4 trillion is traded in foreign exchange markets daily with the figures increasing[40], central bank reserves could be drastically reduced in a fraction of a normal trading day.

Throughout the 1990s, the global economy witnessed systematic attacks by currency speculators. One by one national currencies were targeted by market forces and each nation suffered accordingly. The interesting point to note here is that some central banks actually exploited the situation by adding to the instability of those currencies. As demonstrated in

[39] Lietaer, *Supra* at 16.

[40] See Chapter 1 Figure 1.1 Growth of Forex Trading, p 12.

Chapter 4, central banks do participate in the foreign exchange market and do add to the instability of currency values[41]. If market players continue their expansion and grow more powerful, and if those attacks are ever condensed to the short term, strongly significant economic disruption could result.

Expanding that line of thought, Lietaer (1997) gave a stark warning about the possible scenarios that could unfold. Because fluctuations in currency values are the means by which speculators derive their returns, there is an added desire within the market for increasing instability. He said:

> Big fluctuations in the values of currencies allow for big profits to be made by trading them … One of the things to watch for in the future will be such an 'attack' on the US dollar, which is the linchpin of the whole system … When the dollar crisis occurs, the world will have no system left[42].

Lietaer spoke of the only precedent that he knew of, which matched the total collapse of an international monetary system ~ that being the collapse of the Western Roman Empire in 476 AD[43]. He said:

> … in the 1929 crash, the [global] monetary system held. We had all kinds of other problems - unemployment, stock market crashes, currency inflation in Germany - but there was a gold standard that held. Today, we have no gold standard to fall back on. So there is no precedent for a collapse of this nature … And this would be a truly global phenomenon … All currencies in the world are based on the dollar … So if you have a crisis on the dollar, you pull out the linchpin and … boom[44].

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[41] See Chapter 4 section 4.3.1.

[42] Lietaer, *Supra* at 17.

[43] It should be noted that the Eastern Roman Empire and the Asian Empires of the Sassanians, Ruanruans, Guptas and the Changs were not adversely affected by the Western Roman Empire collapse.

[44] Lietaer, *Supra* at 17.

While Lietaer had some valid points relevant to the 1990s, with the passage of time it is hard to agree totally with his pessimism on this particular point. While all currencies are relatively important, since the 1990s, two more currencies have evolved which now play a significant role in the global monetary system. These are the euro (EUR) and the yuan (CNY), the significance and the impact of which is discussed in more detail in Chapter 8.

2.8 The Asian Meltdown

The issue of capital mobility got much attention after the Asian meltdown. The reversal of capital inflows, which went hand in hand with massive depreciations in exchange rates and significant contractions in economic growth placed doubt on the determinants and benefits of cross-border capital flows. Some studies examined those issues with mixed results. Kose et al. (2006) showed that a crisis by itself does not prove cross-border capital flows are bad for a country[45]. Typically, a country that has integrated with the global financial market is likely to grow faster than a country that deploys financial isolation. Numerous studies on the effectiveness of Malaysian capital controls which were imposed in response to the Asian meltdown have also been undertaken. Dornbusch (2001) insisted that the Malaysian controls did not play an important role or contribute to the speed of its economic recovery[46]. It was a point hotly contested by other academics and most notably, Malaysia's Prime Minister Dr Mahathir bin Mohamad who had been very critical of unrestrained capital movements for some time[47].

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[45] Kose, M., Prasad, E., Rogoff, K. and Wei, S-J. (2006) Financial Globalisation: A Reappraisal *IMF Working Paper* /06/189.

[46] Dornbusch, R. (2001) Malaysia: was it different?, *National Bureau of Economic Research*, Working Paper, No. 8325.

[47] Mahathir, M. (2000) How trading in the ringgit was stopped, *New Straits Times*, 25th August 2000, p 14. Considering Rudi Dornbusch worked for the IMF, it is perhaps plausible to understand why they didn't agree on this point. Mahathir had staunchly opposed the proposals being put forward by the IMF to fix the Malaysian economy. History demonstrates that Mahathir's strategies out-performed IMF policies which other countries had adopted giving Malaysia more growth and quicker recovery.

At the 1998 Asia-Pacific Economic Co-operation (APEC) Summit in Kuala Lumpur world leaders met to discuss, amongst other things, matters relating to the Asian financial crisis[48]. Mahathir as chairman, expressed major concerns about the role of hedge funds and currency traders and the need for global regulation of financial markets. Some leaders hoped to reach a consensus about the architecture of the international monetary landscape and whether the market should be left alone or regulated.

It appeared that Mahathir was one of the few political leaders who understood what was going on. He was one of those '*few men in a million*' that John Maynard Keynes wrote about[49] who could actually diagnose what was happening to his economy. Mahathir was adamant about solving Malaysia's economic woes. For the preceding decade prior to 1997, the Malaysian economy had been growing at 8 -10 percent annually. Then the value of the ringgit dropped sharply. By the end of 1997, it was 35 percent below its value of 12 months earlier. The stock market in Kuala Lumpur plummeted and the country's economy experienced a drastic contraction. Investment and private consumption also dropped sharply resulting in increased unemployment. The economy went from 8 percent plus growth to contraction in the space of six weeks[50].

In some respects the Malaysian solution followed what other countries did. In an attempt to prevent the ringgit collapsing completely, the central bank put interest rates up sharply to persuade foreign and local investors to hold on to the national currency. But what made the

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[48] Asian Economic News (1998) APEC leaders want disclosure from hedge funds, *Kyodo News International, Inc.*, 23rd November 1998. Available at: http://findarticles.com/p/articles/mi_m0WDP/is_1998_Nov_23.

[49] Keynes, J. M. (1919) *The Economic Consequences of Peace*, Harcourt, Brace, and Howe, Inc., New York, Chapter 6, paragraph VI.14.

[50] Mahathir, M. (1998) *Mid-Term Review of the Seventh Malaysia Plan,* Pelan Pemulihan Ekonomi Negara, Malaysia, opening note.

difference between the recovery times of Malaysia and the other Asian Tigers; Thailand, South Korea, Indonesia and the Philippines, was that Mahathir did not seek financial assistance from the International Monetary Fund.

IMF loans invariably come with conditions which Mahathir wished to avoid. This meant Malaysia was free to choose its own economic policies to handle the crisis. Void of having to follow the IMF conditions, in 1998 Malaysia imposed controls on capital account transactions, pegged its currency to the US dollar, cut interest rates and reflated its economy[51]. Malaysia also introduced new controls on currency trading[52]. Foreign investors were told they would have to keep their money in Malaysia for at least a year. All ringgit held abroad would have to be returned within a month and tight restrictions were imposed on the amount of currency Malaysians could take out of the country. Mahathir affectionately called this his 'Sinatra Principle' ~ he cured the Malaysian economy 'his way' by ignoring IMF directives, taking control of his economy and restricting speculative capital flows. Because Dr Mahathir could diagnose the problem and successfully find a cure, it is perhaps fitting to read what he said on the subject.

> Even George Soros who had condemned Malaysia and its leadership for singling out the currency traders as the culprits responsible for devaluing currencies and damaging the economies of countries, now admits that Malaysia had done the right thing in not submitting to the IMF and the standard formula that it prescribed for all economic ailments.
>
> Strangely enough Soros … has actually agreed that currency trading needs to be regulated, that the market is imperfect and cannot be relied on to determine exchange

[51] Kamer, P.M. (2004) The role of capital account controls in developing countries: lessons from Malaysia, *Journal of Cross Cultural Management*, Barmarick Publications, Vol. 11, No. 4, at p 91.

[52] Mahathir, M. (2000) How trading in the ringgit was stopped, *New Straits Times*, 25th August 2000, p 14, continued through to p 19 'Confidence has returned and People have money to spend once again'.

rates. But the IMF and the economically and financially powerful countries of the West are still adamant that the freedom to trade in currency must be maintained.

Freedom is sacred and must in no way be curbed. It is an article of faith that must never be questioned. There can be no doubt that currency trading had caused terrible damage to the economies of countries whose currencies were devalued by the traders. In several instances, the financial and economic turmoil due to devaluation was accompanied by massive unemployment, shortages of food and fuel, demonstrations, riots, the burning of business premises, looting, rape and murder.

Still the currency traders are not blamed for the damage done to these economic tigers. The blame is put squarely on the shoulders of the Governments. They are accused of corruption, of cronyism and nepotism, of lack of transparency and generally of bad governance.

For as long as there is this refusal to admit that it was currency trading and the greed of the currency traders which caused the unnecessary destruction of the economies of many countries, for so long will the damage continue to be done …

There is no hope that currency trading will be banned or even curbed any time soon. Too many influential people are making too much money from it. That the currency is coming from the misery of poor people in poor countries is just unfortunate.

The currency crisis is an unnecessary crisis and need not have happened if the objective of the international financial system is really to facilitate trade and other economic interactions between nations, including foreign direct investments.

But the big capitalist powers want more than that. They want to promote their political agenda as well, and it is because of this political agenda that the international financial system not only permitted but at times even encouraged currency trading, a totally unnecessary activity, which destroys more wealth that it creates[53].

[53] *Id.*

Despite the passion behind Mahathir's 'Sinatra Principle' his actions proved correct; the quantitative studies that support his position are outlined below in section 2.10.

The detrimental effects of hedge fund activities were also highlighted by Hong Kong's chief executive Tung Chee Hwa. He told a post-Summit press conference that these funds: 'have caused so much damage to the economies of the region' and that there was a need for greater accountability[54]. He said Hong Kong wholeheartedly supported ongoing international efforts to strengthen prudential supervision on international lending to leveraged funds and to enforce higher standards of transparency and disclosure.

Mahathir found support from several countries including China, Mexico, Chile and Peru, but other countries like the US, South Korea and Australia expressed opposition to market regulation and wanted to preserve the unrestricted flow of capital for all kinds of investors. Those countries argued that regulation of short-term capital flows could prevent long-term capital flows as well. Needless to say it was impossible to forge consensus. The trouble, as chairman of China Trust Commercial Bank of Taiwan, Jeffrey Koo said, APEC is not equipped to deal with international financial issues and could not implement concrete action to tackle the region's crisis. Mr Koo's statement more or less reinforced the fact that the IMF and the US were in charge of the IMS and would continue to prescribe the terms for international finance.

Although the APEC leaders could not reach agreement on global currency regulation, the Summit's *Declaration of Recommendations* called for a task force to examine transparency and disclosure standards of private financial institutions to strengthen the global financial

[54] Khor, M. (1998) APEC meetings end with call for hedge funds review, *SUN - South-North Development Monitor*, 20th November 1998, Third World Network, Penang Malaysia.

system. This, like Malaysia's previous request to the IMF to conduct a study on hedge funds did not lead to any concrete action. Thus the countries which were on the receiving end of the speculative attacks and wanted assistance from the bodies with greater control of the IMS were ignored. At face value, it appears that the interests of the controlling entities were at odds with the general desire for international financial stability.

The IMF viewed Malaysia's controls as having had a broadly neutral effect [55] but Krugman (1998)[56] and Rogoff (2002)[57] extolled the benefits of restrictions as a temporarily measure to avoid major capital flight in times of financial crisis; this, they believed, could divert the composition of capital flows toward long-term foreign direct investment (FDI). Kaplan and Rodrik (2001) compared economic variables in Malaysia with those in Korea and Thailand which undertook the IMF programs. They found that the Malaysian-control policies produced faster economic recovery, smaller declines in employment and real wages, plus a faster rebound in the stock market[58]. Kaplan and Rodrik maintained that the controls were very effective, but they acknowledged that they could not entirely dismiss the possibility of a correlation between the effects of the controls and the external economic environment.

Ostry, Ghosh, Habermeier et al (2010) write that many emerging market economies are concerned that the surge in capital inflows could cause problems for their economies. The flows are generally perceived to be temporary, reflecting interest rate differentials which are

[55] Otker-Robe, I. (2000) Malaysia's experience with capital controls, in IMF's Occasional Paper Series No. 190, *Capital Controls: Country Experiences with Their Use and Liberalisation*, Appendix III.

[56] Krugman, P. (1998) Malaysia's Opportunity, *Far Eastern Economic Review*, Vol. 161, No. 38, p 32-33.

[57] Rogoff, K. (2002) Straight talk - rethinking capital controls: When should we keep an open mind?, *Finance and Development*, Vol. 39.

[58] Kaplan, E. and Rodrik, D. (2001) Did the Malaysian Capital Controls Work?, *National Bureau of Economic Research*, Working Paper No. 8142.

partially reversed when interest rates in advanced economies rise. They recognise massive inflows can lead to exchange rate overshooting or inflate asset prices. 'From an individual-country point of view, the usual elements of the toolkit to manage inflows include currency appreciation, reserves accumulation, adjustments in fiscal and monetary policy, and strengthening the prudential framework'[59]. However, they go on to say there is no certain 'one-size-fits-all way' to deal with the impact of potentially destabilising short-term capital flows. They warn that: 'capital controls are a legitimate part of the toolkit to manage capital inflows in certain circumstances, but that a decision on their use should reflect a comparison of the distortions and implementation costs that they may impose'[60]. They say there is a need for a regular re-assessment to ensure that capital controls remain the appropriate response and that any use of those controls should internalise the systemic dangers that could result from widespread adoption by a large number of countries.

Jongwanich (2010) examined capital flows in the developing regions of Asia focusing on their responses to the 2008 global financial crises. He discovered portfolio investments and bank loans (both short-term inflows and outflows) were more prone to the financial crises than long-term foreign direct investment. His analysis showed that speculative flows from G3 countries were crucial in affecting portfolio investment and bank loans which resulted in significant pullbacks of short-term capital[61]. Jongwanich's study also demonstrated the positive impact of a strong savings ethic within Asia. Those basic fundamentals helped the region successfully manage most of the adverse effects of the GFC. The correlation between

[59] Ostry J, Ghosh A, Habermeier K, Chamon M, Qureshi M and Reinhardt D (2010) *Capital Inflows: The Role of Controls*, International Monetary Fund Staff Position Note, SPN/10/04. Washington, DC. p 4.

[60] *Ibid*. p 15.

[61] Jongwanich, J. (2010) Capital mobility in developing Asia: how does it respond to the financial crises?, *ASEAN Economic Bulletin*, Vol. 27, No.1, p 27-56.

capital flows and savings in the region highlighted the shifting composition of long and short-term capital movements: this he says has policy implications that will need to be considered to shape developing financial markets. Although foreign direct investment showed an increased trend during the Asian meltdown as multi-national corporations bought up cheap Asian stock, it showed a declining trend during the GFC as investors pulled back their money to the safe haven of their home economy. The one key feature that Jongwanich drew from the Asian meltdown and the GFC was that long term FDI tended to be more resilient to the economic shocks than short-term capital flows. This supports previous findings that short term SCF create volatility compared to long term FDI which has a more stabilising effect.

2.9 An Australian Perspective

Grenville (1999) reported on some of the negative effects exchange rate speculation had had on the Australian economy[62]. He described the tactics that had been employed by speculators to damage the value of the Australian dollar. The Deputy Governor of the Reserve Bank of Australia speaking of overshooting said:

> … the episode (coinciding with the Asian crisis), saw a variant on the overshooting theme. That is, speculators who believe that they could make money by attacking an exchange rate which has already overshot, so that it overshoots even further. The tactic is straightforward enough, simply take a short position[63] in the currency which is already a bit undervalued, and then, by a mixture of highly public additional short selling and vigorous orchestration of market and press opinion, get the exchange rate to move down quite a bit further. As it does, a bandwagon forms, with market players

[62] Grenville, S. (1999) *International Capital Mobility and Domestic Economic Stability*, Reserve Bank of Australia Deputy Governor's address to The Reinventing Bretton Woods Committee Conference, Canberra, 15th July 1999.

[63] A short position is one in which the speculator borrows or sells forward, a foreign currency with the anticipation of purchasing it at a future lower price to repay the foreign-exchange loan or fulfil the forward sale contract. In other words, they are agreeing to commit to something that they do not presently have, but hopefully will be able to make a profit on, provided the future sale / purchase price is more favourable than the cost of the transaction.

> anxious to sell the currency as it becomes cheaper, in the belief that it will become cheaper still. As the herd moves in, the original speculators can square up their position, at a profit.
>
> This is the world that we saw in operation in the middle of 1998 …
>
> The most disturbing element of this is that it was part of a concerted effort at market destabilisation. Some of the players themselves told us, at the time, that their objective was to push down the Japanese yen to the stage where the Chinese renminbi was under irresistible pressure to devalue, which would have broken the Hong Kong dollar peg. The Australian dollar was a minor secondary target – collateral damage – for these Masters of the Universe ...
>
> … we carry from this experience a strong viewpoint into the debate on international financial architecture concerning the hedge funds (or, as they are known in that context, the 'highly leveraged institutions'). There are those who deny, even now, that the hedge funds played any significant role. For these pundits, it may be enough simply to observe that the hedge funds[64] themselves do not deny their actions …[65].

The movement of exchange rate values through the 1997-1999 period, including large currencies such as the yen, provided more evidence that hedging was being played out in the global market with some drastic results. As the hedge funds cut their short positions in yen to cover their losses in the Russian rouble, the yen fell 11 percent in a week[66], driven by events totally unrelated to any Japanese internal influence or adjustments to economic fundamentals.

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[64] US Fund Manager George Soros wrote a best-selling book about the existence and benefits of Hedging. Soros, G. (1998) *The Crisis of Global Capitalism*, Little, Brown and Company (UK), London.

[65] Grenville, S. (1999) *Supra.*

[66] See Reserve Bank of Australia's Exchange rate data base, www.rba.gov.au for the first week October 1998.

Hong Kong, South Africa, South Korea, Indonesia and Thailand experienced similar stories. These currencies were systematically attacked, all suffered depreciation which basically resulted in: lower purchasing power in the global market; increased cost of any foreign debt; a shift in the national community indifference curve; and ultimately, a drop in national utility[67]. In view of the pivotal role that exchange rate misalignments have assumed in explaining the uneven development performance of various countries, Yotopoulos and Sawada (2005) wrote: 'It is now widely accepted that the chronic misalignment in the real exchange rate has been a major source of slow growth'[68]. But that level of understanding in relation to the negative effects of capital movements is relatively new.

2.10 Quantitative Studies

Ohanian and Wright (2010) demonstrated that during the 'golden era' of international finance between 1880-1913, capital movements had a positive effect on economic growth for both supplying and receiving countries. The traditional expectation that capital flows from low to high return countries improved economic efficiency held firm. However Ohanian and Wright noticed that this trend broke down in the interwar period[69]. The beneficial expectation was further disproved as capital movements changed from long-term investments to short-term speculative flows. Gu and Sheng's (2010) study exposed the empirical invalidity of orthodox theory that capital freedom may benefit capital-exporting and capital-importing countries[70].

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[67] Microeconomic theory uses *utility* as a measure of satisfaction by a consumer. The higher the *utility* means the consumer is better off. Utility can be represented in graph form as an indifference curve for the individual or household. The further away the convex curve is from the X,Y origin, the higher the *utility* and the better off the consumer will be.

[68] Yotopoulos P. and Sawada Y. (2005) Exchange Rate Misalignment: A New test of Long-Run PPP Based on Cross-Country Data, *Applied Financial Economics*, Vol. 16, Issue 1 & 2 January 2006, p 127.

[69] Ohanian, L. and Wright, M. (2010) Capital flows and macroeconomic performance: lessons from the golden era of international finance, *American Economic Review*, Vol. 100, No.2, p 68.

[70] Xinhua Gu and Li Sheng, (2010) A sensible policy tool for Pareto improvement: capital controls, *Journal of World Trade*, Vol. 44, No.3, p567.

Their study examined how managed capital flows under government controls were superior to that of unregulated capital flows which led to market distortions.

Feldstein and Horioka (1980) found that countries' investment rates were highly correlated with their national savings rates. They also determined economies with low capital mobility had negative savings rates compared with positive saving rates for high capital mobility countries[71]. Typically, developing countries with financial openness had greater access to external capital markets for borrowings which in turn stimulated domestic investment and economic growth. Thirty years after Feldstein and Horioka's 1980 study, with the changing dynamics of speculative capital movements, Younasa and Nandwab (2010) argued that financial openness had weakened the correlation between domestic savings and investment. They say cross border movements of capital seek-out worldwide opportunities to earn higher returns; therefore domestic investment is largely financed by the pool of world capital rather than domestic savings[72].

It can be contended that liquidity and market uncertainty are two important reasons for currency values to deviate from the conventional interbank bid-ask spread. It has also been suggested that speculative behaviour is regarded to be the main factor that prevents exchange rates from reflecting their fundamental value. Neely (1997) argued that speculative forces can destabilise currencies and prevent them from reflecting a country's economic fundamentals[73]. However, Hutcheson's (2003) survey of Australian foreign exchange dealers found that

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[71] Feldstein, M. and Horioka, C. (1980) Domestic savings and international capital flows. *Economic Journal*, Vol. 90, p 314-329.

[72] Younasa, J. and Nandwab, B. (2010)Financial openness and capital mobility: a dynamic panel analysis, *International Review of Applied Economics*, Vol. 24, No. 2, p 239 – 246.

[73] Neely, C. (1997) Technical analysis in the foreign exchange market: a layman's guide, *Federal Reserve Bank of St. Louis Review*, September Issue, p 23-38.

respondents did not unanimously support speculation as a destabilising force. Her respondents agreed with the theoretical argument that exchange rate movements can be explained by changing economic fundamentals but that this explanation holds mainly over the longer term. In her survey, respondents believed speculation was seen to increase exchange rate volatility yet somehow improve market efficiency. Excessive intervention by central banks also received considerable support as a factor behind non-fundamental exchange rate movements. Although the respondents did not feel that speculative forces fully explained intra-day exchange rate movements, factors considered to have influence on movements in exchange rates were order placements by major investors and overreaction of market participants to events. Consequently, market forces in general have a broad influencing effect on currency values.

Respondents to Hutcheson's survey believed intervention by the Reserve Bank of Australia tended to successfully move exchange rates towards their fundamental value. She reported that after official announcements of Australian interest rates, dealers usually react within less than a minute to correctly price any anomalies into exchange rates. Of her respondents, 55.6 percent indicated that speculation mainly moves exchange rates towards their fundamental values while 44.4 percent indicated that speculation moves it away[74].

Hutcheson's results can be compared with the findings of Cheung and Wong (2000) who studied practitioners in the interbank foreign exchange markets in Hong Kong, Tokyo, and Singapore. In their study most respondents agreed that non-fundamental factors had a persuasive impact on short-run exchange rates. Speculation and central bank intervention were both believed to increase volatility but also improve market liquidity. Despite their

[74] Hutcheson, T. (2003) Exchange rate movements as explained by dealers, *Economic Society of Australia*, Economic Papers, Vol. 22.No. 3, p 35-47.

claim that intervention exacerbated volatility, more than half the respondents suggested official intervention helped restore equilibrium[75].

Cheung and Chinn (2001) surveyed US foreign exchange traders. Their findings indicated, *inter alia*, that: market norms are an important determinant of the interbank bid-ask spread and the most widely-cited reason for deviating from the conventional bid–ask spread is a thin/hectic market. They say news about macroeconomic variables is rapidly incorporated into exchange rates but economic fundamentals are perceived to be more important at longer horizons, while short-run deviations from the fundamentals are attributed to excess speculation and institutional customer/hedge fund manipulation. Cheung and Chinn's survey reported speculation is generally viewed positively by market traders even though it exacerbates volatility[76].

In economies with floating exchange rates, capital controls were often imposed to protect the stability of the financial system. They could also reduce shocks to aggregate demand arising from the overcorrecting of real exchange rates plus offset the institutional bias in favour of debt finance. Edwards (1999) characterised capital controls as being commonly applied in three possible situations. Firstly, capital controls can be applied over a long period in order to discourage inflows, usually by discouraging short-term borrowing from overseas. Secondly, capital controls can be applied in order to prevent outflows from an economy before an

[75] Cheung, Y-W. and Wong, C.Y-P. (2000) A survey of market practitioners' views on exchange rate dynamics, *Journal of International Economics*, Vol. 51, p 401-419.

[76] Cheung,Y-W. and Chinn, M. (2001) Currency traders and exchange rate dynamics: a survey of the US market, *Journal of International Money and Finance*, Vol. 20, p 439–471.

exchange rate crisis eventuates. Thirdly, capital controls can be applied to limit further outflows of capital after a speculative attack on the exchange rate has already occurred[77].

Applegate (2003) recognised that the imposition of controls on capital flows has the potential to impose several well-known costs on an economy. The most important of these costs is a trend reduction in the rate of growth resulting from higher local interest rates. Also capital controls can reduce a country's ability to smooth their consumption through adjustments in the current account. The country's residents would be less able to diversify their investment portfolios internationally or to make use of exchange rate futures and swap markets[78]. He said moderate controls on capital flows tend not to be able to prevent exchange rate speculation from occurring. China and India both had systems of relatively strict invoice-based capital controls that were effective in closing avenues for exchange rate speculation. He found that if countries were inclined to prevent exchange rate speculation, then strict controls should be maintained but as he noted with China and India, strict controls could lead to a possible refusal by foreigners to roll over their loans or reduce portfolio equity investment.

Glick and Hutchison (2000) conducted an empirical investigation to determine whether or not countries that had imposed capital controls had a lower chance of experiencing an exchange rate crisis. They found no evidence that countries with capital controls experienced fewer exchange rate crises[79]. However they did not differentiate between the different types of capital controls nor did they make allowances for the possibility that fixed exchange rate

[77] Edwards, S. (1999) How effective are capital controls?, *Journal of Economic Perspectives*, Vol. 13, No. 4, p 65-84.

[78] Applegate, C. (2003) Capital controls as a means of minimising speculative bubbles in real exchange rates, *Economic Society of Australia*, Economic Papers No. 22.3, p 47-60.

[79] Glick, R. and Hutchison, M. (2000) Capital controls and Exchange Rate Instability in Developing Countries, *Federal Reserve Bank of San Francisco Pacific Basin Working Paper Series* No. PB000-05 December.

regimes would be more prone to crises and therefore more likely to implement controls on capital flows.

van Wijnbergen (1990) observed that rapid trade liberalisation is often followed by a decline in private savings. His study identified how trade policy uncertainty could reduce savings but that if countries held reserves of foreign currency, it gave them an insurance policy or buffer to use those reserves if necessary for servicing debt during financial turmoil[80]. The sovereign liquidity helps cope with uncertain income streams and cash flows but while it is sitting idle waiting to be used in a financial crisis, it does not actively benefit the economy.

Younasa and Nandwab (2010) used Chinn and Ito's (2008) financial openness index[81] to examine the impact of financial market liberalisation on the degree of capital mobility in 104 countries. Even though its effect was statistically insignificant in OECD countries, they found that financial openness increased capital mobility in developing countries while simultaneously supplementing domestic savings.

Choi, Sharma and Stromqvist (2009) found something similar when they examined the link between net capital flows and international reserves. They found that the effects of net capital flows on reserve accumulation had shifted from negative to positive for emerging markets but not so for advanced countries[82]. With concerns about sudden stops in capital flows, emerging

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[80] van Wijnbergen, S. (1990)Trade Reform, Policy Uncertainty and the Current Account: A Non-Expected Utility Approach, *Centre for Economic Policy Research*, Discussion Paper 441.

[81] Chinn, M. and Ito, H. (2008) A New Measure of Financial Openness, *Journal of Comparative Policy Analysis*, Vol. 10, No.3, p 309 – 322.

[82] Choi, W-G., Sharma, S. and Stromqvist, M. (2009) Net capital flows, financial integration, and international reserve holdings: the recent experience of emerging markets and advanced economies, *IMF Staff Papers*, Vol. 56. No. 3, p 516 -541.

markets had rapidly built up reserves through external financing and net capital inflows. Considering the lessons learnt from the Asian meltdown, in the following decade many emerging economies built up their foreign reserves through disciplined savings habits and mild capital controls which positioned them favourably through the GFC.

Obstfeld (1998) argued that monetary policy is powerless to achieve a domestic goal when the exchange rate is fixed and capital movements are free[83]. He termed this phenomenon as an economic 'trilemma' to describe the reality that an open capital market deprives a country's government of its ability to target its exchange rate and use monetary policy at the same time in pursuit of other economic objectives. Hence we start to see the confusion between choosing a monetary regime that maintains monetary sovereignty and one that is subservient to the free market.

Kant (2005) studied the mobility of capital by examining savings–investment correlations, real interest rates differentials, covered and uncovered interest parity, and equity home bias. He examined the returns/flows relationship for all major components of capital. He used those indicators to indirectly reflect capital mobility by testing the return/total flow specification of the Mundell–Fleming model. Kant found that while portfolio equity and debt flows were statistically affected by capital mobility, direct foreign investment was not. Convincingly, the inclusion of direct investment made the aggregate-capital variable unresponsive to interest rates across all indicators. From those findings Kant determined that countries could have independent monetary policies with full capital mobility[84]. This finding

[83] Obstfeld, M. (1998) The global capital market: Benefactor or menace?, *Journal Economic Perspectives*, Vol. 12, p 9-30.

[84] Kant, C. (2005) Capital mobility among advanced countries, *Journal of Policy Modelling,* Vol. 27, No. 9, p 1067-1081.

however did not consider the 'impossible trinity' view[85], that an economy can only have two of the following options: either an independent monetary policy, a fixed exchange rate or capital account openness. Kant's out-come could only work if the economy operated under fully-floating exchange rates. If that occurred, speculative capital movements would have to be factored into the equation. But as other studies have since determined[86], there are contradicting effects between long-term FDI and short-term SCF. Kant's study confirmed, foreign direct investment does not have a statistically significant bearing on a country's interest rate or contribute to currency volatility but he did not investigate the effects of short-term speculative capital flows.

Warnock and Warnock (2009) on the other hand demonstrated how foreign purchases of US government bonds had an economically large and statistically significant impact on long-term interest rates. While the dramatic reductions in both long-term inflation expectations and the volatility of currency rates contributed much to the decline of interest rates in the 1990s, more recent foreign flows have become important. They estimate that without the substantial foreign inflows into US government bonds, the 10-year Treasury yield would be about 80 basis points higher[87]. This means that foreign inflows kept US interest rates lower than what would have perhaps been suitable to limit over-generous lending practices that produced run-a-way domestic spending in the lead-up to the GFC.

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[85] Apart from Obstfeld (1998) cited above, see also Robert McCauley (2001) Setting Monetary Policy in East Asia, paper in the Reserve Bank of Australia's conference *Future Directions for Monetary Policies in East Asia*, held at the H.C. Coombs Centre for Financial Studies, Kirribilli, NSW, 24th July 2001, at p 29.

[86] Choi, Sharma and Stromqvist (2009), Younasa and Nandwab (2010), Jongwanich (2010).

[87] Warnock, F. and Cacdac-Warnock, V. (2009) International capital flows and U.S. interest rates, *Journal of International Money and Finance*, Vol. 28, No.6, p 903-920.

Cohan and Rangan (2010) report how speculative capital flows are creating both unexpected business opportunities and threats that chief executive officers and chief financial officers should be addressing to protect their businesses. They say that executives should familiarise themselves with capital flows and the 'Entrepreneurial Ecosystem' to identify emerging trends that will shape the value of their enterprises. Companies may need to change their strategies when expanding abroad to comply with foreign government regulations or to capitalise on emerging market opportunities. They say: 'While capital inflows to a growing market can create opportunities, they can also strengthen competitors'[88]. Key aspects such as corporate governance, capital raising, financial management and intellectual property can all be distorted by the effects of SCF.

Frankel (2005) said many of the currency and financial crises over previous decades were associated with the contractionary effects of currency depreciation and substantial output losses[89]. Aizenman and Marion (2004) recognised that after the Asian meltdown, emerging markets reduced short-term external debt and stockpiled reserves to minimise their vulnerability to future crises[90]. Choi, Sharma and Stromqvist (2009) reported that at the end of 2005, the average reserves-to-GDP ratio reached 19 percent in emerging markets, compared with a ratio of only 10 percent in the advanced countries. They say with increasing financial liberalisation and openness to cross-border transactions, managing a country's liquid assets to facilitate current and future international transactions will become a key

[88] Cohan, P. and Rangan, U. (2010) Global capital flow creates opportunities, *Financial Executive International*, Vol. 26. No.5, p 52.

[89] Frankel, J. (2005) On the Renminbi: The Choice between Adjustment under a Fixed Exchange Rate and Adjustment under a Flexible Rate, *National Bureau of Economic Research*, Working Paper No. 11274.

[90] Aizenman, J., and Marion, N. (2003) The High Demand for International Reserves in the Far East: What Is Going On?, *Japanese and International Economics*, Vol. 17, p 370 - 400.

element in macroeconomic management. Similar to Aizenman and Marion (2004), Choi et al. (2009) also observed that countries which were vulnerable to contagion accumulated reserves to cushion their economies to external economic shocks.

Choi, Sharma and Stromqvist (2009) explain:

> With increasing financial integration, and greater exposure and dependence on international capital, sovereign liquidity management has become crucial for macroeconomic stability. The fact that more capital does not flow from rich to poor countries might be substantially attributable to credit-market imperfections. For the high-growth emerging markets, the paucity of capital has been ameliorated by financial globalisation. Nonetheless, emerging markets may take advantage of the wave of capital inflows to stockpile reserves, as in other times external financing may be expensive ... With increased capital and financial account transactions, the risk of capital flow reversals … can result in huge output losses …[91]

Because sovereign liquidity shortages may lead to expensive borrowings or a forced reduction in consumption and investment, smaller economies have an incentive to fend off the risk of binding liquidity constraints by hoarding reserves ~ a phenomenon that was typical throughout Asia after the Asian meltdown. In contrast, advanced economies, given their better access to international capital markets, have not shown this pattern. Although holding large reserves could be perceived as costly, the actual cost could be small relative to the economic and social cost of a crisis. Choi et al. (2009) say an important issue in the context of global financial stability is how to calculate reserve levels and put the savings to better use without compromising financial security. They conclude:

> Arrangements among central banks for liquidity risk sharing (for example, through reserve pooling and currency swaps) and better access to international financial

[91] Choi, W-G., Sharma, S. and Stromqvist, M. (2009) Net capital flows, financial integration, and international reserve holdings: the recent experience of emerging markets and advanced economies, *IMF Staff Papers*, Vol. 56, No. 3, p 516 -541.

markets will help improve sovereign liquidity management in the face of potentially volatile capital flows. As emerging markets mature, they will probably have smaller reserve cushions and prefer to hold a larger proportion of their foreign assets in higher return investments. The increasing creation of sovereign wealth funds is already leading to a move in this direction, and the adoption of investment and operational norms for such funds could accelerate the process[92].

Using micro-level panel data, Demir (2009) analysed the impacts of speculative capital flow volatility on investment spending of publicly traded firms in the emerging markets of Argentina, Mexico and Turkey. His empirical study using sensitivity tests, found that increasing volatility of capital inflows had an economically and statistically significant negative effect on new investment spending in private firms. Typically, a 10 percent increase in capital flow volatility reduced fixed investment spending in the range of 1-1.7, 2.15-2.3, and 1 percent respectively[93].

Wright (2006) sought to discover the effects of emerging market capital flows toward private sector borrowers. He wanted to investigate whether those flows led to more efficient outcomes and whether capital controls could improve welfare. Wright concluded that the answers depend on the form of default risk. If cross-border private loans were not enforceable, borrowing could be potentially inefficient, in that instance, capital controls could be potentially Pareto-improving. If there was a risk that the government might default on behalf of all residents, capital flow subsidies might be needed for a Pareto-improvement[94]. What was important to recognise from Wright's study was the fact that capital controls are an

[92] Choi et al. (2009) p 539.

[93] Demir, F. (2009) Volatility of short-term capital flows and private investment in emerging markets, *Journal of Development Studies*, Vol. 45, No.5, p 672 -693.

[94] Wright, M. (2006) Private capital flows, capital controls, and default risk, *Journal of International Economics*, Vol. 69, No.1, p 120-150.

effective tool, which if used properly, can lead to Pareto-improvements and increased welfare.

Edwards (1998) presented an analysis of the interaction between capital flows and real exchange rates in Chile. Using vector auto-regression analysis, he compared the structural change of interest rates between the restrictive periods and other periods with no controls[95]. Also focusing on Chile, Laurence and Cardoso (1998) and Valdes-Prieto and Soto (1998)[96] constructed indexes of restriction levels and estimated the effectiveness of the capital controls. In the case of asymmetric information in capital markets, Laurence and Cardoso (1998) suggest that capital account restrictions can be welfare improving by adjusting for financial market imperfections[97]. All three studies maintained that government controls led to a decline in short-term speculative capital inflows.

Chung (2002) analysed government controls of international capital flows using South Korean data. Based on documented policy changes made by the South Korean government, he constructed indexes of liberalisations to measure the effects of controls on capital inflows and outflows. He used vector auto-regression models to examine capital flows and other macroeconomic variables. He found that capital inflows increased persistently after adjustments to liberalisation policies while capital outflows increased only temporally. He also found that shocks to liberalisation of capital outflows attracted capital inflows, a result explicable by two competing theories; one that it signals more friendly government policy for

[95] Edwards, S. (1998) Capital flows, real exchange rates, and capital controls: some Latin American experiences, *National Bureau of Economic Research*, Working Paper No. 6800.

[96] Valdes-Prieto, S. and Soto, M. (1998) The Effectiveness of Capital Controls: Theory and Evidence from Chile, *Social Science Research Network*, Working Paper No. 92192.

[97] Laurence, B. and Cardoso, J. (1998) Managing capital flows: Lessons from the experience of Chile. *IMF Working Paper*, WP/98/168.

the future and two, liberalisation of capital outflows removes investment irreversibility[98]. The favourable conditions could help attract foreign investment.

Eichengreen and Leblang (2002) suggest that capital account liberalisation is neither a plague nor a panacea and that the net effect of capital controls is context specific: it is positive in periods of financial instability, when the insulating capacity of controls is precious, but negative when crises are absent. They acknowledged that controls influence macroeconomic performance through two channels, directly ~ what they thought of as positive impacts on resource allocation and efficiency ~ and indirectly by limiting the disruptive effects of crises at home and abroad. They say because these influences work in opposite directions, it is not surprising that studies have been unable to agree whether the effect of controls tilts one way or the other. Ultimately, they found that the benefits are likely to dominate its costs when the domestic financial system is robust and the international financial system is not prone to costly and disruptive crises[99]. Typically it is not a situation that prevails in the real world; not all economies are robust and financial crises persist.

Goh (2005) investigated whether the Malaysian capital controls imposed during the Asian meltdown were effective in reducing short-term capital flows. His analysis employed regressions using dummy variables and constructed a profit rate differential index as an independent variable. The regression results pointed out that gross capital flows and net capital inflows fluctuated in tandem with the content of controls but that the flows were

[98] Chung, J-H.(2002) An empirical analysis on government capital controls and international capital flows in Korea, *Applied Economics Letters*, Vol. 9, No. 14, p 919 – 923.

[99] Eichengreen, B. and Leblang, D. (2002) Capital account liberalisation and growth: was Mr. Mahathir Right?, *National Bureau of Economic Research*, Working Paper No. 9427.

dependent on profit differentials of securities[100]. That finding demonstrated that capital investments were affected by the 12-month waiting period rule which prevented foreign investors from selling their securities and withdrawing their money from the Malaysian economy. Goh (2005) determined that the Malaysian government's strategy enabled it to partially control gross capital flows of foreign investment but that those controls also decreased net capital flows even after the controls were relaxed.

Reinhart and Magud (2006) observed that there was no unified theoretical framework to analyse the macroeconomic consequences of controls and that empirical studies had lacked a common methodology. They identified another problem with the study of measuring capital controls; that being there are multiple definitions of what constitutes 'success'. They attempted to standardise a methodology by constructing two indices of capital controls: the Capital Controls Effectiveness Index, and the Weighted Capital Control Effectiveness Index. While they acknowledged that capital controls had partially achieved their objectives in Chile and Malaysia, they looked for less well known instances where controls did not reflect the same level of success. Their results were without definitive conclusions because Chile and Malaysia had significantly 'overweighted' the case for success[101].

Law (2009) examined the effects of trade openness and capital flows on financial development among a group of developing countries. He found that trade openness and capital flows are statistically significant determinants of banking sector development in

[100] Goh, S-H. (2005) New empirical evidence on the effects of capital controls on composition of capital flows in Malaysia, *Applied Economics*, Vol. 37, No. 13, p 1491 – 1503.

[101] Reinhart, C. and Magud, N. (2006) Capital Controls: An Evaluation, *National Bureau of Economic Research*, Working Paper No. W11973. Like Rudi Dornbusch, Nicolas Magud also worked for the IMF. It seems to be an agenda within the IMF to play-down the significance of successful capital controls because those policies do not fit with the IMF mandate.

developing countries, particularly private sector credit. He says openness can weaken the political power of entrenched business interests that might otherwise block institutional reforms. Banks will be more likely to support reforms that promote a deeper and more efficient financial system since they need greater access to external sources of capital. Even though Law's empirical findings indicate that openness in terms of trade and capital accounts leads to financial development, the level of openness in developing countries is highly conditional on a country's pre-existing circumstances[102]. But before removing all trade and capital barriers, he suggests some characteristics ~ such as a stable macroeconomic policy, credible government policies, strong domestic financial systems, reliable legal institutions and well-defined property rights ~ should be fulfilled first in order to minimise costs and maximise social and economic benefits.

Kim (2010) reviewed South Korea's financial system in the wake of the global financial crisis. During the crisis, the South Korean won depreciated much more than other East Asia currencies. His study revealed that the liberalisation of financial markets policy drastically increased the short-term debt exposure in foreign currency. Encouraging the participation of foreign investors was a quick way to jump-start the Korean bond markets but the rapid flow of out-bound capital during the crisis devalued the won with astonishing speed. He provided evidence from Taiwan and Singapore on how varying policy environments helped those countries weather the GFC much better than South Korea. Taiwan's controlled opening of its financial market along with conservative monetary policy helped to reduce the volatility in its exchange rate. Singapore, with wide-open financial markets, was able to maintain a stable macroeconomic environment with its careful monetary policy focused on exchange rate targeting.

[102] Law, S-H. (2009) Trade Openness, Capital Flows and Financial Development in Developing Economies, *International Economic Journal*, Vol. 23, No. 3, p 409 – 426.

Kim (2010) says it is important to remember that sound and conservative management cannot be overemphasised as an essential ingredient for economic stability[103] but as the GFC demonstrated, economic mismanagement in one country can spill over into the global economy very quickly. While individual countries may implement strategies to deal with financial management issues stemming from within their own sphere of influence, when the problem is global they are often instructed towards following IMF directives which are not always correct. Kamer (2004) explains: 'The undue hardships imposed by the IMF regime suggest that it is time to re-evaluate the role of currency controls in mitigating the destabilising effects of unfettered capital flows' [104].

Bird and Rowlands (2008) found that the effects of IMF programs on bond-related flows were not representative of capital flows in general. Evidence of negative effects was discovered for some types of private capital flows. They found that the IMF's catalytic effect on an economy ~ brought on by its structural adjustment programs ~ was either insignificant or even negative. If their findings are correct, it means that the IMF has been ineffective in its management stabilisation techniques. They suggested that understanding the catalyzing role of the IMF more fully should have an important bearing on the broader issue of the effectiveness of the IMF as an international financial institution [105]. Such findings could also suggest that the IMF should limit its involvement in controlling national economies and concentrate more on the bigger picture, that of the efficient management of the international monetary and financial system by creating a robust environment for stable exchange rates.

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[103] Kim, Y. (2010) Controlling International Capital Flow: Emerging Economy Experiences, *Samsung Economic Research Institute Quarterly*, Vol. 3, No.3, p 51-65.

[104] Kamer, P.M. (2004) The role of capital account controls in developing countries: lessons from Malaysia, *Journal of Cross Cultural Management*, Barmarick Publications, Vol. 11, Issue 4, at p 91.

[105] Bird, G. and Rowlands, D. (2008) Catalysing private capital flows and IMF programs: some remaining questions, *Journal of Economic Policy Reform*, Vol. 11, No. 1, p 37 - 43.

It remains the case to this day that nothing has been done to correct this weakness in the international monetary and financial system. Later Chapters provide evidence of current policy agendas which helps explain why there has been no serious attempt to improve the system by those who exercise control over it. It is clear from the literature however, that there is ample political, professional and academic criticism abounding about the management of the IMS and the need to improve the efficiency of the present system. In particular the United Nations Conference on Trade and Development (2012) stated: 'misaligned exchange rates affect competitiveness positions and cause current account imbalances, which matter both at the regional and global levels… In general, exchange rate movements that are persistently inconsistent with achieving balanced global competitiveness positions provide strong evidence for the need to co-ordinate global currency markets'[106].

2.11 What the Literature Reveals

Having explained what speculative attacks are and the correlation between capital flows and currency values, the literature highlighted some of the implications of SCF on the global economy. The empirical studies demonstrate that speculative capital flows do have a significant negative impact on national economies; the effects of which may develop into a full-blown financial crisis. Generally, short term speculative flows exacerbate volatility in exchange rates whereas long term foreign investments do not. The increased volatility in exchange rates allows speculators to capitalise on extra profit opportunities, which in turn creates a self-perpetuating cycle of fluctuations. The quick turn-around in speculative capital does not provide long term liquidity to markets but rather siphons wealth from a targeted economy. Those fluctuations generate uncertainty in financial markets which produce economic inefficiencies. Additionally, the economic losses generated in one country by SCF

[106] United Nations Conference on Trade and Development (2012) *Development and Globalization: Facts and Figures 2012*,UNCTAD/WEB/GDS/DSI/2012/2 at p 36.

could have contagious flow-on effects to other nations thus compounding the problem in destabilising the global economy. Conclusively, there seems little benefit in allowing these destabilising capital flows to continue but no one has calculated the actual dollar value of the potential gains to be made by restricting those movements.

The literature also reveals how strict government controls on capital flows can have positive effects in maintaining economic stability within the national setting. Interestingly, none of the studies indicated with much certainty that the global financial system would be better off if speculative capital movements were eliminated altogether. But realising that inefficiencies do exist with the present arrangements, if we are to develop the full potential of a globalised financial system to benefit well-developed and underdeveloped economies alike, it becomes necessary to focus research into this important area of global financial governance. Henceforth this dissertation seeks both economic and legal remedies to solve the distortions attributable to speculative capital flows.

As part of the solution, international monetary law becomes the catalyst to initiate reform; subsequently this requires an examination and analysis of the legal framework of the IMS. It is through the process of combining economic evidence and legal reasoning that this thesis expands the existing body of knowledge and makes its contribution to help stabilise the global economy and promote efficiency.

However, in the global arena there are competing forces at play which are diametrically opposed. Notwithstanding the quantitative evidence that substantiates the use of capital controls to improve financial stability, there are some proponents who out-right reject the need to regulate or curtail speculative capital flows. The next Chapter presents the argument

in favour of free market speculation and analyses whether maintaining the current status quo is the logical proposition.

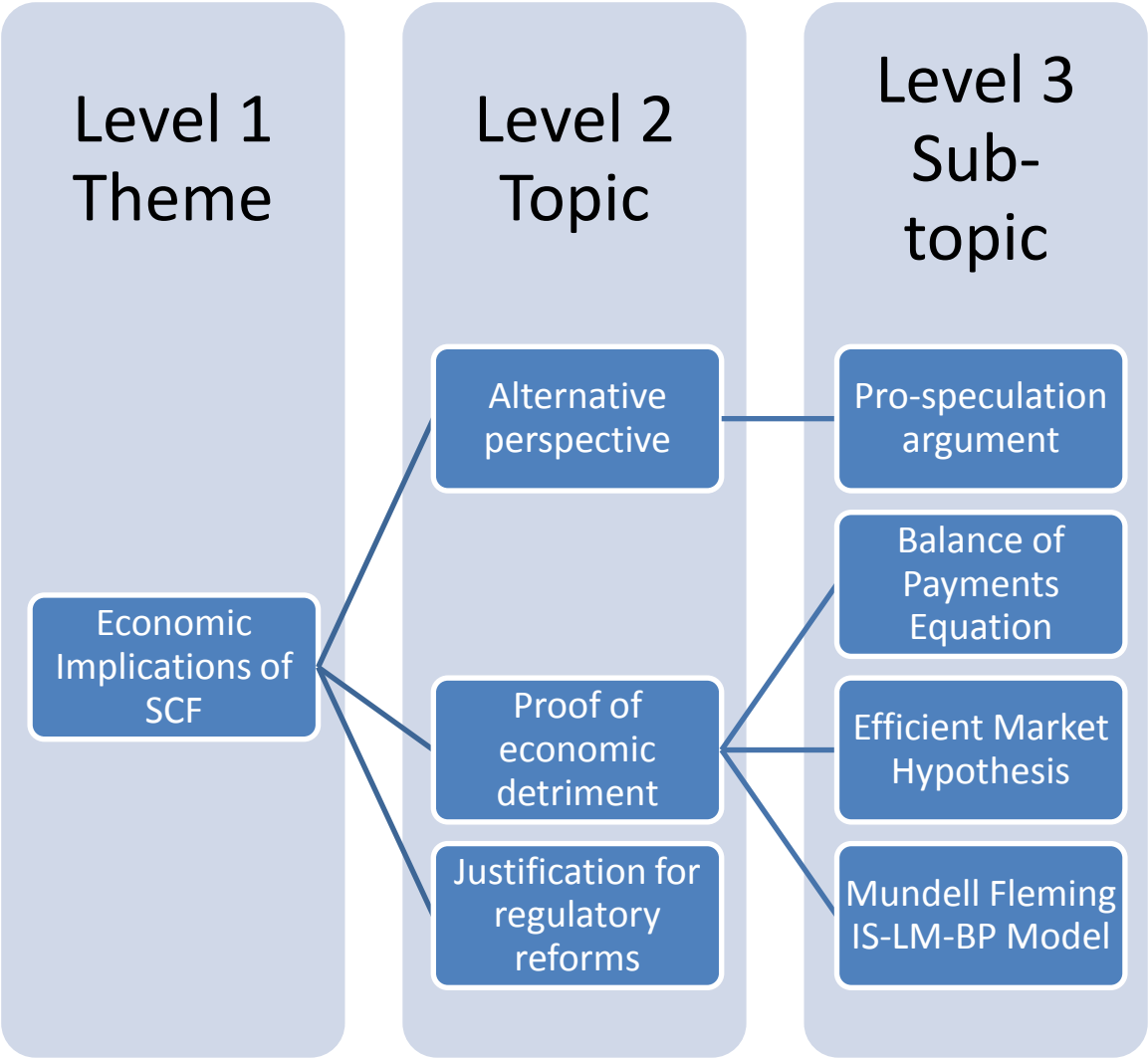
Summary of Chapter 2

This Chapter:

- identified the literature that would justify the reasons for undertaking this research
- provided a brief description of how foreign exchange trading operates and how that practice fits within the scope of the IMF *Articles of Agreement* and other laws
- described the implications of speculative currency attacks and ensuing financial crises
- presented evidence of the correlation between capital flows and volatile currency values
- provided examples of speculative capital flows relating to the Asian Meltdown of the late 1990s and the Australian experience
- reviewed the quantitative studies in relation to financial stability to reveal how speculative capital flows do have a significant negative impact on national economies
- supports the idea that capital controls would help reduce currency volatility therefore warranting research into what economic and legal solutions are available to address the thesis problem

Chapter 3

Do Speculative Capital Flows Enhance Economic Efficiency?



Chapter 3

Do Speculative Capital Flows Enhance Economic Efficiency?

Chapter Abstract

This Chapter: considers arguments for and against allowing un-restricted speculative activity in forex markets to continue; demonstrates the economic effects of that practice by using economic modelling; and justifies the need for reform. Despite the quantitative research presented in the Literature Review, there is a long-standing *laissez faire* tradition that speculation plays an important part in free market economies ~ to which governments should not interfere with. To promote the need for better regulatory controls over capital markets, this Chapter presents some historical facts to dispel the myth that SCF enhance economic efficiency. The economic realities of un-restricted capital movements are proven using the *Efficient Market Hypothesis*, the *Balance of Payments* (BOP) *Equation* and the *Mundell Fleming IS-LM-BP Model*.

The Efficient Market Hypothesis demonstrates that the currency market is clearly not efficient because it is always in a continuous self perpetuating cycle of volatile fluctuation. The BOP equation shows how an economy is affected by the exogenous forces of foreign currency values and the Mundell Fleming Model highlights how SCF can induce higher interest rates, lower output, lower income, less money in circulation and higher unemployment ~ plus the long term liabilities are increased for the entire nation.

The Chapter concludes that because it will help preserve national wealth and increase efficiency in the global economy, finding a way to minimise the negative effects of speculative capital flows ought to be a major priority for world leaders.

3.1 Perceived Realities

The January 2011 *Report* by the National Commission on the Causes of the Financial and Economic Crisis in the United States[1] found *inter alia*, that the financial crisis was avoidable; and widespread failures in financial regulation and supervision proved devastating to the stability of American financial markets. As we all know, that domestic failure proved contagious to the global economy, but in the wake of the financial tsunami and post crash analysis, the important issue of speculative capital flows (SCF) got overlooked.

From the stand point of *laissez faire* economics, the Austrian School of Economic thought, and anarcho-capitalism, there is a long standing belief that the free market is capable of managing itself and that intervention on the part of the State should be minimal and un-intrusive. Despite the havoc of the GFC, there are some people who believe speculation in all its forms is a necessary component for a well functioning economy and that risk takers should be entitled to play the market as they see fit without due regard to the economic hardship they may cause to other parties. While that may be a conceivable proposition with stocks and commodities, the trading of national currencies propels the argument into a much higher realm.

Speculative capital flows are phenomena which have managed to escape the regulatory radar for an unjustifiable amount of time[2]. Notwithstanding the fact that Brazil, China, Malaysia, India, South Korea *et al* have resorted to implementing capital controls to restrict 'hot

[1] National Commission on the Causes of the Financial and Economic Crisis in the United States (2011) *The Financial Crisis Inquiry Report*, US Government Printing Office, Washington, DC.

[2] George Soros outlined the weaknesses he saw in financial markets and the international monetary system over twenty years ago, yet nothing has been done to rectify any of the problems he identified. In the third edition of the *Alchemy of Finance*, Soros wrote: 'Exchange rate misalignments have become a major source of disruption for the world economy… speculation tends to exaggerate currency moves … the system of freely floating currencies is cumulatively destabilising'. Cf: Soros, G. (2003) *The Alchemy of Finance*, 3rd ed., John Wiley and Sons Inc., New Jersey, at p 337.

money' flowing in to and out of their economies, most Western economies have either carelessly or intentionally turned a blind-eye to the impact of SCF[3]. Hence, to improve financial stability and economic efficiency it becomes necessary to question whether SCF are economically efficient and beneficial to the global economy?

This chapter answers that question, by analysing the process of SCF within the international monetary market (IMM) and examining the effects that activity has on national economies and the international monetary and financial system (IMS). For methodology, it employs Eugene Fama's *Efficient Market Hypothesis* (EMH)[4] to demonstrate that the IMM is anything but efficient. It also uses the *Balance of Payments Equation* and the *Mundell Fleming IS-LM-BP Model* to highlight the negative effects of SCF on national economies. The chapter demonstrates how SCF have a tendency to syphon the wealth from a domestic economy and cause significant disruptions to the IMS.

Notwithstanding the obvious need for more regulatory controls in international financial markets, there are however, some market participants who strongly object to the idea of governments interfering with the speculators' rights to play the market. A long standing ideological belief exists that speculators play an indispensible role in the economy and therefore should not be restricted. This chapter explains why that ideological belief cannot be

[3] The reason that may be so is because the West is home to approximately 97 percent of all global hedge funds and has the largest dollar value of funds to put to work*; plus, ten Western banks account for nearly 80 percent of global turnover in foreign exchange markets**.

*Maslakovic, M. (2009) *Hedge Funds*, International Financial Services London (IFSL) Research. Available at: www.ifsl.ogr.uk

**Theweekly FiX (2010) *FX Poll 2010*: The Euromoney FX survey. Available at: http://www.reuters.com/article/idUSLDE6460UN20100507.

[4] Fama, E. (1965) The Behaviour of Stock Market Prices, *Journal of Business*, Vol. 38, No.1, p 34–105.

maintained with respect to the smooth functioning of the IMM. It disproves the myth that speculative capital flows are economically efficient and beneficial to the global economy.

3.2 A Long-Standing Belief about Free Market Speculation

In *The Theory of Money and Credit* Austrian School economist Ludwig von Mises (1912) promoted the virtues of free market speculation by saying:

> Speculation does not determine prices; it has to accept the prices that are determined in the market. Its efforts are directed to correctly estimating future price situations, and to acting accordingly. The influence of speculation cannot alter the average level of prices over a given period; what it can do is to diminish the gap between the highest and the lowest prices. Price fluctuations are reduced by speculation, not aggravated, as the popular legend has it[5].

Explaining the process of speculation von Mises (1919) said: 'Speculation anticipates future price changes; its economic function consists in evening out price differences between different places and different points in time and, through the pressure which prices exert on production and consumption, in adapting stocks and demands to each other'[6]. He also said (1922):

> Without speculation there can be no economic activity reaching beyond the immediate present ... Speculation in the capitalist system performs a function which must be performed in any economic system however organised: it provides for the adjustment of supply and demand over time and space ... Speculation performs an

[5] von Mises, L. (1912) *The Theory of Money and Credit*, translated by H.E. Batson, 5th edition,1981, Liberty Fund Inc., p. 142.

[6] von Mises, L. (1919) *Nation, State, and Economy*, 1983 ed., New York University Press, NY, p 145.

> economic service which cannot conceivably be eliminated from any economic system[7].

And again, explaining why everyone engages in free market speculation von Mises (1949) wrote:

> Every action refers to an unknown future. It is in this sense always a risky speculation. Man is faced with the fact that there are fellow men acting on their own behalf as he himself acts. The necessity to adjust his actions to other people's actions makes him a speculator for whom success or failure depend on his greater or lesser ability to understand the future. Every action is a speculation. There is in the course of human events no stability and consequently no safety.
>
> … landowners and labourers are by necessity speculators. So is the consumer in providing for anticipated future needs …
>
> A capitalist is always also virtually an entrepreneur and speculator. He always runs the chance of losing his funds. There is no such thing as a perfectly safe investment. If it were possible to calculate the future state of the market, the future would not be uncertain. There would be neither entrepreneurial loss nor profit[8].

Similarly Victor Niederhoffer (1989), a Wall Street investment broker and casual author, describing the service to society speculators perform wrote:

> … when my daughters ask me if my job is as important as the butcher's, the doctor's or the scientist's, I answer that the speculator is a hero, and has been throughout history.

[7] von Mises, L. (1922) *Socialism*, 6th ed., 1981, Liberty Fund Inc., New York, p 125.

[8] von Mises, L. (1949) *Human Action*, excerpts reproduced in *The Freeman*, Vol. 31: September 1981, p 563.

> Some speculators are discoverers like Christopher Columbus, creators like Henry Ford, or inventors like Thomas Edison. Their job is easy to place on a high plane. My role in the grander order is indirect, relatively invisible and unplanned. The only discoveries I make are the routes that prices will travel. Like hundreds of thousands of other traders, I try to predict the prices of common goods a day or two or a few months in the future. If I think the price of an item will go up, I buy today and sell later. If I think the price is going down, I'll sell at today's higher price. The miracle is that in taking care of ourselves, we speculators somehow ensure that producers all over the world will provide the right quantity and quality of goods at the proper time, without undue waste, and that this meshes with what people want and the money they have available[9].

Niederhoffer, continued:

> … the speculator does far more than merely iron out prices over time. By dampening price oscillations, he accomplishes something of crucial importance: the stockpiling of widgets during the years of plenty, when they are least needed, and the dissipation of the widget inventory during times of shortage, when they are most useful.
>
> Furthermore, the speculator's actions in the market signal to all other businessmen that an era of short supply is expected in the future. His present purchases raise widget prices, and hence the profitability of producing them now. This encourages others to do so before the lean years strike. The speculator is the Distant Early Warning System of the economy[10].

Economist Dwight Lee (1999) wrote:

> … speculators are best thought of as conservationists. They are constantly looking to the future and conserving resources they believe are becoming more valuable. Since no one can predict the future with full confidence, speculators necessarily take risks.

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[9] Niederhoffer, V. (1989) The Speculator as Hero, *Wall Street Journal*, Dow Jones and Co., Inc., 10th February 1989.

[10] *Ibid*.

> And when a speculator misjudges the future, he moves resources from periods when they are worth more to periods when they are worth less. But speculators who consistently make mistakes are soon left without the finances to continue speculating, and their mistakes create profitable opportunities for better prognosticators to take corrective action[11].

It is a fact however, that whenever prices rise 'we hear a chorus of complaints blaming the speculator', economist Walter Block (1981) said: 'speculators have always been vilified for high and rising prices. This view is incorrect. In fact, the opposite is true: speculation holds the rise of prices to less than would have prevailed without it'[12].

Another Austrian School economist Hans Sennholz (1979) wrote: 'When all other explanations are exhausted, modern governments usually fall back on the speculator, who is held responsible for all economic and social evils'[13]. John Ahrens (1994) says: 'Financial speculators who reap enormous profits from correctly anticipating market fluctuations are not generally respected in the United States; they are commonly thought to be unproductive parasites, and probably criminals as well'[14]. von Mises (1949) stated: 'The fact that the term "speculator" is today used only with an opprobrious connotation clearly shows that our contemporaries do not even suspect in what the fundamental problem of action consists'[15]. Notwithstanding their comments, the six authors quoted above are adamant that speculators play an essential role in the market.

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[11] Lee, D.R. (1999) Speculation and Risk, *The Freeman*, Vol. 49: September Issue, p 50.

[12] Block, W. (1981) The Benefits of Speculation, *The Freeman*, Vol. 31: December 1981, p 717.

[13] Sennholz, H. (1979) *Age of Inflation*, Appleton, Belmont, MA, p 85.

[14] Ahrens, J. (1994) Sweet Speculation, *The Freeman*, Vol. 44: July 1994, p 358.

[15] von Mises, L. (1949) *Human Action*, excerpts reproduced in *The Freeman*, Vol. 31: September 1981, p 563.

Nevertheless Niederhoffer (1989), a staunch advocate of speculation, admitted:

> If the speculator guesses incorrectly and sees years of plenty ahead when belt tightening is really in store for the economy, chaos can result. Instead of stabilising prices and supplies of widgets, the speculator will destabilise them; instead of hoarding during the fat years and reducing inventories during famines ~ and leading others to do so as well ~ he will encourage needless saving under adversity and wasteful profligacy in good times[16].

Similarly, Sennholz (1979) commenting on the accusations being made against private speculators wrote:

> … the speculator is to most politicians and statesmen: the embodiment of evil. He is said to be imbued with ruthless and fickle selfishness that is capable of wrecking the national economy, government plans, and in the case of German inflation, the national currency. No matter how blatantly contradictory this explanation may be, it is most popular with government authorities in search of a convenient explanation for the failure of their own policies[17].

The habit of blaming speculators for the failings of the free market is not new. Sennholz wrote the above quote almost 40 years ago and to a large extent, the same tactic was employed against speculators in the 2008 financial crisis. The initial blame for the GFC was directed towards ordinary citizens who were allowed to borrow beyond their repayment capabilities[18]. Then the focus shifted towards the financial institutions that engaged in

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[16] Niederhoffer, V. (1989) The Speculator as Hero, *Wall Street Journal*, Dow Jones and Co., Inc., 10th February 1989.

[17] Sennholz, H. (1979) *Age of Inflation*, Appleton, Belmont, MA, p 85.

[18] In April 2007, the federal financial agencies issued a *Statement on Working with Mortgage Borrowers* and followed this with the July 2007 *Statement on Subprime Mortgage Lending*. Both statements encouraged federally regulated institutions to work constructively with residential borrowers at risk of default and to consider prudent workout arrangements to avoid unnecessary foreclosures. In these statements, the federal financial agencies stated that prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term interest of both the financial institution and the borrower. The Conference of State Bank Supervisors (CSBS), the American Association of Residential Mortgage Regulators (AARMR), and the National Association of Consumer Credit Administrators developed a parallel Statement on *Subprime Mortgage Lending* that applied to state-supervised mortgage brokers and lenders. In June 2007, CSBS and AARMR issued a consumer alert and an industry letter to address resetting mortgage loans*.

irresponsible lending practices and then to speculators who sold their mortgage backed securities (toxic assets) onto other speculators who also on-sold them. After the bubble burst, the US politicians arose from their sleep in the midst of the collapsing economy and drastically started searching for an explanation as to why the system had failed.

Either love them or hate them, the resultant effect is we have a situation where there are supporters who insist that speculators contribute a vital function to the economy and then there are others who despise them. To solve this argument, let's look at the historic and economic realities.

3.3 Some Historical Facts about Free Market Speculation

A very short glance at economic history reveals numerous situations where speculation got ridiculously out-of-hand. Additionally, a simple demonstration using the supply and demand model highlights the disruption of free market speculation and exposes the fallacies within von Mises's economic ideology.

Flower power:

In the Netherlands during the early part of the seventeenth century, tulip bulbs sold faster than they could grow which provided the impetus for a speculative bubble. Scottish writer Charles Mackay (1841) explained:

> The demand for tulips of a rare species increased so much in the year 1636, that regular marts for their sale were established on the Stock Exchange of Amsterdam, in Rotterdam, Haarlaem, Leyden, Alkmar, Hoorn, and other towns. Symptoms of gambling now became, for the first time, apparent. The stock-jobbers, ever on the

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*Cf. US Federal Reserve (2007) *Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages*. Available at: http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20070904a1.pdf

> alert for a new speculation, dealt largely in tulips, making use of all the means they so well knew how to employ, to cause fluctuations in prices. At first, as in all these gambling mania, confidence was at its height, and everybody gained. The tulip-jobbers speculated in the rise and fall of the tulip stocks, and made large profits by buying when prices fell, and selling out when they rose. Many individuals grew suddenly rich. A golden bait hung temptingly out before the people, and, one after the other, they rushed to the tulip marts, like flies around a honey-pot[19].

Prices rose so high that growers asked the government to ban the trade, however before that transpired, rare bulbs peaked at 1,500 guilders a pound ~ equivalent to about four years' income for a master carpenter. The crash came in early February 1637, when prices fell by approximately 90 percent[20].

Similar speculative bubbles happened in the early eighteenth century with Britain's South Sea Company[21] and John Law's Compagnie de la Louisiane ou d'Occident in Mississippi[22] following the same path as tulipmania. The effects were felt throughout England, Europe and America. Many people who had invested in these companies were financially ruined.

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[19] Mackay, C. (1841) *Extraordinary Popular Delusions and the Madness of Crowds*, reprinted 1980, Harmony Books, New York, Chapter 3 paragraph 7.

[20] Goldgar, A. (2007) *Tulipmania: Money, Honor, and Knowledge in the Dutch Golden Age*, University of Chicago Press, Chicago.

[21] The South Sea Company was formed in 1711 by the Lord Treasurer Robert Harley, but failed disastrously in 1720. The company held £9 million worth of government bonds and was given a monopoly of British trade with the islands of the South Seas and South America. The contract was granted based on the expectation of securing extensive trading concessions from Spain, however the concessions did not materialise which severely undermined the viability of the company. To hide reality, the company directors ~ one of whom was John Aislabie, the Chancellor of the Exchequer ~ exaggerated the true financial position of the company which led to a fraudulently induced wave of speculation. Meanwhile, by publicising the names of their elite stockholders, the Company managed to clothe itself in an aura of legitimacy, which attracted and kept other buyers. This drove the price of the company's stock from £128 to £1,000 within eight months before its collapse in September 1720.

[22] In August 1717, Scotsman John Law who fled to France and later migrated to America founded the Compagnie de la Louisiane ou d'Occident. Because of his earlier financial success and banking connections in France, he was granted monopolistic rights to exploit the Mississippi region in America. However, Law exaggerated the wealth of Louisiana with an effective marketing scheme, which led to wild speculation on the shares of the Compagnie d'Occident. In 1719, shares rose to 15,000 livres, but by the summer of 1720, there was a sudden decline in confidence, and the price tumbled to 500 livres.

Moreover, confidence in the other European companies was also destroyed, and many in turn went bankrupt.

Speculative bubbles can strike any market at any time. A recent example in the commodities market was cocoa. Between 2009 and 2010 the price of cocoa doubled; cocoa futures hit a 33-year high as Europe's futures market became concentrated in a small group of financial players. Cocoa futures for July 2010 delivery on London's NYSE LIFFE reached £2732 a tonne[23]. The frenzy of activity in the market prompted a comment from the International Cocoa Organisation (ICCO), which said price volatility may reflect an attempt by traders to 'technically squeeze' the market by buying up all available supplies[24]. The ICCO said traders might find themselves struggling to fulfil their future obligations. But while speculators push the price of cocoa up, consumers will find themselves paying more for chocolate based products. Chocoholics, Milo drinkers and sweet toothed children end up paying for the speculator's profits. It is another example where speculators ~ in this case BNP Paribas and Newedge Group ~ have distorted market prices to gain profits even though they are totally remote from the growing, manufacturing and distribution process.

Following tradition but ignoring the lessons of history, the Dot-com bubble[25] of the late 1990s, the US housing boom[26], and the rising Dow Jones Index experienced just before the

[23] International Cocoa Organisation (2010) Cocoa year 2009/10, *Quarterly Bulletin of Cocoa Statistics*, Vol. XXXVI, no. 1.

[24] Henshaw, C. and Henschen, H. (2010) Hot cocoa market fuels price fears, *Dow Jones* Newswires, 17th July 2010.

[25] Between 1998 and 2000 Western stock markets saw equity values rise rapidly in the internet and e-commerce sector. The NASDAQ peaked at 5132.52 in March 2000 but was followed by the spectacular failure of many new Internet-based companies.

[26] The US housing bubble affected housing prices which peaked in early 2005. By December 2008 the Case-Shiller home price index reported its largest price drop in its history. This coincided with increased foreclosure rates in the subprime mortgage market and highlighted the growing indebtedness of the US economy.

2008 global financial crisis[27], all ended in collapse. Similarly, speculative trading in financial markets does nothing to correct the false belief that long term prosperity and financial stability can be achieved through unlimited expansion of credit and an ever increasing array of products of low or no social value (eg: credit default swaps[28], mortgaged backed securities[29] and option ARMs[30]).

Booms are always relatively short lived and inevitably end up costing a lot of people a lot of money. While some people may make an enormous amount of money riding the wave of speculation to its peak, it is in reality a travesty of economic principles because it is typically no more than a run-a-way Ponzi/pyramid scheme but for one condition ~ there is no identifiable villain.

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[27] The Dow Jones Industrial Average indicated the market's despair. In September 2008 it dropped by hundreds of points in a matter of moments, the largest drop on record. Selling was so intense that just 162 stocks rose on the NYSE compared with 3,073 that dropped.

[28] Credit Default swaps are a form of credit protection insurance to minimise certain risk or exposure of losing money on bad loans. It works so long as the seller of the swap has the cash to make good in case of a borrowers non-payment (default). The price of swaps is based on statistical percentages of bad loans; they work well in the expansionary phase of an economic cycle but typically come undone in a contractionary phase ~ hence no social value.

[29] Mortgage-Backed Security (MBS) is a type of asset-backed security, originating from a regulated and authorised financial institution, that is secured by a mortgage or collection of mortgages. These securities are grouped and usually pay periodic payments that are similar to coupon payments. When you invest in a mortgage-backed security you are essentially lending money to a home buyer or business via the bank which acts as a middleman between the borrower and the investment markets. This type of security is also commonly used to redirect the interest and principal payments from the pool of mortgages to shareholders. These payments can be further broken down into different classes of securities, depending on the riskiness of different mortgages.

[30] An adjustable rate mortgage (ARM) is a loan where the interest rate on the note is periodically adjusted based on a variety of indices. An 'option ARM' is typically a 30-year ARM that initially offers the borrower four monthly payment options: a specified minimum payment, an interest-only payment, a 15-year fully amortising payment, and a 30-year fully amortising payment.

3.4 Economic Realities of Free Market Speculation

To be sure the speculators are blamed for distorting prices, but those speculators are just ordinary every-day people. So does the fault rests squarely with what Charles Mackay described as the 'delusions and the madness of crowds'[31], or what John Maynard Keynes described as 'animal spirits' and 'herd like behaviour'[32]?

The speculator engages in a form of voluntary saving through delayed consumption, therefore the only difference between the ordinary consumer and the speculator is the time factor. The speculator's consumption is realised when he sells his holdings, takes a profit (or loss) and spends his earnings. In reality, the speculator is no different than any retailer, who likewise buys merchandise, holds it in his shop on display waiting for customers to come in and purchase the stock. The shopkeeper also tries to buy at a lower price and sell at a higher price to make a profit, and again, the only variation between immediate consumption and delayed consumption is the time factor.

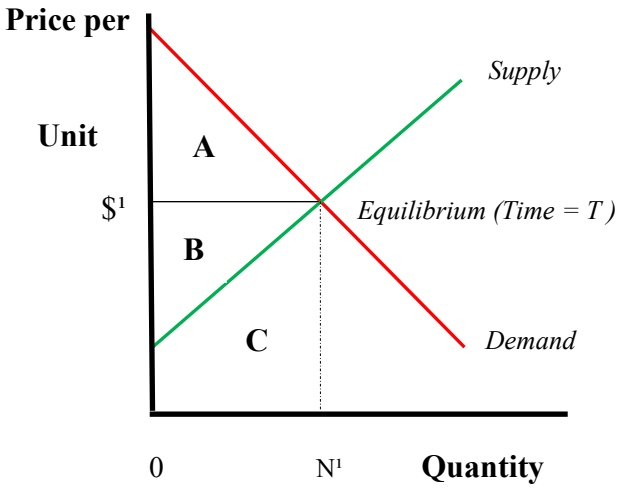
Like most investments, people who delay consumption invariably want to protect their savings, and if possible, make enough money to counter the effects of inflation and have a little extra for the future. In this simple model there seems nothing wrong with speculation. It could be argued that the speculator produces nothing tangible for society but extracts a profit at the expense of the eventual purchaser. Basically, that is exactly the same as what the retailer does, he does not produce anything either, he merely buys and sells merchandise, but we discern that the retailer provides a valuable service to society. So how do we determine

[31] Mackay, C. (1841) *Extraordinary Popular Delusions and the Madness of Crowds*, reprinted 1980, Harmony Books, New York.

[32] Keynes, J.M. (1936) *The General Theory of Employment, Interest and Money*, Macmillan, London, p149-50

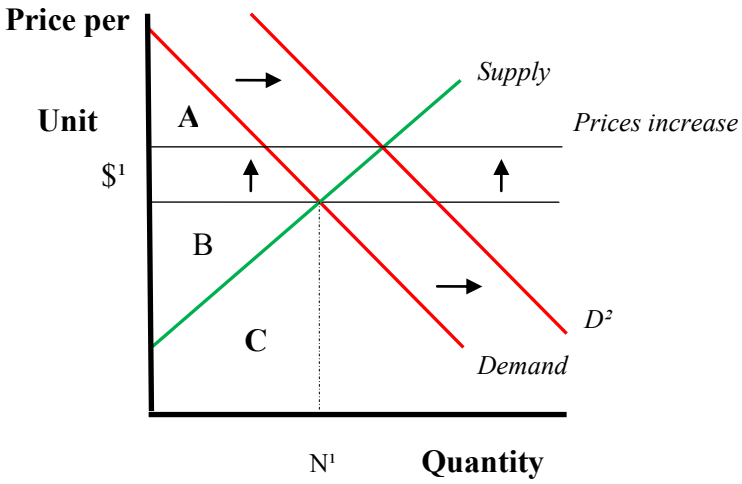
whether the speculator provides a valuable service to society? Relating the speculator's activities to the *Supply and Demand Curve* reveals the answer.

Figure 3.1 Supply and Demand Curve with Consumer and Producer Surpluses



The producers'/supplier's and consumers' surpluses are illustrated with supply and demand curves in the equilibrium state. In the equilibrium state quantity demanded equals quantity supplied at quantity N^1 and price $\$^1$. The area under the Demand curve represents the price consumers are willing to pay at each quantity level. The value to consumers of quantity N^1 (ie what consumers were willing to pay for quantities from 0 to N^1) is represented by areas **A**+**B**+**C**. Even though some consumers were prepared to pay more, at equilibrium consumers will only need to pay price \$B+C or ($\$^1$ x N^1), therefore area **A** represents the *consumers' surplus* (or the price saving advantage for the equilibrium quantity). In the equilibrium state, producers/suppliers receive revenue of \$B+C. Area **B** represents the *producers' surplus* (in this case the producers' profit) because *production costs* of \$C are incurred to produce quantity N^1.

Figure 3.2 Speculator's Effect on Consumer and Producer Surpluses when Buying



When buying, the speculator adds to demand and shifts the demand curve to the right thereby increasing the *producer surplus* **B** (profits for the producer provided he raises his prices when demand is higher) when otherwise prices would normally be lower [33]. The speculator also reduces the amount of *consumer surplus* **A** (the benefit of what the purchaser would have normally paid and what he actually paid after the speculator entered the market and forced prices up). The Consumer's surplus and the Producer's surplus when added together equals the *total social benefit*. If the total social benefit is not at equilibrium it means the market is not efficient and a deadweight loss enters the economy[34].

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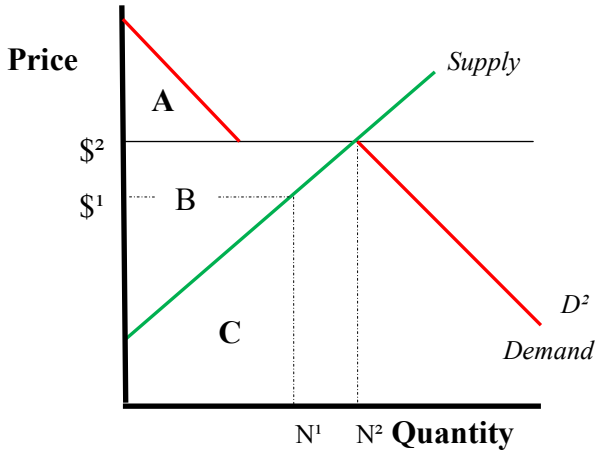
[33] An alternative way of putting it is that speculators buy in when the price is low, and then sell when the price is high. This is transferring the product from a market where the marginal value is low to one where it is high, which would result in a temporary increase in supplier surplus*.

While it could be argued that such processes might reduce price fluctuations over time in line with what von Mises said at the beginning of section 3.2 above, the explanation following Figure 3.5 below makes it clear that total social benefit is reduced overall.

*It is assumed that a supply /demand description in a market for durable goods should equally apply to a supply / demand situation for international capital markets.

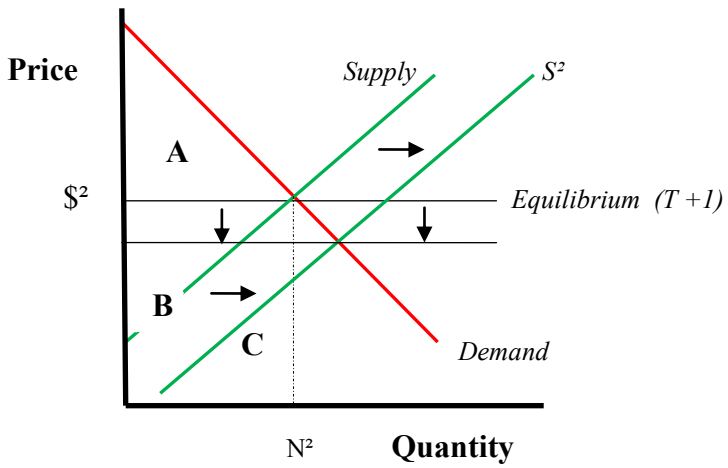
[34] A deadweight loss (sometimes called a Harberger's triangle) is a loss of economic efficiency that can occur when equilibrium for a good or service is not Pareto optimal. See; Harberger, A. (1950) Currency Depreciation, Income, and the Balance of Trade, *Journal of Political Economy*, February, p 47-60; (1954) Monopoly and Resource Allocation, *American Economic Review*, Vol. XLIV, No. 2 (May), p 77-87; (1971) Three Basic Postulates for Applied Welfare Economics, *Journal of Economic Literature*, Vol. IX, No. 3, September, p 785-97.

Figure 3.3 Speculator's Effect on Consumer and Producer Surpluses after Purchase



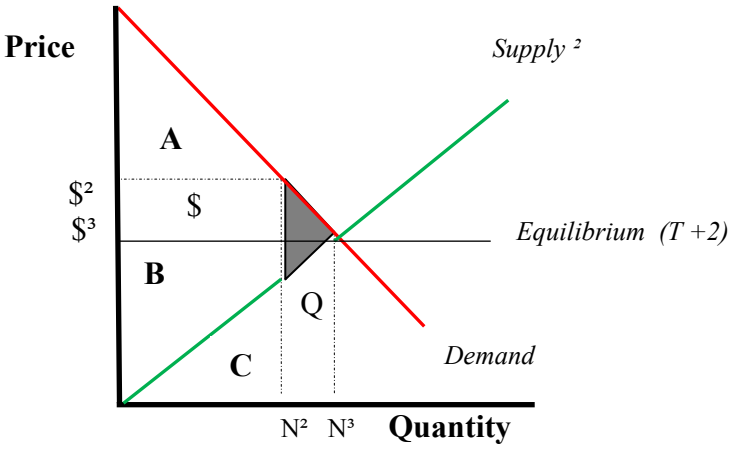
In effect, the speculator increases quantity demanded from N^1 to N^2 and increases price from $\$^1$ to $\$^2$, therefore the ordinary consumer is forced to pay a higher price. Understand the speculator did not consume what he bought, so he is then in the position to re-sell when prices are higher. The result is that the speculator capitalises on the price differentials to make a profit. If the speculator bought into the market when the price was $\$^1$ and sells at price $\$^2$, he makes a profit of: $P = (\$^2 - \$^1) \times (N^2 - N^1)$.

Figure 3.4 Speculator's Effect on Consumer and Producer Surpluses when Selling



When the speculator sells, he acts as an extra supplier to the market. This shifts the supply curve to the right, but this time it decreases *supplier surplus* and increases the *consumer surplus*. Because the speculator does not incur any expenses in supplying the market, original *production costs* **C** remain unchanged.

Figure 3.5 Speculator's Effect on Consumer and Producer Surpluses after Sale



The speculator buys at equilibrium (T) price $¹ and pushes the price to $² at equilibrium (T + 1); sells at equilibrium (T + 1) price $² and capitalise on the price differences. The full cycle of the speculator's trading activities allows the market to settle at a new equilibrium (T + 2) at price $³. If timed correctly, the speculator makes money by reducing *consumer surplus* when he buys and reducing *producer surplus* when he sells. His profits are derived at the expense of both consumers and producers ($² - $¹) x (N² - N¹); consumers paying higher prices at T + 1 and producers supplying less widgets to the market at T + 2. The *total social benefit* is reduced as a deadweight loss (grey area). These activities do not improve price stability within the market.

The fact that the speculators' activity decisively distorts prices in all time periods seems to be an accepted practice in free market societies where individuals are encouraged to be

entrepreneurial and fend for themselves. Withstanding the profundity of the existing norm, what von Mises said in *The Theory of Money and Credit*, is essentially incorrect. True, speculation may not determine prices but contrary to what von Mises said, speculation does affect market values. Speculators are motivated by profit and act according to prevailing prices. Speculation alters the average price level over given periods, it does not diminish the gap between the highest and the lowest prices ~ rather it expands price differences. In stark contrast to what the Austrian School of economic thought would have us believe, history in combination with simple economic modelling proves price fluctuations and market volatility are exacerbated by speculation.

Similarly the *Efficient Market Hypothesis*, the *Balance of Payments Equation*, and the *Mundell Fleming IS/LM/BP Model* clearly expose the effects of speculation and the negative impact of speculative capital flows.

3.5 Efficient Market Hypothesis (EMH)

Fama (1965) proposed that markets are characterised by multiple participants acting in a rational manner in an effort to earn profit[35]. He contemplated that in an efficient market, competition among the participants leads to a situation where the actual prices of financial assets already reflects the combined total of all known information ~ hence the market price settles at its equilibrium and is therefore at its optimum efficiency[36]. This section explains why the EMH cannot apply to the IMM.

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[35] Fama, E. (1965) The Behaviour of Stock Market Prices, *Journal of Business*, Vol. 38, No.1, p 34–105.

[36] Efficient Markets Theory contemplates asset prices moving to whatever level is needed to clear the market in the face of changing expectations of future cash flows. In theory, there will always be a market price, even if it gyrates wildly from day to day or minute to minute. Cf: Access Economics (2009) *Navigating Reform: Australia and the Global Financial Crisis*, Financial Services Institute of Australasia, Sydney, p 10.

The weak form of the EMH asserts that prices fully reflect the information contained in the historical sequences of prices[37]. A rational expectation is an expectation that uses all the available information that is relevant for forecasting a future price. Since the actual price of a stock or currency is equal to the rational expectation of the future price, the current price should also embody all relevant information that is available. A market in which the actual price embodies all currently available information and where all profit opportunities are exhausted is called an efficient market. The term efficient market is more correctly an oxymoron. Efficient markets do not necessarily equate to the most efficient allocation of scarce resources nor do they alleviate market failures. Quiggin (2010) says:

> Although economists since Adam Smith have pointed out the virtues of markets in general, the Efficient Market Hypothesis, with its focus on financial markets, is specific to the era of finance-driven capitalism that emerged from the breakdown of the Keynesian Bretton Woods system in the 1970s. The Efficient Market Hypothesis justified, and indeed demanded, financial deregulation, the removal of controls on international capital flows, and a massive expansion of the financial sector. These developments ultimately produced the Global Financial Crisis[38].

Nevertheless and notwithstanding the disturbing ripple effect that currency trading has on national economies, the foreign exchange / monetary market is said to be efficient if profit opportunities are diminished and market values fully and correctly reflect all relevant information in determining future currency prices. Thus, investors cannot devise an investment strategy to yield abnormal profits on the basis of an analysis of past price patterns. So, by rights, in an efficient market it should be impossible for traders to forecast directional

[37] *The New Palgrave: A Dictionary of Economics*, (1987) The Macmillan Press Limited, London, Vol. 2, E-J, p 120.

[38] Quiggin, J. (2010) *Zombie Economics: How Dead Ideas Still Walk among Us*, Princeton University Press, New Jersey, p36.

changes in price. If this assumption does not hold true, then the market should not be considered efficient.

If the general forecast is that the price of a stock or currency is going to rise in the next period, it is more than likely that an investor would purchase the item now, since the price would be low today compared with what the predicted price would be in the future. The action of buying today acts as an increase in demand and increases today's price. It is true that the action of a single small time investor will not make much difference to a large international market, but if traders in general expect a higher price in the next period and they all act today on the basis of that expectation, then today's price will rise due to the increased demand. The price will continue to rise until it reaches the expected future price. At that price, traders no longer envision making a profit and subsequently demand settles at the higher price.

The thing to note however is that while the single small time investor might not be able to disturb the market, large funds can and often do. Some investment funds are accumulating sums as large as US$100 billion[39]. That amount of money can disturb the market considerably.

According to the EMH, an efficient market must have two features: first, its price level should equal the expected future price and embody all available information; and secondly, there should be no forecastable profit opportunities left in the market. The billion dollar incomes enjoyed by successful currency traders tends to suggest that there are ample

[39] Example; James Simons' Renaissance Institutional Equities Fund is designed to handle $100 billion in assets.

opportunities within the market to realise substantial profits[40]. So even in the sense of the EMH, currency markets cannot be classified as efficient because abundant profit opportunities exist. It might be more correct to say that the efficient market occurs only after all arbitrage opportunities have been exploited and demand has settled at a new price level. But in currency trading prices do not settle; they are in a constant state of fluctuation. The fluctuations in part are caused by the very act of trading which more or less perpetuates further fluctuations.

Employing the EMH and the probability equations to determine whether or not the IMM is efficient is unnecessary because the second leg of the Hypothesis which states that there should be no forecastable profit opportunities left in the market is never attained. In an efficient market, prices should become stable, but this is not the case. Accordingly, the inefficiency of the forex market is proven simply by using visual observations of the volatility of any currency pair[41].

Because the market does not ever settle at a specific price level for more than a few seconds at a time, it is incorrect to label the market as being efficient. It is also incorrect to assume that speculators add to the liquidity of the market by making capital available for investment.

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[40] We need only examine what the highest paid hedge fund managers are earning to determine that they are taking full advantage of the weaknesses within the IMS. For instance, in 2009 the top 25 hedge fund earners were paid a collective $25.3 billion. Fund managers like: Steve Cohen, Carl Icahn, Edward Lampert, Kenneth Griffin, John Arnold and Philip Falcone earnt around a billion dollars each. Three managers among the top 10, George Soros (No. 2), James Simons (No. 3) and John Paulson (No. 4) were each $3 billion plus winners with David Tepper coming outright winner with personal earnings for 2009 of almost $4 billion* equalling just under US$11 million per day. To give an indication of how their personal incomes have increased over the past several years, in 2006, the top 25 hedge fund managers earnt a combined total of just over US$14.25 billion. Their average personal income was $570 million each, compared with US$362 million in 2005 and US$251 million in 2004**.
*Schwartz, N. and Story, L. (2010) Pay of Hedge Fund Managers Roared Back Last Year, *New York Times*, 31st March 2010, p B1.
**Taub, S. (2007) The Top 25 Moneymakers: The New Tycoons, *Institutional Investor Magazine*, 20th April 2007.

[41] See Appendix A & B for examples of currency pair volatility.

Their transactions are normally very short term for the sole purpose of capitalising on an arbitrage opportunity and taking a profit.

With the growing sophistication of the world's data bases and improved information systems, investment managers are now able to monitor any departure away from market prices and can better understand the circumstances that are favourable for a forex purchase. The record demonstrates quite clearly that professional currency traders consistently take advantage of the existing flaws in the international monetary framework. The flaw is the perpetual existence of varying currency differentials within the IMS. If the flaws can be identified there seems no reason why they cannot be rectified ~ all that is required is a desire to improve the efficiency of the system by those who control it ~ by either implementing prohibitive legislation that restricts speculative capital flows, or alternatively, eliminating the weakness altogether by returning to a rigid exchange rate mechanism.

Having demonstrated how the EMH invalidates the notion that speculative capital flows enhance economic efficiency, the next section focuses on the effects of SCF to explain why unrestricted capital flows are inevitably detrimental to a national economy.

3.6 The Balance of Payments Equation

The Balance of Payments (BOP) is one of the key economic indicators of a nation's economy. Most countries which are formal members to the IMF or the OECD group use the IMF *Balance of Payments Manual* as a guide to calculate their figures. The international standard for this framework is the System of National Accounts, which encompasses transactions and other financial flows affecting the level of assets and liabilities from one accounting period to another. The figures for the BOP are derived from the differences between inward and outward transactions of a nation's economy. The BOP represents the

sum of economic transactions with the home country and the rest of the world. These transactions include exports and imports of goods and services, inward and outward income flows earnt from investments, inward and outward financial flows, such as investment in shares, debt securities and loans, and all other transfers such as foreign aid and migrant capital.

With the deregulation and globalisation of financial markets and the exponential growth in the international movement of capital for foreign investment and debt, more emphasis is being placed on each nation's net investment position. Just like the normal family budget or that of a corporation, every country must maintain a sense of order in its National Accounts. If a corporation spends more than it earns, it must either borrow money or liquidate its assets to pay for its liabilities. Likewise if a nation spends more than it earns, it too must make up that shortfall by either selling more to the rest of the world or by allowing foreign / loan Capital to make up the difference. Because a country's external debt is a subset of the financial liabilities in its international investment position it is therefore necessary to include its foreign assets (ie claims on the rest of the world including foreign currencies, gold and Special Drawing Rights[42]), its foreign debt liabilities (gross debt liabilities to the rest of the world), and its net foreign debt (the net sum of debt liabilities and assets) in its Capital Account as either a credit or a debit.

[42] SDR are an international form of overdraft facility. See Articles XV - XXV of the IMF *Articles of Agreement*. Effective of January 2011 and subject to revision every five years, one IMF SDR is equivalent to the sum of US$ 0.660, 0.423 Euro, 12.1 Japanese yen and 0.111 pound sterling.

Ignoring the complexity of the components that make up the Current and Capital Accounts, the simplified BOP equation states:

$$\text{Balance of Payments} = \text{Current Account} \pm \text{Capital Account} = 0. \qquad \text{(E-1)}$$

The equation provides a simple guide to ensure that the international monetary system is not adversely affected by one country's inability to pay its liabilities owed to other countries. The equation means that in order to maintain a balanced position any short-fall incurred by over spending in the Current Account on items like goods and services is counter balanced by an equivalent injection of money via the Capital Account. The equation also applies in reverse. If one country earns more money than it spends it will accumulate reserves of foreign currency in its Capital Account. For a national economy to just sit on its reserves makes no sense because the actual value of that asset will erode over time with the effects of inflation. Those reserves however, can be invested elsewhere to generate further income adding to the nation's prosperity. In this sense any shortfall in one country's BOP can be made up by the surplus from another country's BOP.

The BOP equation becomes more complex because both the Current Account and Capital Account are reliant on variables associated with currency values. Regardless of whether a central bank employs fixed, moveable pegs or fully floating exchange rates, all countries are exposed to the costs related to changing currency values because those values have a direct effect on national income.

Using the GDP Expenditure Model we can algebraically calculate the income (Y) of a country. For explanatory purposes the components which form part of the BOP equation or are directly dependant on foreign currency values are *italicised* in **bold**.

$$\boldsymbol{Y} = \boldsymbol{GDP} = C + G + I + \boldsymbol{X} - \boldsymbol{M} \qquad \text{(E-2)}$$

(*X–M* = balance on goods and services in the Current Account)

$$\boldsymbol{CAB} = \boldsymbol{X} - \boldsymbol{M} + \boldsymbol{NY} + \boldsymbol{NCT} \qquad \text{(E-3)}$$

$$\boldsymbol{GNDY} = C + G + I + \boldsymbol{CAB} \qquad \text{(E-4)}$$

$$\boldsymbol{GNDY} - C - G = S \qquad \text{(E-5)}$$

$$S = I + \boldsymbol{CAB} \qquad \text{(E-6)}$$

$$S - I = \boldsymbol{CAB} \qquad \text{(E-7)}$$

$$S - I + \boldsymbol{NKT} - \boldsymbol{NPNNA} = \boldsymbol{CAB} + \boldsymbol{NKT} - \boldsymbol{NPNNA} = \boldsymbol{NFI} \qquad \text{(E-8)}$$

(*NKT – NPNNA* = balance on the capital account of the balance of payments)

Where:

GDP = gross domestic product	C = private consumption expenditure
G = government consumption expenditure	I = gross domestic investment
S = gross domestic saving	X = exports of goods and services
M = imports of goods and services	NY = net income from abroad
GNDY = gross national disposable income	CAB = current account balance
NCT = net current transfers	NKT = net capital transfers

NPNNA = net purchases of non produced, nonfinancial assets

NFI = net foreign investment or net lending/net borrowing *vis-à-vis* the rest of the world

It can be observed from the algebraic equations above that the income and inherent wealth of a country is heavily influenced by forces and currency values independent of the domestic economy. As it is necessary for the BOP to equal zero, when there are short-falls in the BOP

these can be made up in the form of allowing Foreign Direct Investment (FDI) into the country or by drawing against the IMF's Special Drawing Rights. An alternative to those measures is to adjust the national exchange rate value to accommodate any imbalance away from zero. In this instance the exchange rate is consequently sensitive to all of the influences that typically affect trade and investment decisions, especially expectations about future asset prices and expectations about the exchange rate itself. Because SCF can alter those expectations and distort GDP it is worth demonstrating what effect those flows have on a nation's economy. This can be done by examining Robert Mundell and Marcus Fleming's *IS-LM-BP Model*.

3.7 The Mundell Fleming Model

The *IS-LM Model* was first developed by economists John Hicks[43] and Alvin Hansen[44] in the 1930s but Robert Mundell[45] and Marcus Fleming[46] expanded its parameters to include the balance of payments in the 1960s. Dornbusch (1976,1980)[47] synthesised Mundell's model and Fleming's model into one which he called the 'Mundell-Fleming Model'. The Mundell-Fleming model was first known as the *IS-LM-FE* model, emphasising the three markets and equilibrium curves involved: *IS* for the goods market, *LM* for the money market, and *FE* for

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[43] Hicks, J.R. (1937) Mr Keynes and the Classics - A Suggested Interpretation, *Econometrica*, Vol. 5 (April): p 147-159.

[44] Hansen, A. (1938) *Full Recovery or Stagnation?*, W. Norton & Co., New York.

[45] Mundell, R. (1960) The Monetary Dynamics of International Adjustment under Fixed and Flexible Exchange Rates, *Quarterly Journal of Economics*, Vol. 74, p 227-57.

Mundell, R. (1963) Capital Mobility and Stabilisation Policy under Fixed and Flexible Exchange Rates, *Canadian Journal of Economics and Political Science*, Vol. 29, No. 4, p 475-85.

[46] Fleming J.M. (1962) Domestic Financial Policies Under Fixed and Under Floating Exchange Rates, *International Monetary Fund Staff Papers*, Vol. 9, p 369-79.

[47] Dornbusch, R. (1976) Exchange Rate Expectations and Monetary Policy. *Journal of International Economics*, Vol. 6, p 231-244.

Dornbusch, R. (1980) *Open Economy Macroeconomics*, Basic Books, New York, p 194.

the foreign exchange market. However the model can change the third label to *IS-LM-BP* model which showcases the BOP instead of the foreign exchange market. The *IS-LM-BP* model can be used to demonstrate that an economy cannot simultaneously hold exchange rates steady and maintain an independent monetary policy when SCF are present.

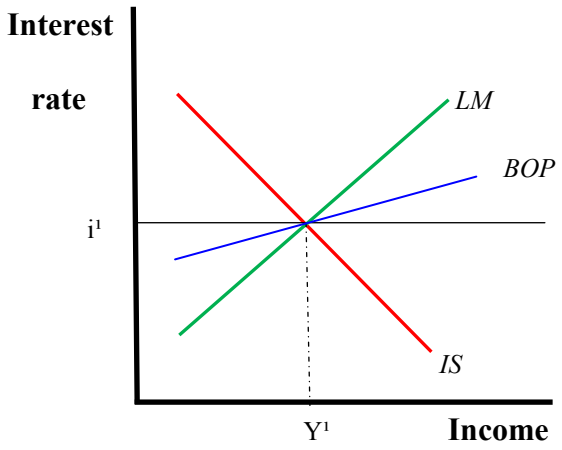
The *IS-LM Model* shows the interaction between the goods market and the money market and how the equilibrium level of output is influenced by interest rates (i) which affect national income (Y). The expanded version of the *IS-LM Model* (with the added *BP*) demonstrates the relationship of interest rate changes on national income and the BOP, and thus forms the basis upon which monetary policy and fiscal policy decisions can be established. The *Mundell-Fleming IS-LM-BP Model* can also map optional responses to inside and outside shocks for an open economy.

Points along the *IS* schedule (the curve [48]) signify the level at which planned spending equals income. The *IS* equilibrium schedule also shows combinations of interest rates and output levels when the goods market will be in equilibrium[49]. Ignoring all other components in an economy, another way of describing the *IS* curve is that Aggregate Demand (AD) equals Income (Y), or Y = AD. The *IS* curve is negatively sloped because a rise in interest rates reduces output and income. Increases in autonomous spending as well as government purchases pushes the *IS* curve to the right.

[48] In its original context used by Hicks and Hansen, *IS* stood for the 'Investment/Saving equilibrium' but since then it expanded to represent equilibrium in the goods market, where total expenditure equals an economy's total output and income or simply GDP. Total expenditure is made up of consumer spending (C) + planned private investment (I) + government purchases (G) + net exports (NX).

[49] In a closed economy, the IS curve can also be defined as: Y = C (Y-T) + I(r) + G, where Y represents income, C(Y − T) represents consumer spending as a function of disposable income (income, Y, minus taxes, T), I(r) represents investment as a function of the real interest rate (r), and G represents government spending.

Figure 3.6 Mundell Fleming IS-LM-BP Model in Equilibrium



The *LM* component of the *Mundell Fleming Model* represents finance and money in an economy[50]. The *LM* schedule has an upward-sloping curve because any increase in output or income creates a corresponding increase in demand for money. The slope of the LM curve is determined by the ratio of *income elasticity demand for money* to the *interest rate elasticity demand for money*[51]. Points along the *LM* schedule signify the level at which the demand to hold money as an asset and the supply of money by banks and the central bank are in equilibrium. It basically means that the correct amount of money is in circulation to meet all current demands without having too much money in the economy. Any deviation off the curve would suggest that either too much or too little money is in circulation. Too much money means the economy could suffer from inflationary pressure and too little money means that economic activity will be slowed which in turn lowers prices. Like the *IS* schedule, the *LM* schedule also indicates the interest rate and level of income for each point along the curve. Usually the government controlled central bank of a country will determine

[50] In its original context used by Hicks and Hansen, *LM* stood for the 'Liquidity preference/Money supply equilibrium'.

[51] *Price elasticity of demand* shows the responsiveness to the quantity demanded of a good or service to a change in its price. *Ceteris paribus,* it gives either a positive or negative percentage change in quantity demanded in response to a percentage change in price. See: Marshall, A. (1920) *Principles of Economics*, Book Three: On Wants and Their Satisfaction, 8th Ed., Macmillan and Co., Ltd., London, Chapter 4, The Elasticity of Wants.

the nominal monetary supply (optimal amount of money in circulation) but in some instances the task of issuing currency may still be performed by private banks such as it is in the case of Hong Kong[52] or the US [53]. An increase in the supply of money shifts the LM schedule to the right.

The BOP component or *BP* schedule in the *IS-LM-BP Model* signifies what effect the other variables have on the System of National Accounts[54]. The *BP* curve shows combinations of income and interest rates at which points the BOP should equal zero. If exogenous variables affect the BOP and therefore the position of the *BP* curve those variables permeate into other areas of the economy. A position above or below the *BP* curve means that adjustments in other components of the economy should be made to bring the Accounts back in order. The *BP* curve is sloped positively upwards due to the fact that there is *imperfect mobility of capital* [55] in international monetary transfers. Because a rise in household income generally encourages increased imports from other parts of the world, the extra spending has a tendency to push the Current Account into deficit and consequently lifts the *BP* curve. To counter balance the deficit in the Current Account interest rates must rise to attract capital from overseas to top up the Capital Account to the point where the BOP is restored to zero.

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[52] It is the way most countries operated prior to the creation of government controlled central banks wherein the central bank then monopolised the issuance of currency. Unlike most countries the Hong Kong dollar is controlled by the Hong Kong Monetary Authority in conjunction with two private British banks both headquartered in London. These being the Hong Kong and Shanghai Banking Corporation (HSBC) and The Standard Chartered Bank where both banks print and issue currency for circulation in Hong Kong.

[53] Numerous central banks are privately owned or in partnership with their national governments. The US Federal Reserve for instance is a 100% privately owned corporation; it is not a government body. Belgium, Italy, Japan, Switzerland are private/government partnerships. Other central banks are fully owned by their State; eg. Australia, Canada. The Banque de France and the Bank of England were private but were nationalised after World War II.

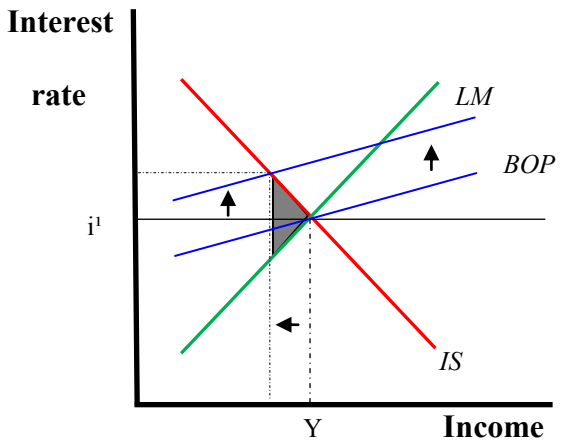
[54] The Mundell Fleming Model is also called the *IS-LM-FE Model*, where *FE* stands for the foreign exchange market. The *FE* and *BP* schedules basically mirror each other as most current account deficits are neutralised by injections of foreign capital.

[55] Capital is *imperfectly mobile* when investors respond quickly to interest rate differentials between countries but the response is not total or instantaneous. *Perfect mobility of capital* means that the *LM* curve would be horizontal and all countries would keep the same rate of interest and produce the same yields on investment.

The point where the *IS-LM-BP* schedules intersect represents a short-run equilibrium in the monetary market, goods market and BOP. When the goods markets and money markets are in equilibrium and the BOP equals zero both the interest rate and real GDP are at their optimum level for the prevailing conditions of the economy.

As it was shown earlier in the equations for calculating GDP (E-1) and net foreign investment (E-8), the BOP is heavily influenced by exogenous forces and currency values originating from abroad. It is also important to recognise that the BOP has serious implications for domestic macroeconomic stabilisation policies in that SCF can effect interest rates and currency values. In turn the capital flows effect the balance of payments and level of prosperity in the domestic economy. Again the open economy is caught in a cycle that has a self perpetuating element of instability brought about by the effects of capital movements. As shown in the Figure below, capital flows out of an economy shift the *BP* curve upwards which adds to the net debt position of the National Accounts.

Figure 3.7 Mundell Fleming IS-LM-BP Model out of Equilibrium



The intersection of the *IS* and *LM* curves is where the market is at its most efficient level. The upward movement of the BOP has thrown the economy out of equilibrium. When demand or supply is moved away from market equilibrium through speculative distortions an area of inefficiency enters the equation as a deadweight loss (grey area)[56]. Speculation also creates a secondary market where *price discrimination*[57] might enter the market. Because various buyers have differing price elasticities of demand, price discrimination may be effectuated by the speculators reselling their currency holdings at different price levels. Because the speculator's marginal revenue varies with the split market the difference in selling prices relating to changing quantities demanded allows the speculator to earn greater profits. The profits to the speculator represent a *negative externality*[58] which results in a net welfare loss to society represented by deadweight loss.

In order to rectify that imbalance several things must happen. Firstly because the BOP must equal zero in order to make up for any shortfall a further injection of capital is required to top-up the Capital Account. To achieve that, interest rates must rise (moving from i^1 in Figure 7. to i^2 in Figure 8. below) to attract more capital from overseas. Higher interest rates will have a stalling effect on the economy in that the cost of borrowing money is now more expensive, domestic businesses will limit their investment in new plant and equipment or expansion until such a time when it becomes financially viable for them to do so. The slowing down of the economy results in less output/income (Y reducing to Y^2) and higher unemployment. Because the demand for money is reduced the economy now faces another

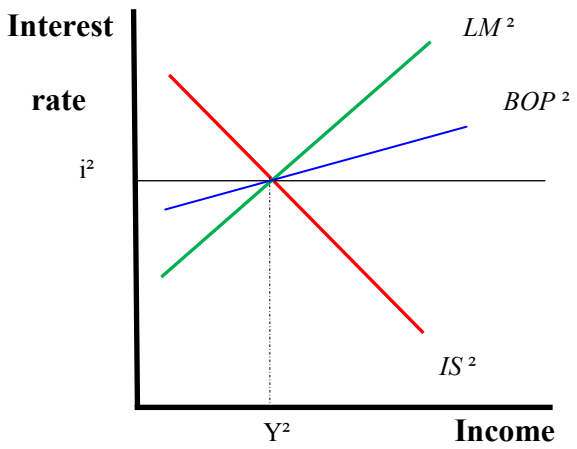
[56] When the natural quantity supplied is less than the artificial quantity demanded by speculation there is a shortage in the market which in turn pushes prices up. In effect this relates to an inefficient allocation of resources. The existence of a deadweight loss means the economy is worse off.

[57] Price discrimination occurs when a vendor sells his product/commodity/currency at different price levels to different groups of purchasers for reasons not associated with costs. He may sell 10 units at a higher price but sell 20 units at a lower price. He may sell leftover stock at an even lower price. The aim is to maximise profits at every level of the market.

[58] Typically an external cost is paid for by society as a whole even though they were not part of the transaction.

problem of having too much money in circulation. To counter balance that dilemma the central bank has to withdraw money from circulation to prevent *stagflation* (rising inflation with rising unemployment). The reduction of money in the economy moves the *LM* curve to the left so that equilibrium is restored but the entire economy is now worse off.

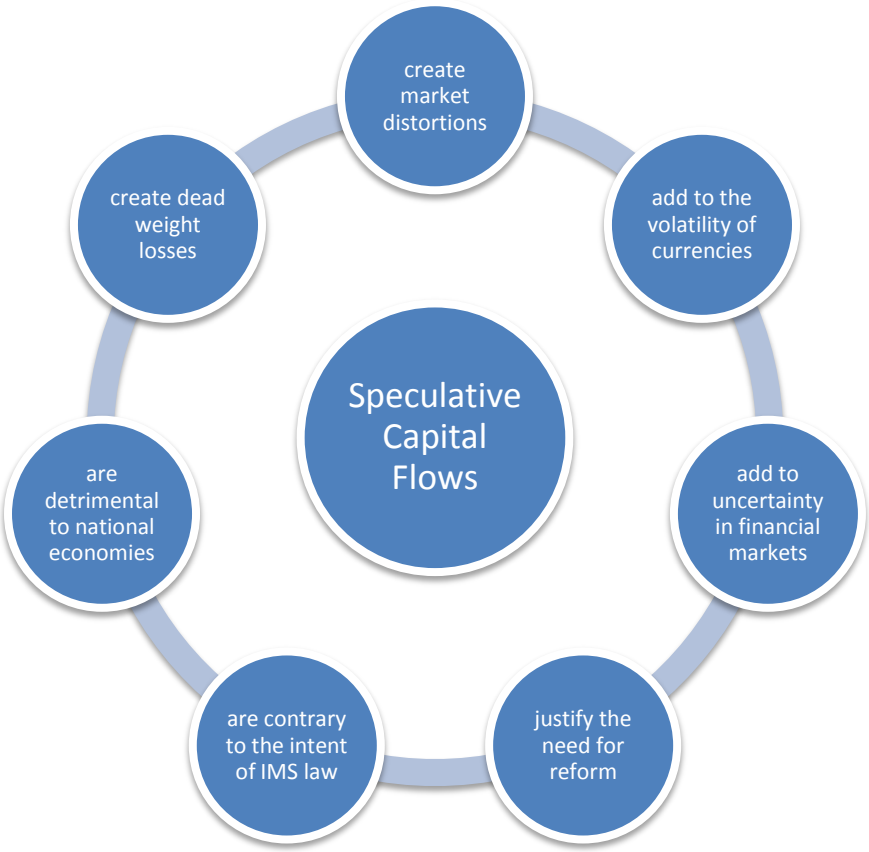
Figure 3.8 Mundell Fleming IS-LM-BP Model back in Equilibrium



After the adjustments are made the Model can be returned to the equilibrium state. The new economy results in higher interest rates (i^2), lower output (*IS* ²), lower income (Y^2), less money in circulation (*LM* ²) and higher unemployment. An important aspect to consider is that because of the higher interest rates now being paid by the central bank to attract foreign capital to the country to equalise its BOP, the long term liabilities are increased for the entire nation. It means future generations will have to pay for expenses incurred by today's regimes that have built up debt; hence equity and intergenerational fairness must be added to the complex equation. Speculative capital flows made with the intention of gaining a profit on the differentials in currency values contribute to all those negative effects.

Optimal policy adjustments for an economy are nevertheless reasonably complex where *multiple equilibria* create frictions and co-ordination problems. The problem being that the government/central bank must choose a position before it knows what equilibrium will be obtained. Therefore an important part of this process is determining which variables will affect the equilibrium to obtain the optimal position[59]. Not only do the citizens of an economy find themselves worse off, but the dynamics of maintaining stability in an economy must also be taken into account.

Figure 3.9 Effects of Speculative Capital Flows



[59] Jovanovic, B. (1989) *Observable Implications of Models with Multiple Equilibria-congruent to Econometrica*, Thomson ISI, Nov. 1989.

Bisin, A., Moro, A. and Topa, G. (2006) *Empirical Implications of Models with Multiple Equilibria*, Meeting Papers, Society for Economic Dynamics.

Figure 3.9 highlights the negative effects of speculative capital flows, therefore throughout this thesis those attributes may be referred to as disruptive capital flows, market distortions or volatility in currency markets. While the terminology is technically different for each label, the fact remains that the distortions can all be traced back to SCF; consequently whenever SCF are mentioned, it should conjure in the reader's mind a broad spectrum of related problems that need to be addressed and hopefully ignite a desire to solve them.

None of the out-comes expressed above are favourable to the constituents of an economy, therefore if the preservation of scarce resources and rational maximising behaviour are considered, one would imagine that such detrimental economic conditions should be avoided as much as possible. However, as we can see from the British example below, the economic disruptions caused by SCF have been widely known for years yet very little has been done to regulate the market or stabilise currencies.

3.8 The Sterling Attack of 1992

In late 1992, American financier George Soros determined that the British pound was indefensibly overpriced. He fearlessly sold sterling against the US dollar and then bought the currency back when its price bottomed out. He made almost 2 billion dollars profit within a few hours. How then, is it possible to make 2 billion dollars profit in a few hours? More importantly the question should be, where does that 2 billion dollars come from and who pays for it?

In August 1992, the UK Treasury held some US$24 billion in net foreign currency reserves. By the end of September 1992, Britain's net foreign currency reserves stood at minus US$16 billion after the government's futile bid to maintain the pound's place in the European

Exchange Rate Mechanism (ERM). In the case of the British pound, all of Britain paid for it. Keeping other variables constant, the lowered value of the pound meant that all British exports would be cheaper on the world market thus lowering British income. Additional to this, British imports would cost more from that point onwards. The nation as a whole lost out. It took the British Treasury and the Bank of England six years to gather the information and calculate the losses. In 2005, thirteen years after the event and seven years after the calculations were completed, Chris Giles from the *Financial Times*, with the aid of the *Freedom of Information Ac*t (UK) reporting on the losses wrote: 'Huge intervention in currency markets in August and September 1992 cost the [British] taxpayer £3.3bn'[60]. It equated to slightly over £57 per man, woman and child living in the UK[61]. Giles compiled the figures from government documents but it is interesting to note that such significant economic information relating to the detrimental effects of speculative currency flows was not willingly publicised by the relevant authorities.

This raises another question; why was the pound overvalued to start with? The pound increased in value over a period of time due to the increased demand for that currency. Because brokers allow 1:100 leverage in the forex market, US$1 did not only buy 55 pence, it bought the right to acquire £55 at a later date at a predetermined fixed price. This leverage, when multiplied by billions of investor dollars, created an artificial demand for the pound thus raising its price. Speculators hastened the process by borrowing pounds and selling them for Deutsche mark, in the expectation of being able to repay the loan in the revalued currency and to profit on the difference. Once the market grew complacent about the increased value of the

[60] Giles, C. (2005) Black Wednesday Documents: Losses on currency markets cost more than £3bn, *Financial Times*, National News, 10th February 2005.

[61] Based on 1992 UK population of 57,600,000* and £3.3 billion in losses. *Optimum Population Trust (2008) *UK Population Growth*, available at: http://www.optimumpopulation.org/opt.more.ukpoptable.html

pound, astute investors unloaded their portfolios of pounds selling at the higher price and realised a profit. The flood of selling caught the uninitiated unaware and pushed the value of the pound down below its correct value thus allowing speculators to move back in buying at the over-shot-lower-price. Even if the speculator made a profit of just ¼ a cent per dollar, leveraged at 1:100 they have the potential to make a 25 percent profit on investment within a few hours. The sophisticated techniques of foreign exchange speculation and the ease with which experienced players profit contributes to the significant increase in activity in the international monetary market.

3.9 Justification for Regulatory Reform

The speculative capital movements of which this thesis speaks are highly sophisticated financial transactions carried out in real time with the aid of both hardware and software based technologies. The profitability of such transactions is amply demonstrated and reflected in the incomes of the highest paid people in the world who all manage hedge funds and trade in currencies. The investment systems that those people and the major financial institutions employ are designed to maximise winning deals by taking advantage of technology, information and sophisticated mathematical calculations developed over the past half century. For the rational maximising risk adverse investor the parameters of the complex computer driven investment techniques are set to minimise loss situations and maximise profits. Banks, hedge fund operators and traders employing these types of technology are causing currency volatility, undermining the stability of economies and depleting the wealth of nations. Because of the interconnectedness of the global economy, it means that virtually every national economy is a potential target.

The *Efficient Market Hypothesis* demonstrates that the currency market is clearly not efficient. The currency market does not settle at an equilibrium state because it is always in a constant state of fluctuation. Arbitrage opportunities exist in such vast quantities that it allows traders to reap substantial benefits systematically in a continuous self perpetuating cycle. The more they trade, the more volatile the market becomes and hence more opportunities arise to be exploited. The BOP equation shows how an economy is affected by the exogenous forces of foreign currency values and the *Mundell Fleming IS-LM-BP Model* points out the negative effects of SCF, they include: higher interest rates, lower output, lower income, less money in circulation and higher unemployment. The long term liabilities are increased for the entire nation.

The reason why traders are able to capitalise on currency differentials is because the IMS has been subject to mismanagement and exposed to market failure. The market failure being that the capitalistic nature of commerce has compounded the inefficiencies of the present system which perpetually allows for currency traders to extract wealth from a national economy at the expense of the nation's constituents. The traders realise a financial benefit at the expense of the national economy without contributing to any form of production or delivering any form of service to the country from which they take profits. In reality they have reaped where they have not sown.

Because it will help preserve national wealth, finding a way to eliminate disruptive capital flows ought to be a major priority for any country which finds itself on the negative end of such practices. The next Chapter examines the evolution of the international monetary market to determine what made the international monetary and financial system what it is today.

Knowing its history will identify what caused the volatility in foreign exchange markets, why and how it happened, and help determine what needs to be done to 'fix' the problem.

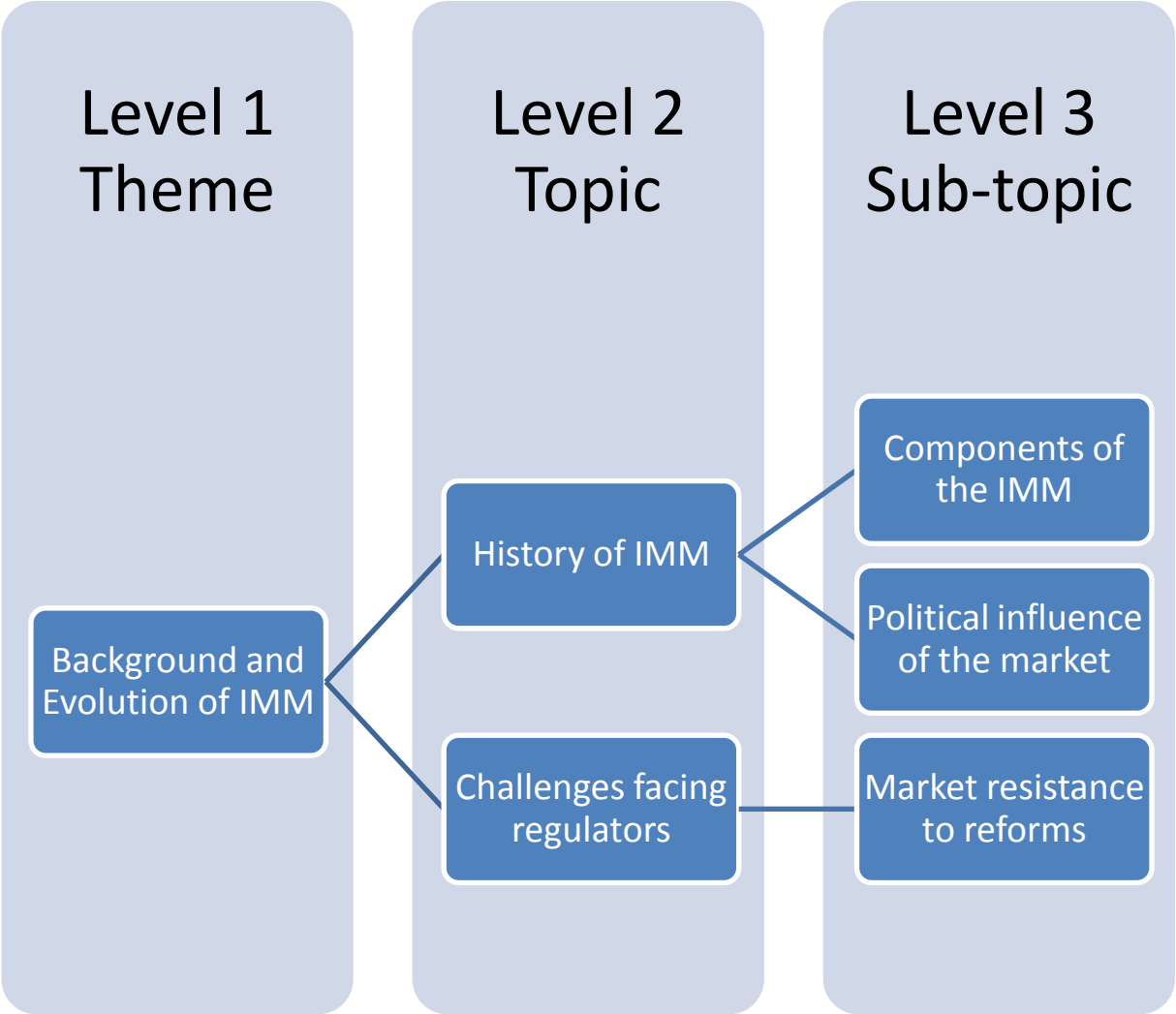
Summary of Chapter 3

This Chapter:

- expressed the alternative argument for governments not to intervene in financial markets but went on to prove why increased regulation is imperative
- presented historical examples of free market speculation
- used the Efficient Market Hypothesis, the Balance of Payments Equation and the Mundell Fleming IS/LM/BP Model to demonstrate the negative effects of SCF
- discredited the long-standing belief that speculative activity enhances economic efficiency
- demonstrated how speculative capital flows contribute to exchange rate volatility, higher interest rates, lower GDP output, higher unemployment and a drop in living standards ~ not to mention the increased liabilities placed on future generations
- reviewed the speculative attack of 1992 on the British pound and provided justification for needing regulatory reform in financial markets

Chapter 4

The International Monetary Market



Chapter 4

The International Monetary Market

Chapter Abstract

This Chapter describes the historical background and current overview of the International Monetary and Financial System (IMS) so as to identify how speculative capital flows got so out of hand. It provides a very brief history of the International Monetary Market (IMM) and reviews some of the social, economic and political considerations which led to its creation by the Chicago Mercantile Exchange (CME) in the early 1970s. It explains how the IMM fits within the framework of the IMS and how it impacts upon the global economy. It discusses Milton Friedman's influence over US monetary policy and highlights the impact dropping the gold standard had on the increase of speculative capital flows. It also introduces the major players within forex trading namely: central and private banks, hedge funds, retail brokers and the exchanges. The IMM came into existence in a regulation-free environment because it was something that had never existed before, and hence, there were no laws that catered to the new paradigm. It raises the question whether the IMS can continue in its present form and discusses some of the challenges facing regulators.

The Chapter explains how the present international monetary system no longer provides a fair and just mechanism of mutual benefit for domestic economies or international traders. The Chapter discovers how the IMS does not cater to, assist or protect the best interests of impoverished, developing or first world nations alike. It argues that the management of the international monetary market is in desperate need of an overhaul, but resistance from the financial service industry in general and reaching concensus between national governments will significantly stifle any reform process.

The Chapter proposes that the regulator's challenge is perhaps not to restrict or police the market, but rather governments should try to minimise volatile price differences between currencies and hence minimise or eliminate the opportunities for arbitrage profit. If the financial incentive to trade is removed, then traders will respond accordingly and simply withdraw from the market. The Chapter concludes that because the current economic disruptions can be attributed to a socio-political agenda stemming back to the economic policies and the actions of government, the problem can therefore be addressed within the domestic and international legal framework.

4.1 The Chicago Mercantile Exchange

Established as a not-for-profit corporation, the Chicago Butter and Egg Board was founded in 1898 and evolved into the Chicago Mercantile Exchange (CME) in 1919. At that time, futures contracts were offered only on agricultural products, such as butter and eggs. Since its inception, CME has pioneered a number of innovative products, services and systems. These included frozen pork belly futures contracts in 1961, live cattle futures contracts in 1964 and the International Monetary Market (IMM) in 1972 ~ which offered the world's first financial futures contracts revolving around the seven major international currencies.

The creation of CME's International Monetary Market futures exchange was inextricably linked with the collapse of the Bretton Woods system of fixed exchange rates. The newly created monetary market occurred only a few months after the closure of the gold window. According to Merton Miller (1986), it represented 'the most significant financial innovation' of the latter half of the twentieth century[1] .

[1] Miller, M.H. (1986) *Financial Innovation: The Last Twenty Years and the Next*, Chicago University Press, Selected Papers Number 63, May 1986.

The first Chairman of the Board of Directors of the IMM and the man behind its creation, Leo Melamed, recalled in his essay on *The Merits of Flexible Exchange Rates* [2], how the futures exchange came about. He said:

> … if ever one needed proof of the sagacity of 'necessity is the mother of invention' one need only review the economic disorders leading to the creation of our new exchange. These events proved beyond anything … that the IMM was an invention made necessary by the dictates of the times.

Melamed submitted that the Bretton Woods' IMF Agreement was:

> … a short-term solution uniquely suited for the post-World War II reconstruction. If applied much beyond that, as it was, then its basic and fundamental flaw ~ its rigidity ~ was destined to become its undoing. A fixed exchange rate system could not forever effectively cope with the continual change in currency value resulting from the daily flows of political and economic stresses between the member nations … The different external and internal interests of the participants ~ their different rates of economic growth; their different fiscal and monetary policies, beholden to different forms of governments; their different work force considerations; their different election timetables and political pressures ~ all would combine to destroy a system dependent upon a unified opinion regarding respective exchange values… [3].

Milton Friedman had already considered the same theme. He had long argued for the cessation of rigid exchange rates[4] and argued that governments should not prop up the value

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[2] Melamed, L. (1987) *The Merits of Flexible Exchange Rates: An Anthology*, George Mason University Press, Washington DC. Available at: http://www.leomelamed.com/essays/87-acfx.htm

[3] *Id*.

[4] Friedman, M. (1953) The Case for Flexible Exchange Rates, *Essays in Positive Economics*, University of Chicago Press, Chicago, p 157-203.

Friedman, M. (1959) Statement on Monetary Theory and Policy, In *Employment, Growth and Price Levels*. Hearings before the Joint Economic Committee. Washington, DC: Government Printing Office. p 605−612. Reprinted as M. Friedman, 'Monetary Theory and Policy', in R.J. Ball and P. Doyle (eds.), (1969) *Inflation*, Penguin, London, p 136−145.

Friedman, M. (1960) *A Program for Monetary Stability*, Fordham University Press, Fordham, NY.

of their currency if there were external market forces applying pressure to revalue. Freidman's ideas spawned even more literature on the subject[5].

Freidman wrote:

> ... from the time Bretton Woods became effective, it was inevitable it would break down ... It tried to achieve incompatible objectives: freedom of countries to pursue an independent internal monetary policy; fixed exchange rates; and relatively free international movement of goods and capital ... As one of the architects of Bretton Woods, Keynes tried to resolve the incompatibility by providing for flexibility of

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Friedman, M. (1963) *Inflation: Causes and Consequences*. Asia Publishing House, New York.

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[5] Brunner, K and Meltzer, A. (1972) Friedman's Monetary Theory. Reproduced in Robert J. Gordon (Ed.) (1975) *Milton Friedman's Monetary Framework: A Debate with His Critics*, University of Chicago Press, Chicago, p 63.

Davidson, P. (1972) A Keynesian View of Friedman's Theoretical Framework for Monetary Analysis. Reproduced in Robert J. Gordon (Ed.) (1975) *Milton Friedman's Monetary Framework: A Debate with His Critics*, University of Chicago Press, Chicago, p 90.

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Phelps, E.S. (1968) Money-Wage Dynamics and Labor-Market Equilibrium, *Journal of Political Economy*, Vol. 76, p 678−711.

Phillips, A.W. (1958) The Relationship between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861−1957, *Economica*, Vol. 25, p 283−299.

Sargent, T. (1971) A Note on the 'Accelerationist' Controversy, *Journal of Money, Credit, and Banking*, Vol. 3, p 721−725.

Tobin, J. (1972) Friedman's Theoretical Framework. Reproduced in Robert J. Gordon (Ed.) (1975) *Milton Friedman's Monetary Framework: A Debate with His Critics*, University of Chicago Press, Chicago, p 77.

Macpherson, C.B. (1973) Elegant Tombstones: A Note on Friedman's Freedom. *Democratic Theory: Essays in Retrieval*, Clarendon Press, Oxford, p 156.

> exchange rates through what he intended to be frequent and fairly easily achieved changes in official parities. In practice, this hope was doomed because maintaining the announced parity became a matter of prestige and political controversy. Countries therefore held on to a parity as long as they could, in the process letting minor problems grow into major crises ... [6].

Following President Nixon's August 1971 announcement abandoning the gold standard, Melamed, sensing that there was an opportunity to capitalise on the situation, commissioned Professor Friedman to write a paper outlining the need for a currency exchange. In 1971, there were no US Federal laws or agencies from which the Chicago Exchange was required to receive approval prior to listing new futures contracts[7]. Although CME legal counsel assured Melamed that he did not need governmental authorisation to proceed, he thought it prudent to acquaint the appropriate US officials with his intentions. He felt that there were several compelling reasons to consult with the government in order to: first, give the IMM concept the proper level of import and prominence it deserved; second, to gain, if possible, a positive reaction that the Exchange might be able to use in promoting the idea; and third, to be aware of and control any negative fallout from the proposal.

Friedman lent Melamed's concept his academic credentials. Friedman's paper[8] was intended to be a marketing exercise to convince government that there was a genuine need to create a new financial services product. Melamed lamented: 'without this help we could not possibly

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[6] Friedman, M. (1975) *There's No Such Thing as a Free Lunch*, Open Court Pub Co., Chicago, Illinois. Reproduced in T.M. Weithers (2006) *Foreign Exchange*, John Wiley & Sons, Inc., New York, p 219.

[7] The US Federal statute creating the Commodity Futures Trading Commission (CFTC) was not legislated by Congress until 1974.

[8] Friedman, M. (1971) *The Need for Futures Markets in Currencies*, printed in the Chicago Mercantile Exchange's publication, *The Futures Market in Foreign Currencies* , p 6 -12.

have defended ourselves from the onslaught of official and unofficial negativism awaiting us'[9]. The Chicago Mercantile Exchange paid Milton Friedman US$5,000 for his services.

Friedman wrote:

> Changes in the international financial structure will create a great expansion in the demand for foreign cover. It is highly desirable that this demand be met by as broad, as deep, as resilient a futures market in foreign currencies as possible in order to facilitate foreign trade and investment … Such a wider market is almost certain to develop in response to the demand. The major open question is where. The US is a natural place and it is very much in the interests of the US that it should develop here[10].

Those words and subsequent supporting articles by Friedman on behalf of the IMM were invaluable in facilitating the Exchange's creation, and indispensable in supporting its fragile existence during its formative years. Melamed said: 'it was his [Milton Friedman's] unquestionable prestige and credentials that opened doors for us in Washington and enabled us to state with confidence that a futures exchange for foreign currency was a necessity whose time had come' [11]. Despite some initial scepticism from certain areas of the media, the currency exchange showed signs of success within weeks of commencing[12].

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[9] Melamed, L. (1973) Chicago's Future in Futures. Speech presented at the 23rd Annual Fall Management Conference, Northwestern University, Evanston, Illinois, 7th November 1973. Available at: http://www.leomelamed.com/essays/73-chgo.htm

[10] Friedman, M. (1971) *Supra*.

[11] Melamed, L. (1973) *Supra*.

[12] Not all commentators understood or appreciated the concept of a currency market. Condemning the IMM from the start *Business Week* proclaimed: 'The New Currency Market: Strictly for Crapshooters'. Cf: *US Business Week*, 22nd April 1972.

By March 1976, all the world's major currencies were floating. The economic disruptions[13] of the 1970s proved successful for the newly created Exchange which could help manage the risk of losses caused by currency devaluations. No doubt this was a good thing for corporations engaging in international trade as they could lock-in currency values and know precisely what they would have to pay or receive when contracts fell due months ahead.

However, it was soon realised that the system also provided very profitable opportunities for investors who paid attention to the varying trends of the buoyant currencies. Needless to say, demand for the service increased accordingly. With the assistance and support of Chicago's largest bank, the Continental Illinois National Bank & Trust Company (Continental), which already had an established world-wide network, Melamed had a vehicle to take his concept to the world. Continental agreed to act as the delivery agent for the new currency contracts and helped devise a secure world system for this purpose. That delivery mechanism established a global network whereby currency traders from around the world could tap into the newly formed market.

Offering the most diverse complement of financial instruments, the IMM ultimately captured the major share of the financial services market. Its success catapulted its parent company, the CME, from a lowly secondary position in the domestic market to a primary role in international finance. Because of its resounding success, many other Exchanges followed the Chicago initiative and created their own currency trading floors.

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[13] In October 1973 Egyptian armed forces attacked Israel during their Yom Kippur religious season and war broke out. Simultaneously, the Organisation of Arabic Petroleum Exporting Countries (OAPEC) decided to reduce or ban exports to some Western countries and the Organisation of Petrol Exporting Countries (OPEC) decided to massively increase petroleum prices. Along with the break-down of the Bretton Woods Agreement, these events caused major economic instability. What followed was an era of financial turmoil that tested the very foundations of Western society; the value of the US dollar plunged; unemployment rose; oil prices increased by over 300 percent to US$39 a barrel; stock-market indices fell; gold reached US$800 an ounce; inflation exploded; and interest rates followed suit. It took over 20 years for the volatility to settle down.

In 1987 the CME signed a joint venture with Reuters Holdings Pty Ltd, the world's largest communications organisation, to create a global electronic transaction system for currency trading. As Melamed expressed, it was a bold and revolutionary concept made in response to the demands of globalisation. Using 1980s' state-of-the-art technology, the Post Market Trade (P-M-T) system worked 24 hours a day and linked all of the world's financial centres to a single clearing entity. The Chicago Exchange had created a single trading market and for the first time in history, there truly was an international monetary market.

4.2 The Illusive International Monetary System

The abandonment of the gold standard was a serious shock to the international monetary system. Mundell (1997) noted, instead of relying on the equilibrium produced by automatic adjustments of gold: 'the US resorted to bashing its trading partners, which it treated as enemies'[14]. It unleashed financial reverberations that lasted two decades and to a large part made the global economy what it is today. Fixed, pegged and floating currency values have disrupted numerous economies ever since. Accordingly, several academics: Francis Gavin (1996)[15], John Williamson (2005)[16] and Max Corden (1994)[17], have all called the current monetary system a 'non-system' and not without cause.

An international monetary system in the strict sense of the word does not presently exist. Apart from the euro zone and a few countries in the African Union, most countries have their

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[14] Mundell, R. A. (1997) *The International Monetary System in the 21st Century: Could Gold Make a Comeback?* Lecture delivered at St. Vincent College, Letrobe, Pennsylvania, March 1997. Available at: http://www.columbia.edu/~ram15/LBE.htm. This topic is expanded upon in Chapter 8.

[15] Gavin, F. J. (1996) *The Legends of Bretton Woods - monetary system - Economic Myths Explained*, Orbis Publishing, London.

[16] Williamson, J. (2005) *Revamping the International Monetary System*, A paper presented at the conference on *The Future of the IMF* held by the Institute for International Economics on 23rd September 2005.

[17] Corden, M. (1994) *Economic Policy, Exchange Rates, and the International System* , Oxford University Press, Oxford.

own independent monetary system. Mundell (1997) says this is rationally unconventional. Since the Middle-Ages, the advanced trading countries had either anchored their currency to one of the precious metals or directly to another currency. But within the first few years after the abandonment of the gold standard, many countries were forced to determine the value of their own currency ~ a phenomenon that had no historical precedence in international finance[18]. When the international monetary system was linked to gold, gold managed the interdependency of the currency system ~ it established an anchor for fixed exchange rates and stabilised inflation. When the gold standard ceased, these valuable functions were no longer performed and the world moved into a phase of erratic inflation and volatile currency movements. Because there was so much disruption, smaller countries found it difficult to even link their currency to a major currency for fear of losing too much in the event of a major devaluation by the superior currency[19].

From its beginning in 1945 to 1971, the IMF, via its *Articles of Agreement*, gave countries a coherent philosophy of macroeconomic management based on the principles of pegged exchange rates. Being established to defend and manage the anchored dollar system of semi-fixed exchange rates, the IMF lost its relevance as the guardian of the international monetary system when the US did away with the gold standard. This led to the events of 1973 when the fixed rate system collapsed altogether and free floating exchange rates came into existence out of necessity. The mandate for the IMF to change its role within the IMS was never given by the international community. It was made redundant by Nixon's Administration to preserve what little gold remained in US possession. The IMF shifted from its role at the centre of the

[18] Information in this section is derived from Eckes (1975), Garritsen de Vries (1986), and Horsefield (1967).

[19] Between December1971 and February 1973, the US devalued its dollar twice first by 7.9 percent and later by another 10 percent. Following the devaluation, Treasury Secretary George Shultz proclaimed: 'There can be no doubt we have achieved a major improvement in the competitive position of American business'. Cf. The Winners and Losers from Devaluation, *Time Magazine*, 26th February 1973.
Available at: http://www.time.com/time/magazine/article/0,9171,910593,00.html

international monetary system to a lesser role as an *ad hoc* macroeconomic consultant and debt monitor. The IMF and the rest of the world simply had to re-organise their affairs to suit the extraneous conditions imposed upon them by the US.

The current IMS has been criticised for not providing sufficient levels of stability which in turn has triggered exponential levels of speculation in foreign exchange and capital markets. This non-system has witnessed an unjustifiable succession of international monetary crises which have resulted in economic hardship for numerous countries[20].

4.3 The Major Players in Forex Trading

4.3.1 Central Banks

After the formation of the IMF but prior to the abandonment of the gold standard in 1971 central banks revalued or devalued their currencies only occasionaly. With the introduction of semi-floating or fixed but movable peg exchange rates central banks played an ever more important role in the foreign exchange markets. In order to maintain some form of stability in the domestic economy central banks were compelled to control the value of their currency by being actively involved in the buying and selling of international currencies as well as their own. In the early stages of floating currencies, Milton Friedman argued that the best stabilisation strategy would be for central banks to build up currency reserves when opportunities arose and then use those assets when needed. In times of turmoil the banks could sell those reserves to stabilise the market by converting the reserves back into the domestic currency to prop up its value. Using this strategy central banks did not always achieve their objectives. The combined resources of the free market often overwhelmed any

[20] Throughout the 1990s there evolved growing interest in the causes of speculative pressures on currencies. This became evident, stimulated by the attack on the exchange rate mechanism (ERM) of the European Monetary System in September 1992, followed by the devaluation and float of the Mexican peso in December 1994, and continued with the Asian meltdown through 1997 - 98. The Asian meltdown affected five national economies within ten months, whereas the 2008 GFC affected all Western markets and Asian markets within three months.

central bank intervention in protecting its currency[21]. This method also forced central banks to tie up huge amounts of national wealth in foreign currencies that provided no interest[22].

Gradually as more nations moved towards fully floating currencies the role of central banks diminished in the foreign exchange markets. However this did not prevent some central banks from proping up or reducing the value of their national currency when times required. Despite the formal acceptance of floating currencies the 'dirty float' became a popular tool for central banks to protect their national currency. Having national wealth tied up in foreign reserves also gave central banks the opportunity to make money by shifting their assets into appreciating currencies. What the central banks lost on non-interest bearing reserves was compensated by actual profits derived from currency trading. The profits proved so sucessful that it warranted the implementation of forex trading departments within most central banks[23].

In the early 1990s inflation targeting became the new priority for the more advanced /technically sophisticated central banks and thus the focus shifted more to controlling inflation within the economy than on maintaining the rigid value of its currency. This shift in focus did not relinquish the bank's desire to give up currency trading but as the free market provided more opportunities and larger remuneration packages for competent traders, there tended to be a brain drain from the central banks to the private sector. Hence private sector profits rose as a consequence of increased participation in lucrative forex trading by experienced traders who posessed heuristic knowledge of the market.

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[21] Several events of this nature were seen in the 1992–93 ERM collapse, the 1997 Southeast Asian crisis and the South American financial crisis in 2002.

[22] As an example, the IMF Reserve data from the Reserve Bank of Australia for February 2011 stated that the RBA was holding AU$12·423 billion in US dollars, AU$15·098 billion in euro, AU$1·669 billion in yen and AU$2·010 billion in other assets not in the SDR basket. Available at http://www.rba.gov.au/statistics

[23] For instance the Reserve Bank of Australia has a department that exclusively manages the Bank's foreign currency reserves. Their web site outlines their investment mandate and performance measurements. Available at http://www.rba.gov.au/mkt-operations/about-mkt-operations.html

4.3.2 The Private Banking Sector

While the priorities of the central bank do not normally rest in currency trading or in (some cases) delivering profits to shareholders[24], that is not the case with privately owned banks. By far the largest proportion of the forex market is dominated by the private banking sector. The inter-bank market caters for both commercial turnover and the majority of speculative trading. The substantial size of the private sector demonstrates how difficult it would be for a central bank to defend its currency if the free market mobilised to conduct a speculative attack on the nation's currency[25].

The trading undertaken by the private banking sector is usually performed by the in-house proprietary desks, trading for and on behalf of their customers and on the bank's own account. But increasingly the banks have launched their own hedge funds. In the US in particular, there is a lack of law relating to hedge funds, hence many banks set up their own hedge funds which allows them to dispense with many of the regulatory requirements normally imposed upon their investment activities. This means that US banks are given an additional corporate veil through which to conduct business but they are not the dominant players in the forex market. Foreign exchange trading is concentrated in Western Europe, which accounts for about 55 percent of global turnover on a net-gross basis, due mainly to the presence of the German, UK and Swiss trading centres, followed by those in the United States (19%), Japan (6%), Singapore (5%), Hong Kong SAR (5%) and Australia (4%)[26].

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[24] Some central banks are privately owned (eg: US Fed) while others are co-owned or in partnership with government (eg: Japan & Italy).

[25] In Australia for instance the RBA's Real-Time Gross Settlement Statistics for February 2011 showed that Australian based banks had over AU$167 billion tied up in foreign currency assets. This outweighed the RBA's own forex reserves of AU$31.2 billion by over 500 percent. RBA Austraclear - Real-time Gross Settlement Statistics – Table C7 at http://www.rba.gov.au/statistics.

[26] Bank for International Settlements (2010) *Triennial Central bank Survey of Foreign Exchange and Derivatives Market Activity 2010* , Press & Communications Basel, Switzerland. P 18.

According to a 2014 poll of foreign exchange service providers, Euromoney FX identified the ten largest participants in the global market[27]. The findings are sumarised in Table 4.1 below.

Table 4.1 Top Ten Participants in Forex Trading (2014)

Rank	Institution	% of daily turnover	US$ daily trading activity	
1	CitiGroup	16.04%	850.12	billion
2	Deutsche Bank	15.67%	830.51	billion
3	Barclays Capital	10.91%	578.23	billion
4	UBS AG	10.88%	576.64	billion
5	HSBC	7.12%	377.36	billion
6	JPMorgan	5.55%	294.15	billion
7	B of America Merrill Lynch	4.38%	232.14	billion
8	Royal Bank of Scotland	3.25%	172.25	billion
9	BNP Paribas	3.10%	164.30	billion
10	Goldman Sachs	2.53%	134.09	billion
	Total attributed to top ten traders	**79.43%**	**4209.79**	**Billion**

Source: Euromoney FX 2014 Survey

Using figures derived from the Bank for International Settlements' 2013 Triennial Report the volume of forex trading and other foreign exchange instruments as of April 2013 stood at an average of US$5·3 trillion per day. The increase from 2010 was driven by the 48 percent growth in turnover of spot transactions, 31 percent growth in outright forwards and 36 percent growth in currency swaps. BIS said the higher turnover was associated with the increased trading activity of non-reporting banks, hedge funds, pension funds, mutual funds, insurance companies and central banks.

[27] Theweekly FiX (2014) *FX Poll 2014*: The Euromoney FX survey. Available at: http://www.euromoney.com/Article/3331628/FX-survey-2014-Results-index.html

Although the top ten banks accounted for around 79·4 percent of daily forex turnover amounting to US$4·209 trillion, that figure does not represent how much money those banks actually have tied up in foreign reserves. The daily turnover is made up of the sum of many smaller transactions buying in and selling out of the market constantly throughout the day. Banks are generally the market-makers whereby they quote two way prices allowing other participants to either buy in or sell out on their bid/ask spreads. In the interim however, the banks are nevertheless simultaneously competing with their customers in the market. As with most forex traders, they scrutinise the data looking for the profitable opportunities presented by micro variations in the currency diferentials. The traditional method of banks earning revenue from interest collected on their lending activities has become secondary to the profits generated by currency trading. Therefore any proposal to limit or abolish currency trading would probably find strong opposition from the banks as it would dramatically reduce their revenue. Hence, solving the problems caused by SCF will necessarily require a regulator that will not be intimidated by the demands of corporate entities, but rather will be technologically sophisticated enough and have the power to implement, monitor and police disruptive trading activity at an international level.

As the ten major banks with their internal hedge funds account for around 79·4 percent of daily forex turnover, the remaining 20·6 percent or US$1090.21 billion is attributed to other investment institutions and of course, companies carrying out international commercial transactions for goods and services. Retail brokers and internationally traded goods and services have similar turnover figures of between US$45 – 55 billion each per day. Central bank trading activity accounts for approximately 1·3 percent[28] or US$69 billion of the daily turnover leaving approximately US$966 billion for smaller banks, independent hedge funds,

[28] BIS 2007 Triennial Survey, Statistical Annex, Table E1. This information was not included in the BIS 2010 Report.

sovereign wealth funds, private equity firms, building societies, leasing companies, insurance companies, mutual funds, pension funds and financial subsidiaries of corporate firms.

4.3.3 Hedge Funds

Both bank and private hedge funds have engaged in aggressive currency speculation since the early 1990s. Controlling billions of dollars and being able to move it around freely within the forex market has on many occasions overwhelmed stabilisation intervention by central banks. Galati and Melvin (2004) reason that hedge funds have grown markedly over the years in terms of both number and overall size due mainly to their 'lucrative returns' and now play an increasingly important role in financial markets in general, but particularly in the forex market[29].

The impetus for hedge fund growth in the US was due mainly to the 1999 partial repeal of the *Glass Steagall Act* (US)[30] ~ the Depression-era law that forced a separation between savings banks, commercial banking investment firms and insurance companies and brought moderate accountability to the financial services industry. For over sixty five years the *Glass Steagall Act* was one of the pillars of US banking law. In effect, the law kept savings banks from doing business on Wall Street, and vice versa. It prohibited savings banks from using their customer's deposits to invest in securities such as stocks and bonds but when the law was repealed, the savings banks headed straight to the trading floors.

[29] Galati, G. and Melvin, M. (2004) Why has FX trading surged?, *BIS Quarterly Review*, Bank for International Settlements, December 2004.

[30] More correctly the *Bank Act of 1933* US Code, Title 12, Chapter 3, Subchapter 1, Section 227, was named after the two congressmen who launched the bill.

Anderson (2007) wrote:

> While Wall Street still mints money advising companies on mergers and taking them public, real money ~ staggering money ~ is made trading and investing capital through a global array of mind-bending products and strategies unimaginable a decade ago. Banks navigating that complex territory do it for their own bottom line and for their clients, and increasingly in far-flung corners of the world[31].

The result of this development was that many banks created their own hedge funds to take advantage of the non-reporting requirements associated with hedge funds. This allowed the banks to allocate large sums of capital to fund managers who effectively had free rein to invest that money with little government supervision and minimal regulatory accountability.

In 2005 over 2,000 hedge funds opened for business in the US alone. By mid 2006 US hedge funds controlled an estimated $1.2 trillion in assets, almost 3,000 percent more than they did in 1990[32]. In December 2007 HedgeFund.net and Institutional Investor News, two hedge fund data, news and information providers, released the *2008 Hedge Fund Asset Flows & Trends Report*. The comprehensive industry report included an overview of 2007 and the outlook for 2008 of the major asset flows, performance and key trends in the hedge fund industry. Because large institutional investors had entered the industry, asset levels continued to rise. By the end of 2007, total assets held within hedge funds were in excess of US$2.7 trillion[33].

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[31] Anderson, J. (2007) Goldman Runs Risks, Reaps Rewards, *New York Times*, 10th June 2007, p BU1.

[32] Bogdanich, W. and Morgenson, G. (2006) S.E.C. Is Reported to Be Examining a Big Hedge Fund, *New York Times*, 23rd June 2006, p BU1.

[33] Institutional Investor News (2007) *Hedge Fund Asset Flows & Trends Report 2008*, HedgeFund.Net, Available at http://www.iialternatives.com/fundflows08.

The GFC had a detrimental effect on the number of hedge funds. The number of hedge funds managing more than US$1 billion fell by more than 40 percent globally in 2008[34]. According to a survey by PerTrac Financial Solutions, about 200 funds had assets of more than $1 billion, down from 350 in the 2007 survey. By early 2009 total assets held by hedge funds stood at $1.8 trillion, down more than 33 percent from the US$2.7 trillion in 2007[35]. Given that the American sub-prime mortgage crisis eroded the value of some stocks like Federal National Mortgage Association (Fannie Mae), and the Federal Home Mortgage Corporation, (Freddie Mac) by over 2000 percent[36], it is unfortunate, but understandable that a trillion dollars in wealth evaporated from assets under management in hedge funds. Despite investor outflows which appeared to peak in December 2008, since then the trend has slowly reversed, due mainly to the initial $1.2 trillion US government T.A.R.P. bailout, the subsequent quantitative easing measures[37] and resulting re-bound in the US stock market.

It is important to note however, that hedge funds are not uniquely an American phenomenon[38]. They operate in England, Europe, Australasia and other parts of the world, but what makes the American market so important is that the US is home to approximately 70

[34] Cf Money Morning Investment News http://www.moneymorning.com/2009/04/02/global-investment-news-briefs-39/ 2 April, 2009.

[35] *Id*.

[36] Share pricing for FNM and FRM went from approximately $89 down to 33 cents by November 2008. They have since rebounded slightly to around $1·40.

[37] US quantitative easing measures were commonly referred to as QE II and QE III.

[38] The father of hedge funds, US businessman Alfred Jones experimented with several investment strategies including the hedge idea in the 1940s. The vehicle through which he operated was a limited partnership with a unique investment strategy combining two speculative tools to create what he considered a conservative investment scheme. He used leverage to buy greater volumes of shares, and used short selling to off-set potential market risk. His strategy was adopted in currency trading. Cf: Loomis, C. J. (2001) *Alfred W. Jones*, in Charles D. Ellis and James R. Vertin, ed. (2001) *Wall Street People: True Stories of Today's Masters and Moguls*, John Wiley & Sons, Inc., New York.

percent of all global hedge funds ~ down from 82 percent in 2003[39]. Not only does the US have the largest number of funds, it also has the largest dollar value of funds to put to work. The UK is home to approximately 20 percent of global hedge funds[40] but represents 85 percent of European based funds[41]. Subsequent to the GFC, London's 2009 share was slightly down on the previous year due to a bigger fall in hedge fund assets in Europe than in the US. Japan, Hong Kong and Australia[42] count for approximately 7 percent of the global hedge fund market while the remaining 3 percent is spread between Russia, the Middle East and South America. Taking those figures into account, it directs us to focus attention on the American situation in order to capture over 70 percent of the world's hedge funds[43].

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[39] Maslakovic, M. (2009) *Hedge Funds*, International Financial Services London (IFSL) Research. Available at: www.ifsl.ogr.uk

[40] London accounts for about 20 percent of the global hedge fund market and is currently home to about 85 percent of Europe's hedge funds. Maslakovic, M. *Supra*. For a slight variation on these figures see: Merco Press Editorial (2009) EU hedge funds regulations threaten London's position as global financial hub, *Economy, International. Merco Press*. 3rd September 2009. Available at: http://en.mercopress.com/2009/09/03/eu

[41] Maslakovic (2009) *Supra*, p 2.

[42] 'Although the Australian hedge fund industry has grown rapidly, it is still small relative to the wider funds management industry'. Cf: McNally, S., Chambers, M. and Thompson, C. (2004) The Australian Hedge Fund Industry, Reserve Bank of Australia, *Financial Stability Review*, September 2004, p 63.

[43] Continental Europe is home to approximately 5 percent of global hedge funds. Although regulation in connection to hedge funds is sparse, the European Commission plans to regulate hedge funds saying its proposals are necessary 'to overcome gaps and inconsistencies in existing regulatory frameworks at the national level' and that they will 'improve the macro-prudential oversight of the sector and [allow governments] to take co-ordinated action as necessary to ensure the proper functioning of financial markets'. Cf: Merco Press Editorial (2009) EU hedge funds regulations threaten London's position as global financial hub, *Economy, International. Merco Press*. 3rd September 2009. Available at: http://en.mercopress.com/2009/09/03/eu

The British Financial Service Authority (FSA) only requires hedge funds to disclose certain 'short' positions. In conjunction with the European Commission, the FSA is presently seeking to place hedge funds under more stringent regulatory supervision. Cf: Bryan-Low, C. (2009) U.K. Parliament Grills Hedge-Fund Heads, *The Wall Street Journal,* 28th January 2009*,* p C2.

In Australia, there are no specific regulations covering hedge funds. 'Like other types of managed funds, hedge funds fall under the scope of the *Corporations Act* 2001 (Cth): the provisions that apply depend on whether they are structured as trusts or companies. In the case of a trust, if a hedge fund is marketed to retail investors it must be registered with the Australian Securities and Investment Commission, and is subject to certain operational and disclosure requirements designed to protect investors' interests. These requirements include the appointment of a responsible entity charged with certain fiduciary duties, the provision of adequate product disclosure statements and annual or semi-annual reporting of financial statements. Hedge funds which do not accept funds from retail investors are subject to fewer requirements, as their investors are considered to be better placed to monitor and manage their investments without government regulation. Hedge funds structured as companies must comply with provisions covering capital raisings, corporate governance and disclosure requirements'. Cf:

Investment manager Robert Milroy (2000) writing a guide to offshore investments described the changing role of the hedge fund as:

> Originally set up to 'hedge bets' or insure against currency or interest rate risks, hedge funds have since taken on a much wider remit, investing in assets ranging from equities and fixed interest stocks to derivatives and commodities. Their aim is to make absolute returns, that is to make performance returns irrespective of which way the markets are going. Rather like derivative funds, hedge funds use derivative instruments or gearing (borrowing against the fund's assets) to gain greater exposure to their investments or to protect against losses[44].

Soros (2000) explains:

> Hedge funds engage in a variety of investment activities. They cater to sophisticated investors and are not subject to the regulations that apply to mutual funds geared toward the general public. Fund managers are compensated on the basis of performance rather than as a fixed percentage of assets. 'Performance funds' would be a more accurate description[45].

The critical point to note from Mr Soros's explanation is that US hedge funds are not subject to regulation in the same manner that public companies, mutual funds and normal bank activities are. Due to the private nature of these types of investment, some funds do not even release audited financial statements because the law simply does not require it[46]. The lack of

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McNally, S., Chambers, M. and Thompson, C. (2004) The Australian Hedge Fund Industry, Reserve Bank of Australia, *Financial Stability Review*, September 2004, p 58.

[44] Milroy, R.B.(2000) *Standard & Poor's Guide to Offshore Investment Funds*, 5th edition, International Offshore Publications Limited. at: http://www.sec.gov/spotlight/hedgefunds/hedge-vaughn.htm

[45] Soros, G. (2000) *Open Society: Reforming Global Capitalism*, Perscus Books Group, New York, at p 197.

[46] Two US Acts which provide the loop-holes for reporting procedures applicable to hedge funds are the *Investment Company Act* and the *Investment Advisors Act* both of 1940. US Code, Title 15, Chapter 2D, Subchapter I, Sections 80a-1 and Subchapter II, Sections 80b-1 respectively. Because hedge funds are not required to register or report their activities to the SEC under the *Investment Company Act* their advisors can also qualify for the registration exemption under the *Advisors Act* if each separate fund they manage has fewer than the prescribed number of investors. The loophole is that it is irrelevant how large each investor is. One fund manager could have fifteen clients in the form of another hedge fund or a private equity fund with each having hundreds of millions if not billions of dollars to invest. A tangled web of obscurity is thus woven by

regulation and transparency means there is little to stop US hedge fund managers from misleading investors.

Hedge funds are commonly perceived as small, secretive investment funds run by financiers who earn extraordinary returns managing money for the super rich. Another perception is provided by Neil Weinberg and Bernard Condon from *Forbes Magazine*, who described hedge funds as: 'The Sleaziest Show on Earth ... a business rife with exorbitant fees, phony numbers and outright thievery' [47]. The US Securities and Exchange Commission's enforcement actions against hedge fund fraud [48], tends to support Weinberg and Condon's opinion.

In February 2007 the Bush Administration stated, via Treasury Secretary Henry Paulson, that there was no need for greater government oversight to protect the nation's financial system from the rapidly growing hedge fund industry or other private investment groups. Following the Panel's argument about the loss of American competitiveness, and in agreement with industry representatives, the Administration announced that: '… investors, hedge fund companies and their lenders could adequately take care of themselves by adhering to a set of

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allowing hedge funds to invest in other hedge funds or private equity funds none of which are publically accountable.

[47] Weinberg, N. and Condon, B. (2004) The Sleaziest Show On Earth, *Forbes Magazine*, 24th May 2004. At: http://www.forbes.com/global/2004/0524/030.html

[48] The US Securities Exchange Commission filed 78 enforcement actions against hedge funds between 2002 and 2005*. By comparison, the SEC filed approximately 250 enforcement actions just in the first half of 2009**. High profile cases include; Michael Berger's Manhattan Fund, David Mobley's Maricopa Fund, Edward Strafaci's Lipper Convertible Fund, John Barry's Beacon Hill Asset Management Fund, and Bernard Madoff's $50 billion fraud. *Bogdanich, W. and Morgenson, G. (2006) S.E.C. Is Reported to Be Examining a Big Hedge Fund, *New York Times*, 23rd June 2006 p BU1.
**SEC Litigation Releases. Available at: http://www.sec.gov/litigation/litreleases.shtml

nonbinding principles'[49]. The decision reflected both the strong anti-regulatory ideology of the Bush Administration and the formidable influence of Wall Street[50].

Needless to say the Administration's *laissez-faire* philosophy toward market regulation was not embraced enthusiastically by the SEC or other prominent academics. Harvey Goldschmid of Columbia Law School who served as general counsel and as a member of the SEC vehemently expressed:

> The report pays lip service to the need for rigorous enforcement and would dramatically diminish the effectiveness of the SEC, of criminal enforcement, of state attorney general enforcement and of private damage actions … The recent drive for accountability and deterrence would be replaced by a world in which almost anything goes … overall their recommendations are unbalanced and unwise[51].

The increase of hedge funds within banks may be seen as either a streamlining of business activity or alternatively, another mechanism through which the banking sector escapes

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[49] President's Working Group on Financial Markets (2007) *Common Approach to Private Pools of Capital Guidance on hedge fund issues*, The White House, 22nd February 2007. http://www.treasury.gov/resource-center/fin-mkts/Documents/hp272_principles.pdf

[50] The Bush Administration was heavily influenced by the policy advice advocated by Goldman Sachs, Citibank, Bank of America and J P Morgan. Nomi Prins highlights how both political parties in the US are guided by the policy recommendations of the largest commercial banks and major Wall Street firms. Four of the Bush Administration's most senior economic policy-makers: Treasury Secretary Henry Paulson Jr, his top deputy Robert Steel and White House chief of staff Joshua Bolten were all past CEOs or senior executives of Goldman Sachs*. John Thornton was president of Goldman Sachs when Henry Paulson was its chief executive, and Glenn Hubbard who co-chaired the Panel making the recommendations was a former chairman of President Bush's Council of Economic Advisers. See: Prins, N. (2009) *It Takes a Pillage: Behind the Bailouts, Bonuses, and Backroom Deals from Washington to Wall Street*, John Wiley & Sons, Inc., Hoboken New Jersey.

Other past Goldman Sachs (GS) employees who held influential positions included: Robert Ruben Vice Chairman of GS became Secretary of Treasury before moving to Citigroup. Stephen Friedman a Chairman of GS became Chairman of Economic Council. John Corzine became Governor of New Jersey before becoming a US Senator. Robert Zolick former Vice Chairman of GS became President of the World Bank. John Whitehead from GS was a former Chairman of Lower Manhattan Development Committee, became a Chairman of the NY Federal Reserve before becoming Deputy Secretary of State.

*Cf: Labaton, S. (2007) Officials Reject More Oversight of Hedge Funds, *New York Times*, 23rd February 2007, p C4.

[51] Norris, F. and Labaton, S. (2006) Panel to Urge Rewriting Rules to Aid Companies, *New York Times*, 30th November 2006, p BU1.

prudential regulation. As the 2008 financial crisis highlighted, stricter oversight and regulation of US banks may have prevented many problems caused by the financial crisis[52] . Hence a strong argument for tighter control over the free market banking sector has merit because those entities were largely responsible for the disruptions in the IMS and volatility in currency values during the GFC.

4.3.4 Retail Brokers

Retail forex brokers and corporate spending represents a small fraction of the total volume of the foreign exchange market. While the use of forex for traded goods and services has shown consistent growth, retail brokers have multiplied in number and turnover quite substantially in recent years. The BIS 2010 Report said: "the spread of electronic trading platforms has contributed to greater activity by other financial institutions, particularly algorithmic trading"[53]. The connectivity of the internet has allowed freer access for small time investors to dabble in the market via their exchange interface.

4.3.5 Goods and Services

A very small but important part of the forex market comes from the financial activities of companies and governments seeking foreign exchange to pay for internationally supplied goods and services. Trade flows are an unavoidable factor in the long-term direction of a currency's exchange rate especially when purchasing big dollar items like A380 jet airliners

[52] The US Congressional Oversight Panel on Regulatory Reform carried out an extensive examination of the reasons why the 2007- 09 financial crisis occurred. Amongst other things, the Panel recommended ~ be it all a bit late: 'It is critical that the lessons [of the GFC] be studied to restore a proper balance between free markets and the regulatory framework necessary to ensure the operation of those markets to protect the economy, honest market participants, and the public'. Cf: Congressional Oversight Panel Special Report on Regulatory Reform (2009) *Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability*, Senate Committee Prints, US Government Printing Office, p 2.

[53] Bank for International Settlements (2010) *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity,* Press & Communications, Basel, Switzerland, p16.

or military hardware. Corporations often trade fairly small amounts compared to those of banks or speculators, and usually their trades have little impact on the market. Nonetheless government spending and some corporate purchases can have an unpredictable impact on the balance of payments and therefore the market when their purchasing intentions are not expected by specialised forex traders. But since the forex transactions are secondary to the actual investment decision, international purchases of goods and services are not seen as speculative or aimed at disrupting the IMM.

4.4 Competition Between the Exchanges

While the different Exchanges usually specialise in specific financial products[54], they also compete on a host of products that are identical. For instance, the Chicago Mercantile Exchange was the first Exchange to open a platform for currency futures in 1972 and held an enviable monopolistic position in the IMM simply based on trading seven major currencies. The London International Financial Futures and Options Exchange (LIFFE) came into existence in 1982 in response to the removal of currency controls which the UK government lifted in 1979. Modelling itself on the Chicago Mercantile Exchange, it also offered similar products on foreign exchange and interest rate derivatives, futures contracts and options linked to short term interest rates and foreign currencies ~ particularly futures contracts on 10 year German Government Bonds. Trading was conducted by open outcry on the trading floor and by the end of 1986, LIFFE had become the largest futures exchange in Europe. However

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[54] As an example, the Amsterdam market which opperates on central European time, buys and sells Euro/US Dollar Currency Futures and US Dollar/Euro Currency Futures. The London market handles Euro/yen (TIBOR), Euro/swiss, Euro (EURIBOR), Euro/dollar, Short Sterling, Two/Five/Ten Year Euro Swapnotes, US Dollar Swapnotes and EuroMTS* Government Bonds. Other cash markets cover; Equities, Warrants, Trackers, Bonds, Convertible bonds, Investment funds, Borrowing/Lending Subscriptions and Application Rights.

*EuroMTS Limited is the company that manages the pan-European electronic trading platform for government and quasi-government Eurobenchmark bonds ~ bonds denominated in euro.

competition from France and Germany soon put an end to its European monopoly. The Marché à Terme International de France (MATIF) Paris's futures exchange and the Deutsche Terminbörse in Frankfurt also joined international currency trading. In 1988 the Frankfurt Stock Exchange [55] which had a three hundred year history in currency trading implemented a lucrative strategy against the competition in the IMM and launched the Eurex ~ the first fully automated real time electronic trading platform. Within six months the Eurex platform had captured 90 percent of LIFFE's market share and made in-roads to the CME's market. For increased transparency and regulation, in 1992 the German Finance Ministry expressed support for a single unified Stock Exchange. In response to this the Frankfurt Exchange amalgamated with several other German and Swiss exchanges to become the Deutsche Börse AG[56] in 1993. Since then, it has expanded its fully electronic trading systems of Eurex and Clearstream, and built operating trading systems to support its global network. Appendix D provides a schematic history of the three major platforms.

To combat competition from the London and European Exchanges, CME commenced its electronic Globex platform in June 1992. The Globex terminals were originally hard-wired to Reuters' global network anchored to a mainframe in Long Island NY, with trading being carried out in Chicago, New York, Paris and London. CME added the euro, Canadian dollar, Swiss franc and Korean won futures to its list of products[57].

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[55] Frankfurter Wertpapierbörse, now part of the Deutsche Börse Group.

[56] AG in the company's name means Aktiengesellschaft, which is the equivalent to a public corporation that is limited by shares, owned by shareholders and tradeable on the stock market. Similar provisions in other jurisdictions include Public Limited Companies (PLC) in the UK, Limited Liability Corporation (Federal LLC not State LL Companies) or Corporations (Corp.) in the US and Limited companies (Ltd) in Australia and Canada.

[57] Chicago Mercantile Exchange (2006) *European-Style Options on CME FX Futures*, CME Foreign Exchange Products flyer.

Lagging significantly behind the European based platforms and the CME, LIFFE moved to an all electronic trading model in 1998 and introduced its after-hours trading operations. The competition continued. In 2000 the Amsterdam and Brussels Stock Exchanges and the Paris Bourse merged to create Euronext, the first pan-European exchange. In 2002 Euronext acquired the LIFFE and joined with Bolsa de Valores de Lisboa e Porto ~ formerly the Lisbon Stock Exchange and the Porto Derivatives Exchange Association.

In 2000 CME became the first US financial exchange to demutualise into a shareholder-owned corporation. What was once a not-for-profit organisation made up of members, the CME went public and is now listed on the New York Stock Exchange and provides dividends to its shareholders. The move towards profit driven performance meant there was an added incentive to increase SCF and hence its long-term investment and promotion of currency trading increased.

In 2002 average daily volume reached 1.2 million contracts through the CME. By 2007 that number had grown to 8.5 million contracts a day. CME now offers 41 individual FX futures and 34 options on futures products, all of which trade electronically on the CME Globex platform. By 2008 CME was the largest futures exchange in the US and the second largest in the world, handling over 1 billion futures contracts annually worth more than US$660 trillion[58]. To facilitate electronic trading, CME Globex supports mass quoting capabilities for several currencies. It uses selected regional brokerage firms to provide continuous, transparent and competitive electronic access for market participants to its 23 hour per day Globex network.

[58] Chicago Mercantile Exchange (2008) *CME Globex Newsletter*, 9th January 2008.

In 2003 when the Frankfurt based Eurex[59] sought to begin trading in the United States, the Chicago Board of Trade and the CME lobbied Washington to scrutinise Eurex's application for an Exchange License on the grounds that a foreign-based Exchange would be difficult for US authorities to regulate. Eurex filed their application with the US Commodities Futures Trading Commission to offer futures and options on two, five and ten-year US Treasury Notes and on 30-year Treasury Bonds. It meant that the Chicago Exchange could face fierce competition from a European based exchange selling US financial products in its previous exclusive market. Eurex's fully electronic platform commenced trading out of Chicago in 2004 under full US regulation. In 2005 Eurex US extended its trading day to 23 hours, beginning at 5:00 pm Chicago time continuing through to 4:00 pm the next calendar day. The extended trading hours applied to all its financial products and meant that Eurex US was the only exchange to offer trading in futures on US Treasury products during the full Asia-Pacific morning. Satish Nandapurkar, CEO of Eurex US said this change would meet customer needs by offering trading during the core business hours of all time zones, and reinforce a truly global marketplace for trading derivatives[60].

Although the Eurex US Exchange was launched in an effort to challenge Chicago's dominance in trading US Treasury futures, Eurex had difficulty making inroads. After twelve months, Treasury volume on Eurex US accounted for less than one percent of CBOT[61] contracts. The Swiss German Exchange then started trading foreign exchange futures which

[59] Eurex, currently the world's largest derivatives exchange, is jointly owned by Deutsche Boerse (commonly still referred to as the Frankfurt Stock Exchange) and the Swiss Stock Exchange.

[60] Deutsche Börse (2005) *Eurex US Extends Trading Day to 23 Hours*, 1st February 2005. http://deutsche-boerse.com/press-releases.

[61] Chicago Board of Trade.

posed a much greater threat to CME's market share[62]. In 2006 recognising the growing importance of China as a world financial centre and to expand its foreign exchange marketplace, CME developed three Chinese yuan-based contracts; yuan/US dollar, yuan/euro and yuan/yen futures and options[63].

In December 2005 the New York Stock Exchange launched its Hybrid Market creating a unique blend of auction and electronic trading. In 2006 the NYSE transformed into a for-profit, publicly-owned company. (Shares of the NYSE Group are traded under the *Ticker Symbol* of 'NYX'). Later in 2006 the NYSE Group bought a stake in Marco Polo Network and provided it with an electronic platform offering automatic executions for global investors to trade equities and derivatives listed on emerging market exchanges. Edgeing out its German rival, Deutsche Börse, to clinch the deal, the New York Stock Exchange agreed to buy the pan-European Euronext exchange creating a business worth approximately US$20 billion[64] ~ making it (at that time) the world's third largest financial products exchange.

The 2007 amalgamation of the NYSE Group and Euronext marked a milestone for global financial markets. It brought together major market participants from across Europe and the US and created the world's first multinational financial marketplace group. The newly formed NYSE Euronext became the first foreign Stock Exchange to receive approval to open an

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[62] Financial Technology Network (2005) *Eurex to extend trading hours to attract US business*,6th July 2005. http://www.finextra.com

[63] Chicago Mercantile Exchange (2006) *CME Chinese Renminbi Futures and Options*, CME Foreign Exchange Products flyer. When the Chicago Mercantile Exchange added the Chinese renminbi-based contracts to its list of products, it reflected the same boldness that they had when they launched the IMM in 1972. If anything the CME has always been innovative in creating products much the same as a casino does in creating gaming products ~ either way the bank usually wins as the odds are always stacked in their favour.

[64] BBC News (2006) *NYSE and Euronext in $20bn merger*, 2nd June 2006, http://news.bbc.co.uk/business.

office in China which it did in Beijing in September 2007[65]. Similar to the CME experience of becoming a publicly-listed company, NYSE's move towards profit motive and the promotion of currency trading has given it a commercial incentive to keep currency trading as an accepted and profitable portion of its business.

By 2008 the Deutsche Börse Eurex, Chicago Mercantile Exchange Globex and the New York Stock Exchange Euronext**,** accounted for over 89 percent of the global market. In February 2011 the Deutsche Börse initiated the purchase of the New York Stock Exchange for US$9.53 billion. It now means that just two enterprises, which own all the major trading platforms in Europe and America, dominate the global monetary market.

Notwithstanding the ownership issues, the trading platforms provide a valuable service to investors who wish to buy and sell financial assets by building the infrastructure and operating systems in which the IMM functions. The various trading platforms have different fee structures for their clients ranging from small percentages of purchase or sell value through to nominal set fees per transaction. Like the old fashioned stock broker who made money regardless of whether or not the investor made a profit, the trading platforms make their money by collecting a small fee from the brokers on every single contract that passes through their system. Typically, it is in the best financial interests of the exchanges to strive for the highest possible turnover volume. Speculative currency transactions add substantially to that volume, therefore any proposal to limit or abolish currency trading would dramatically reduce their revenue and generate resistance for change from the exchanges.

[65] NYSE Euronext (2007) *NYSE Euronext Corporate Timeline*, NYSE Publications.

Resistance from the financial service industry in general is going to be a major hurdle regulators will face in controlling SCF, but reaching concensus between national regulators will also significantly stifle the reform process. Therefore, the regulator's challenge is perhaps not to restrict or police the market, but rather to simply minimise currency volatility and price differences and hence eliminate the opportunities for profit. If the financial incentive to trade is removed, then traders will respond accordingly and simply withdraw from the forex market and seek better opportunities elsewhere.

4.5 Free Market Opposition to Reform

As Chapter 3 revealed, there are two diametrically opposed forces at play in relation to free market speculation. At one end there are the anarcho-capitalist who reject all form of government intervention in the market; and at the other extreme, people who prefer command style or centrally controlled economies. In between there are variations ranging from moderate capitalists to reform socialists. Somewhere in the middle, all parties must reach a compromise, and that is what we see on a regular basis as the pendulum swings back and forth from extreme to extreme. To put that in perspective with the management of the IMS, this recent example provides an insight to the existence of those competing forces.

Early in 2013, the Basel Committee on Global Banking Supervision watered down a key element of their plan for creating a safer financial system. They relaxed the 'liquidity coverage ratio' requirements of the 2010 Basel III accord. Giving-in to two years of intense pressure from the banking industry, the regulators made it easier for banks to meet the rule by delaying its full implementation by 4 years to 2019. One of the most vocal critics of the new

requirement was the Washington based Institute of International Finance, whose members include most of the world's largest banks, exchanges and insurance companies[66].

Mervyn King, governor of the Bank of England and chairman of the Committee on Global Banking Supervision, backed by Ben Bernanke, chairman of the US Federal Reserve, and Mario Draghi, president of the European Central Bank, said: 'there was no intent to go easier on lenders' but rather the relaxation was meant to assist the banks in providing liquidity to the market and assist in the global economic recovery[67]. The banking industry had opposed the stricter liquidity ratios stating that the relaxation was necessary to prevent a further down-turn. However, this action on the part of the Basel Committee represents a backward step in regulating the banking industry more stringently. If anything, it signifies the immense power of the banking lobby groups who used predictions of financial melt-down if they did not get their way. But above all, King, Bernanke and Draghi, who control the three most powerful central banks in the western world, which can all supply extra money/liquidity to their respective economies, adopted an agenda that was totally subservient to the market. That in itself should indicate that the banking elite still hold enormous influence over the management of the global economy. It is because of that influence, any proposed reforms that impose additional obligations on market participants or could reduce the earning potential or income of the financial services industry is going to be met with fierce resistance. Therefore, any proposed reform to reduce volatility in currency values should focus on the inter-governmental management structures of the IMS rather than imposing rules, regulations, compliance issues and additional costs onto market participants.

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[66] The Institute of International Finance has more than 450 members headquartered in more than 70 countries. http://www.iif.com/membership/members/

[67] Enrich, D., Smith, G. and Morse, A (2013) Rules for Lenders Relaxed, *Wall Street Journal*, 7th January 2013, p C1.

4.6 Chapter Analysis

Although the CME lost its global monopoly over international currency contracts[68], its creation of the International Monetary Market and the subsequent competition that it spawned gave the world a system of market finance which still bears its name. The IMM was created in the 1970s and the exponential growth in forex trading over the past 40 years now impacts significantly on world financial markets. Today currency exchanges[69] as well as banks and hedge funds all over the world engage in the practice of buying and selling currencies. These organisations as a mass conglomerate form the IMM and as such are the entities responsible for not only the productive movement of capital but the disruptive movement of capital as well.

The IMM came into existence in a regulation-free environment because it was something that had never existed before and hence, there were no laws that catered to the new paradigm. Neither domestic nor international regulatory agencies reacted appropriately or in a timely manner to monitor or control the growing volume of capital flows.

Because the international monetary market is not regulated it is open to abuse which in turn has the potential to adversely affect not only the wealth of individuals but also national economies. Additionally, because there are numerous banks and other investment entities profiting from the movement of speculative capital, there is an added incentive to keep the market in an unregulated state. Collectively these institutions by their very nature of being driven for profit through currency trading contribute to global financial instability. The

[68] Refer back to sections 4.1 and 4.4 for the explanation of the monopoly.

[69] Apart from the three major platforms described above already, other examples out of hundreds include: Bermuda Stock Exchange (BSX): Offshore electronic securities market; Sydney Futures Exchange; The Tokyo International Financial Futures Exchange (TIFFE).

present international monetary system no longer provides a fair and just mechanism of mutual benefit for domestic economies or international traders. The IMS does not cater to, assist or protect the interests of impoverished or developing nations nor does it protect the interests of first world nations. It is in need of an overhaul and the specific reason why there should be effective leadership within the inter-governmental management structures of the IMS.

Because the economic disruptions can be attributed to the lack of discipline in the IMM, which was a consequence of a socio-political agenda stemming back to the economic policies and the actions of government, the problem can therefore be addressed within the domestic and international legal framework. The next Chapter examines the legal framework under which the current system operates to unlock clues as to how to better manage volatile currencies.

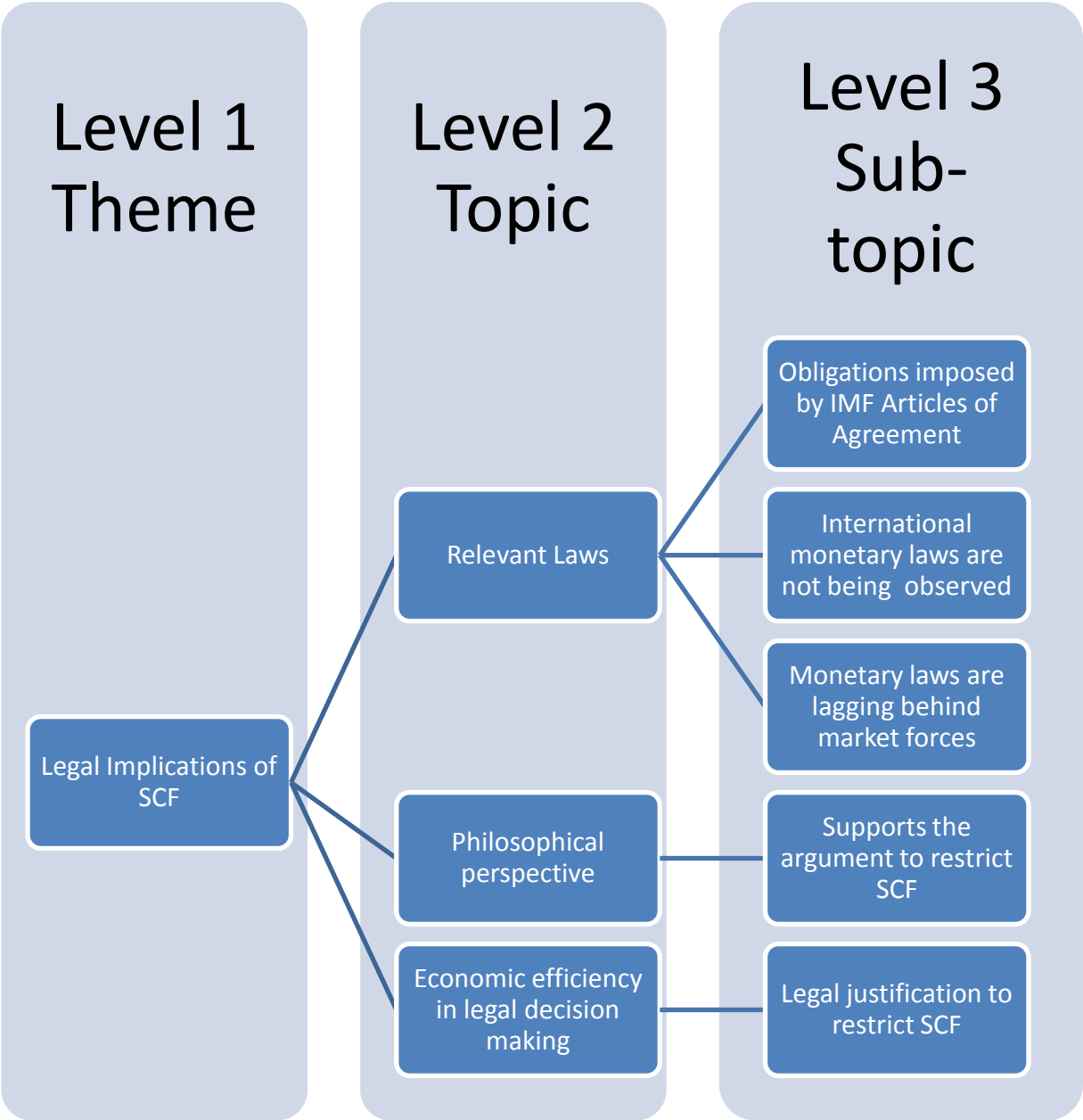
Summary of Chapter 4

This Chapter:

- provided a brief history of the Chicago Mercantile Exchange and explained how it was instrumental in creating the international monetary market
- identified the major players in forex trading which included central banks, the private banking sector, hedge funds, sovereign wealth funds and retail brokers
- explained the impact that those entities have on currency price stability
- described the competition between the exchanges and revealed the free market opposition to potential reform

Chapter 5

International Monetary Law and Economic Efficiency



Chapter 5

International Monetary Law and Regulatory Opportunities

Chapter Abstract

This Chapter examines the legal framework under which the international monetary system operates. The purpose is to build a solid case for initiating meaningful reform relating to currency markets. The argument for enhanced regulation to maximise financial stability and create a more robust global economy is based on a philosophical approach, an economic efficiency approach and a legal requirement. Economic evidence, logic and legal reasoning supports the argument in favour of reducing the negative effects of SCF, but to protect someone's rights, laws must be first legislated to prohibit a detrimental practice; or alternatively, new strategies adopted to minimise the economic shocks attributable to volatile exchange rates.

The Chapter scrutinises the legal underpinnings of international monetary law; State sovereignty; regime theory; the United Nations and Bretton Woods Institutions; the IMF *Articles of Agreement* and the application of economic efficiency in legal decision making. The findings demonstrate that international monetary laws are lagging way behind market forces and that most States are not fulfilling their social contract obligations. And despite the notion that government intervention in the free market produces less efficient out-comes, this Chapter concludes that reducing the negative impact of SCF through new universally applicable laws would go a long way towards improving the stability of the global economy.

5.1 A General Argument for Reform

The financial disruption, erosion of wealth and economic inefficiencies of monetary crises are prevalent and well documented. The GFC demonstrated, and the January 2011 *Report* by the National Commission on the Causes of the Financial and Economic Crisis in the United States[1] confirmed, that the 2008 financial crisis was avoidable and widespread failures in financial regulation and supervision within the US proved devastating to the stability of the global economy. Hence, the reasons for wanting stronger regulatory requirements and reporting procedures for banks and hedge funds are now more obvious. Considering the size of the funds involved and the contributing impact their collapse had on the global economy, it amply justifies calls for stronger regulatory oversight. But despite the fall-out of the GFC, to-date little has been done (particularly within the US[2]) to prevent another episode from re-occurring. Rational maximising behaviour would indicate that to allow the present conditions to continue would not be in the best interests for society. So what can be done?

While Chapters 7 and 8 justify the institutional need for implementing effective market discipline, broader reporting responsibility, legislative action, and reducing speculative capital flows through tax, more currency unions, and government intervention, this Chapter explores the legal framework (both domestic and international) under which the IMS

[1] National Commission on the Causes of the Financial and Economic Crisis in the United States (2011) *The Financial Crisis Inquiry Report*, US Government Printing Office, Washington, DC.

[2] At the time of writing, the proposed *Credit Default Swap Prohibition Bill* (H.R. 3145, 111th Congress, House of Representatives, 1st Session, 9th July 2009) which sought to provide the US Securities and Exchange Commission with the authority to regulate swap agreements had not proceeded. Similarly, S. 1682 of 111th Congress: *Derivatives Market Manipulation Prevention Bill* of 2009 which was to provide the Commodity Futures Trading Commission with antimarket manipulation authority also met a dead end. More successful however was the Dodd–Frank *Wall Street Reform and Consumer Protection Act* (Pub.L. 111-203, H.R. 4173) passed in July 2010. The Dodd-Frank legislation gives the Federal Reserve oversight of the largest financial institutions, including non-banks to improve accountability and transparency while also reversing the "too big to let fail" doctrine. It also gives the Fed a prominent role in the Financial Stability Oversight Council, a body of regulators with the power to liquidate systemically important financial company if its insolvency threatens the economic stability of the US. Although the *Dodd-Frank Act* initiated these steps, sorting out the finer points of the *Regulations* has delayed its implementation. Industry lobby groups including the United State Chamber of Commerce and the Futures Industry Association have challenged the proposed changes. See *Business Roundtable and Chamber of Commerce of the USA v SEC,* No. 10-1305 United States Court of Appeals (D.C. Cir. 2011).

functions. It addresses the issue of economic efficiency within the IMS and examines the legal and philosophical implications of SCF. The essential argument of this Chapter is that the IMF *Articles of Agreement* impose certain obligations on signatory States and that most governments do not take the necessary steps to ensure a system of stable exchange rates. It is not so much an argument based on 'fairness' but rather on what is most economically efficient (as described in Ch1) and what falls within the scope of international monetary law; after all, we are dealing with the global economy and it deserves to be made as efficient as possible because it effects the welfare of every person on the planet.

Although it has been evident for decades, the IMF (2010) formally acknowledged the problem of fluctuating currency values saying: 'An imperfection of the current system is the significant degree of exchange rate volatility at both high and low frequencies, which can impose significant economic costs'[3]. Because SCF can be detrimental to national and global economies, carefully planned and effective strategies could perhaps reduce those capital movements if not eliminate them altogether. Such measures might require national governments to regulate the private sector banks and hedge funds more stringently to restrict certain types of capital movements. Although touched on briefly in this Chapter, possible remedies are explained in more detail in later Chapters. For now, the reason for desiring such reforms can be based on several points of view, a philosophical approach, an economic efficiency approach and a legal requirement. This Chapter will consider the three perspectives but because the scope of each approach overlaps with the others, the discourse will intermingle the areas of discussion to build a solid argument for initiating reform.

[3] IMF Papers (2010) *Reserve Accumulation and International Monetary Stability*, Strategy, Policy and Review Department, Washington, p 19.

5.2 The International Monetary Market and Speculation

Round (2000) said: 'The International Monetary Market has become a global casino'[4]. Speculators seeking quick profits can move huge sums of money from one economy to the next, at the click of a mouse button. Similar to tangible investments like real estate, stocks, commodities and precious metals, speculators operating in the IMM make profits from the variations in price values. However with currency trading, no factories are built, no jobs are created, and no goods are produced, yet the successful investor can reap substantial rewards. Those rewards are derived from the national economies that have their currencies exploited.

Currency exchange rates are necessarily volatile due to the highly competitive nature of foreign exchange markets. With the advent of real time electronic commerce operating 24 hours per day throughout the world, currency values are determined instantaneously by the invisible hand of market forces and animal spirits. Provided of course, central banks refrain from intervening, the free market equilibrium exchange rate occurs at the point at which the natural quantity demanded of a particular currency is equal to the natural quantity supplied of that currency. However, as demonstrated in Chapter 3, currency speculation and the ensuing capital movements distort the natural supply and demand resulting in dead weight losses and economic inefficiencies.

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[4] Round, R (2000) Time for Tobin, *New Internationalist*, Vol. 320, January-February 2000.
Available at: http://www.newint.org/issue320/tobin.htm

Robin Round is with the Halifax Initiative, a coalition of Canadian NGOs working for the democratisation of economic decision-making. She headed their campaign to introduce a Currency Transaction Tax (CTT)* and lobbied the Canadian Government for its implementation. * Commonly known as a *Tobin Tax* so named after Nobel Prize-winning economist Professor James Tobin who promoted the idea in 1978.

In flexible exchange rate systems, currencies must adjust their exchange rate value to accommodate for any imbalance away from zero in the overall balance of payments[5]. The exchange rate is consequently sensitive to all of the influences that typically affect trade and investment decisions, especially market expectations about future asset prices, including expectations about the exchange rate itself. These expectations can dominate in the short term and can change quickly in response to such things as economic forecasts, negative prospects for the current account, changing perceptions about policy or even to political events and terrorist attacks.

The volatility that is caused by sudden changes in these expectations can be exacerbated by the behaviour of market traders, who often exhibit herd-like behaviour[6]. In this situation, exchange rates are prone to overshooting by being forced to accommodate speculative investments with detrimental consequences. Any prolonged departure of the exchange rate from its natural equilibrium level can, in turn, produce imbalances in the domestic economy as well as on the external accounts. Such inefficiencies should therefore become a matter of serious concern for all politicians and international policy makers who wish to maintain financial stability within their jurisdiction. So what legal mechanisms are available to rectify this problem?

[5] Balance of Payments = Current Account ± Capital Account = 0. This means that any short fall incurred by over spending in the Current Account is counter balanced by an equivalent injection in the Capital Account. If a nation spends more than it earns, it must make up that shortfall by allowing foreign / loan Capital to make up the difference. This can be made up in the form of allowing Foreign Direct Investment into the country or by drawing against the IMF's Special Drawing Rights. SDR ~ an international form of overdraft facility. See Articles XV - XXV of the IMF *Articles of Agreement*.

[6] "herd-like behaviour" and "over shooting" are discussed on pages 9, 33, 57, 93 and particularly Grenville (1999) at p 59.

5.3 Recognition of the Problem

China acknowledged the negative impact of speculative capital flows several years ago and took the necessary steps to partially protect its economy by restricting those flows into and out of its economy[7]. Brazil, Malaysia, India and South Korea have also implemented capital controls to restrict 'hot money' flowing into and out of their economies, but most Western governments have either carelessly or intentionally turned a blind-eye to the negative impact of SCF[8]. Drawing lessons from the GFC, Soros (2011) said: 'The world does need order and that order needs maintenance. The idea that markets can correct their excesses turned out to be false'. He continued: 'Perfect order and global governance are not realistic expectations however. It is a sad fact that Western democracies provide less effective leadership than China'. Soros warned that China's model of State capitalism, in which the interests of the individual are subordinate to those of the government, poses a danger if its market control mechanisms and subsequent prosperity become 'the envy of the world'[9]. On reflection, China's market control policies have been very successful in restricting SCF, keeping the value of the yuan competitive and maintaining financial stability within its borders. Legislators in Western governments could pay attention to the positive benefits of adequate regulation and market discipline in securing financial stability within their own domestic markets.

Notwithstanding the fact that currency traders can add substantially to GNP at the expense of other nations, Western governments should realise the necessity for such controlling measures to foster not only international relations, but also to promote a stable global

[7] See Appendix E for the Chinese perspective.

[8] Ferguson, C. (2010) *Inside Job*, a documentary about the banks' relationship with government, Sony Pictures.

[9] Soros, G. (2011) *Speech on global financial regulation*, French-American Foundation, Paris Traveller's Club, 9th March 2011. Available at: http://dealbook.nytimes.com/2011/03/09/soros-the-world-does-need-order/?nl=business&emc=dlbkpma21

economy. Consequently, international law and State co-operation become essential ingredients to enhancing global financial stability.

5.4 Evolution of International Monetary Law

Historically, international law was concerned almost exclusively with the relations and activities of States but this situation began to change after World War I when the *Covenant of the League of Nations* was drafted along with the *Minorities Treaties* which entered into force as a result of the Paris Peace Conference in 1919. Since then significant changes in the form, content and sources of international law have occurred, notably with the acceptance of new areas of international law like universal human rights and other legal obligations owed by States to individuals[10]. Other areas of customary international law which developed post World War II through treaties include: war crimes and crimes against humanity, law of the sea, international monetary laws, the protection of the environment, exploitation of resources and raw materials plus energy and trade[11]. Increasingly, over the past four decades national courts have been called upon to consider and resolve issues turning on the correct understanding and application of international law (Fatima 2005)[12].

The evolving common law nature of international law has subsequently put pressure on established doctrines of constitutional law; particularly where countries have treated international law and domestic law as separate legal systems under a dualist approach

[10] Brownlie, I. (2008) *Principles of Public International Law*, Oxford University Press, USA, p 553.

[11] For instance see: Bayers, M. (1999) *Custom, Power and the Power of Rules: International Relations and Customary International Law*, Cambridge University Press, Cambridge, UK. esp Ch 7 Legitimate expectation and judgements of the International Court of Justice at p 120.

[12] Fatima, S.(2005)*Using International Law in Domestic Courts*, Hart Publishing, Portland, OR. particularly Ch 1 International Law in Domestic Practice Areas p 3.

(Jennings and Watt 2008)[13]. Notwithstanding natural resistance to change, further advances in international law are required especially so when it comes to the financial stability of the global economy. So where and how does money, fluctuating exchange rates and SCF fit into the legal framework of international law?

5.5 The *Res Communes* of a Currency as a Public Good

One of the great hallmarks of a sovereign State has been its claim to *absolutus summus dominium* or its absolute right to make all and any laws applying to its territories. Amongst other things, it includes the right to produce and manage its own currency[14]. From time immemorial nation States have claimed their prerogative to decide what form of currency they would use and what value denominations their currency would take[15]. On many occasions the monarch/State also declared what other currencies would be allowed as legal tender within the kingdom/republic. Employing this long-established form of monetary policy, controlling the nation's coinage gave the sovereign the mechanism to not only influence economic activity but also the power to extract taxes and cripple or enhance national wealth. As demonstrated earlier, speculative currency trading diminishes the sovereign State's ability to effectively manage its economy.

[13] Jennings, J. and Watts, A. (Ed.) (2008) *Oppenheim's International Law: Volume 1 Peace*, 9 ed., published posthumously by Oxford University Press, USA. See Essential Difference between International and Municipal Law p 26.

[14] Currency usually includes the coin and paper money of a nation or of a foreign country that: is designated as legal tender; and circulates as, and is customarily used and accepted as, a medium of exchange in the country of issue.

[15] History is full of philosophers who have contemplated this topic. Starting in Ancient Greece with Xenophone, the medieval times with Henry de Bracton, the middle ages with Saint Augustine and Bishop Nicolas Oresme, and post Renaissance with Sir Robert Cotton, John Locke, Adam Smith and William Blackstone, but to name a few.

Under normal circumstances if any entity abuses a public good [16] it is perceived to be an injustice towards the rest of society. If we can comprehend that a nation's currency is a form of public good, to which the population has complete access, if any entity abuses that public good it is arguably an injustice towards that society. Just as society saw the need to protect the environment from the abuses of industrial pollution by enacting laws restraining corporations and individuals from damaging the public goods of clean air and fresh water, legislators could also protect the value of their nation's currency.

Through the domestic legal process, corporations have been prohibited from sabotaging public goods within national boundaries, likewise currency traders can also be prohibited from sabotaging the value of a nation's currency. The analogy between making a cleaner environment and enhancing financial stability has several similarities. Both are dependent on the ability of individual States to legislate effectively; and the other critical point is that unless laws are common among countries and commonly enforced, one country's inaction will undermine the efforts of other States. Regardless of whether the problem lies with reducing pollution, limiting carbon emissions or enhancing global financial stability, international co-operation in law making and cross-border enforcement are prerequisite.

5.6 State Sovereignty

One of the issues that must be addressed to solve the problem of speculative capital flows is conflicts associated with State sovereignty ~ especially so when the speculative capital flows originate from one State affect another State economically. Garcia (2002) writes:

> … sovereignty can be understood at least historically as a progressive human rights concept: to strengthen the autonomy of States was to clarify their independence from

[16] A 'public good' is anything that is shared in common and can be used or consumed by everyone. One person's consumption of a public good should not reduce the amount available for anyone else. Examples include: fresh air, highways, street lighting, public libraries etc.

> imperial and pontifical ambitions. It was, in this way, a subsidiary principle, bringing the locus of control closer to the fundamental moral unit ~ the individual. Of course, State sovereignty is only part of the contemporary doctrinal equipment for protecting human rights … Our challenge is to preserve those vital and progressive aspects of sovereignty in a new, global environment, while reconfiguring its unnecessary, outmoded, or inimical aspects[17].

Sovereign countries are, in theory, equal subjects under international law[18]. Supposedly, the sovereignty of one nation cannot infringe on the sovereignty of another[19]. However in practise, it is not always easy to know where the sovereignty of one State begins and the sovereignty of another State ends. With the free and unregulated movement of capital happening globally and the obligations imposed on IMF members not being implemented by most States, the divide becomes even more blurred.

5.7 Monetary Sovereignty

Mann (1992) wrote that monetary sovereignty includes essentially three exclusive rights for a given State[20]. First there is the right to issue currency; secondly there is the right to determine and change the value of that currency; and thirdly there is the right to regulate the use of that currency or any other currency within its territory. The first and third rights correspond to the role of money as a medium of exchange. The second right reflects the role of money as a unit of account. Conceptually the two functions are separate from one another but collectively their existence facilitates the opportunities for speculative attacks and financial instability. Subsequently, monetary sovereignty must be analysed to see how the laws permitting,

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[17] Garcia, F. (2002) Humanising the Financial Architecture of Globalisation: A Tribute to the Work of Cynthia Lichtenstein, *Boston College International & Comparative Law Review*, Vol. 25, no. 2, at p 204.

[18] Article 2 of the UN Charter.

[19] Of course, illegal invasions and wars demonstrate how ineffective these presumptions really are.

[20] Mann, F.A. (1992) *The Legal Aspect of Money*, 5th edition, Oxford University Press, Oxford, p 460-78.

supporting and validating national monetary rights may be applied to solving the problems related to cross-border speculative capital flows.

Gianviti[21](2004) examined the different components of monetary sovereignty and assessed the extent to which these components had or had not been restricted by rules of international law[22]. He said press articles and ministerial communiqués often misinterpret the IMF's role by referring to it as a financial institution which provides financial assistance to its members. He pointed out that the role of the IMF was first and foremost to attain certain objectives within international monetary relations, essentially relating to exchange rate stability and the liberalisation of payments and transfers for international transactions by employing several different instruments. Although the IMF regularly assists members by making foreign exchange available to them in times of crisis, Gianviti said one of the purposes of the Fund as outlined in the *Articles of Agreement* was to provide them with the opportunity to 'correct maladjustments in their balance of payments without resorting to measures destructive to national or international prosperity'[23].

Gianviti explained:

> The Fund monitors the compliance by its members with certain obligations specified in the *Articles of Agreement*. These obligations constitute a code of good monetary conduct that Fund members are required to observe.
>
> By becoming members of the Fund, they have accepted these obligations and, to that extent, limited their monetary sovereignty. In exchange they receive certain benefits. One of them is that other members too have agreed to limit their sovereignty for the

[21] Professor François Gianviti, former General Counsel for the IMF.

[22] Gianviti, F. (2004) *Current Legal Aspects of Monetary Sovereignty*, presented at the IMF Seminar on Current Developments in Monetary and Financial Law, Washington DC, 24th May – 4th June 2004.

[23] The Fund is guided in all its policies and decisions by the purposes set forth in Article 1.

> sake of international co-operation and for the common good of all. Another benefit is that in times of crisis they will have access to financial assistance from the Fund if they meet the required conditions[24].

It is useful to pay particular attention to the last sentence, 'in times of crisis they will have access to financial assistance from the Fund if they meet the required conditions'. The required conditions are fulfilling the obligations that the IMF imposes. That incentive structure acts as an inducement to comply with the *Articles of Agreement*. The French can bear testimony to the realities of not complying with the IMF directives.

Under the original IMF *Articles of Agreement*, prior to the amendments made in the 1970s after the gold standard was dropped, the value of a member State's currency was determined in terms of its value to the US dollar and gold. The *Agreement* created an obligation on members to maintain exchange rates within specified margins around a parity based on its value in relationship to at least two other currencies[25]. The par value could be changed unilaterally by the member, but beyond a specified threshold, the IMF's approval for the change had to be sought. If the IMF refused the change but the member changed the value anyway ~ as France did in 1948 ~ the member became ineligible to use the Fund's resources[26]. It meant that access to the international ledger system was denied and the shot-term overdraft facility revoked.

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[24] Gianviti, F. (2004) *Current Legal Aspects of Monetary Sovereignty*, printed in the IMF Legal Department (2008) publication *Current Developments in Monetary and Financial Law*, Washington DC. Ch 1 p 3.

[25] As an example, prior to the mid 1960s, Australia based the value of its currency (then in pounds) on its relationship with the British pound, US dollar and French franc. After 1970 but prior to 1983, the Australian Bureau of Statistics in conjunction with the Reserve Bank of Australia determined the value of the Aussie dollar on a basket of approximately 25 currencies. The currencies in the basket were weighted according to their trading significance to Australia (Trade Weighted Index). In October 1983, the Australian Government floated the Australian dollar, allowing its value to be determined by market forces with few exchange controls and minimal Reserve Bank intervention.

[26] Under IMF *Article* V section 3, and *Article* XXVI section 2(a), if a member fails to fulfil any of its obligations under the *Agreement*, the Fund may declare the member ineligible to use the general resources of the Fund. That could include denial of overdraft facilities and other special drawing right privileges. If the member does not

Mann (1992) said a change in the value of a currency is not a breach of international law. A State is not liable for its consequences on holders of its currency, or on creditors or debtors with respect to obligations denominated in that currency[27]. In the case of France, the change in the value of its currency was not regarded as a breach of international law as such, but more a prerogative to abandon a partial obligation under the IMF *Articles of Agreement*. Therefore it can be concluded that the State's compliance with the IMF *Articles of Agreement* is by consent but if they do not comply they can be sanctioned economically. Although France was penalised directly by the IMF, France's sovereignty was nevertheless recognised and she remained free to adopt the principles which she regarded as best and most suitable to her cause.

Writing on themes of globalisation and sovereignty, Lichtenstein (1993) noted how monetary globalisation would reshape the architecture of power among States. She said that international organisations need standards for supervising financial conglomerates and controlling systemic risk[28]. She believed that in a global economy money must be regulated trans-nationally saying risks and consequences flowing from unregulated capital movements necessitated a degree of international oversight[29]. Although this may be seen as an erosion of State sovereignty, Lichtenstein said it can be a positive development for global social welfare provided capital is managed effectively and fairly for the benefit of all concerned by the institutions of globalisation[30].

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rectify its breach within certain time limitations, that member may be required to withdraw from membership in the Fund (XXVI section 2 (c)).

[27] Mann, F.A. (1992) *The Legal Aspect of Money*, 5th edition, Oxford University Press, Oxford, at p 464.

[28] Lichtenstein, C. (1993) International Standards for Consolidated Supervision of Financial Conglomerates: Controlling Systemic Risk, *Brooklyn Journal of International Law*, Vol. 19, p 137.

[29] Lichtenstein, C. (1998) Dealing with Sovereign Liquidity Crises: New International Initiatives for the New World of Volatile Capital Flows To and From Emerging Markets, *McGeorge Law Review*, Vol. 29, p 807.

[30] *Ibid*. at 812.

Garcia (2002) said:

> The real problem is not multilateralism *per se*, but situations in which the political element of international financial regulation allows the interests of powerful capital-owning classes, multinational corporations, and capital-rich countries to overpower the interests of the rest of the world in the structure of international financial policy. If the interposition of a layer of international governance between States and their money is to have any legitimacy, it must result in an increase in prudent decision-making in the best interests of the system and of the people it serves, particularly those in capital-poor countries[31].

But as the GFC highlighted, the US government's failure to implement domestic laws[32] to enhance financial transparency and regulate the market more stringently placed the IMS at considerable risk. The domino effect of contagion flowed on to Britain, the Eurozone and every other economy. So why is there reluctance by Western governments (particularly America) to implement meaningful change? The answer could rest with the fact that the IMS lacks a cohesive mechanism that could bring the G20 countries together to adopt an international policy for exchange rate stability. The IMF (2010) says:

> Currently, there is no comprehensive international framework that covers all types of capital flows or that has global membership. A multilateral framework would

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[31] Garcia, F. (2002) Humanising the Financial Architecture of Globalisation, *Boston College International & Comparative Law Review*, Vol. 25, No. 2, at p 209.

[32] Although the Clinton Administration initiated a joint working group of the major federal financial regulators to produce reports which subsequently recommended regulatory changes to the regime governing hedge funds*, there was little support from the Bush Administration to implement the changes. Despite those recommendations and the growing number of fraudulent malpractice suits before the courts, in the early part of 2007 the Bush Administration made it clear that there would be no reform in reporting procedures or accountability for hedge funds in the immediate future**.

*President's Working Group on Financial Markets (1999) *Hedge Funds, Leverage, and the Lessons of Long-term Capital Management*, The White House, 28th April 1999.

See also: US Securities Exchange Commission Staff Report (2003) *Implications of the Growth of Hedge Funds*, available at http://www.sec.gov/news/extra/hedgestudyfacts.htm

** President's Working Group on Financial Markets (2007) *Common Approach to Private Pools of Capital Guidance on hedge fund issues*, The White House, 22nd February 2007.

> recognise the benefits of capital account liberalisation under appropriate circumstances, while acknowledging a role for certain measures, such as capital controls, to dampen excessive movement when necessary. The emphasis should be on making sure that measures on cross-border flows motivated by domestic economy considerations actually help reduce global volatility and do not have adverse effects on others[33].

An examination of national policy agendas might explain why the IMS is slow to move towards reform.

5.8 Regime Theory

Amongst the considerations outlined above, it is important to recognise that most political regimes will pursue their own national self interests. Krasner (1982) wrote:

> Regimes can be defined as sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations. Principles are beliefs of fact, causation, and rectitude. Norms are standards of behaviour defined in terms of rights and obligations. Rules are specific prescriptions or proscriptions for action. Decision-making procedures are prevailing practises for making and implementing collective choice[34].

However, the collective choices of Western monetary policy provide evidence of an agenda. Strange (1995) rebuked American ethnocentrism arguing that the World Bank, the General Agreement on Tariffs and Trade and the IMF were simply instruments of America's grand strategy[35]. Through those institutions the US promoted its economic doctrines onto other States under the pretence that it was the best way forward for those countries' development.

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[33] IMF Papers (2010) *Reserve Accumulation and International Monetary Stability*, Strategy, Policy and Review Department, Washington, p 15.

[34] Krasner, S. (1982) Structural Causes and Regime Consequences: regimes as intervening variables, *International Organization*, Vol 36. Spring 2. pp 185 - 205.

[35] Strange, S. (1998) *Mad Money: When Markets Outgrow Governments*, University of Michigan Press, Michigan. See Ch 1, The Casino Image Gone Mad pp 1 - 21.

But that practice ignored other countries' rights and dispensed with the obligations the US owed to the rest of the world (Shelton 1994)[36]. Williamson's (1989) 'Washington Consensus'[37] was no more a consensus than coercion[38]. The IMF's Structural Adjustment Programs (SAP) made many developing economies worse off[39]. Chossudovsky (1997) said

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[36] Professor Judy Shelton (1994) cited numerous instances where countries like Germany and France were forced to accept initiatives imposed by the US and the IMF that were contrary to the original IMF Agreement. These variations were reluctantly accepted by the European countries, not so much as a form of respect for previous favours bestowed upon them by the US, but rather as an unchallengeable stipulation. One instance read:

> Succumbing to pressure from the US Treasury, West Germany agreed in March 1967 to forgo its right to exchange dollars for gold; as far as the Bundesbank was concerned, the dollar was inconvertible. The West German government was well aware that the United States was reneging on its commitment to perform its duties as the world's monetary anchor, but it did not want to press the issue. With US troops actively protecting German citizens, and with US taxpayers footing a large part of the defence bill, West Germany's government could hardly complain.
>
> But West Germany was unique in its passivity towards the dollar and in its initial acceptance of US monetary policies. For the most part, Europe had begun to feel like a dumping ground for the residual effects of US inflation. European leaders resented the situation, but felt helpless to do anything about it. They could appeal to the US Treasury officials, they could complain about the accumulated dollars in their central banks, they could chastise the United States for drifting away from its mandate to preserve the stability of the international monetary system. But they could not abandon the dollar. Their own currencies were tied solidly to the dollar through the fixed exchange rate system, and there was no alternative key currency*.
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> * Shelton, J. (1994) *Money Meltdown*, Free Press, New York, at p 78.

[37] The *Washington Consensus* was a phrase coined by John Williamson in the late 1980s to refer to the lowest common denominator of policy advice being promoted by the Washington-based financial institutions ~ the IMF and World Bank ~ to Latin American countries. He first used the term in 1989 in a conference paper*, but in the intervening years the phrase has been used in several different senses, 'causing a great deal of confusion'**. A popular interpretation is that it refers to market fundamentalism or the neo-liberal agenda being promoted by the IMF and World Bank. It has also been referred to as a form of *laissez-faire* Reaganomics with the innuendo of 'let's bash the State, the markets will resolve everything'***.

*Williamson, J. (1989) *What Washington Means by Policy Reform*, conference paper reproduced in *The Progress of Policy Reform in Latin America*, Institute for International Economics, November 1989.

** Williamson, J. (2000) What Should the World Bank Think about the Washington Consensus?, *The World Bank Research Observer*, Vol. 15, No. 2 (August 2000), p 251. *** *id*.

[38] Professor Michel Chossudovsky (1997) explained how the IMF tightly monitored the restructuring of central banks in a manner that deprived national governments of their ability to control monetary supply. He says: 'In practice this means that the IMF rather than the government controls money creation … the IMF prevents the funding of government expenditure and the provision of credit by the central bank … the IMF on behalf of the creditors is in a position virtually to paralyse the financing of real economic development. Incapable of using domestic monetary policy to mobilise its internal resources, the country becomes increasingly dependent on international sources of funding which has the added consequence of increasing the level of external indebtedness'. Cf: Chossudovsky, M. (1997) *The Globalisation of Poverty*, Zed Books Ltd, London, at p 58.

[39] Former chief economist at the World Bank, Professor Joseph Stiglitz essentially resigned from that position in 2000 because he thought that the reforms being imposed by the BWI upon the less developed economies were actually detrimental to their economic growth. Within six months Professor Ravi Kanbur did the same thing.

that the economic policies and reforms originating from the IMF and World Bank are: 'the cruel reflection of a destructive "economic model" imposed under the neoliberal agenda on national societies throughout the world'[40]. US sponsored *Economic Hitmen* sabotaged many developing nations forcing them towards bankruptcy[41] and Williamson (2000) openly admits that the Washington Consensus focused principally on policy reforms that were aimed at reducing the role of government in developing nations[42]. Williamson had realised for some time[43] that his first formulation of the Consensus was flawed in that it totally neglected any recommendations for financial market supervision. Williamson went as far as saying that the policies of the US Treasury, the Federal Reserve Board, the IMF, and the World Bank: 'advocated in the 1990s were inimical to the cause of poverty reduction in emerging markets'[44]. The advocacy of capital account liberalisation was, in his view, the main cause of

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Stiglitz (1998) questioned the priority given to rapid privatisation and the lack of attention given to competition or building social and organisational capital. He expressed strong objection to the financial liberalisation packages being promoted by the BWI, arguing that in spite of BWI recommendations, the success of some East Asian countries stemmed mainly from their protection policies of directing credit to particular industries rather than allowing international markets to have free access. The Malaysian experience supported his argument perfectly. Stiglitz said that the implicit policy objectives underlying the Washington Consensus were inadequate. He advocated a policy package to supersede the Consensus altogether, suggesting that instead of pursuing economic expansion and freer markets, the objectives should also consider sustainable development, egalitarian development, and democratic development. Cf: Stiglitz, J. (1998) *More Instruments and Broader Goals: Moving toward the Post–Washington Consensus*, United Nations University/World Institute for Development Economics Research, Helsinki.

[40] Chossudovsky, M. (1997) *The Globalisation of Poverty*, Zed Books Ltd, London, at p 260.

[41] Economist John Perkins (2005) says he was trained to build up the American empire, to bring and to create situations where as many resources as possible would flow to the US, to corporations and government alike. He admitted that he and others like him, were very successful in building the largest empire in history with very little military intervention. He says it is only in rare instances like Iraq where the military comes in as a last resort. Perkins confesses that the US empire has been built primarily through economic manipulation, through cheating, and through State sponsored fraud. Cf: Perkins, J. (2005) *Confessions of an Economic Hitman*, Ebury Press, Great Britain.

[42] Williamson, J. (2000) What Should the World Bank Think about the Washington Consensus?, *The World Bank Research Observer*, Vol. 15, No. 2 (August 2000), at p 256.

[43] Williamson, J. (1996) *Are the Latin American Reforms Sustainable?*, in Sautter, H. and Schinke, R. eds., *Stabilisation and Reforms in Latin America: Where Do We Stand?* Vervuert Verlag, Frankfurt.

[44] Williamson, J. (2000) *supra*, at p 257.

the East Asian meltdown which resulted in a: 'tragic interruption to the poverty reduction process'[45].

Henry Kissenger's (1969) construction of a new world order[46] coupled with the Project for the New American Century's achievement of unchallengeable military power and American leadership[47] demonstrates how the US has pursued its 'Imperial Grand Strategy'[48] to the detriment of other nations. The aim of securing global dominance in both military and economic terms has advanced American interests but it has come at the expense of destabilising the global economy, expanding economic inequality and generating political mistrust. There was no collective choice or consensus, the Washington Consensus was purely a prescription for US advancement.

Given the realities of *Regime Theory*, it appears any initiative to curb SCF is going to generate resistance from within the industry and place pressure on governments to avoid change. Because ten banks and three exchanges dominate the global movement of capital and profit significantly from the trade, it would not be in their financial interests to allow speculative currency trading to be banned. And as Ferguson (2010) demonstrates, those entities have considerable influence to lobby governments and get their way[49]. The fact that

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[45] Williamson, J. (1999) *Implications of the East Asian Crisis for Debt Management*, in Vasudevan, A. ed., *External Debt Management: Issues, Lessons, and Preventive Measures*, Reserve Bank of India, Mumbai.

[46] Kissinger (1969) said: 'We must construct an international order before a crisis imposes it as a necessity'* and without a new concept of international order, global political stability would prove elusive. He wrote: 'A new international order is inconceivable without a significant American contribution … Our deepest challenge will be to evoke the creativity of a pluralistic world, to base order on political multipolarity even though overwhelming military strength will remain**. *Kissinger, H. A. (1969) *American Foreign Policy*, Lowe & Brydone Ltd, London, at p 49. ** at p 59.

[47] Project for the New American Century *Statement of Principles* can be found at, http://newamericancentury.org

[48] Chomsky, N. (2004) *Hegemony or Survival: America's quest for global dominance*, Allen & Unwin Publishers, Crows Nest, NSW. Australia.

[49] Ferguson, C. (2010) *Inside Job*, a documentary about the banks' relationship with government, Sony Pictures.

governments bow to lobby groups and big business while pursuing their own political and economic interests accentuates the moral hazards of international finance. Consequently, very little has been done to improve the efficiency or management of the global monetary system despite ample evidence of the negative effects of the GFC, unregulated markets and SCF.

It could be argued that Western governments cannot be blamed for looking after their national interests, but they can be accused of ignoring the mandates of the *UN Charter* and the rules of the IMF *Articles of Agreement* in which they were so instrumental in constructing.

Kell and Ruggie (1999) contemplating the necessity of a fairer global compact between the established West and emerging markets wrote:

> The international economic order constructed by the West after World War II reflected a highly advantageous configuration of factors that produced a generation of sustained economic expansion … There was broad ideological consensus regarding the role of the State in ensuring domestic employment, price stability and social safety nets. A commensurate body of economic analysis and policy prescriptions existed that enabled the State to act on these preferences[50].

The international economic order constructed by the West after World War II was imbedded into the *Charter of the United Nations*[51] and the IMF *Articles of Agreement*. Those documents were introduced to clarify the concepts of international law and instil faith to the global community; supposedly, they would be a basis for future security and prosperity by standardising international monetary laws to which the countries of the world would comply.

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[50] Kell, G. and Ruggie, J. (1999) *Global Markets and Social Legitimacy: The Case of the 'Global Compact'*, paper presented at York University, Toronto, Canada, 4th – 6th November 1999.

[51] The *Charter of the United Nations* was signed on 26th June 1945, in San Francisco, at the conclusion of the United Nations Conference on International Organisation and came into force on 24th October 1945.

So what are the international laws which apply to the global economy and are they being met?

5.9 The United Nations and Bretton Woods Institutions

In the Preamble of the *United Nations Charter*, the people of the United Nations determined, amongst other things, to save succeeding generations from the scourge of war, to reaffirm faith in fundamental human rights, and to establish conditions under which justice and respect for the obligations arising from treaties and other sources of international law could be maintained. It specifically mentioned social progress and better standards of life as being part of the United Nation's mandate. To those ends the signatory States agreed to practice tolerance and live together in peace with one another as good neighbours and to employ international machinery for the promotion of the economic and social advancement of all people.

Article 1 of the *UN Charter* outlines the purposes of the United Nations. Apart from the maintenance of international peace and security, and the suppression of acts of aggression or other breaches of the peace, the *Charter* also provides for the settlement of international disputes, the development of friendly relations among nations and a platform for international co-operation in solving international problems of an economic, social, cultural, or humanitarian character.

Similarly, the formation of the IMF and World Bank in 1945 meant that the global monetary system had new supra-national governing bodies which were ideally positioned to promote international co-operation on monetary affairs. Somewhere along the way however, those

institutions became a tool for the US national agenda[52]. Being in control of the global issuance of credit had its advantages ~ the most direct being seigniorage[53] revenue and the power and increased wealth that comes with it. The newly acquired status of the US as the global economic super-power also gave the US added responsibilities to ensure that the global financial system would not only be beneficial to the US but diligently that they would be seen to be doing the right thing towards the rest of the world ~ that being maintaining the international Balance of Payments ledger[54] and providing a stable platform through which payments in relation to international trade could be facilitated.

5.10 The Articles of Agreement

The *Articles of Agreement* of the IMF state quite clearly what is and what is not expected of a member nation State. With respect to the international monetary system, the States' obligations in relation to exchange arrangements are framed within Article IV. Article VIII in turn describes the general obligations of members. The purposes of the IMF are outlined at the very beginning of the document under Article I which states:

> The purposes of the International Monetary Fund are:

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[52] Refer back to section 5.8 for an explanation of how the US pursued its grand strategy. Nonetheless, the vulnerability of the IMS to manipulation by the leading powers still exists; the changing dynamics in the global economy and the effect on existing institutions is discussed in Ch 4, Ch 5 and again in Ch 10.

[53] Seigniorage is the process of making a profit by getting the central bank to print and issue currency. Historically this was done when a government issued coins rated above their intrinsic value. The Roman Empire financed their expansion using this method for over eight hundred years but with fiat money a central bank can turn on the printing presses and sell those notes to any other country that is willing to pay for them. If the notes never return to the country from which they originated then that country benefits by the amount the other country purchased.

The US Federal Reserve earns tens of billions of dollars each year in seigniorage. According to former Federal Reserve Governor Laurence H. Meyer, this contributes to around 0.2 percent of US GDP. Cf. Remarks by Laurence H. Meyer at the European Institute's Conference *Challenges to the European Millennium,* Four Seasons Hotel, Washington, DC, 26th April, 1999.

[54] ie: keeping track of the amount of money countries owed each other.

(i) To promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The *Agreement* states that the Fund shall be guided in all its policies and decisions by the purposes set forth in Article I.

Article IV Section 1 sets out the obligations regarding exchange arrangements. It recognises that the essential purpose of the international monetary system is to provide a framework that facilitates: the exchange of goods, services and capital among countries and; to sustain sound economic growth and; the continuing development of orderly conditions which are necessary

for financial and economic stability. As a signatory: 'each member undertakes an obligation to collaborate with the Fund and other members to assure orderly exchange arrangements and promote a stable system of exchange rates'. In particular, each member *shall*:

(i) endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and

(iv) follow exchange policies compatible with the undertakings [of the *Agreement*].

The word *shall*, imposes an obligation on the member States to perform particular tasks. Here specifically under Article IV Section 1 clause (iii) States shall avoid manipulating exchange rates to gain an unfair competitive advantage over other members. Referring back to the Purposes of the Fund in Article I (iii), it too outlines the need to promote exchange stability, maintain orderly exchange arrangements and avoid competitive exchange depreciations.

Although it is not the State that is actually causing disruptions to the global economy through speculative capital movements, the States nevertheless have an obligation under Article IV (1)(i) to direct their economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability. Under Article IV (1)(ii) States are obliged to promote financial stability by fostering orderly underlying economic and financial conditions

and a monetary system that does not tend to produce erratic disruptions. To achieve that, States should exercise some measure of control over commercial entities within their jurisdictions if those entities are destabilising orderly or underlying economic and financial conditions. If States do not regulate market participants when their activities destabilise the IMS, then they are not fulfilling their obligations to other member States.

Although lacking in finer details, the *Articles of Agreement* give guidance to the national legislatures on what is required of them. However it is up to the individual States, either working individually or collectively, to fulfil their responsibilities to the international community. Presently, currency traders are acting contrary to the intent of international monetary law and, through government inaction, are permitted to get away with it. This raises a serious question as to whether or not signatory States can be held accountable if they do not develop policies that foster orderly conditions within the market or do nothing to correct a monetary system that produces erratic disruptions.

Member States are directed to follow exchange policies that are compatible with the undertakings of general exchange arrangements. To allow for the smooth operation of the international ledger, each member must notify the Fund of the exchange arrangements it employs and of any changes it intends to make.

Under Article IV Section 2(b) exchange arrangements may include:

(i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or

(ii) co-operative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or

(iii) other exchange arrangements of a member's choice.

To assist with the development of the international monetary system, the Fund may change the provisions for the general exchange arrangements but this is meant to be conditional as specified under Article IV section 2 (c). First any intended change has to be consistent with the purposes of the Fund; secondly it should be approved by an eighty-five percent majority of the total voting membership[55]; and thirdly, it must not limit the right of individual members to have exchange arrangements of their own choice.

Article IV Section 3 of the Fund's *Agreement*, gives the IMF surveillance responsibilities over domestic exchange arrangements by monitoring each member's activities. Section 3 states:

(a) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.

(b) In order to fulfil its functions under (a) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies. The principles adopted by the Fund shall be consistent with co-operative arrangements by which members maintain the value

[55] The provisions of this subsection were disregarded when the US abandoned the gold standard and essentially forced the world into following their system of floating exchange rates. The US had only 17 percent voting rights yet it changed the entire system. Eighty five percent consensual agreement for the change was never sought or reached.

> of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.

Article IV Section 4 allows the IMF, in conjunction with members, to enhance the IMS. The section reads:

> The Fund may determine, by an eighty-five percent majority of the total voting power, that international economic conditions permit the introduction of a widespread system of exchange arrangements based on stable but adjustable par values. The Fund shall make the determination on the basis of the underlying stability of the world economy, and for this purpose shall take into account price movements and rates of expansion in the economies of members. The determination shall be made in light of the evolution of the international monetary system, with particular reference to sources of liquidity, and, in order to ensure the effective operation of a system of par values, to arrangements under which both members in surplus and members in deficit in their balances of payments take prompt, effective, and symmetrical action to achieve adjustment, as well as to arrangements for intervention and the treatment of imbalances. Upon making such determination, the Fund shall notify members that the provisions … apply.

The general obligations of members are described under Article VIII of the *Agreement*. The first obligation in Article VIII Section 2, is that no member shall, without the approval of the Fund, impose restrictions on making payments and transfers for current international transactions. Exchange contracts that involve the currency of any member which are contrary to the exchange control regulations shall be unenforceable in the territories of any member. Article VIII section 3 provides that no member shall engage in any discriminatory currency arrangements or multiple currency practises.

Article VIII section 4 refers to convertibility of foreign-held balances. Subsection 4(a) says that each member shall buy balances of its currency held by another member if the latter requests but the buying member shall have the option to pay either in special drawing rights, subject to Article XIX, Section 4, or in the currency of the member making the request.

Article VIII Section 5(a) expands the provisions of Article IV Section 3(b) by stating that the Fund may require members to furnish information deemed necessary for the effective discharge of the Fund's duties. This information is to include data from official sources such as the treasury, the taxation office, the central bank, and the bureau of statistics as well as the domestic banking and financial agencies. Article VIII Subsection 5(a)(v) requires that information on total exports and imports of merchandise, in terms of local currency values and the countries of destination and origin be submitted to the IMF. Subsection 5(a)(vi) requires information on the international balance of payments, including; trade in goods and services, gold transactions, capital transactions, and any other item deemed necessary, be forwarded to the IMF.

The information provided daily to the IMF by the domestic financial intermediaries and the various government departments allows it to keep up-to-date records relating to each nation's balance of payments. The adoption of real time gross settlements also allows the IMF to observe international transactions as and when they unfold. It is a central component of the IMS which has given the IMF an unequalled vantage point by which to observe international monetary transfers and affairs as they unfold.

All 185 countries[56] wishing to be part of the global economy must comply with the reporting requirements of the IMF if they wish to have access to the banking / ledger-entry arrangements that it provides. The *Articles of Agreement* are reasonably specific about what type of information is to be provided by the member States to the IMF. Given the vast array of information available to the IMF, it should be fully aware of the negative effects of speculative currency trading, but it has not calculated or disclosed that information. In defence of the IMF, it could argue that entities such as the banking industries' in-house hedge funds, private equity funds and sovereign wealth funds ~ which control enormous amounts of wealth but do not have to disclose their transactions even to their own prudential supervisors (particularly in the US) ~ produce an epistemic opacity through which the IMF is incapable of monitoring precisely the disruptions caused by SCF.

5.11 Uniform Statutes

Although the nation State might be a signatory to an international treaty, unless the content and purpose of the treaty is enacted into domestic legislation via constitutional procedures, the treaty has practically no effect on the constituents of the nation. Mann (1983) described the process as follows:

> Uniform statutes are provisions enacted or authorised by Parliament and derived from treaties or similar arrangements which a group of nations agrees to incorporate into their respective legal systems with a view to unifying legal rules in a particular field. Even though, as a matter of form, the legislative act itself is, in constitutional law, usually the direct and, indeed, the only source of municipal enforceability, the fact that uniform statutes are the ultimate product of a treaty constitutes their special characteristic[57].

[56] There are 196 countries but some countries do not have their own currency so subsequently use another recognised currency and hence do not have to comply with rigid reporting requirements to the IMF. Some examples are: the USD in Panama, Ecuador and El Salvador, EUR in Montenegro or AUD in Kiribati.

[57] Mann, F.A. (1983) Uniform Statutes in English Law, *Law Quarterly Review*, Vol. 94, at p 376.

What makes treaties special is their international character. Treaties are open to varying interpretations in different jurisdictions and may not necessarily be fully adopted into domestic legislation. Some States may choose to adopt certain aspects of the treaty while other States might fully embrace all the provisions of the treaty. However, when disputes arise between enterprises from different States, some form of uncertainty may be realised owing to the jurisdiction hearing the complaint. Several cases highlighted these dilemmas in the early part of the twentieth century. Scott L.J. explained the British position in 1938 in *The Eurymedon*[58], saying: 'the maintenance of uniformity in the interpretation of a rule after its international adoption is just as important as the initial removal of divergence'[59]. Mann said the ultimate object in interpreting uniform statutes is to find answers conforming to the wording, purpose and idea of the treaty that is acceptable to all or most of those countries which have ratified it[60].

The fact that the global economy continues to move from one financial crisis to another makes it clear that the provisions of the IMF treaty are not being met. Because there is no stability with fully floating exchange rates the IMS is in a constant state of fluctuation as speculative capital moves from one currency to the next in order to capitalise on the variations in currency values. The existing system of fully floating exchange rates which dominates the Anglo-American and European run IMS does not foster orderly conditions for the global economy so what can be done to make the IMS more stable? Can States be forced to implement policies that reduce erratic disruptions or limit destabilising capital movements? To answer that, the *Lotus case*[61] pointed out, international law does not prohibit a State from

[58] *The Eurymedon* [1938] Prob. 41.

[59] *Ibid*. at p 61.

[60] Mann, F. A. (1983) *supra*, at p 377.

[61] *French Republic v Turkish Republic* (1927) Permanent Court of International Justice, Series A - No. 10, A.W. Sijthoff's Publishing Company, Leyden. In 1926, a collision occurred on the high seas between the French

exercising jurisdiction in its own territory and every State remains free to adopt the principles which it regards as best and most suitable. Despite the international treaty's existence as being a source of international monetary law, State sovereignty has remained dominant. Nonetheless, the move towards financial stability requires that the provisions of the IMF *Articles of Agreement* should be implemented.

5.12 Understanding the IMF Articles of Agreements

Mussa[62] (2007) discussed the nature and operation of Article IV's provisions regarding the States' obligations to exchange arrangements. He wrote:

> Because [the] concept of exchange rate manipulation is potentially so broad, virtually all countries could be considered to be 'manipulating' their exchange rates almost all of the time. Correspondingly, however, there is no presumption that exchange rate 'manipulation' is generally bad. Indeed, under Article IV section 1(iii) only exchange rate 'manipulation' that is pursued '… in order to prevent balance of payments adjustment or gain unfair competitive advantage over other members' is specifically precluded under this sub-point of section 1. Exchange rate manipulation that occurs for other reasons, especially as the ancillary and unavoidable consequence of policies legitimately pursued for domestic economic stabilisation, does not run afoul of Article IV section 1(iii) and is not generally precluded under the rest of Article IV or other provisions of the *Articles of Agreement*[63].

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steamer Lotus and the Turkish steamer Boz-Kourt, causing the death of eight Turkish sailors and passengers. Upon arrival at Constantinople the French steamer was impounded and criminal proceedings in pursuance of Turkish law were initiated against the captain of the Boz-Kourt and the officer on watch of the Lotus at the time of the collision. The French government opposed criminal proceedings against its French citizen by the Turkish government claiming that only the State whose flag the vessel flew had exclusive jurisdiction over the matter. The International Court of Justice rejected France's position stating that there was no rule to that effect in international law and that sovereign States may act in any way they wish so long as they do not contravene an explicit prohibition. Nevertheless, thirty years later the 1958 *Geneva Convention of the High Seas* reversed the Lotus principle, confirmed the French position and directed that only the flag State of the vessel which the alleged offender was a national had jurisdiction regarding incidents occurring in international waters. The *Convention of the High Seas* had the effect of standardising and clarifying the law to the international community about the independence of sovereign States.

[62] Senior Fellow of the Peterson Institute and former IMF Economic Counsellor and Director.

[63] Mussa, M. (2007) *IMF Surveillance over China's Exchange Rate Policy*. Paper presented at the Conference on China's Exchange Rate Policy, Peterson Institute, 19th October 2007, at p 13.

... the Fund's *Principles for the Guidance of Member's Exchange Rate Policies*, adopted pursuant to Article IV section 3(b), explicitly instruct that members '… should intervene in foreign exchange markets if necessary to counter disorderly conditions …'. The Fund's Legal Department points out that this instruction is not contained in the language of the *Articles of Agreement* and is therefore not an 'obligation' of members. However, it is quite clear that if a member intervened in foreign exchange markets with the effect of creating disorderly conditions to the detriment of other members, the Fund could and should caution the member about such behaviour. If the member refused to desist or to offer a plausible justification for its behaviour when called upon to do so by the Fund, then the offending member could be found in violation of its general obligation under the Article IV section 1 'to collaborate with the Fund and with other members in order to assure orderly exchange arrangements and promote a stable system of exchange rates'[64].

More broadly, it is clear that the Fund has the authority to call upon members to modify their exchange rate policies and other policies if this reasonably appears needed to counteract an actual or threatened impairment of the effective functioning of the international monetary system. Without such authority, the Fund has no way to fulfil its foremost responsibility under Article IV section 3(a) to '…oversee the international monetary system in order to ensure its effective operation…'. The general obligation of members under Article IV section 1 to 'collaborate with the Fund and with other members to assure orderly exchange rates and promote a stable system of exchange rates…' provides the Fund with the requisite authority. It implies an obligation of members to comply with reasonable requests from the Fund ~ acting on behalf of the world community ~ to ensure the effective operation of the international monetary system[65].

[64] *Ibid*. at p 14.

[65] *Id*.

> If the member refused to act and to offer a convincing explanation for its refusal, then the issue of a violation of obligations under Article IV section 1 would become relevant[66].

With such reasoning, it suggests that the IMF should in fact be monitoring the consequences of disruptive capital flows and be in a position to call upon members to modify domestic practises to ensure the effective functioning of the IMS. The IMF *Articles of Agreement* are clear that the IMF can call upon members to modify exchange rate and other financial policies, but the Agreement does not go so far as to explain that member States should interfere or restrict private enterprise conducting SCF. It may be a recommendation for reform, but at present it is not an existing obligation.

The critical distinction is that treaties often regulate relations between States but foreign exchange contracts contemplate commercial relations between private parties which would normally be interpreted pursuant to the law of *locus in quo*[67]. Hence, obligations imposed by an international treaty do not typically extend to the private citizens engaged in commercial contracts. And this is the main problem with the IMF *Articles of Agreement*. The signatory States are obliged not to engage in destabilising currency practices, but the *Articles of Agreement* makes no mention of private citizens doing the same thing.

Subsequently, banks, insurance companies, hedge funds, other financial intermediaries and private traders can collectively destabilise the global economy through SCF and assume

[66] *Ibid*. at p 15.

[67] Latin meaning 'the scene of the event' or 'the place in which' a contract is signed. To overcome potential conflicts, the 1980 *United Nations Convention on Contracts for the International Sale of Goods* (CISG) outlines uniform sales law that govern contract formation setting forth the rights and obligations of buyers and sellers. The CISG enables cross-border parties to avoid difficulties in negotiating 'whose law will govern' issues by articulating internationally accepted substantive rules on which contracting parties, courts, and arbitrators may rely. See: US Department of Commerce (2007) *The U.N. Convention on Contracts for the International Sale of Goods*. Available at http://www.osec.doc.gov/ogc/occic/cisg.htm

nothing is wrong. Plus, the present arrangements and the institutions which have the power and authority to reduce the disruptions ~ whether caused by toxic assets or speculative currency flows ~ have demonstrated their reluctance to modify or improve the efficiency of the international monetary and financial system. If the regulatory authorities in the Western countries which have the largest banks and largest value of funds to transfer are reluctant (or restricted) to initiate change, how else is it possible for the IMS to be improved?

The saving grace for the global economy is the fact that Article IV (1) of the IMF *Articles of Agreement* specifically instructs that States 'shall endeavour' to direct their economic and financial policies toward the objective of fostering orderly economic conditions and a monetary system that does not tend to produce erratic disruptions. To date, States have not been questioned or reprimanded even though entities under their control are engaging in activities that directly undermine the purposes and obligations of the international treaty. While the treaty imposes obligations on member States to: 'avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members'[68], those rules do not apply to the private sector participants even though they should[69].

Recalling that the IMF's purpose is to: 'promote international monetary co-operation'[70]; 'promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation'[71]; 'establish a multilateral system of

[68] IMF *Articles of Agreement*, Article IV, Section 1(iii).

[69] Because the private banking/financial sector drives the IMM which then destabilises the IMS, the main focus of any policy aimed at increasing efficiency in the global economy needs to be directed toward regulating the entities that adversely affect financial stability.

[70] IMF *Articles of Agreement*, Article I (i).

[71] IMF *Articles of Agreement*, Article I (iii).

payments … between members'[72]; 'give confidence to members … under adequate safeguards … without resorting to measures destructive of national or international prosperity'[73]; 'and lessen the degree of disequilibrium in the international balances of payments of members'[74], then as a policy recommendation, the IMF should fulfil its obligations by: 'oversee[ing] the international monetary system in order to ensure its effective operation, and … the compliance of each member with its obligations'[75]; and 'exercise firm surveillance over the exchange rate policies of members, and adopt specific principles for the guidance of all members with respect to those policies'[76].

The IMF is in a position to introduce: 'a widespread system of exchange arrangements based on stable but adjustable par values' if 'an eighty-five percent majority of the total voting power' permits it[77]. Article IV Section 4 allows the IMF, in conjunction with members, to enhance the efficiency of the IMS. If the IMF was to initiate a new policy calling on member States to limit SCF into and out of each nations' economy and could gain 85 percent support from its members, then the global economy could be improved. By reducing the volatility of exchange rates and the imbalances attributed to speculative capital flows, the global economy becomes more efficient. By regulating market participants and minimising SCF, the dead weight loss in the Mundell-Fleming *IS-LM-BP Model*[78] attributed to speculation can be eliminated. Total social benefit is restored. Therefore the Fund should: 'make this

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[72] IMF *Articles of Agreement*, Article I (iv).

[73] IMF *Articles of Agreement*, Article I (v).

[74] IMF *Articles of Agreement*, Article I (vi).

[75] IMF *Articles of Agreement*, Article IV, Section 3(a).

[76] IMF *Articles of Agreement*, Article IV, Section 3(b).

[77] IMF *Articles of Agreement*, Article IV, Section 4.

[78] Chapter 3, Figure 3.7.

determination on the basis of the underlying stability of the world economy … to ensure the effective operation of a system of par values …'[79].

According to purposes of the IMF *Articles of Agreement*, the IMF 'should'[80] promote international monetary co-operation and provide the machinery for consultation and collaboration on international monetary problems[81]; and facilitate the expansion and balanced growth of international trade, and contribute to the promotion and maintenance of high levels of employment, real income and the development of the productive resources of all members as primary objectives of economic policy[82]. The IMF is also obliged to assist in the establishment of a multilateral system of payments in respect of current transactions between members and eliminate foreign exchange restrictions which hamper the growth of world trade[83].

The IMF has promoted the above ideals publically but there seems little evidence of actual achievement. It seems straight forward, the international laws outlining both the IMF's responsibilities and the member States' obligations are already in place. The mechanism which can reduce instability in currency values is available but will the IMF take the lead in addressing this problem or will it sit idle and let the present arrangements continue?

[79] IMF *Articles of Agreement*, Article IV, Section 4.

[80] IMF Articles of Agreement, Article 1 wording says 'shall'; therefore it means it is a duty.

[81] IMF Articles of Agreement, Article 1(i).

[82] IMF Articles of Agreement, Article 1(ii).

[83] IMF Articles of Agreement, Article 1(iii).

5.13 What the IMF Says and what it Does

Horst Köhler, a former IMF Managing Director said: '… in a globalised world, the IMF, with its universal membership, is a cornerstone for promoting growth and stability'[84]. The IMF's website says:

> We can anticipate a further integration of markets and massive global private capital flows. We can also anticipate tough challenges: poverty, aging of populations, and a surge in extremism and violence if the inequalities between the poorest and most affluent countries are not reduced. The IMF will meet these challenges by responding to the needs of each of its members and by responding to the systemic needs of a globalised world[85].

Speaking on the challenges facing the IMS in the twenty first century, another past Managing Director of the IMF, Michel Camdessus (2000), said:

> … the issue of stability of the international monetary and financial system has been viewed in the context of the broader issue of world economic governance. This is not a reference to some kind of world economic government, but instead to the more limited ambition of finding a global response to inescapable global problems. The task is monumental … The challenge is to find mechanisms for managing the international economy that … offer solutions to problems which now transcend the boundaries of the nation State[86].

He said it would be a 'tall order indeed!' but proposed several remedies. Amongst other things he recommended that the IMF: 'boldly adopt surveillance of the financial sector'; use instruments 'to address poverty as the ultimate systemic threat'; modernise its facilities 'to better serve its entire membership when acute balance of payments crises occur'; complete its

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[84] IMF website, accessed 13th March 2011: http://www.imf.org/external/np/exr/center/mm/eng/mm_gi_07.htm

[85] *Id.*

[86] Camdessus, M. (2000) *An Agenda for the IMF at the start of the 21st Century*. Speech by IMF MD to the Council on Foreign Relations, New York, 1st February 2000.
Available at: http://www.imf.org/external/np/speeches/2000/020100.htm

work on financial architecture 'to facilitate a stay in the most severe debt crises and to avoid disorderly outcomes'; design contingency plans as instruments 'for the use of the SDR in the event of a global liquidity crunch'; engage in the study of how to 'maintain the stability of the international monetary system'; adopt institutional changes to 'promote better exercise and perception of the political accountability of the IMF'; ensure that each member country 'permanently feels properly associated to the decision making process'; and 'conceive and experiment with the structures of co-ordination to ensure the proper coherence of decision making at world level'. He said these items must: 'be part of any reform agenda of the IMF'.

Camdessus (2000) noted two problems: first, coherence in international economic decision-making, and second, political responsibility. He advised: 'May the world leaders who … expressed … their interest in reforming the IMF and the other international financial institutions … remember that [there] must also be a period of intense work toward reform … calling for a high sense of responsibility, for bold action, and for more intense co-operation'.

It seemed the IMF's intention was there to promote reform but nothing meaningful happened between 2000 when Camdessus expressed his views and 2008 when the GFC struck. In fact, the IMF's (2008) internal audit identified major problems within its organisational structure[87]. But what was even more contradictory to achieving the goal of global financial stability was the fact that the IMF Managing Director also supported the need to change the *Articles of Agreement* 'to facilitate work in promoting full freedom of capital movements'. The economic evidence presented in Chapters 2 and 3 demonstrates that full freedom of

[87] Conducted in house by the Independent Evaluation Office, the audit assessed the governance arrangements of the IMF and identified numerous areas where they were deficient. These were: effectiveness, efficiency, accountability, and voice. The IMF had been accused of failing to adapt to changing global realities and, of being widely perceived as both slow to respond to emerging world issues and, ineffective in delivering strategies to tackle problems. The audit confirmed the reality of those accusations. Cf: IMF Independent Evaluation Office (2008) *Aspects of IMF Corporate Governance Including the Role of the Executive Board*, IMF Internal Audit Report, April 2008.

capital movements in a world system of floating exchange rates is actually destabilising, therefore the IMF *Articles of Agreement* should be amended not to promote those capital flows but rather to recognise the volatility they generate and subsequently restrict or limit those types of flows.

Following the first meeting of the IMF's International Monetary and Financial Committee (IMFC), in 2000 with Gordon Brown as the Chairman, the Committee reaffirmed the IMF's commitment to strengthen international economic co-ordination within the evolving global economy. The Committee noted that the IMF had undergone continuous change to equip itself to better assist its member countries and pledged to continue to work to make the IMF more effective, transparent and accountable. Brown said these moves were designed to strengthen the IMF's 'unique role as the cornerstone of the international monetary and financial system'[88].

The IMFC agreed that the IMF's financial operations should continue to adapt to the changing nature of the global economy, including the rapid growth and integration of international capital markets. It also saw the need to preserve the IMF's ability to provide financial support to all member countries, and encourage countries to adopt strong measures to prevent crises by supporting reforms that deal with structural problems. The Committee recognised the importance of adherence to international standards and codes of good practice in reducing economic and financial vulnerabilities but did not take any initiatives to stabilise exchange rate volatility.

[88] IMF (2000) IMFC joint press conference given by the chair of the International Monetary and Financial Committee, Gordon Brown, and Acting Managing Director of the IMF, Stanley Fischer, 16th April 2000, Washington.

And although the IMFC agreed on the importance of prevention as the first line of defence against economic crises and noted that countries participating in international capital markets should seek to establish a strong and continuous dialogue with their private creditors, it did not recommend strategies that would help achieve those results; least of all consider amending the IMF *Articles of Agreement* to reflect those ideals. So while the intention is there to improve the stability of the IMS, the IMF has done nothing positive to limit destabilising capital movements.

5.14 Are Speculative Capital Flows at Odds with International Law?

Despite the economic disruptions caused by SCF, currency trading cannot be regarded as illegal because there are presently no prohibitive laws within the Western dominated monetary framework that expressly restrict the practise. Although there is a lack of prohibiting law that could help curtail SCF, arguably, the practise can still be considered to be at odds with the spirit and nature of international law because of the simple tenets contained within Article IV section 1 of the IMF *Articles of Agreement* ~ specifically each signatory nation to the treaty is obliged to collaborate with the IMF and other members to ensure orderly exchange arrangements and promote a stable system of exchange rates. Conclusively, speculative currency trading does not foster such outcomes so should SCF be stopped?

The answer to the above question depends on whose interpretation of the laws we examine. It could depend on which philosophical position we take, or perhaps on whether the greatest good for the greatest number should be considered. Market traders, banks and trading platforms which derive substantial income from SCF would more than likely put up a good argument why the practise should be allowed to continue *ad infinitum*. This is something that

the free market does best. It capitalises on opportunities as they arise in order to extract and economic gain but sometimes those gains are at the expense of other parties.

Referring to a quote from *Hamlet*: '… there is nothing either good or bad but thinking makes it so'[89]. What someone perceives as a right, someone else may perceive as an injustice. Some may call these currency traders 'robber barons'[90] while others see then as the 'new age financiers'[91] or even 'masters of the universe'[92]. However, using the term new age financiers would suggest that they provide capital and liquidity to the market on a long term basis to finance the means of production[93]. With speculative currency trading that is clearly not the case; transactions are made in and out of the spot market within minutes. There is no long term liquidity to justify the new age financier label so the other label of 'robber barons' might be the more appropriate description. However, the free market does not consider such deliberate windfalls as exploitation but rather sees them as a natural right to gain a living based on an individual's ability at having a strategic advantage over his competitors.

Apparently: 'Greed works! … Greed, in all of its forms ~ greed for life, for money, knowledge ~ has marked the upward surge of mankind'[94]. This however sounds like a

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[89] Shakespeare, W. (circa 1601) *The Tragedy of Hamlet Prince of Denmark*, in Stanley Wells and Gary Taylor Eds (1986), *Complete works of William Shakespeare*, Clarendon Press, Oxford, UK, p 735.

[90] Anderson, J. and Creswell, J. (2007) Top Hedge Fund Managers Earn Over $240 Million, *New York Times* online, 24th April 2007, p BU1.

[91] *Id*.

[92] Grenville, S. (1999) *International Capital Mobility and Domestic Economic Stability*, Reserve Bank of Australia Deputy Governor's address to The Reinventing Bretton Woods Committee Conference, Canberra, 15th July 1999.

[93] Those being *land*, *labour* and *capital*.

[94] Weiser, S. and Stone, O. (1987) *Wall Street*, Twentieth Century Fox, Directed by Oliver Stone. The fictional character Gordon Gekko's famous "Greed is good" speech was an excellent representation of investment banking in the late 1980s, and still remains relevant today. The character Gordon Gekko has since become a pop-culture symbol of corporate greed.

reversion to the law of the jungle where anything goes, everyone fends for himself and only the strongest and fittest survive[95]. English philosopher Thomas Hobbes called this the 'state of nature' which inevitably leads to conflict, resulting in '*bellum omnium contra omnes* ~ a war of all against all' ~ and thus human life becomes 'solitary, poor, nasty, brutish, and short'[96]. To avoid such a brutish existence, Hobbes prescribed that people choose to enter a *social contract*, giving up some of their liberties to the State in order to guarantee social order and enjoy some measure of peace.

Dutch jurist Hugo Grotius, on the other hand, wrote: 'It is not … contrary to the nature of society to look out for oneself and advance one's own interests, provided the rights of others are not infringed'[97]. Consequently, individual rights provide an objective baseline for determining whether or not a violation has taken place. If some act or omission or representation were to infringe upon an individual's right then, according to social contract theory, it would be expected that the State should intervene and protect the individual's rights. 'When laws are predicated upon this principle, then the government serves in its proper role as the defender of its citizens' rights'[98]. Mossoff (2001) who specialises in property rights says laws are aimed at the protection of citizens' economic interests. He writes: 'In adjudicating the anti-trust laws, Courts have enunciated the standard of "consumer

[95] Spencer, H. (1864) *Principles of Biology*, Williams and Norgate, London, Vol. 1, at p 444. British economist Herbert Spencer drew parallels between his economic theories and Charles Darwin's biological ones and made the first printed use of the phrase 'survival of the fittest' in his *Principles of Biology* writing: 'This survival of the fittest, which I have here sought to express in mechanical terms, is that which Mr Darwin has called 'natural selection', or the preservation of favoured races in the struggle for life'. See also Social Darwinism where the *law of the jungle* or *survival of the fittest* is widely used in reference to any form of unrestrained competition ~ including economic competition.

[96] Hobbes, T. (1651) *Leviathan: Or the Matter, Forme and Power of a Commonwealth Ecclesiastical and Civil,* reprinted 1970, Collier Books, London, Chapter 13.

[97] Grotius, H. (1625) *The Law of War and Peace*, (trans. F.W. Kelsey, 1925) reprinted in Schneewind, J.B. Ed. (2003) *Moral Philosophy from Montaigne to Kant*, Cambridge University Press, UK, at p 100.

[98] Mossoff, A. (2001)The Anti-trust Laws Require the Government To Initiate Force Against Innocent Citizens, *Capitalism Magazine*, 1st March 2001. At: http://capitalismmagazine.com/2001/03/the-antitrust-laws-require-the-government-to-initiate-force-against-innocent-citizens/

harm" as the basis for distinguishing between illegal versus legal business activity'[99]. With respect to anti-trust laws, there are several prominent cases which support that position[100], but the test of 'consumer harm' has not been applied to international monetary law.

Now depending from which perspective we look at speculative capital flows, it could be regarded as a successful investment in the international monetary market by *laissez faire* competitive capitalists taking full advantage of their superior position or it could be called an unfair exploitation which ultimately results in consumers being adversely affected. The triggering mechanism for the State's intervention under social contract theory is the determination that someone has first violated another person's rights. Consequently, does financial harm ~ whether intended direct or resultant collateral ~ in the form of lower economic standing for an entire nation qualify as an infringement on other peoples' rights? If it does, then the State should intervene to fulfil its obligation under the social contract.

Wellman (1975) wrote:

> Law and order are essential to the preservation of any society and to the well-being of every citizen … A legal right consists in, or can be defined in terms of, a legal duty of one or more other persons to the possessor of that right[101]. And a legal duty is a real obligation, is really obliging or binding, only because the commands of law are

[99] *Id*.

[100] In *United States v Microsoft Corporation* 87 F. Supp. 2d 30 (D.D.C. 2000) an allegation of collateral harm to consumers formed a basis to commence legal proceedings. In *Data General Corp. v Grumman Systems Support Co*. 36 F.3d 1147, 1183 (1st Cir.1994) it was held that business activities are justifiable only if they relate directly or indirectly to the enhancement of consumer welfare. A European example is case *T-201/04 Microsoft Corp. v European Commission* [2005] ECR. II-1491.The European Commission found that Microsoft infringed Article 82 EC and Article 54 of the *Agreement on the European Economic Area* (EEA) by twice abusing its dominant position. Microsoft shielded itself from effective competition from vendors of potentially more efficient media players who could challenge Microsoft's position; and interfered with the normal competitive process which would have benefited users by ensuring quicker cycles of innovation. Although these cases related to anti-competition laws, the decisions were based primarily on infringements to consumer protection.

[101] John Austin analysed a legal right in terms of a relative duty, a duty to some determinate person or persons. Wesley Hohfeld and Joel Feinberg proposed similar views.

> backed up by legal punishment for disobedience[102]. Hence, if any legal right is in danger, the logical solution is to increase the sanction behind the legal duty and ensure that this sanction is known by every potential offender [103].

Understandably, if international laws are not being followed, then the practical solution would be to either implement stricter enforcement of those laws, or alternatively, create a new international monetary system and do away with the redundant laws altogether.

5.15 The Philosophical Perspective

Brown and MacCormick (1998) writing on legal philosophy say:

> Taking an overall view, the project of establishing the rule of law as an independent base for the critique and control of State action is put in serious doubt, since interpretation is through-and-through political; and appeals to the rule of law can themselves be moves in a political game, expressions of ideology rather than of higher values[104].

Money, being what it is, has a tendency to be very persuasive in politics, so hence the entities which would like to see SCF continue in an un-restricted environment, would be inclined to resist any idea for regulating currency markets. But with all things, there must be progress and that progress must inevitably relate to law. In an era of globalisation and rapid change, financial instability and economic crises highlight the reasons why more attention needs to be paid to enforcing the rules of international monetary law.

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[102] The classical sources for this position are Thomas Hobbes, Jeremy Bentham and John Austin.

[103] Wellman, C. (1975) Upholding Legal Rights, *Ethics*, Vol. 86 No.1 October, p 49.

[104] Brown, B. and MacCormick, N. (1998) *Philosophy of Law*, in E. Craig (Ed.), *Encyclopedia of Philosophy*, Routledge, London at p 549.

Typically, the laws that govern society change with the level of development and as society changes so do its laws. The more complex a society, the more complex its laws need to be. This becomes evident when cases come before the courts containing facts and allegations that have no previous precedent[105]. Just as the bourgeoisie revolutions prompted the development of laws relating to the security of commercial transactions[106], globalisation and international co-operation can do much the same for the security of national wealth in the twenty-first century, but as Brown and MacCormick (1998) observed, the process is governed by political agendas.

Locke (1698) wrote extensively about man's role in the political State saying political power:

> ... is a right of making laws, with penalties of death, and consequently all less penalties for the regulating and preserving of property, and of employing the force of the community in the execution of such laws, and in the defence of the commonwealth from foreign injury, and all this only for the public good[107].

In order to dispel the myth that all government was merely the 'product of force and violence', Locke said, political power was derived from the original state found in nature, wherein all men were naturally at a state of perfect freedom to order their actions, and

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[105] As societies developed capital-pooling and complex banking systems, property laws clarified the distinction between basic possession and ownership entitlements. Property interests took on new dimensions. During the development of these laws the importance of possession was de-emphasised, while that of ownership rights was elevated. To protect the ownership rights attributed to the new types of property, laws were adjusted and modified to fit the new parameters. King George II's 1757 *Act* of *Obtaining Money by False Pretences* (30 Geo. II, c. 24) enlarged the scope of property offences to cover any acquisition of property by false pretences with the intent to cheat or defraud the owner. On several occasions the English courts were not capable of enunciating a legal theory that could accommodate the new dimensions of property interests. Two historic UK cases to highlight this point were *R v Pear* (1779) 1 Leach 212 (4th ed.); 2 East PC 685; 168 ER 208 and *R v Bazeley* (1799) 2 Leach 973 (3rd ed.) (Case CCCXI); 168 ER 517. Pear's Case demonstrates how the court took a step towards criminalising conduct involving an interference with a property right over that of a trespassory invasion of possession. The court basically took a pro-active stance to expand the scope of larceny to ensure justice was achieved. The decision in *Bazeley's Case*, led to the enactment of the *Embezzlement Act* of 1799 (39 Geo. III, c. 85) which henceforth extended the concept of a breach of trust into the realm of criminal law.

[106] Tigar, M. (1977) *Law and the Rise of Capitalism*, Monthly Review Foundation, New York, p 93; (1984) The Right of Property and the Law of Theft, *Texas Law Review*, 62, May 1984.

[107] Locke, J. (1698) *Two Treatises of Government*, Awnsham and John Churchill, London. Second Treatise, Chapter I, Section 3.

dispose of their possessions and persons in a manner as they thought fit, without requiring or depending upon the approval of any other man. It was also a state of equality, wherein no one had more than another, there being 'all born to the same advantages of Nature without subordination or subjection … no one ought harm another in his life, health, liberty or possessions'[108]. Yet disruptive currency trading does harm the economic welfare of others.

According to Locke, a transgression permits two distinct rights: one of punishing the action, for restraint and preventing like offences, where the right of punishing is vested in everybody; or the other of taking reparation, which belongs only to the injured party. In the latter situation, the person who has suffered the damage has a right to demand in his own name, by right of self-preservation, a power of appropriating to himself the goods or service of the offender. Here Locke says that governments are appointed to restrain the partiality and violence of men and that civil government is the proper remedy for solving the inconveniences of the state of nature.

Locke says the liberty of man in society is to be under no other legislative power but that established by consent in the commonwealth, and that the legislative shall enact laws according to the trust put in it. Therefore the freedom of men under government is different to that of nature. In society men must 'have standing rules to live by, common to every one of that society, and made by the legislative power erected in it'[109]. This also meant that the sovereign State had an obligation to protect the interests of society over which it ruled.

[108] Second Treatise, Chapter II, Section 4.

[109] Second Treatise, Chapter IV, Section 22.

To restrain the partiality and violence of men that transgressions may bring, civil government was created as the proper remedy for solving these inconveniences. Locke asserts that:

> … the end of law is not to abolish or restrain, but to preserve and enlarge freedom. For in all the states of created beings, capable of laws, where there is no law there is no freedom. For liberty is to be free from restraint and violence from others, which cannot be where there is no law[110].

In *The Spirit of the Laws*, de Secondat argued that the best type of government was one that accorded with the nature of the people under its rule and that the main function of law was to produce justice. He considered mankind amidst an infinite diversity of laws and manners and said his studies 'were not solely conducted by the caprice of fancy' but to show how 'every particular law is connected with another law, or depends on some other of a more general extent' [111]. He wrote: 'If the legislator … does not enact laws … inequality will break in where the laws have not precluded it, and the republic will be utterly undone'[112]. Hence for the preservation of this equality it is absolutely necessary there should be some regulation in respect to settlements, and all other forms of contracting. Such reasoning obviously extends to trade and commerce at the international level. de Secondat says: 'The mischief is, when excessive wealth destroys the spirit of commerce, then it is that the inconveniences of inequality begin to be felt'[113].

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[110] Second Treatise, Chapter VI, Of Power, parra 57.

[111] de Secondat, C., Baron de Montesquieu (1748) *De l'esprit des lois*, translated *The Spirit of the Laws* by Thomas Nugent (1752), ed. Cohler, A. et al. (2002), Cambridge University Press, Great Britain, Preface.

[112] *The Spirit of the Laws*, Book V. That the Laws Given by the Legislator Ought to Be in Relation to the Principle of Government. Ch 5 ~ In what Manner the Laws establish Equality in a Democracy.

[113] *The Spirit of the Laws*, Book V. That the Laws Given by the Legislator Ought to Be in Relation to the Principle of Government. Ch 6 ~ In What Manner the Laws Ought to Maintain Frugality in a Democracy, paragraph 4.

Discussing the meaning of *liberty* de Secondat says: 'Liberty is a right of doing whatever the laws permit'[114]. He noted: 'commercial laws improve manners'[115], so when adopting conventions for commerce, 'the law ought to consider the public prosperity as of greater importance than the liberty of a citizen'[116]. Personal liberties therefore, should give way to the: 'limitations that humanity and good policy demand'[117]. Clearly policing the existing laws that are already in place to improve financial stability in the IMS would be a good starting point. Additional to those laws, better regulation or restrictions on capital flows would arguably be warranted.

Consequently the people of the nations which experience economic loss due to the depletion of their national wealth through intentionally detrimental transgressions can enact and implement laws which prevent such events. If UN principles[118] are to be followed, States have an obligation to protect the economic rights of their citizens. Restraining the transgressors could preserve the freedom and economic rights of common people and although it is something that the citizens of the world might desire, civil government is the mechanism through which such ends must be achieved. If the world is a global community, and the transgressions of disruptive currency flows affect most States, then engaging international monetary law is the proper remedy.

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[114] *The Spirit of the Laws*, Book XI. Ch 3 ~ In what Liberty consists.

[115] *The Spirit of the Laws*, Book XX Ch 1.

[116] *The Spirit of the Laws*, Book XX Ch 15.

[117] *Id*.

[118] The *Charter of Economic Rights and Duties* was adopted by the UN General Assembly, at its twenty-ninth session on 12th December 1974. It reaffirmed the fundamental purposes of the United Nations, in particular the maintenance of international peace and security, the development of friendly relations among nations and the achievement of international co-operation in solving international problems in the economic and social fields.

5.16 Fulfilling the Expectations of International Monetary Law

Since the IMF came into existence in 1945, much of what happened in the intervening years was not foreseen. The abandonment of the gold standard, fully floating exchange rates and exponential growth in forex markets and destabilising capital flows would have been the subject of non-conformist thinking, but that is exactly what happened. The unexpected! Because things change unexpectedly and rapidly, contingency measures must be put into place. This means the current laws must change to suit the new economic environment.

Adam Smith's (1776) thesis was that, except for limited functions (defence, justice and certain public works), the State should refrain from interfering with the economic life of a nation. Smith advanced responsible capitalism based on moral values and ethical standards presumably because of the fact that he was a professor of moral philosophy at Glasgow University. This position was supported by an elaborate analysis of history and how economic systems function and develop over time. Smith sought to show how competition in the marketplace would lead businessmen to supply the goods consumers want, to produce these goods efficiently, and to charge only what they were worth. He saw competition as promoting the best interests of society. He further argued that economic growth, which depends upon capital accumulation and an increased division of labour, would be promoted best by private rather than public efforts[119]. He deduced people would save and invest for the future because of the inherent desire of individuals to better their own condition. Only by the

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[119] Smith's concept of *laissez faire* economics and capital accumulation may have applied more suitably to an era when gold and silver were the measure by which wealth was counted, but the reasoning needs to adjust in the case of a State sponsored fiat currency. Because money is an invention of the human imagination, and because gold and silver are of limited supply, and because we now have a global population 30 times larger than that of the 18th century, a global monetary system based on Smith's reasoning would be unattainable; if it were the price of gold would be thousands of times its present value, and there would be no method to increase the supply of money into circulation unless the value of gold ever increased. Hence we do see the need for considerable involvement by government in the market because all economic activity is dependent upon the supply of money which the State ~ in most cases ~ has monopolistic control.

freedom of labour to compete with itself is it possible that the industry of society can be directed into the most beneficial channels[120].

Although Adam Smith promoted *laissez faire* capitalism and rejected government intervention in the market, he did however support the need for business to be controlled when merchants took advantage of their position and abused the trust placed in them. When talking of protecting consumer's security against fraud, Smith openly admits that regulations are necessary to prevent this abuse[121].

In order to protect its citizens against the mischief generated by certain enterprises, there may be instances where governments should actively monitor, regulate and supervise business activity. The larger the potentially adverse effect a particular industry may have on the welfare of a nation, the more the government is justified in regulating the activity. That reasoning applies to the private financial service industry more than any other sector. If business practises adversely affect consumer welfare or destabilise the global economy, then the legislators should enact laws to prevent economic harm to their citizens. Smith (1776) advises: 'The protection of trade in general, from pirates and freebooters, is said to have given occasion to the first institution of the duties of customs'[122]. Therefore tax upon trade, in order to 'defray the expense of protecting trade in general'[123] became a common practise.

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[120] Morrow, G. (1923) *The Ethical and Economic Theories of Adam Smith.* Augustus M. Kelly Publishers, Clifton New Jersey, reprinted 1973, at p 67.

[121] *Wealth of Nations*, Book I, Chapter 10, Part 2, paragraph 12.

[122] *Wealth of Nations*, Book V, Chapter 1, paragraph 92.

[123] *Id*.

Subsequently, we can see the need for government to be actively involved in the simplest matters of commerce and even more so when global financial stability is at stake[124].

If a social contract was applied to currency trading, it could perhaps take the form of a prohibitive restriction on speculative capital movements. Alternatively, removing a root cause of currency volatility would be another method by which authorities could enhance the efficiency of the IMS and thus eliminate reasons for complaint. Those ideas are expanded upon in Chapter 8 but the following economic perspective provides a mechanism for improving present monetary practices.

5.17 Modern Philosophers

The philosophy behind liberal free markets as espoused by John Locke's (1698) *Two Treatises of Government*, Baron de Montesquieu's (1748) *The Spirit of the Laws* and Adam Smith's (1776) *Wealth of Nations*, was engineered on the basis of presumed moral and ethical imperatives. Pope Francis adopted very similar reasoning in May 2013 when he issued a strong call for global economic and financial reform along ethical lines to produce economic benefits for everyone. The Pontiff termed free-market capitalism as: 'a new and heartless image in the cult of money and the dictatorship of an economy which is faceless and lacking any truly human goal'[125]. In attacking the 'dictatorship' of money in the global financial system, he warned that the 'cult of money' was making life a misery for millions, and that

[124] Government involvement necessarily includes regulation which is analysed in detail in Chapter 9.

[125] Glatz, C. (2013) Pope calls for global, ethical finance reform, end to cult of money, Catholic News Service, Vatican City, 16th May 2013. At: http://www.catholicnews.com/data/stories/cns/1302173.htm

countries should impose more control over their economies and not allow 'absolute autonomy', so as to provide 'for the common good'[126].

As a method of wealth redistribution, Arthur Pigou, (1912, 1920) [127] originated the idea that governments can, via a mixture of taxes and subsidies, correct market failures or internalise the externalities[128]. Subsequently, *Pigovian taxes* were named after him which were used as a deterrent to minimise negative externalities. His proposition was that government regulation enhances efficiency by correcting imperfections attributed to market failures.

Pigou gave an example that if party A, by engaging in trades with C or D, harms party B ~ who is an innocent bystander ~ and B suffers a negative externality (cost) from party A's action, some form of remedy ought be forthcoming. The typical explanation was, if A was a factory producing smoke and fall-out that damaged B's property, then it would be expected that A would be responsible for B's losses. These facts closely resembled the real life case of *St Helen's Smelting Co. v Tipping* [129] where the plaintiff had moved to St Helens and claimed that his house and garden were being damaged by industrial fall-out from the defendant's copper smelting factory. There could be several remedies though. One was to make the owner of the factory liable for damage caused to those injured by the smoke; or to place a tax on the

[126] Squires, N. (2013) Pope Francis urges global leaders to end 'tyranny of money', *The Telegraph*, London, 16th May 2013. At: http://www.telegraph.co.uk/news/worldnews/the-pope/10061700/Pope-Francis-urges-global-leaders-to-end-tyranny-of-money.html

[127] Pigou, A.C. (1912) *Wealth and Welfare*, Macmillan and Company, London;
Pigou, A.C. (1920) *The Economics of Welfare*, Macmillan and Company, London.

[128] 'Externalities' are indirect costs imposed on others by independent forces or economic agents. It can be a side-effect of consumption or production which is not taken into account by actors who inadvertently or intentionally affect the utility of other members of society.

[129] *St Helen's Smelting Co. v Tipping* (1865) 11HLC 642; 11 ER 1483. In this case the fact of damage gave a prima facie case of *nuisance* against the defendant. The smelting factory had to show that its activities were reasonable in the circumstances otherwise strict liability for material damage would apply. In the end the copper smelter was forced to close through an injunction imposed by the Court of Chancery. For a more detailed discussion of the decision in the context of the time, see McLaren, J. (1983) Nuisance Law and the Industrial Revolution: Some Lessons from Social History, *Oxford Journal of Legal Studies*, Vol. 3, No. 2, p 155-221.

factory owner varying with the amount of smoke produced and equivalent in money terms to the damage it would cause; or, to exclude the factory from residential districts and presumably from other areas in which the emission of smoke would have harmful effects on others. It is here that Ronald Coase (1960) identified more dilemmas ~ the problem of social cost and determining where the blame for externalities should lie. He wrote:

> The real question that has to be decided is: Should A be allowed to harm B or should B be allowed to harm A? The problem is to avoid the more serious harm[130]…
> The problem which we face in dealing with actions which have harmful effects is not simply one of restraining those responsible for them. What has to be decided is whether the gain from preventing the harm is greater than the loss which would be suffered elsewhere as a result of stopping the action which produced the harm[131].

Henry Sidgwick had already recognised the difficulty of making judgements on the reciprocal nature of external effects as early as 1874 when he published *The Methods of Ethics*[132]. He wrote that preventing harm to one party restricts the freedom of action of another party. While reflecting his utilitarian approach to these issues, he contended that the extent to which one party should be free from interference of the other: 'can only be settled by a careful balance of conflicting inconveniences'[133].

Similarly Keynes (1923) warned that: 'to convert the business man into the profiteer is to strike a blow at capitalism because it destroys the psychological equilibrium which permits the perpetuance of unequal rewards. … The business man is only tolerable so long as his gains can be held to bear some relation to what, roughly and in some sense, his activities have

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[130] Coase, R.H. (1960) The Problem of Social Cost, *Journal of Law and Economics*, Vol. 3, No. 1, p 1.

[131] *Ibid*. at p 11.

[132] Sidgwick, H. (1874) *The Methods of Ethics*, Macmillan and Company, London.

[133] Sidgwick, H. (1897) *The Elements of Politics*, 2nd ed. Macmillan, London, at p 69.

contributed to society'[134] . On the basis of presumed moral and ethical imperatives, gross inequality could undermine the legitimacy of capitalism.

Hence, the conflicting inconvenience with respect to currency trading is that the greater mass of global society is paying for the financial rewards and privileges gained by speculators who intentionally capitalise on the inefficiencies of the present system. The more serious harm lies with the disruption caused to national economies the world over. Hence the big questions to ask are: What strategies would help eliminate the negative externalities and the dead-weight-losses attributable to market failure? And can governments enhance the efficiency of the IMS if they regulate or restrict SCF?

5.18 Pareto Efficiency

Vilfredo Pareto (1906) developed a concept of economic efficiency and income distribution in the first decade of the twentieth century. His theory in economics with broad applications in game theory, engineering and the social sciences is commonly referred to as *Pareto efficiency*, or *Pareto optimality*. The basic tenets are that in a world of scarce resources given a set of alternative allocations and a set of individuals, a movement of resources from one alternative allocation to another that can make at least one individual better off, without making any other individual worse off is called a *Pareto improvement*. The allocation of resources is *Pareto efficient* when no further improvements can be made. In government policy it is commonly accepted that outcomes that are not *Pareto efficient* are to be avoided[135].

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[134] Keynes, J.M. (1923) *A Tract on Monetary Reform*, MacMillan and Co. Limited, London, at p 24 -25.

[135] Ng, Yew-Kwang (1983) *Welfare Economics*, Macmillan, London. Also: Sen, A. (1993) Markets and freedom: Achievements and limitations of the market mechanism in promoting individual freedoms, *Oxford Economic Papers*, Vol. 45(4), p 519-541.

In Pareto's words:

> … any small displacement in departing from that position necessarily has the effect of increasing the optimality which certain individuals enjoy, and decreasing that which others enjoy, of being agreeable to some, and disagreeable to others[136].

A policy or action that makes at least one person better off does not mean that it automatically results in the greatest good for the greatest number of people[137]. Because speculative capital flows are movements of a resource where some individuals are made better off at the expense of the wider international community, it does not qualify as an improvement. Therefore following the rationale of Pareto economics, SCF should be avoided.

Nicholas Kaldor[138] and John Hicks[139] modified Pareto's concept by having less stringent criteria and therefore made it applicable to more circumstances. Their concept built upon the underlying rationale of benefit-cost-analysis[140] and is widely applied in welfare economics

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[136] Pareto, V. (1906) *Manuale di Economia Politica*, English, *Manual of Political Economy*, translated by A.S. Schwier (1972), Augustus M. Kelly, Clifton N.J., p 261.

[137] John Stuart Mill's formulation of utilitarianism, known as the 'greatest-happiness principle', holds that an action is right in so far as it promotes happiness in all people affected by that action, and wrong in so far as it brings unhappiness to the people affected by that action. He writes: '… actions are right in proportion as they tend to promote happiness, wrong as they tend to produce the reverse of happiness … Happiness … is by no means an indispensable condition to the acceptance of the utilitarian standard; for that standard is not the agent's own greatest happiness, but the greatest amount of happiness altogether'*.

*Mill, J.S. (1863) *Utilitarianism*, Savil and Edwards, Covent Garden, London, p 6.

[138] Kaldor, N. (1934) A classificatory note on the determinateness of equilibrium, *Review of Economic Studies* Vol. 1, February, p 122.

Kaldor, N. (1939) Welfare propositions and interpersonal comparisons of utility, *Economic Journal*, Vol. 49, 195, September, p 549.

[139] Hicks, J.R. (1939) The Foundations of Welfare Economics, *Economic Journal*, Vol. 49, December, p 696.

Hicks, J.R. (1937) Mr Keynes and the Classics: A suggested simplification, *Econometrica*, Vol. 5, 2, p 147.

[140] Dupuit, A.J. (1863) L'économie politique est-elle une science ou n'est-elle qu'une étude?, *Journal des économistes*. Wanting to evaluate the net economic benefit of public services, French engineer Jules Dupuit analysed capacities for economic development, and attempted to construct a framework for utility theory by

and managerial economics. Using *Kaldor-Hicks efficiency*, a redistribution of resources could lead to a more efficient economic outcome but it could nevertheless leave some people worse off. Here, an outcome is more efficient if those who are made better off could in theory compensate those who are made worse off and lead to a *Pareto optimal* outcome. The major difference is the matter of compensation. *Kaldor-Hicks efficiency* does not require compensation to be paid, merely that the possibility for compensation would allow the injured party to be reimbursed for any losses while still leaving the other party better off. This way, like *Pareto optimality*, there could still be a net efficiency gain for society but a portion of society would be made worse off. As it presently stands however, no State has initiated any processes addressing the matter of compensation for the negative effects of SCF.

With SCF, a few currency traders are made better off, most citizens are made worse off, the cost to society is greater than the benefit, and no one is compensated for their losses. Speculative currency trading is neither *Pareto optimal* or *Kaldor-Hicks efficient* and therefore not in the best interest for society.

Samuelson (1947) demonstrated the possible economic out-comes of policy decisions employing *Utility Possibilities Frontiers*, *Edgeworth-Bowley boxes* and *indifference curves*[141]. Using these analytical tools, it soon became apparent whether or not government policies were economically viable. If governments were in a position to tax the beneficiaries of a reallocation of resources while still allowing them to make a profit, the government could receive more revenue. The government could then ~ if necessary or desired ~ use that

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measuring the prosperity derived through public works. The US Army Corps adopted the approach in the early twentieth century but called it *cost-benefit-analysis*.

[141] Samuelson, P.A. (1947) *Foundations of Economic Analysis*, reprinted (1983), Harvard University Press, Cambridge, Massachusetts.

gain to partially reimburse or compensate the people who were made worse off; thus maintaining some form of social justice and stability within the community. In our present situation, the market generated allocation of resources is imperfect resulting in a dead weight loss[142]. A few people are made much better off, but because currency traders derive their gains in foreign currencies, domestic governments are not in a position to tax traders in foreign lands who have grown rich at the domestic nation's expense. The bulk of society is made worse off, no one is taxed, no one has been compensated. The *social indifference curve* is shifted resulting in lower utility for the affected community.

Clearly, the free market does not always provide the most desirable outcome. Henceforth, government has the opportunity to intervene in the market and implement strategies that enhance economic efficiency. Provided the cost of setting up the agency to deal with the externality does not exceed the available benefit, regulating speculative capital flows could be sound economic policy[143].

5.19 Posner's Economic Efficiency in Law

Richard Posner[144] considered the application of economics in legal theory arguing legal rules ought to be efficient[145]. He discussed the impact of the legal system on the allocation of resources by the market and of the economic aspects of behaviour and reasoning within the

[142] Refer to Chapter 3.

[143] That course of action would be dependent, of course, upon policy makers and legislators diligently carrying out their duties but there are many reasons why that may not be the case; for example there may be inadequate statistical information to develop effective policy, lack of motivation and accountability. Those issues are explored in later chapters.

[144] Former Professor of Law and Justice of the US Federal Court of Appeals.

[145] Posner, R.A. (1973) *Economic Analysis of Law*, Little Brown and Co., New York; (1981) *Economics of Justice*, Harvard University Press, Cambridge, Mass; (1990) *Problems of Jurisprudence*, Harvard University Press, Cambridge, Mass; (1999) *Problematics of Moral and Legal Theory*, Harvard University Press, Cambridge, Mass.

legal system. The purpose of Posner's writing was, *inter alia*, to promote economic efficiency in law, mainly in the legal decision-making process. Although lacking in practical mathematical analysis, he invited the legal fraternity to consider the economic consequences of legal decisions. He said that there was: 'abundant evidence that legislative regulation of the economy frequently, perhaps typically, brings less efficient results than the market-common law system of resource allocation'[146]. And although:

> ... the structure of the administrative process is designed to increase political control over the process of legal regulation rather than to increase efficiency … [W]ithin the constraints imposed by the fundamentally political purpose of regulation the evidence is consistent with the hypothesis that the agencies, like other organisations, are rational utility maximisers[147].

Posner implies that the legal system, along with other government institutions, is aware of the need for economic efficiency even though it might sometimes fall short of peak performance. He uses the standard concept of *Pareto optimality* and the *Kaldor-Hicks Efficiency Theory* to discuss the correct measurement of compensatory (legal) damages to induce efficient behaviour. He does however acknowledge that just because something might be efficient, it does not make it necessarily lawful. It could be counter phrased that just because something is inefficient, it does not mean it is unlawful but in that situation it would not be a rational maximising choice or in the best economic interest for society. Hence the goal of global financial regulators should be to make laws that enhance economic efficiency by eliminating market failures attributable to SCF.

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[146] Posner, R.A. (1973) *Economic Analysis of Law*, Little Brown and Co., New York, at p 329.

[147] *Ibid*, at p 386.

Generally what the IMS lacks is a method of assessing the social costs to parties affected by externalities ~ such as those resulting from activities of currency traders in other sovereign States. Applying Posner's logic to the problem of speculative capital flows, Mundell-Flemming's *IS-LM-BP* model and the *Efficient Market Hypothesis,* it establishes that those flows are inefficient. Added to this is the fact that the laws are already in place which impose obligations on signatory States of the IMF *Articles of Agreement* to maintain an efficient international monetary system. To streamline the efficiency of the IMS where economic welfare is diminished, the application of Posner's proposition is that the efficiency constraints imposed by regulation should be designed to be rational utility maximisers; any move away from that equilibrium position would be considered not in society's best interests.

5.20 Discussion

The economic modelling in Chapter 3 demonstrated that an economy which has been subject to the extraction of wealth by means of SCF is made worse off. The individual's rights have been infringed because the constituents of that economy have had their purchasing power eroded and their cost of living increased. Citizens and consumers are adversely affected. There is also the matter of the increased debt burden forced onto future generations by higher interest rates and long-term national commitments made in consequence to re-establish the equilibrium position on the *IS-LM-BP Model* after capital flows have distorted the BOP.

If a central bank increases interest rates to attract foreign capital to top-up the Capital Account, the citizens of that economy must eventually repay that capital plus the accumulated interest that goes with it. Speculative capital flows have a propensity to subvert the value of currencies the world over while making handsome profits for those who successfully employ the practise. To paraphrase Keynes (1936), with extreme efficiency, speculative currency

trading 'engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose'[148].

Logically, States have a vested interest in their economies to protect the value of their currency. The central bank is typically entrusted to support the economic policies of an open market economy favouring an efficient allocation of resources and maintaining economic growth commensurate with the economy's long run potential to increase production, maximise employment, stabilise prices, moderate long-term interest rates and enhance the welfare of the people[149].

Speculative capital flows, on the other hand, do not enhance long run growth, do not increase production, maximise employment, stabilise prices, or moderate long-term interest rates. SCF are not an efficient allocation of resources nor are they directed towards economic prosperity and welfare of the common people. If States allow billions of dollars to be syphoned from an economy through speculative currency trading, then they are not doing what is required of them; they are not fulfilling their part of the social contract with their nation's citizens.

There are however numerous examples where States do become involved to protect the citizens' rights; most notably in criminal activity and commercial transactions. Anti-trust law cases provide meaningful examples where governments have intervened in the market to protect the wider communities' economic rights and well being. As cases like *United States v*

[148] Keynes wrote: 'There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose'. Cf: Keynes, J.M. (1919) *The Economic Consequences of Peace*, Harcourt, Brace, and Howe, Inc., New York, Chapter 6, paragraph 14.

[149] See for instance: *Statute of the European System of Central Banks* (Europa) Article 2.; *Federal Reserve Act* 1913 (US) section 2A, US Code, Title 12, Ch. 6, 38 Stat. 251; *Bank of England Act* 1946 (UK) section 11; *Reserve Bank Act* 1959 (Commonwealth of Australia) section 10(2).

Microsoft Corp.[150], *Data General Corp. v Grumman Systems Support Co.*[151], *Microsoft Corp. v European Commission*[152] and *Aspen Skiing Co. v Aspen Highlands Skiing Corp.*[153] demonstrate, individual rights provide an objective baseline for determining whether or not an economic violation has taken place. Even in *laissez faire* capitalistic markets, if consumers are harmed in any manner or their rights are adversely affected by the activities of market participants, then the State can intervene as the defender of the citizens' rights[154]. If the citizens of a nation are made worse off by the activities of speculative currency transfers, then economic evidence, logic and legal reasoning should support an argument in favour of restricting SCF.

But to protect someone's rights through the courts, laws must be first legislated to prohibit the practice of causing other people economic harm. In the West, with respect to SCF, this is not presently the case so the economic inefficiencies of the market continue. That outcome is not good policy; it is an erosion of wealth and waste of scarce resources. Hence, should the

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[150] *United States v Microsoft Corporation* 87 F. Supp. 2d 30 (D.D.C. 2000). It was found Microsoft abused its position in its handling of operating system sales and web browser sales by manipulating its application programming interfaces to gain greater market share. Windows users had a copy of Internet Explorer automatically installed on their computer which unfairly restricted competing web browsers such as Netscape Navigator and CompuServe's Internet in a Box from being installed on the same computer.

[151] *Data General Corp. v Grumman Systems Support Co*. 36 F.3d 1147, 1183 (1st Cir. 1994). It was held that business activities are justifiable only if they relate directly or indirectly to the enhancement of consumer welfare. The ratio decidendi was that the pursuit of efficiency and quality control might be a legitimate competitive reason to refuse to deal with someone but a desire to acquire a monopolistic market share would not.

[152] Case *T-201/04 Microsoft Corp. v European Commission* [2005] ECR. II-1491. It was held Microsoft abused its position by ensuring the worldwide ubiquity of Windows Media Player, by creating disincentives for original equipment manufacturers to pre-install competing media players on their client's PCs.

[153] *Aspen Skiing Co. v Aspen Highlands Skiing Corp*. 472 U.S. 585 (1985). The US Supreme Court held that the question of intent is relevant to the offense of monopolisation in determining whether the challenged conduct is fairly characterised as exclusionary, anti-competitive or predatory. The Court held that if the evidence indicates that consumers were adversely affected and that the defendant failed to offer any efficient justification for its pattern of conduct, then an offence would be made out under the *Sherman Act*.

[154] This is not always the case. There are many instances where government bodies refuse to get involved in consumer complaint actions citing such things as limited man-power, costs restraints, degree of difficulty, prospects of success, public interest value, lack of news worthiness and novelty value as reasons to not get involved.

world economy be subjected to such inefficiencies or should we start implementing strategies now in order to preserve scarce resources, improve efficiency and create a more robust global economy? The next chapter examines possible legal remedies using the doctrines of *due diligence* and *State Responsibility*.

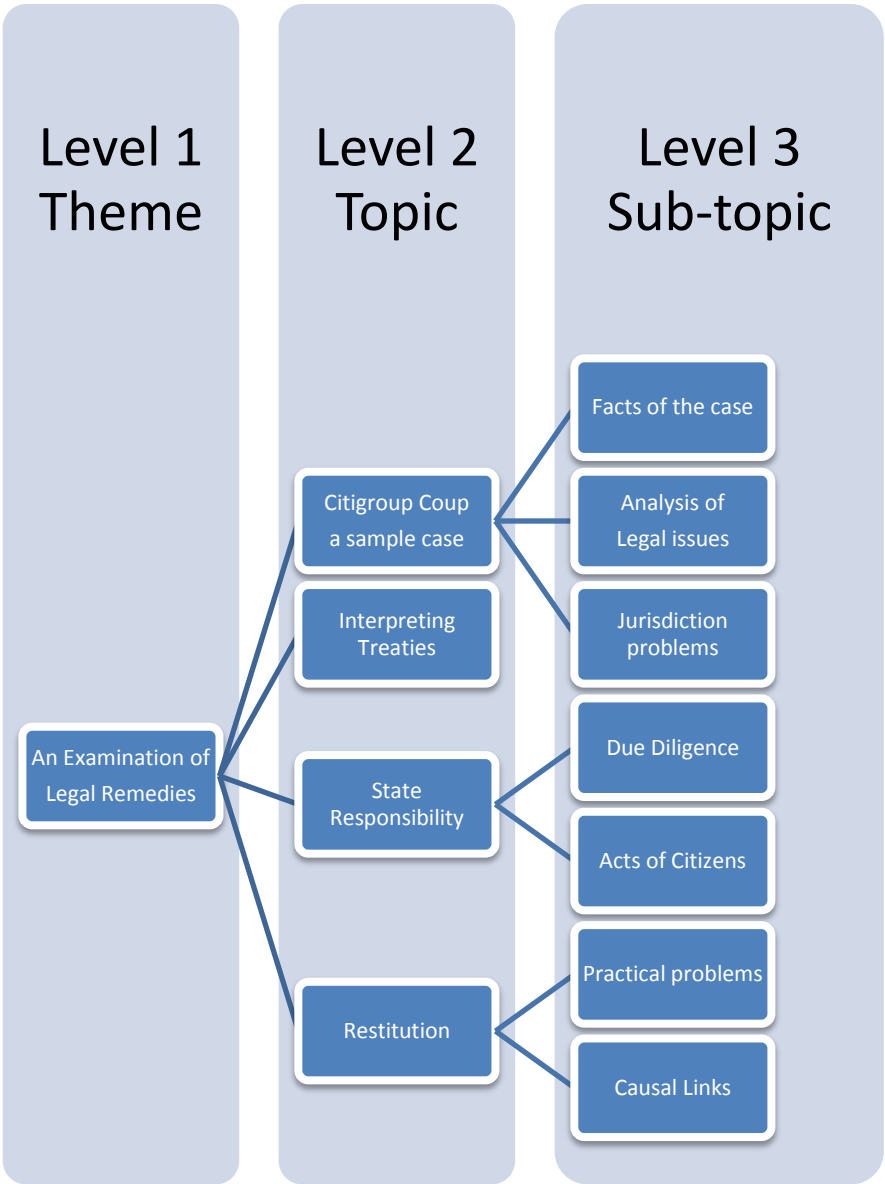
Summary of Chapter 5

This Chapter:

- sought a justifiable argument for initiating reforms within the IMS
- described the failings of the international monetary market to identify the source of the problem
- looked at the evolution of international monetary law to reveal how the doctrines of State sovereignty, monetary sovereignty and regime theory pose significant hurdles to implementing world-wide reforms
- reviewed the United Nations and Bretton Woods Institutions' *Articles of Agreement* and how those documents form part of our uniform statutes
- described the finer details of the IMF *Articles of Agreement* to identify what is required of member States with respect to exchange rate practices
- revealed how speculative capital flow practices are at odds with the intent and purposes of international monetary law
- evaluated several philosophical doctrines to establish the need for improved efficiency in relation to the problems caused by SCF (namely exchange rate volatility, higher interest rates, higher unemployment etc)
- revealed how economic and legal reasoning would support States to regulate the market in order to preserve the wealth of nations by limiting SCF

Chapter 6

Ramifications, State Responsibility and Remedies



Chapter 6

Ramifications, State Responsibility and Remedies

Chapter Abstract

Following on from the discussion in the previous Chapters about the need to reduce the negative impact of speculative capital flows, this Chapter assesses possible legal remedies to mitigate economic and financial losses caused by SCF. The purpose is to unravel the complexity of international monetary law and demonstrate how national interests are not being protected from disruptive market forces even though there are demonstrable adverse economic effects caused by SCF. The Chapter analyses a 2004 incident of a cross-border monetary play to highlight the legal implications associated with regulating and policing capital movements at the international level. It looks at the interpretation of international agreements and applies the doctrines of due diligence and State Responsibility to speculative capital flows to see if a legal remedy is available to curtail speculative movements.

The Chapter concludes that the existing legal framework is incapable of adequately regulating the international monetary market; and that there is no suitable legal remedy available at present to address the matter of restitution or compensation associated with SCF. Therefore new strategies must be developed and new laws enacted to improve financial stability by better managing stable currencies and reducing arbitrage opportunities.

6.1 Searching for an Answer

Previous Chapters have shown how speculative currency trading can have detrimental economic consequences for a State. They also described how speculative currency trading in its present unregulated form is legal but against the nature and spirit of international law. Under Article IV (1) of the IMF *Articles of Agreement*, each signatory member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member *shall* endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability. But what happens when a State does not promote a stable system of exchange rates or make the effort or 'endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability … and a monetary system that does not tend to produce erratic disruptions … [or] avoid manipulating exchange rates … to gain an unfair competitive advantage over other members'[1]?

That situation raises this problem: If those laws exist, then why are national interests not being protected from speculative capital flows when there are such adverse economic effects? This Chapter focuses on the socio-economic, legal and remedial implications associated with SCF. It starts by reviewing a 2004 Citigroup trade where an American bank based in London engaged in cross-border activity in the European bond market which had some interesting consequences. This case was chosen for examination because it represents the first instance where disruptive cross-border currency practices were the subject of government disciplinary

[1] Article IV section 1.

action. In 2005 the British Financial Service Authority[2] (FSA ~ formerly the Securities and Investment Board) fined Citigroup for issues relating to its speculative transaction.

6.2 The Citigroup Coup

On the morning of 2nd August 2004, Citigroup's bond desk conducted a trade in less than two minutes that sent economic shockwaves around the world. Not only did the trade make a neat profit in the vicinity of US$20 million for Citigroup, it also created a near-riot among banking competitors and humiliated the electronic trading platforms on which it was orchestrated[3].

The American Bank's London-based European-bond traders led by Spiros Skordos, placed sell orders for about €11·3 billion worth of EU bonds within 18 seconds ~ around a 100 different types in 11 different markets on 13 different electronic trading platforms set up by European-government-debt issuers. They also sold off another €1·5 billion worth in other international markets. Prices instantly tumbled across the board on the massive sell orders. The traders then turned around within minutes and bought back, by way of the same electronic platforms, some €3·8 billion of the same paper, but this time at the reduced price. Skordos's team would have bought back more, but swamped exchanges quickly halted trading. Some market participants withdrew their quotes for up to three days.

Recognising it is a zero sum game, some of the banks that lost out to the Citigroup coup included: ABN AMRO, Deutsche Bank, Barclays Capital, JP Morgan Chase and UBS, all of

[2] The UK's Financial Services Authority is a corporate government entity that regulates the British financial services industry. The FSA exercises its statutory powers under the *Financial Services and Markets Act* 2000. Its regulatory decisions can be appealed to the Financial Services and Markets Tribunal.

[3] Editorial (2004) Trade of the Year; Citigroup Floods the Zone, *Trader Daily Magazine*, Wednesday 8th December 2004, available at http://www.traderdaily.com/directions.asp

which found themselves suffering losses of as much as €800,000 each ~ not to mention the losses incurred by thousands of smaller market participants. The trade happened so quickly, Goldman Sachs survived relatively unscathed only because it occurred when its European Bond trader went to the toilet and no deals were made. A *Trader Daily* reporter claimed many rivals accused Citigroup of: 'breaking a "gentleman's agreement" not to flood the market but that others privately admitted that they wished they had thought of the trade first'[4].

> Many market participants could at first find no clear grounds to object to what just seemed a big, bold trade. Sure it disrupted the euro monetary trading system (Euro MTS[5]), they reasoned, but only temporarily; it cost other banks money, but trading is a battlefield; and Citigroup was acting within the rules of MTS, which obliges banks to post and honour quotes on bonds. Perhaps, some argued, Citi had even done the market a service by pointing out the dangers in the super-liquid MTS system[6].

Two days after the Citigroup coup, European officials imposed limits that prevented more than €1 billion worth of any bond being traded in any two-minute period. Traders described the limits as 'silly' saying it impeded the market's flexibility[7]. It emerged later that before selling the bonds at 10.28am, Citigroup had driven up their price by buying Bund and Bobl futures contracts on the less liquid Eurex market in Frankfurt. This led to accusations that

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[4] Editorial (2004) Trade of the Year; Citigroup Floods the Zone, *Trader Daily Magazine*, Wednesday 8th December 2004, available at http://www.traderdaily.com/directions.asp.

[5] The EuroMT system is an electronic trading platform. It was developed by European governments to bolster the tradability of their debt. The platform requires that its *market-makers* (the various brokers) post price quotes for bonds at restricted bid-and-offer spreads for at least five hours every day. This enforced liquidity ensures that market-makers have to sometimes buy bonds they probably do not want or sell others they wish to keep. In practice, it is rare for a bank to trade more than 10 different bonds at any given time. But Citigroup sold some 100 different types within a few minutes.

[6] Euromoney Institutional Investor PLC. (2005) FSA sends confusing signal with £14m Citigroup fine, *EuroWeek*, Issue, 910 – 1st July 2005. Available at: http://www.globalcapital.com/article/k5fchr4j75xs/fsa-sends-confusing-signal-with-14m-citigroup-fine

[7] Editorial (2004) Markets board chiefs meet on Citigroup raid, *The Sunday Times Online*, 15th August, 2004. At: http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article470364.ece

Citigroup had distorted the market. The German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht ~ BaFin) contemplated bringing criminal charges for intentionally manipulating the European Government Bond Market but prosecutors found none of the traders had committed any criminal offence. Within days officials from the UK's Financial Services Authority (FSA) met EuroMTS executives and requested that they be given the details of Citigroup's trades in order to determine whether the bank's actions constituted an offence under new market-abuse rules applicable to England where the coup was orchestrated. The consensus at the time was that few traders expected any enforcement action to be taken[8].

In February 2005, an email surfaced that a Citigroup government bond trader had written to a colleague on 20th July 2004, two weeks before the controversial trade, explaining how the trading strategy would work. It mentioned pushing up the price of Bund futures in advance. The email outlined how the trading strategy would be beneficial because: 'it would destabilise MTS, lead to copycat trades, kill off some of the smaller dealers and open the way for a system more like the US market which would be more profitable for big banks like Citigroup'[9]. Needless to say the email's leak caught the attention of FSA investigators[10].

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[8] Editorial (2004) Markets board chiefs meet on Citigroup raid, *The Sunday Times Online*, 15th August, 2004. At: http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article470364.ece

[9] Euromoney Institutional Investor PLC. (2005) *Supra*.

[10] The UK's *Financial Services and Markets Act* 2000 (*FS&M Act*) provides the framework within which the Financial Services Authority operates. The *FS&M Act* imposes four statutory objectives upon the FSA. The first objective is to maintain market confidence in the financial system. The second is to promote public understanding of the financial system. The third is to secure protection for consumers and the fourth is the reduction of financial crime. The *FS&M Act* also equips the FSA with a full range of statutory powers and created the Financial Services and Markets Tribunal and the framework for a single ombudsman.

Under subordinate legislation to the *Financial Services and Markets Act*, the FSA must have regard to the *Principles of Good Regulation* as set out in the FSA's *Handbook* when discharging its functions. These include: the need to use its resources in the most efficient and economic way; to guard against unnecessary intrusion by the FSA into firms' activities; the desirability of facilitating innovation in connection with regulated activities and not to unduly restrict market participants from launching new financial products and services; maintaining the competitive position of the UK; taking into account the international aspects of financial businesses

After a year-long enquiry the FSA criticised the way Citigroup had conducted the trade, rather than the trade itself. The FSA decided not to class the trade as market abuse but rather the bank was found to have broken Principles 2 and 3 of the FSA's *Code of Conduct* ~ it was guilty of a failure to act with due skill, care and diligence and failures in systems and controls. The FSA's decision not to find Citigroup at fault under Principle 5, which deals with market manipulation, encouraged the bank to make confident statements to the press. William Mills, chairman and chief executive of Citigroup's corporate and investment banking division in Europe, told *EuroWeek Magazine*: 'We have been consistent in the fact that we did not break any rules or violate any market conduct activities. It has always been an issue of control to us'[11].

The FSA's 14 page report gave a brief account of how the trade was conducted and of its effects on the European government bond market, but it did little to dispel the cloud of legal ambiguity that surrounded the trade. The report confirmed that the trader's email set out the strategy for the trade and that Citigroup used the Eurex futures market to drive up the price, yet stated that: 'the success of the trading strategy did not depend on price positioning or other distortive behaviour' [12]. One would seriously have to question the FSA's reasoning behind their judgment call on the evidence ~ after all, in Citigroup's own words, its intention was to: '…destabilise [the] MTS, lead to copycat trades, kill off some of the smaller dealers

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management; co-operating with overseas regulators to agree on international standards and to monitor global firms and markets effectively; to minimise the adverse effects on competition that arise from the FSA's activities; to facilitate competition between the firms it regulates by avoiding unnecessary regulatory barriers to entry or business expansion; and the imposition of restrictions that are proportionate to the benefits that are expected.

[11] Euromoney Institutional Investor PLC. (2005) *Supra*.

[12] Financial Service Authority (2005) *Final Notice To: Citigroup Global Markets Limited*. Date: 28th June 2005, at p 14. Available at; http://www.fsa.gov.uk/pubs/final/cgml_28jun05.pdf.

and open the way for a system … more profitable for big banks…'[13]. There is no doubt that numerous people colluded in a strategic plan and implemented it with a clear intention to distort the price in the market and take a quick profit at the expense of other market participants. Under section 118 of the *Financial Services and Markets Act*, Citigroup's actions was clearly 'a manipulating transaction' that should have qualified it as an act of 'market abuse'[14] to which penalties under section 123 should have applied[15].

In a compromise, the Financial Service Authority took Citigroup to task on peripheral matters that related to less serious allegations. The lesser charges carried more lenient penalties. Citigroup's Trading Licence could have been forfeited had the more serious charges been applied. The FSA found fault with the degree of oversight that senior managers had exercised over the trade, criticising Citigroup for failing to have its compliance and legal risk management officials consider the trade before it was executed, and for neglecting to communicate those plans up the management chain. Citigroup's actions had not given due consideration to the franchise, execution, market impact and legal risks of the trade. The FSA also pointed out that traders had not received adequate training in market abuse.

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[13] Words from the Citigroup email explaining the strategy between traders. Cf: Euromoney Institutional Investor PLC. (2005) *Supra*.

[14] Under section 118 of the *Financial Services and Markets Act*, behaviour conducted by one person alone or more persons jointly in concert which occurs in relation to investments traded on a prescribed market and falls within any kind of conduct or type of behaviour set out in section 118(2) to (8) of the *Act*, shall be regarded as market abuse. Market abuse could be any act or omission that distorts the market such as improper disclosure of information, misuse of information or insider dealing.

The behaviour described in section 118(5) of the *Financial Services and Markets Act*, which is behaviour effecting transactions or orders to trade (other than for legitimate reasons and in conformity with accepted market practices on the relevant market) which gives, or is likely to give a false or misleading impression as to the supply of, or demand for, or the price of an investment at an abnormal or artificial level, is termed 'a manipulating transaction' and qualifies as an act of market abuse. The actions taken by Citigroup clearly fell within these parameters. The average daily volume of trading on MTS at the relevant time was around €13.5 billion. In this event, Citigroup sold bonds close to the average total daily volume on MTS within a few minutes.

[15] Power to impose penalties in cases of market abuse is given to the FSA under section 123 of the *Financial Services and Markets Act* 2000 (UK). If the Authority is satisfied that a person or firm has engaged in market abuse, or encouraged another person or persons to engage in such behaviour it can impose penalties.

For the lesser charges, Citigroup was fined £13·9 million. It was the second largest fine ever levied by the Financial Services Authority. The fine comprised all of the bank's £9·96 million profits from the trade, plus a £4 million penalty. It was a slap on the wrist for ~ at the time ~ the world's largest Banking group. The £4 million penalty equated to €5·9 million and represented less than 1/2000th the value of the initial trade which stood at some €12·8 billion. Citigroup was not barred from trading in the market. The FSA in fact, gave Citigroup credit for having given them 'very good co-operation' during their investigation, and for having taken steps to improve Citigroup's internal controls.

Applying *Ockham's Razor*[16] to the situation, one could only imagine the political and economic ramifications had Citigroup been restricted from participating in the market. No doubt the FSA's decision is a reflection of the real world's dilemma on the opportunity costs associated with regulating the free market and the administration of justice. It also highlights the distinction that needs to be made between legitimate trading practices and that which could be classed as manipulative or abusive activity. It is in relation to the latter, that the necessity for stronger international regulation becomes evident.

6.3 Analysis of the Citigroup Coup

The Financial Service Authority action against Citigroup highlights a myriad of issues that need to be addressed if a solution to disruptive capital transfers is to be found. From the late 1980s, through to the present, currency traders have continued to collect billions of dollars by reallocating financial resources from one economy to another and taking advantage of arbitrage opportunities created by volatile exchange rates. Needless to say, such activity

[16] Ockham's Razor is the principle proposed by William of Ockham in the fourteenth century. One of the many interpretations of Ockham's Razor states that: the simple explanation of a phenomenon is more likely to be the correct explanation (probabilistically speaking) over that of a more complex explanation.

unavoidably sends ripples throughout the global economy. Major currency distortions have occurred on every continent since the end of the gold standard, but the damage compounds daily as more and more speculative traders join the market thus destabilising the international monetary system even further.

In the 1992 British experience, currency traders made billions of dollars which cost the British public £3·3bn[17] or the average UK family over £200. The 2004 Citigroup trade also highlighted the fact of no compensation. When the British Financial Service Authority confiscated Citigroup's £9·96 million profits from the trade, and imposed an additional £4 million fine, the FSA did not compensate the banks or any other investors who collectively incurred multi-million dollar losses. The restriction with the FSA is that its jurisdiction only applies to matters concerning Britain's own affairs or traders under its control and conduct originating within UK borders. The FSA can fine an offender who breaches an obligation under its *Codes of Conduct* or in violation of the *Financial Services and Markets Act* 2000 (UK) but it cannot award compensation to market participants who lose or have been adversely affected because of questionable market activity by other parties.

Under domestic law in any jurisdiction, there is presently no remedy available for a nation, financial institution or private investor who is deprived of their wealth if they are collaterally damaged due to market abuse activity or other financially disruptive trading practices instigated by remote ~ but causally connected ~ foreign parties. This legislative gap denies people who have suffered economic loss caused by remote parties in foreign jurisdictions a means of compensation. Without legislative remedies it allows market manipulators to

[17] Giles, C. (2005) Black Wednesday Documents: Losses on currency markets cost more than £3bn, *Financial Times*, National News, 10th February 2005. Available at: http://www.ft.com/cms/s/0/ff1d1f06-7b0d-11d9-a3ea-00000e2511c8.html#axzz3M7tUglCW

continue unabated. It is an area of international monetary law that needs to catch up to the practices of a globalised market. Hence we are left with this problem: What recourse is there when a State does nothing to limit 'erratic disruptions' or prevent entities under its control from manipulating exchange rates or the international monetary system?

According to customary international law, as reflected in Article 26 of the 1969 *Vienna Convention on the Law of Treaties*, '[e]very treaty in force is binding upon the parties to it and must be performed by them in good faith'. 'That applies to all obligations established by a treaty, including procedural obligations which are essential to co-operation between States'[18]. Arguably, a State that does not prevent disruptive trading practices which destabilise currency values and allows one State to gain an unfair competitive advantage over another State by refusing to limit the activities of its currency speculators, is in effect, breaching the terms of the IMF *Articles of Agreement*. Perhaps it rests on a question of how much effort satisfies the requirement that 'each member shall <u>endeavour</u> to direct its economic and financial policies' toward the objectives of price stability. Does 'endeavour' require significant effort or does it simply mean that a State can ignore the situation without actually doing anything to rectify the problem? How are positive obligations meant to be dealt with? Is there a legal method or remedy available that could force a State to direct its economic and financial policies to restrict market participants distorting the balance of payments or gaining an unfair competitive advantage over other members?

While the IMF *Articles of Agreement* impose agreed obligations on States, the provisions of the treaty do not automatically extend to the constituents of the State. Nonetheless, there is an obligation on States to direct their economic and financial policies towards promoting

[18] *Pulp Mills on the River Uruguay (Argentina v Uruguay)*, ICJ Summary of Judgment, 20 April 2010, at p 12.

stability. So, is the objective of fostering orderly economic conditions equivalent to 'endeavouring' to reach financial stability in currency markets? If the intention behind both concepts is the same; how then is it possible to foster orderly economic conditions when market participant activities can undermine the stability of the entire system? Hence, we begin to see that the *Articles of Agreement* are open to wide interpretation. Therefore it is necessary to clarify exactly what is expected of States. The next section discusses how treaty obligations should be interpreted within the international setting.

6.4 Interpretation of International Agreements

The method of interpreting international conventions was stated by Lord Atkin in 1939, when he said:

> For the sake of uniformity it is … important that the courts should apply themselves to the consideration only of the words used without any predilection for the former law, always preserving the right to say that words used in the English language which have already in its particular context received judicial interpretation may be presumed to be used in the sense already judicially imputed to them[19].

As with all ambiguous legal terms, the terms of a treaty cannot be read in isolation, rather they should be construed in their context as is the procedure with domestic interpretations. In *The Hollandia*[20] case, Lord Diplock said words forming part of an international convention 'should be given a purposive rather than a narrow literalistic construction'[21]. With the concurrence of three other Law Lords, the Court held it necessary to pay particular regard to their history, origin and context, saying that where a word of doubtful meaning has received a clear judicial interpretation, the subsequent statute which incorporates the same word or the

[19] *Stag Line Ltd. v Foscolo Mango & Co. Ltd.* [1939] AC 328, at p 343.

[20] *The Hollandia* [1983] AC 565.

[21] *Ibid*. at p 572.

same phrase in a similar context must be construed so that the word or phrase is interpreted according to the meaning that has previously been assigned to it[22].

The purposive duty imposed on States under Article IV (1) of the IMF *Agreement* is that States should 'endeavour' to direct their policies towards fostering orderly conditions for the global economy. The qualifying condition is how much effort satisfies the 'endeavour' requirement? Unfortunately, that question has never been expressly asked or answered in international law.

Today, the interpretation of words contained in international agreements is governed by Article 31of the *Vienna Convention on the Law of Treaties*[23] (VCLT) which states:

> Article 31 General rule of interpretation
>
> 1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
>
> 2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes;
>
> > (a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;
> >
> > (b) any instrument which was made by one or more parties in connexion with

[22] Mann, F. A. (1983) Uniform Statutes in English Law, *Law Quarterly Review*, Vol. 94, 376 at p 382.

[23] The 1969 *Vienna Convention on the Law of Treaties* entered into force in January 1980 and so applies to treaties concluded after that date by those States which signed the VCLT. Nevertheless, for matters of clarity, its application can extend to previous treaties. This was made clear in the British case of *Fothergill v Monarch Airlines Ltd.* [1981] AC 251, where Lord Diplock said the Vienna Convention 'does no more than codify already existing public international law' (at p 282). Arguably, it does not matter when the VCLT came into effect, its content may apply to earlier treaties (if members accept the customary concept of codification) and be used to interpret and clarify the IMF *Articles of Agreement* which entered into force in December 1945.

the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account, together with the context;

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32 provides an additional means of interpretation if ambiguities still exist. It says:

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstance of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31:

(a) leaves the meaning ambiguous or obscure; or
(b) leads to a result which is manifestly absurd or unreasonable.

Reinforcing the application of Articles 31 and 32, the *2007 Report of the International Law Commission* at its Fifty-ninth session determined that the object and purpose of a treaty is to be determined in good faith, taking account of the terms of the treaty in their context. Recourse may also be had in particular to the title of the treaty, the preparatory work of the

treaty and the circumstances of its conclusion and, where appropriate, the subsequent practice agreed upon by the parties[24]. The International Law Commission stated:

> It is by no means easy to put together in a single formula all the elements to be taken into account, in each specific case … Such a process undoubtedly requires more "esprit de finesse" than "esprit de géométrie"[25], like any act of interpretation, for that matter ~ and this process is certainly one of interpretation. Given the great variety of situations and their susceptibility to change over time, it would appear to be impossible to devise a single set of methods for determining the object and purpose of a treaty, and admittedly a certain amount of subjectivity is inevitable[26].

In that context, the International Court of Justice (ICJ) can deduce the object and purpose of a treaty from a number of elements, taken individually or in combination: from its title[27]; from its preamble[28]; from an article placed at the beginning of the treaty that 'must be regarded as fixing an objective, in the light of which the other treaty provisions are to be interpreted and applied'[29]; from an article of the treaty that demonstrates 'the major concern of each

[24] United Nations General Assembly (2007) Official Records Sixty-second session Supplement No. 10 (A/62/10) at p 77.

[25] Pascal, B. (1954) Pensées, in *Oeuvres completes de Pascal*, (ed. Jacques Chevalier), Bibliothèque de la Pléiade, N.R.F. ~ Gallimard, Paris, at p 1091.

[26] *Id*.

[27] *Norwegian Loans, Judgment of 6 July 1957*, I.C.J. Reports 1957, p 24.

[28] *Military and Paramilitary Activities in and against Nicaragua,* (Merits), (*Nicaragua v United States of America*) Judgment of 27 June 1986, I.C.J. Reports 1986, p 138, para. 275; and *Sovereignty over Pulau Ligitan and Pulau Sipadan,* (Merits), Judgment of 17 December 2002, I.C.J. Reports 2002, p 652, para. 51.

[29] *Oil Platforms, Preliminary Objection,* Judgment of 12 December 1996, I.C.J. Reports 1996, p 814, para. 28.

contracting party' when it concluded the treaty[30]; from the preparatory works on the treaty[31]; and from its overall framework[32].

From the above, we can determine that words in a treaty, convention or international agreement have a meaning in line with the purpose of the instrument and commonly, their natural ordinary meaning if no other precedent exists to establish an alternative meaning. In our case, 'endeavour' can be given its ordinary meaning: to try to do something or make an effort to do or attain something. Consequently, under Article IV (1) of the IMF *Articles of Agreement*, it can be argued that States do have an obligation to make an effort to achieve price stability and foster conditions that do not disrupt the global economy, but because there is no clear leadership with respect to international monetary law, countries are left to devise or plan their own strategies to fulfil those obligations through their national legislatures.

The Citigroup coup highlighted how British laws had evolved to address particular problems and how European laws were in the process of catching up[33]. But there are many other States which are yet to consider these issues yet alone implement legislation to tackle the problems associated with SCF. An obvious question to ask at this point is what mechanisms are available to make States comply with international laws?

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[30] *Kasikili/Sedudu Island,* Judgment of 13 December 1999, I.C.J. Reports 1999, p 1072 -73, para. 43.

[31] *Territorial Dispute* (*Libyan Arab Jamahiriya/Chad*), Judgment of 3 February 1994, I.C.J. Reports 1994, p 27 - 28, paras. 55 and 56.

[32] See the *Advisory Opinion of the Permanent Court of International Justice* of 31 July 1930 *on Greco-Bulgarian Communities*, P.C.I.J., Series B, No. 17, p 20.

[33] The *Market Abuse Directive* (No 2003/6/EC) of the European Parliament and of the Council of 28th January 2003 on insider dealing and market manipulation, introduced similar market abuse provisions to Part VIII of the *Financial Services and Markets Act* 2000 (UK). The European Securities and Markets Authority which replaced the Committee of European Securities Regulators in January 2011 now administers securities legislation and regulation of financial markets in Europe.

6.5 State Responsibility

Harris (2003) wrote:

> In any legal system there must be liability for failure to observe obligations imposed by its rules. Such liability is known in international law as *responsibility* … Responsibility arises for the breach of any obligation owed under international law. A State is responsible, for example, if it fails to honour a treaty, if it violates the territorial sovereignty of another State, if it damages the territory or property of another State, if it employs armed force against another State, if it injures the diplomatic representatives of another State, or if it mistreats the nationals of another State[34].

While that seems concise and unambiguous, the acceptance and adoption of such simplicity has been a long time in the making and even today it is still not really clear whether the principle would extend to SCF.

In the early part of the twentieth century the League of Nations sought to codify international laws relating to State responsibility and acts perpetrated by non-State actors. The outcome of the International Conference was:

> ... the position taken by Governments during the preparatory work for the 1930 Codification Conference and at the Conference itself are particularly significant. All the States which participated in this work recognised that acts of private individuals could never be attributed to the State as a source of international responsibility. They agreed that the State incurred responsibility, in certain circumstances, only for the conduct of its own organs in relation to acts of private individuals … even where the said acts take place in special circumstances such as riots, internal disturbances, etc.

[34] Harris, D. (2003) *Cases and Material on International Law*, 5th ed., Sweet and Maxwell Ltd, London, at p 484.

or cause injury to aliens enjoying special protection, such as diplomatic agents accredited to the State[35].

The effect was to diminish the *theory of complicity* which was an accepted tradition in ancient times that mildly existed from around the time of Grotius[36] wherein the State could be held liable for the actions committed by a person under special circumstances[37]. Subsequent to the 1930 Conference, States believed that they did not have to guarantee the protection of persons or property or to reimburse foreigners for losses caused by the State's nationals if those persons were acting as individuals. Notwithstanding that perception, the League still maintained that: 'A State is responsible for damage caused by a private person to the person or property of a foreigner if it has failed to take such preventative or punitive measures as in the circumstances might properly be expected of it'[38].

The United Nations pursued the agenda of *State Responsibility* for over sixty years with very little progress[39]. The post World War II task of devising an international treaty for State

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[35] International Law Commission (1975)*Yearbook of the International Law Commission*, United Nations, Vol II, p 76.

[36] Grotius, H. (1646) *De Jure Belli ac Pacis Libri Tres*, Amsterdam lib II, p 366, and subsequently developed further by de Vattel, E. (1802) *Le drois des gens, ou Principles de la loi naturelle*, Lyons, Robert et Gauthier, Vol. II, p 72.

[37] It should be noted that ancient States took clear responsibility for the acts of its citizens against other States. See Jan A. Hessbruegge (2003) The Historical Development of the Doctrines of Attribution and Due Diligence in International Law, *NYUJ International Law & Politics*, Vol. 36, p 265; Kadish, S. (1985) Complicity, Cause and Blame: A Study in the Interpretation of Doctrine, *California Law Review*, Vol. 73, No. 2 (March 1985), p 323-410.

[38] League of Nations (1930) *Acts of the Conference for the Codification of International Law*, The Hague, 13th March 1930, Vol. IV, p 143.

[39] At its first session, in 1949, the International Law Commission selected State Responsibility as one of the topics for codification, however it never included it on its list of priority topics*. It should be recognised the draft Articles for the *Responsibility of States for Internationally Wrongful Acts* is only a short nineteen pages but it has taken over 60 years to compile and it is still not finalised. *Cf: United Nations (2004) *The Work of the International Law Commission*, 6th ed., Vol. 1, UN Publications.
Available at: http://untreaty.un.org/ilc/publications/ilc_work/ilc_work_6th_edition.htm

responsibility was assigned to the International Law Commission (ILC) in 1949. Although the draft *Articles on State Responsibility* does not define 'harm', the ILC gave this general interpretation in 1985:

> … material harm means 'physical', 'quantitative' or 'tangible' injury to a State's interests. Non-material harm refers to moral or qualitative harm, for example an affront to the dignity or respect of a State, such as the broadcasting of material to another State that is inconsistent with its internal order and its territorial integrity … harm is not expected to result in every case but may result in some cases only. This latter type of injury is referred to as potential injury and includes prejudice to future interests and harm likely to result from accidental injuries. The characterisation of substantial harm, and its point of separation from tolerable harm … is a difficult issue that does not appear to have been resolved or treated uniformly in State practice. Some treaties enumerate the kinds of injuries that are not to be tolerated among the parties, so that activities leading to them are prohibited. Other treaties refer in general terms to activities or certain activities leading to some injury. There are also treaties and judicial decisions which require consultation and prior negotiation for any activity. It would not be totally accurate, however, to assume that the requirement of negotiation and consultation in the latter case is due to the inherent character of certain activities themselves, and not of the injuries they cause. When it is known that certain injuries will always be caused by certain activities, the activities themselves are regulated so as to prevent or minimise their harmful effects[40].

The ILC completed the second reading of the draft *Articles on State Responsibility* at its fifty-third session, in 2001. At that time the ILC decided to amend the title of the draft Articles to *Responsibility of States for Internationally Wrongful Acts* as a measure to distinguish the subject matter from *International liability for injurious consequences arising out of acts not*

[40] International Law Commission (1985) *Survey of State practice relevant to international liability for injurious consequences arising out of acts not prohibited by international law*, United Nations Document: A/CN.4/384, at p 26.

prohibited by international law[41]. At its sixty-second session sitting between October and November 2007, the ILC heard statements from various government representatives. It was noted that the draft *Articles on State Responsibility* had become an authoritative statement of the rules on State responsibility and were being extensively referred to in practice within the International Court of Justice. Although some delegations favoured an immediate adoption of the Convention saying it would ensure legal certainty in the field of State responsibility, other delegations opposed the adoption of the draft Articles. Nirupam Sen, a representative on the Sixth Law Commission Committee, said the delays: 'exhibit the sensitivity to the needs of States in difficult circumstances'[42].

From the outset, the International Law Commission reflected the view that State responsibility should encompass any possible breach of any international obligation, not just those concerning the protection of foreign diplomats[43]. Explaining the scope of the ILC's work, Riphagen[44] (1981) emphasised that State responsibility deals mainly with responsibility for wrongful acts, not liability for injuries arising from lawful acts[45] but that reasoning has altered considerably with the effects of globalisation.

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[41] See Official Records of the General Assembly, Fifty-sixth session, Supplement No. 10 (A/56/10), para. 68. The distinction between the two topics is relevant but the principle of liability and reparations applies to both. The ILC's work on *International liability for injurious consequences arising out of acts not prohibited by international law* has not progressed very far; it was split into two parts in 2007: 'International liability in case of loss from transboundary harm arising out of hazardous activities' and 'Consideration of prevention of transboundary harm from hazardous activities and allocation of loss in the case of such harm'.

[42] Sen, N. (2007) Statement by Nirupam Sen, Permanent Representative on Agenda Item 78: Responsibility of States for Internationally Wrongful Acts, at the 62nd session of the United Nations General Assembly on 23rd October 2007. The Draft Articles no longer provide for the concept of State crimes. The Commission brought in its place the concept of serious breach of an obligation arising under a peremptory norm of general international law.

[43] International Law Commission (1949) *Yearbook of the International Law Commission*, UN Doc. A/CN.4/SER.A/1949, p 49-50.

[44] Willem Riphagen served as special rapporteur of the International Law Commission from 1980 to 1986.

[45] Riphagen, W. (1981) *Second Report on the Content, Forms and Degrees of International Responsibility*, International Law Commission, United Nations.

In questioning the concepts of lawful acts and unlawful acts, Akehurst (1985) took the view that: 'The fact that operating a smelting plant is permitted by international law does not necessarily mean that all acts committed in the course of that activity are permitted by international law; the activity of operating a smelting plant is lawful, but the act of discharging fumes from the plant is not lawful'[46]. Akehurst's reasoning presented a different paradigm from that which the International Law Commission initially perceived. Arguably, the causation of harm is an unlawful act, thus the rules of State responsibility can readily apply. Logically, there is a cross-over point when some lawful acts by citizens might become unlawful at the supra-national level; but that discussion has not been explored nor even considered in the realm of international capital movements by the ILC. But if we examine what Judge Xue wrote about transboundary damage and its affect on other States, it gives us an indication of where international law is headed and the possibility that those principles could be applied to SCF.

Xue[47] (2003) wrote:

> ... the debate over the notion of fault is not a theoretical issue but a policy question on how strict rules of international liability should be imposed on States for transboundary damage. In this regard, the balance of interests ultimately boils down to two aspects of the doctrine of sovereignty, the acting State would insist on its right to conduct activities within its territory, while the injured State would invoke the principle of territorial integrity to contend that the acting State has the duty to pay compensation for damage it caused outside its borders. If fault comprises the notion *culpa*, the acting State would not be held responsible for transboundary damage *per se* unless it is proven that the State has intentionally or negligently failed its international obligation. If the notion only refers to a legal duty under international law, the content

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[46] Akehurst, M. (1985) International Liability for Injurious Consequences Arising Out of Acts not Prohibited by International Law, *Netherlands Yearbook of International Law*, Vol.16, p 8.

[47] Xue Hanqin joined the International Law Commission in 2001 and was appointed Judge of the International Court of Justice in June 2010.

> of the duty would determine to what extent the acting State should be liable for its action. In both cases, the injured State has to prove at least two things: first, that there is a legal duty on the acting State in carrying out the activity to avoid causing damage to other States; and, secondly, that the acting State has failed to observe this obligation. On the first point, the injured State tends to invoke the principle of territorial integrity to claim that the acting State is under an international obligation not to cause transboundary damage. But ... this principle alone is not sufficient to ascertain exactly what is permissible and what is not under international law[48].

Bodansky and Crook (2002) say the rules of State responsibility apply to: ' both acts and omissions, to treaty obligations and customary norms, to breaches of bilateral as well as multilateral obligations, and to the whole gamut of particular subject areas ~ human rights law, environmental law, humanitarian law, economic law, the law of the sea, and so forth'[49].

Xue (2003) explained:

> The formation of international rules on transboundary damage to a large extent is determined by the development of national laws and practice ... In recent years, several factors have rendered traditional rules on international liability insufficient in coping with the problems of transboundary damage. The most notable is that State activities are quickly shrinking ... the tendency towards decentralisation and deregulation by governments further weakens the direct accountability of States in the event of damage caused by such activities …
>
> Transboundary damage caused by normal industrial, agricultural, and technological activities through either accidental mishaps or gradually cumulative harmful effects, is an evolving practical matter between States, as well as a legal issue of growing importance in international law. From relations between neighbouring countries to global interactions among States, the issue touches on a profound change of

[48] Xue, H. (2003) *Transboundary Damage in International Law*, Cambridge University Press, UK, p 298.

[49] Bodansky, D. and Crook, J. (ed.) (2002) *The International Law Commissions' State Responsibility Articles*, Symposium Papers, American Society of International Law, at p 780.

perceptions and perspectives of States and peoples towards their natural resources and environment, and towards each other in economic and social development[50].

Without doubt, traditional rules on international liability are changing under the pressures of globalisation. Applying Xue's reasoning to our problem, cross-border speculative capital flows are non-accidental transboundary acts which typically cause damage to another State's economy; they are computer based technological activities which have surpassed the existing regulatory framework to the advantage of some market participants at the detriment of the wider community; and they have gradual cumulative harmful effects in that economies are made worse off. Recapping the findings of Chapter 3, SCF can lead to higher interest rates, lower GDP output, lower income, less money in circulation and higher unemployment levels. Continuing to apply Xue's reasoning to relations between neighbouring countries and global interactions among States, SCF fall within the scope of international monetary law and hence any damage caused by those activities should be able to be addressed according to State responsibility.

6.6 Applying State Responsibility to Speculative Capital Flows

Despite the delays in compiling the draft *Articles for State Responsibility*, on a positive note, the International Courts[51] and Tribunals[52] have been applying the principles of international law to their decisions since 1922 and 1946 respectively. The draft Articles were merely an attempt to codify the established principles of international law that were already being applied. However, an interesting paradigm in this equation is the fact that the International Court of Justice is vested with the power to make its own rules. Court procedures are set out

[50] Xue, H. (2003) *Transboundary Damage in International Law*, Cambridge University Press, UK, p 327.

[51] Permanent Court of International Justice (PCIJ) and its successor the International Court of Justice.

[52] Nuremberg and Tokyo Tribunals plus the International Criminal Tribunal for the former Yugoslavia.

in the *Rules of Court of the International Court of Justice* 1978 (as amended 29th September 2005). Under the *ICJ Statute*, the ICJ is not formally bound by its previous decisions. Article 38(1)(d) of the *ICJ Statute* says the Court may consider its own previous decisions but Article 59 makes it clear that the common law doctrine of *stare decisis* does not apply at the international level. The Court's decision binds only the parties to each particular controversy ~ not future Court rulings or judgments (Schwebel[53], 1987)[54], therefore international monetary law has the potential to develop very rapidly without being restricted by prior precedents which no longer fit the current paradigm.

Nonetheless, universal acceptance of the draft Convention on State responsibility would simplify the rules as to what is required by each State. Having an international treaty that holds each State responsible for its failure to fulfil its international obligations would strengthen the legitimacy of international law and articulate the requirements of national legislation. The UN recognised this need and thus the draft Articles on *State Responsibility* provide an objective base line from which to examine the legal implications surrounding speculative capital flows.

Some of the Articles for the *Responsibility of States for Internationally Wrongful Acts* which can be applied to SCF are presented in Appendix F. Recognising they are based on already accepted and established principles of international law, applying the draft Articles to a country's reluctance to fulfil its obligations under the IMF *Articles of Agreement*[55], we could

[53] Stephen Schwebel served as a Judge to the International Court of Justice 1981-1997 and as President 1997 - 2000.

[54] Schwebel, S. (1987) Ad Hoc Chambers of the International Court of Justice, *American Journal of International Law*, Vol. 81, p 831.

[55] Articles I and IV provided guidance on the obligations of States to direct their economic policies towards:

Maintaining orderly exchange arrangements that promote price stability.

conceive that there is a possibility that international law might better regulate the market and provide a remedy to bring the worst excesses of disruptive currency trading practices to an end.

Using the draft *Articles of State Responsibility* we can determine that:

The State is responsible[56] for its wrongful omission if it breaches an international obligation[57] that is governed by international law[58], even though it might be carried out by a non-State organ[59] that is either directed or controlled by the State[60] or conducted in the absence or default of official authority[61]. There is a breach of an international obligation by a State when an act or omission of the State is not in conformity with what is required of it[62]. A State has a duty to perform the obligation it breached[63] and cease the act or fulfil the obligation giving appropriate assurances and guarantees of non-repetition[64]. The responsible State is under an

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> Minimising the degree of disequilibrium in the international balances of payments so as to not hamper the growth of world trade or be destructive of national or international prosperity.
>
> Avoid competitive exchange rate depreciations that create instability.
>
> Avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or gain an unfair competitive advantage over other members.

[56] *Responsibility of States for Internationally Wrongful Acts*, Article 1.

[57] *Responsibility of States for Internationally Wrongful Acts*, Article 2(b).

[58] *Responsibility of States for Internationally Wrongful Acts*, Article 3.

[59] *Responsibility of States for Internationally Wrongful Acts*, Article 5.

[60] *Responsibility of States for Internationally Wrongful Acts*, Article 8.

[61] *Responsibility of States for Internationally Wrongful Acts*, Article 9.

[62] *Responsibility of States for Internationally Wrongful Acts*, Article 12.

[63] *Responsibility of States for Internationally Wrongful Acts*, Article 29.

[64] *Responsibility of States for Internationally Wrongful Acts*, Articles 30 (a) & (b).

obligation to make full reparation for the injury caused by the internationally wrongful act[65] in the form of restitution, compensation or satisfaction[66], to re-establish the situation which existed before the wrongful act was committed[67] and pay interest on any principal sum due[68].

Considering billions, if not trillions of dollars have been eroded from national economies in opposition to the intent of the IMF *Articles of Agreement*, the case for allowing speculative currency trading to continue starts to diminish. However, it is here that the distinction between States and their constituents needs to be considered. As explained above, international conventions, treaties and agreements apply to States, but their provisions do not automatically extend to the citizens of States unless domestic laws have been enacted that fulfil the purposes of the international law. Nevertheless several international cases have demonstrated States can be held responsible for the effects of conduct by private parties under their control ~ where the State fails to take necessary measures to prevent or mitigate the damage caused by their constituents to another State or the citizens of another State. Often remotely separate factors, events or peoples come together which results in some form of damage being caused to a third party without initial or direct State involvement. Two prominent international cases to highlight this point were the *Corfu Channel Case* [69] and the *United States Diplomatic and Consular Staff in Tehran case* [70].

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[65] *Responsibility of States for Internationally Wrongful Acts*, Article 31.

[66] *Responsibility of States for Internationally Wrongful Acts*, Article 34.

[67] *Responsibility of States for Internationally Wrongful Acts*, Article 35.

[68] *Responsibility of States for Internationally Wrongful Acts*, Article 38.

[69] *Corfu Channel Case*, Judgment of 9 April 1949: I.C.J. Reports 1949, p 4.

[70] *United States Diplomatic and Consular Staff in Tehran*, Judgment of 24 May 1980, I.C.J. Reports 1980, at 31-33.

6.7 State Responsibility for acts of Citizens

The *Corfu Channel Case* was the first case brought before the ICJ. The action was brought against Albania by the United Kingdom shortly after the end of World War II. The UK sought compensation after two British destroyers hit sea-mines in the North Corfu Strait damaging them and killing naval personnel. The injury in question was effectively caused by a combination of factors, only one of which was ascribed to the responsible State as it happened in Albanian waters. Even though Albania did not lay the mines[71], the international tribunal found in favour of the UK due to Albania's failure to warn the British of the mine field's existence as required by *Hague Convention number VIII* [72]. The British contended that: 'whoever might be the authors of the mine laying it could not have been affected without Albania's knowledge'. As regards to the obligations resulting from that knowledge, it was Albania's duty to notify shipping and especially to warn the ships proceeding through the Corfu Strait about the minefield. The ICJ Tribunal recognised the Albanian Government's complete failure to carry out its duties and the dilatory nature of its diplomatic Notes to inform other States. The Tribunal declared that even though the action of the British Navy constituted a violation of Albanian territorial waters, the UK recovered the full amount of its claim, some £843,947, because Albanian nationals under the control of the Albanian government did nothing to warn the British or mitigate the potential hazard.

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[71] The mines were of German origin and deployed by the Yugoslavian navy a year after WWII ended.

[72] The *Hague Convention VIII* of 18th October 1907, relating to the Laying of Automatic Submarine Contact Mines. Under Article 2 of *Hague Convention VIII*, it is forbidden to lay automatic contact mines with the sole object of intercepting commercial shipping. Under Articles 3 and 4 of *Hague Convention VIII*, States, whether belligerent or neutral, are under an obligation to notify Governments and ship owners where mines have been laid. The location of the danger zones must be communicated to other Governments through the diplomatic channel in a timely manner. Article 3 specifically requires that: 'When anchored automatic contact mines are employed, every possible precaution must be taken for the security of peaceful shipping. The belligerents undertake to do their utmost to render these mines harmless within a limited time, and, should they cease to be under surveillance, to notify the danger zones as soon as military exigencies permit …'. Article 4 states that: 'Neutral Powers which lay automatic contact mines off their coasts must observe the same rules and take the same precautions as are imposed on belligerents'. Article 5 of *Hague Convention VIII* states that: 'At the close of the war, the Contracting Powers undertake to do their utmost to remove the mines which they have laid, each Power removing its own mines'.

The events underlying the United States claim against Iran covered the armed attack on the US Embassy in Tehran carried out on 4th November 1979 by militant student followers of the Imam. The ICJ pointed out that the conduct of the militants in overrunning the Embassy, the unlawful seizure and detention of its occupants, and the appropriation of US property and archives could be directly attributed to the Iranian State if it was established that they were in fact acting on Iran's behalf. The information before the Court did not suffice to establish that fact with due certainty, however, the Iranian State:

> … was under obligation to take appropriate steps to protect the United States Embassy ~ did nothing to prevent the attack, stop it before it reached its completion or oblige the militants to withdraw from the premises and release the hostages. This inaction … constituted a clear and serious violation of Iran's obligations to the United States under Articles of the 1961 *Vienna Convention on Diplomatic Relations*, and the 1963 *Vienna Convention on Consular Relations*[73].

The Court concluded that the Iranian authorities were fully aware of their obligations under the conventions in force, and also of the urgent need for action on their part. The ICJ reasoned that Iran had the means at their disposal to perform their obligations, but that they completely failed to do so. The Iranian authorities' decision to continue the subjection of the embassy to occupation, and of its staff to detention as hostages, gave rise to repeated and multiple breaches of Iran's treaty obligations on top of those already committed at the time of the seizure of the embassy. So even though private individuals instigated the attack on the embassy, the Court held the Iranian State responsible for its failure to protect the personnel and property of the American mission because of the government did not act in a manner positively prescribed by the treaties.

[73] *United States Diplomatic and Consular Staff in Tehran*, Judgment, I.C.J. Reports 1980, p 3, at 32, para 67.

The *Vienna Convention on Diplomatic Relations*[74] made it clear what was expected of the Iranian State so it is easy to rationalise the ICJ's decision[75]. The Iranian State did not protect the personnel of the American mission nor grant them facilities to leave at the earliest possible moment. An international wrongful act was clearly evident as the personal liberties of embassy staff were violated and the Iranian State did nothing to ensure their urgent release even though the State had all the means available to perform their obligations.

In both cases described above, the *ratio decidendi* for the Court's decision was similar. Albania and Iran were held responsible for the effects of conduct of their citizens because each State failed to take necessary measures to prevent or mitigate the damage caused by activities of parties under their control. Both States had obligations under international treaties to perform specific tasks which they failed to carry out. On that reasoning it is conceivable that governments that fail to enforce appropriate financial regulation should also find themselves liable for the actions of their currency traders. If a State took no steps to limit the traders' activities or enforce the provisions of the IMF *Articles of Agreement* to foster stable economic conditions, would that qualify as an omission to fulfil an international obligation? Such possibilities could be considered; after all, IMF signatory members have undertaken to collaborate with the Fund and other members to assure orderly exchange

[74] Ratified at Vienna on 18th April 1961 and entered into force on 24th April 1964, United Nations, Treaty Series, Vol. 500, p 95.

[75] Article 22 of the *Convention on Diplomatic Relations* states: 'The premises of the mission shall be inviolable. The agents of the receiving State may not enter them, except with the consent of the head of the mission. The receiving State is under a special duty to take all appropriate steps to protect the premises of the mission against any intrusion or damage and to prevent any disturbance of the peace of the mission or impairment of its dignity'. Article 26 states: 'Subject to its laws and regulations concerning zones entry into which is prohibited or regulated for reasons of national security, the receiving State shall ensure to all members of the mission freedom of movement and travel in its territory'. Article 29 states: 'The person of a diplomatic agent shall be inviolable. He shall not be liable to any form of arrest or detention. The receiving State shall treat him with due respect and shall take all appropriate steps to prevent any attack on his person, freedom or dignity. And Article 44 of the *Convention* states: 'The receiving State must, even in case of armed conflict, grant facilities in order to enable persons … and members of the families of such persons irrespective of their nationality, to leave at the earliest possible moment. [The receiving State] must, in particular, in case of need, place at their disposal the necessary means of transport for themselves and their property'.

arrangements and to promote a stable system of exchange rates. In particular, each member *shall* endeavour to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability. On that logic, if a State does not endeavour to implement policies which curtail the activities of disruptive currency trading, arguably, they are breaching their international obligation which could therefore invoke State responsibility. That concept is reflected in draft Article 32 of *State Responsibility* which says: 'The responsible State may not rely on the provisions of its internal law as justification for failure to comply with its obligations ...'.

Under draft Article 5 for *State Responsibility*, the conduct of a person or entity ~ which is not an organ of the State as described under Article 4 but which is nevertheless empowered by the law of that State to exercise or conduct its affairs contrary to the State's international obligations ~ might invoke State Responsibility. The degree to which banks, hedge funds and currency traders are 'empowered' by the State to carry out their activities would determine the level of the State's responsibility. If there was a positive 'empowering' Act which gave the speculators *carte blanche* to destabilise the IMS it would be an obvious answer however, in the absence of that 'empowering' authority, the collateral destabilisation is merely a by-product of an under-regulated market.

Nonetheless, elements of governmental authority are considered as acts of State, so if a State fails to fulfil its international obligation by implementing policies and legislation designed to foster stable exchange rates or prevent the banks and currency traders from destabilising the IMS would it be held to be conduct authorised by the State? The following paragraphs highlight the evolving confusion as to why that the above question should be answered in the negative.

Draft Article 8 clarifies the principle by stating:

> The conduct of a person or group of persons shall be considered an act of a State under international law if the person or group of persons is in fact acting on the instructions of, or under the direction or control of that State in carrying out the conduct.

Draft Article 9 covers conduct in the absence or default of the official authorities; it says:

> The conduct of a person or group of persons shall be considered an act of a State under international law if the person or group of persons is in fact exercising elements of the governmental authority in the absence or default of the official authorities and in circumstances such as to call for the exercise of those elements of authority.

Draft Article 12 explains the existence of a breach of an international obligation:

> There is a breach of an international obligation by a State when an act of that State is not in conformity with what is required of it by that obligation, regardless of its origin or character.

The deciding factor is that speculative capital transactions are carried out by banks, corporations and private individuals; meaning they are not a direct act of State as defined in draft Articles 8 and 9, therefore draft Article 12 would not apply to make a State liable. However, if we consider that SCF are acts done by persons or groups of persons empowered by the law of that State to carry out those activities ~ contrary to the State's international obligations and in the absence of prohibitive legislation preventing market traders from destabilising exchange rates ~ then that should rightfully invoke State Responsibility through the doctrine of due diligence.

The clarification as to whether a State was responsible for the acts of private citizens was reflected in the proposed wording of draft Article 11 in 1972 by the Special Rapporteur Roberto Ago who suggested the following words:

> Article 11 ~ Conduct of private individuals
>
> 1. The conduct of a private individual or group of individuals, acting in that capacity, is not considered to be an act of the State in international law.
> 2. However, the rule enunciated in the preceding paragraph is without prejudice to the attribution to the State of any omission on the part of its organs, where the latter ought to have acted to prevent or punish the conduct of the individual or group of individuals and failed to do so[76].

Three years later the wording changed. The 1975 version of Draft Article 11 for *State Responsibility* read: 'The conduct of a person or a group of persons not acting on behalf of the State shall not be considered as an act of the State under international law'. At that time it was generally accepted that in order for a State to be held responsible for the acts of individuals, the violation had to be directly attributable to the State. If that criterion failed, individual criminal or civil responsibility would be applicable; not State responsibility[77]. Continuing the evolution, the 1975 version of draft Article 11 was revised a few more times over the years to reflect the incremental changes in international law. Draft Article 11 now reads:

> Conduct which is not attributable to a State under the preceding articles shall nevertheless be considered an act of that State under international law if and to the extent that the State acknowledges and adopts the conduct in question as its own.

[76] Extract from the Yearbook of the International Law Commission, 1972, Vol. II. Document:-A/CN.4/264. Fourth report on State responsibility, by Mr. Roberto Ago Special Rapporteur – The internationally wrongful act of the State, source of international responsibility, p 126.

[77] In free market economies, neither civil nor criminal responsibility would apply to currency traders anyway because what they are doing is presently lawful; but in countries like Brazil, China, South Korea and India where their governments have imposed restrictions on speculative capital movements non-complying traders could be held responsible at the domestic level ~ not the international level.

The critical words now are: 'that the State acknowledges and adopts the conduct in question as its own'. Ideally this still provides an escape route for any State which could argue that the conduct of its currency traders is not its own, therefore it could never be liable for those activities.

Yet the ILC (2001) interpreted the meaning of Draft Article 11 saying:

> The essence of an internationally wrongful act lies in the non-conformity of the State's actual conduct with the conduct it ought to have adopted in order to comply with a particular international obligation[78].

That means that States do have a positive obligation to put mechanisms in place to meet their international obligations. Any non-complying activity of its private citizens which is in opposition to the State's obligations under international law requires remedial action on the part of the State. That now brings us to the doctrine of due diligence.

6.8 Obligation of Due Diligence

Barnidge (2006)[79] explored the interface of State Responsibility, non-state actors, and the due diligence principle. He deciphered the deliberations of the International Law Commission drawing attention to what is expected of States with regard to the activities of non-State actors. Although the due diligence principle can be restrictively or expansively interpreted, Barnidge holds the view that States are responsible for their acts and omissions related to non-State actors. Chinkin (2010)[80] holds the same view and says the duty of due diligence

[78] International Law Commission (2001) *Draft Articles on Responsibility of States for Internationally Wrongful Acts*, with text adopted by the International Law Commission at its fifty-third session, and submitted to the General Assembly as a part of the Commission's report; commentary on Draft Article 11, at p 54.

[79] Barnidge, R.P. (2006) The Due Diligence Principle Under International Law, *International Community Law Review*, Vol. 8, No. 1, p 81-121. Available at SSRN: http://ssrn.com/abstract=1156773

[80] Chinkin, C (2010) *The Duty of Due Diligence*, Council of Europe , Committee on preventing and combating violence against women (CAHVIO); http://www.coe.int/t/dghl/standardsetting/violence/CAHVIO_2010_7.pdf

has been applied in the context of human rights violations since the landmark case of *Velasquez Rodriguez v Honduras* (1989)[81] wherein the Inter-American Court of Human Rights held that a State must take action to prevent human rights violations, and to investigate, prosecute and punish them when they occur. In that case the Court determined that:

> … an illegal act which violates human rights and which is initially not directly imputable to a State (for example, because it is the act of a private person or because the person responsible has not been identified) can lead to international responsibility of the State, not because of the act itself, but because of the lack of due diligence to prevent the violation or to respond to it as required by the Convention[82].

The Court in *Velasquez Rodriguez v Honduras* said if a State's obligations under a treaty were not met or enforced; 'the system of protection provided for in the Convention would be illusory'[83]. It went on to explain: 'What is decisive is whether a violation of the rights recognised by the Convention has occurred with the support or the acquiescence of the government, or whether the State has allowed the act to take place without taking measures to prevent it or to punish those responsible'[84].

The *Velásquez-Rodríguez* case dealt with human rights violations connected with abduction and torture of political opponents, but the role of the Court was to determine whether the breach of international law was a result of the State's failure to fulfil its duty to respect and guarantee those rights to its citizens, as required of it by Article 1 (1) of the *American*

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[81] *Velásquez-Rodríguez v Honduras*, Inter-American Court of Human Rights, Judgment of 29th July, 1988, Series C No. 4.

[82] *Id.*, para 172.

[83] *Id.*, para 170.

[84] *Id.*, para 173.

Convention on Human Rights. In that situation the State had a legal duty to take reasonable steps to prevent human rights violations and to use the means at its disposal to carry out a serious investigation of violations committed within its jurisdiction, to identify those responsible, to impose the appropriate punishment and to ensure the victim obtained adequate compensation.

The Court held that the resources of the State to prevent those types of incidents should include: 'all those means of a legal, political, administrative and cultural nature that promote the protection of human rights'[85]. The State's obligation therefore, was to ensure that any violations were considered as illegal acts, and treated as such. The Court said:

> If the State apparatus acts in such a way that the violation goes unpunished and the victim's full enjoyment of such rights is not restored as soon as possible, the State has failed to comply with its duty to ensure the free and full exercise of those rights to the persons within its jurisdiction. The same is true when the State allows private persons or groups to act freely and with impunity to the detriment of the rights recognised by the Convention[86].

For the purposes of our study, the IMF *Articles of Agreement* qualifies as a Convention[87]: it is an international agreement concluded between member States in written form and governed by international law[88]. Therefore, if the same precedent for human rights law was applied to international monetary law, States should be held responsible for the negative effects of SCF because of their lack of due diligence in administering their obligations as imposed by the IMF *Articles of Agreement*. For the purposes of human rights or diplomatic protection law, if

[85] *Id*. para 175.

[86] *Id*. para 176.

[87] While the word 'Convention' is used synonymously with 'Treaty', 'Convention' is more commonly reserved to designate proper formal instruments of a multilateral character.

[88] *Concise Australian Legal Dictionary* (1997) Butterworths, Chatswood, Australia.

the State can be held accountable to, or responsible for acts of its citizens, serendipitously, the individual now becomes a component of international law where not only States can be held responsible if it breaches a law by which it is governed, but the individual as well.

To reinforce that assertion, Brownlie (2008) wrote: 'There is no general rule that the individual cannot be a "subject of international law", and in particular contexts he appears as a legal person on the international plane'[89]. Numerous cases from the time of the *Nuremberg Trials*[90] through to *Tadić*[91] promote that idea. Following the same line of thought as Brownlie, Clapham (2010) contemplates the idea that individuals have obligations and rights, and can be held criminally responsible for violations, but says they are seldom able to seek remedies[92] under the general limitations of international law. He says:

> If we do not want the development of international law to stagnate we should perhaps admit the progressive idea that individuals have, in addition to these rights and criminal law obligations, certain international civil law obligations; this step could help to build an international community which properly recognises the role of the individual in international law[93].

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[89] Brownlie, I. (2008) *Principles of Public International Law*, 7th edn, Oxford University Press, at 65.

[90] *Military Tribunal (Nuremberg), Judgment and Sentences*, 1st October 1946: The judges determined that individuals had obligations under international law and could be punished, even with death by hanging, for violating those international obligations. See violations against international treaties at p 50 and sentencing at p 154.

[91] *Tadić Case,* International Criminal Tribunal for the former Yugoslavia (ICTY), Judgement of the Appeals Chamber, The Hague, Case No.: IT-94-1-A, 15 July 1999. The Appeals Chamber found Duško Tadić guilty of grave breaches of the 1949 Geneva Conventions (Article 2 of the Statute of the Tribunal) (para. 171), namely, wilful killing, torture or inhuman treatment, and wilfully causing great suffering or serious injury to body or health and guilty of additional war crimes and crimes against humanity (paras. 235-237). Tadić was the first person tried by the ICTY and the first to appear before an international war crimes tribunal since Nuremberg. He partially served his 20 year sentence in Germany before being granted early release in July 2008.

[92] Notwithstanding all the existing rights to petition an international human rights monitoring body: See, for example, the *Optional Protocol to the International Covenant on Civil and Political Rights*, United Nations, Treaty Series, Vol. 999, p 171; Article 14 of the *International Convention on the Elimination of All Forms of Racial Discrimination*; Articles 22 of the *Convention against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment*, United Nations, Treaty Series, Vol. 1465, p 85.

[93] Clapham, A. (2010) The Role of the Individual in International Law, *European Journal of International Law*, Vol. 21, No. 1, at p 30.

Such forward thinking could hold individuals, hedge funds or banks responsible for disrupting the stability of the global economy but such a hypothesis seems a long way off. Notwithstanding the duty of States 'endeavouring' to implement policies which promote financial stability, the commentaries accompanying the draft *Articles on State Responsibility for International Wrongful Acts* says: 'the principle that individuals, including State officials, may be responsible under international law was established in the aftermath of the Second World War … So far this principle has operated in the field of criminal responsibility, but it is not excluded that developments may occur in the field of individual civil responsibility'[94]. Clearly, draft Article 58 is not intended to exclude that possibility; hence the use of the general term 'Individual responsibility' as its title.

Additionally, draft Article 33 implies a similar provision. Under draft Article 33, the scope of a State's international obligations may be owed to another State, to several States, or to the international community as a whole; depending in particular on the character and content of the international obligation and on the circumstances of the breach. Draft Article 33 operates without prejudice to any right, arising from the international responsibility of the State, which 'may accrue directly to any person or entity other than the State'. That condition depends on both the primary rule establishing the obligation that was breached, and on the circumstances of the breach. However, it is up to the ICJ to assess the scope of the obligation and determine the gravity of the breach.

[94] International Law Commission (2001) *Draft Articles on Responsibility of States for Internationally Wrongful Acts*, with text adopted by the International Law Commission at its fifty-third session, and submitted to the General Assembly as a part of the Commission's report; commentary on draft Article 58, 'Individual responsibility' at p 142.

Although the draft Articles deal mainly with the invocation of responsibility by States, clause 2 of draft Article 33 recognises the possibility that the Articles could apply to persons or entities other than States. In this regard, the draft Articles have not restricted the likely expansion of international law to include individuals in international civil responsibility ~ hence, that possibility may open the way for currency manipulators to be held accountable to the international community. But as Gaja (2010) points out:

> While certain instruments adopted by the International Law Commission reflect views that are relevant in an analysis of the position of individuals as holders of rights in international law, it would be difficult to maintain that the ILC has taken a comprehensive approach on this matter[95].

Gaja explains:

> The ICJ has not yet examined the question whether the existence on the international plane of remedies for individuals affects the ability of a State to invoke international responsibility ...[96]

Unlike human rights or diplomatic protection laws, the IMF *Articles of Agreement* provides no obligations or remedies which are directly actionable by, or attributable to, individuals. For the purpose of international monetary law, the *Articles of Agreement* were intended to be the exclusive domain of States, therefore the idea that individuals or corporate entities could face civil proceedings related to destabilising monetary practices under the present international legal framework is somewhat improbable. But the IMF *Agreement* was drafted in an era before the abandonment of the gold standard, floating currencies, the existence of the international monetary market, and unregulated capital movements. Those new conditions brought about by technological advances and innovation allow for individuals to impact

[95] Gaja, G. (2010) The Position of Individuals in International Law: An ILC Perspective, *European Journal of International Law*, Vol. 21, No. 1, at p 11.

[96] *Id*.

negatively on the smooth operation of the IMS. Consequently, a shift in legal reasoning is required.

Similar to how Iran and Albania erred for not fulfilling their international obligations to protect the people and property of other countries, a State that fails to at least 'endeavour' to implement policies directed toward fostering stable exchange rate mechanisms should be held accountable. Typically, States do control their banks and other financial intermediaries to varying degrees through a plethora of domestic legislation and regulations. Going back to draft Article 8 of *State Responsibility*: 'The conduct of a person or group of persons shall be considered an act of State … if the person or group of persons is in fact acting … under the … control of that State'. *Inter alia*, Iran was responsible for not taking action against its militants, and Albania was responsible because her lighthouse keepers and coastguard failed to warn the British ships of the mine field. Clearly, inaction on the part of the State when people under its control carry out acts which are in opposition to the requirements of international law triggers State responsibility. The same due diligence principle should therefore apply to the activities of disruptive currency trading and the State's failure to take remedial action to mitigate financial instability and economic loss caused to other countries or the nationals of other countries.

6.9 The Present Reality

As the previous sections explained, States can be liable for their own actions ~ and the actions of those they control (Corfu and Tehran examples), but that is where there is real control of government instrumentalities. For this purpose, the ICJ applied the 'effective

control' test as enunciated in *Nicaragua v United States of America*[97]. The indirect control that States have with their obligation to regulate commerce under the IMF *Articles of Agreement* does not match the same level of obligation imposed by the *Vienna Conventions on Diplomatic and Consular Relations*, or the *Hague Convention (number VIII)* relating to the laying of sea-mines. As it stands, the various Articles of the IMF *Agreement* do not extend potential liability to the States due to the activities of free market traders within their jurisdictions. Clearly, there is a need to differentiate between the positive obligations that the States had under the treaties that were involved in the Corfu and Tehran cases and the more esoteric and ephemeral duties that they have to 'endeavour to direct [their] economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability' under the IMF *Articles of Agreement.* In the pure sense, the IMF *Articles* impose no clear duty to introduce any specific regulatory measures to limit the activities of entrepreneurial currency traders ~ and even if they did, and the States started to do something to address the problem, the traders would probably move to a non-treaty jurisdiction and continue their activities. If States conscientiously implemented what the *Articles of Agreement* require, they would inevitably place themselves at a competitive disadvantage. Consequently, none of the current provisions are expressly certain enough to impose compensatory responsibilities on either the traders who cause another country's loss - or on the States in which they reside.

6.10 Possible Legislative Measures

There seems little reason why Western States could not strictly monitor the movement of capital in to and out of their countries and put mechanisms in place to deter the purely speculative movements of capital. Brazil, China, Malaysia, South Korea and other countries

[97] *Military and Paramilitary Activities in and Against Nicaragua*, (Merits), (*Nicaragua v United States of America*), Judgment of 27 June 1986, I.C.J. Reports 1986, at paras 105 – 115.

have already adopted such measures. But like pollution originating in one State flowing across borders into other States, unless the global community implements corrective strategies in a unified fashion, then the efforts of one nation will be wasted while other States do little to solve the problem. Capital controls may protect the value of a currency in the domestic economy to some degree like it has for countries like Brazil, China, Malaysia, and South Korea, but their efforts do little to add to the stability of the global economy as a whole; something more is required.

Despite what was explained in the previous section about the impracticality of holding States responsible for the activities of their currency traders, limiting SCF or holding the speculator to account for its economically disruptive activities might be one possible solution to our problem. The fact is, laws do change, and it usually takes a high profile case to implement legislative reform. Thinking about cases like *R v Pear* [98], *R v Bazeley*[99], *Bird v Holbrook* [100], *McCulloch v Maryland* [101], *St Helen's Smelting Co. v Tipping* [102], *Donoghue v Stevenson* [103], *United States v Russo & Ellsberg* [104], *Roe v Wade* [105] and *Mabo and Others v Queensland* (No. 2)[106], we know those cases dramatically changed existing expectations within society and formed a catalyst for introducing new legislation; so who knows what the ICJ or national

[98] *R v Pear* (1779) 1 Leach 212 (4th ed.); 2 East PC 685; 168 ER 208.

[99] *R v Bazeley* (1799) 2 Leach 973 (3rd ed.) (Case CCCXI); 168 ER 517.

[100] *Bird v Holbrook* (1828) 4 Bing. 628; 130 ER 911.

[101] *McCulloch v Maryland* 4 Wheat. 316 (1819); 17 U.S. 316 (1819).

[102] *St Helen's Smelting Co. v Tipping* (1865) 11 HLC 642; 11 ER 1483.

[103] *Donoghue v Stevenson* [1932] AC 562; [1932] UKHL 100.

[104] *United States v Russo & Ellsberg* Crim. No. 9373 (WNB) (C.D.Cal, 1973).

[105] *Roe v Wade*, 410 U.S. 113 (1973).

[106] *Mabo and Others v Queensland (No. 2)* (1992) 175 CLR 1.

legislatures will do in the future if they are confronted with litigation relating to speculative capital flows?[107]

Alternatively, if the IMF was to live up to its responsibility under Article IV, sections 3(a) and 3(b) of the IMF *Agreement* and direct States to reach agreement on policies and implement mechanisms that foster stable economic conditions that might also work. As the IMF Articles state, the IMF has been entrusted to oversee the international monetary system in order to ensure its effective operation[108]. It is empowered to exercise firm surveillance over the exchange rate policies of members and adopt specific principles for the guidance of all members with respect to those policies. To do that, the IMF must first acknowledge that a problem exists and then work towards devising a strategy that will reduce the volatility of exchange rates. Those ideas are expanded upon in later Chapters, but in the meantime, if States do not 'endeavour' to do anything towards fostering a stable monetary system, would it allow the adversely affected State to seek relief through the International Court of Justice?

6.11 Practical Problems with Restitution

To penalise individuals in international legal matters between State parties is not beyond the scope of international law. In 1946, the International Military Tribunal of Nuremberg said: 'crimes against international law are committed by men, not by abstract entities, and only by punishing individuals who commit such crimes can the provisions of international law be enforced'[109]. Although speculative currency trading is not a crime, it is at odds with the

[107] Chapter 10 explains some of the hurdles implementing uniform change at the international level.

[108] Please note that the IMF's role dramatically changed with the abandonment of the gold standard but the amended *Articles of Agreement* still reflect this duty.

[109] *Military Tribunal (Nuremberg), Judgment and Sentences*, 1st October 1946: Reprinted in AJIL, Vol. 41, No. 1 (January 1947), 172, at p 221.

purposive intent of the IMF *Articles of Agreement* so is it plausible that the ICJ might find itself hearing matters of cross border litigation over a sovereign State's claim for restitution against currency traders from another State? The next few sections explain why that is unlikely to happen.

In accordance with draft Article 34 on *Responsibility of States for Internationally Wrongful Acts*, the function of damages is essentially compensatory. The function of compensation is to address the actual losses incurred as a result of the internationally wrongful act. Compensation corresponds to the financially assessable damage suffered by the injured State or its nationals[110]. It is not meant to punish the irresponsible State, nor does compensation have an expressive or exemplary character. Compensation generally consists of a monetary payment, though it may sometimes take the form of other value[111]. Monetary compensation is intended to offset, as far as may be possible, the damage suffered by the injured State or its constituents as a result of a breach of international law.

The general principle was stated by the Permanent Court of International Justice in the *Factory at Chorzów case*:

> It is a principle of international law that the breach of an engagement involves an obligation to make reparation in an adequate form. Reparation therefore is the indispensable complement of a failure to apply a convention and there is no necessity for this to be stated in the convention itself [112].

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[110] For example, the 1938 *Trail Smelter Arbitration** between the US and Canada involved pollution originating in Canada from a private smelter which affected private farmers in the US. **US v Canada*, RIAA, Vol. III, (1938, 1941), 1905.

[111] Monetary payments may be called for by way of *satisfaction* under draft Article 37 on *Responsibility of States for Internationally Wrongful Acts*, but in that instance, it performs a function distinct from that of compensation. Satisfaction is concerned specifically with non-material injury to the State, in which a monetary value can only be realised in a highly approximate and notional way.

[112] *Factory at Chorzów* (1927) P.C.I.J., Judgment No. 8, Series A, No. 9, p 21.

This suggests that while the IMF *Articles of Agreement* do not specifically state that reparation is a possible remedy for a State's failure to fulfil the obligations required to avoid acts which destabilise the IMS, the offending State may nevertheless be responsible for the economic loss suffered by other States if it can be shown that the offending State breached an engagement or failed to apply the convention.

In the *Factory at Chorzów* case, the Court stated that reparation must, as far as possible, wipe out all the consequences of the breach and re-establish the situation which would, in all probability, have existed if the convention had not been breached[113]. The determination for our situation is whether States that do not direct their policies towards fostering stable economic conditions should be held accountable to States which have been negatively affected by SCF and whether there is a sufficient causal connection between the State's failure to apply a convention and the other State's resultant economic loss.

6.12 Causal Link Between the Wrongful Act/Omission and the Injury

Causality is a necessary element but not a sufficient condition for reparation to be paid[114]. Monetary damages can be awarded when a causal link ~ which is not too remote ~ between a wrongful act and an injury can be established. A wrongful act may be either a breach of a duty or a failure to act. The determination of injury or loss attributable to a wrongful act is a legal process based on facts and historical connections. The International Law Commission comments:

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[113] *Ibid.* at 453.

[114] United Nations Compensation Commission (1994) Recommendations Made by the Panel of Commissioners Concerning Individual Claims for Serious Personal Injury or Death, (Category 'B' Claims) 14th April 1994, S/AC.26/1994/1. UN Document S/AC.26/1994. At p 35, the Commission held that two elements are required by the Panel in order for a claim for serious personal injury to be compensable: a) evidence of the date and fact of the injury; b) proof of causation.

> …the requirement of a causal link is not necessarily the same in relation to every breach of an international obligation. In international as in national law, the question of remoteness of damage is not a part of the law which can be satisfactorily solved by search for a single verbal formula. The notion of a sufficient causal link which is not too remote is embodied in the general requirement in Article 31[of State Responsibility] that the injury should be in consequence of the wrongful act, but without the addition of any particular qualifying phrase[115].

Various terms are used to describe the link which must exist between the wrongful act and the injury in order for the obligation of reparation to arise[116]. Reference may be made to losses attributable to the wrongful act as a 'proximate cause'[117], or to damage which is not 'too indirect, remote, and uncertain to be appraised' [118], or to 'any direct loss, damage including environmental damage and the depletion of natural resources or injury to foreign governments, nationals and corporations as a result of a wrongful act'[119]. Provided the injury is not too remote, the consequential criterion of directness[120], foreseeability[121] or proximity[122]

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[115] International Law Commission (2001) *Draft Articles on Responsibility of States for Internationally Wrongful Acts,* with text adopted by the International Law Commission at its fifty-third session, and submitted to the General Assembly as a part of the Commission's report. Commentary on Article 31, at p 92, para 10, citations omitted.

[116] *Id*.

[117] United States-German Mixed Claims Commission (1923) *Administrative Decision No. II*, United Nations Reports of International Arbitral Awards, UNRIAA, Vol. VII, at p 30.

[118] *Trail Smelter Arbitration* (1938, 1941) United Nations Reports of International Arbitral Awards, UNRIAA, Vol. III, at p 1931.

[119] United Nations Security Council Resolution No. 687 of 3rd April 1991, para. 16. This resolution was adopted with reference to Chapter VII of the UN Charter being expressed to reflect Iraq's liability 'under international law … as a result of its unlawful invasion and occupation of Kuwait'. The United Nations Compensation Commission (UNCC) and its Governing Council provided some guidance on the interpretation of the requirements of directness and causation.

[120] *Id*.

[121] *Portuguese Colonies case ~ Naulilaa incident* (1928) United Nations Reports of International Arbitral Awards, UNRIAA, Vol. II, at p 1031.

[122] Hart, H.L.A. and Honoré, A.M. (1985) *Causation in the Law*, 2nd ed., Clarendon Press, Oxford.
or

may be used to justify a claim for reparation. Other factors may also be relevant; for example, whether the State or its organs deliberately caused the harm in question, or whether the harm caused was within the ambit of an international rule that was breached. The problem with this situation is the extent to which liability could apply. At present, it is highly unlikely that any appropriately constructed forum would sanction such an open ended form of liability as it could potentially 'open the floodgates' of un-necessary and un-warranted litigation[123].

Additionally, it is not always possible to connect a State directly to the wrongfulness of an action that affords an award for reparation, but as the *Corfu Channel* [124] and the *United States Diplomatic and Consular Staff in Tehran* [125] cases demonstrated, States can be held responsible for the acts of their constituents if the State omits to fulfil its due diligence obligations under an international treaty. The IMF *Articles of Agreement* is an international treaty, therefore any duty imposed or any due diligence actions required under those Articles which are not fulfilled can invoke State responsibility.

The key requirement for a State to be responsible for non-State actors is that it controls the person or group who committed the violation. So the question is: what acts or directions by the State amount to 'control'? Is it enough to have overall general control over the group, or does the State have to have effective control over each and every specific action done? Despite the ICJ's application of an 'effective control test' used in 1986 to determine the

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Markesinis, B.S. (1997) *The German Law of Obligations: Volume II, The Law of Torts: A Comparative Introduction*, 3rd ed., Clarendon Press, Oxford, p 95–108.

[123] See Cardozo J in *Ultramares Corporation v Touche*, 174 N.E. 441 (1932) at 444 where he talks of not exposing persons to 'liability in an indeterminate amount for an indeterminate time to an indeterminate class' see also the Australian High Court decision in *Agar v Hyde* (2000) 201 CLR 552.

[124] *Corfu Channel Case*, Judgment of 9th April 1949: I.C.J. Reports 1949, p 4.

[125] *United States Diplomatic and Consular Staff in Tehran*, Judgment, I.C.J. Reports 1980, p 3, at 31-33.

innocence of the US for its paramilitary operations in Nicaragua, there is no clear answer to this question with respect to commerce, therefore it would probably be decided on a case by case basis. To show that this could be a possibility, the ICJ (2010) speaking on the responsibility of States to fulfil treaty requirements by enforcing control over corporate entities within its jurisdictions said it:

> … is an obligation which entails not only the adoption of appropriate rules and measures, but also a certain level of vigilance in their enforcement and the exercise of administrative control applicable to public and private operators, such as the monitoring of activities undertaken by such operators, to safeguard the rights of the other party. The responsibility of a [State] party to the … Statute would therefore be engaged if it was shown that it had failed to act diligently and thus take all appropriate measures to enforce its relevant regulations on a public or private operator under its jurisdiction[126].

Provided there is a breach of a positive obligation to take all appropriate measures to enforce its relevant regulations on a public or private operator under its jurisdiction, the State can be held responsible. That condition could apply to a central bank that willingly participated in speculative capital movements (dirty floating) to improve its economic position over other States[127]; or perhaps even to private banks destabilising capital markets to extract profits from other economic zones like Citigroup did. Those types of situations demonstrate how the doctrines of due diligence and State Responsibility can progressively find their way into matters involving non-State actors, corporations and ordinary citizens participating in the international arena.

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[126] *Pulp Mills on the River Uruguay (Argentina v. Uruguay),* Judgment 20 April 2010, I.C.J. Reports 2010, p 17.

[127] As stated in Chapter 4 section 4.4.1, the profits derived from currency speculation proved so sucessful that it warranted the implementation of forex trading departments within most central banks.

Wood (2004) writes:

> The trend toward non-State parties being the subjects of international law and the employment of the body of law known as *lex mercatoria* have come together with the worldwide acceptance of international commercial arbitration, creating a viable substitute for national courts in resolving increasingly international trade disputes. Law, as it applies to the world economy, has evolved and crystallised into competing concerns of the 'delocalisation' of the arbitral process and the application of mandatory rules …
>
> International treaties and conventions are regarded as the first source of international law, but only one kind actually makes law ~ the 'law-making' treaty, which is an agreement between two or more nations intended to create new rules to be respected by them. Only the signatories are bound initially, and, depending on the number of ratifying States, the treaty can become a source of regional or international law[128].

The trend that Wood identified has been evolving for considerable time. We see more often today commercial disputes between corporate parties at the international level where traditionally States handled those matters through diplomatic channels[129]. For example, in the *Trail Smelter Arbitration*[130] the two States considered the pollution problem not to be a dispute between the two countries but merely a case of civil liability whereby the States represented the interests of their respective citizens[131]. As a prelude to the introduction of

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[128] Wood, D. (2004) International arbitration and punitive damages: delocalisation and mandatory rules, *Defense Counsel Journal*, 1st October 2004 at p 49.

[129] This is reflected in the growing number of international institutions and rule making bodies dealing with international arbitration. The most significant are the International Chamber of Commerce, the International Centre for Dispute Resolution, the American Arbitration Association, the London Court of International Arbitration, the Hong Kong International Arbitration Centre, and the Singapore International Arbitration Centre.

[130] *US v Canada*, RIAA, Vol. III, (1938, 1941), 1905.

[131] Canadian Prime Minister Bennett expressed the view: 'This is not a dispute between the two Governments, and it does not come within any of the ordinary well-known categories of international arbitration ... I have pointed out that it would have been open to the Canadian Government to disclaim international responsibility'. Cf: Bennet, R. (1934) Letter 17th November, 1934 to the United States Under-Secretary of State, W. Phillips, Foreign Relations of the United States, (1934) Vol., 1, 958, at p 961.

environmental protection laws, the *Trail Smelter Arbitration* sets an example as to how the evolution of international law comes into effect. That case commenced in 1934 before international environmental laws barely existed. Yet today: 'the existence of the general obligation of States to ensure that activities within their jurisdiction and control respect the environment of other States or of areas beyond national control is now part of the corpus of international law relating to the environment'[132]. The ICJ emphasised in the *Gabčíkovo-Nagymaros* case: 'in the field of environmental protection, vigilance and prevention are required on account of the often irreversible character of damage to the environment and of the limitations inherent in the very mechanism of reparation of this type of damage'[133].

That change in international environmental law occurred over a short sixty years. So could we expect the same pace of evolution from international monetary law; after all, as the Citigroup coup revealed, cross-border speculative capital flows originating from one State can cause economic damage in other States. Withstanding the improbability in the immediate future that free market banks, hedge funds, insurance companies and the like would be deemed [in the international legal sense[134]] to be under the control of the State, but what would happen if that was the accepted norm? States would have to seriously contemplate what actions and policies they should adopt to control the market more stringently so as to conform to the IMF obligations.

Nevertheless, in the absence of any current legal remedy, the discourse draws us to the conclusion that the existing law and treaty provisions provide virtually no legally enforceable

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[132] *Legality of the Threat or Use of Nuclear Weapons*, Advisory Opinion, I.C.J. Reports 1996 (I) p 242, para 29.

[133] *Gabčíkovo-Nagymaros Project (Hungary/Slovakia)*, Judgment, I.C.J. Reports 1997, at p 78, para 140.

[134] *Military and Paramilitary Activities in and Against Nicaragua*, (Merits), (*Nicaragua v United States of America*), Judgment of 27 June 1986, I.C.J. Reports 1986, at paras 105 – 115.

solution to our problem. So perhaps a revamp of international monetary law is necessary. Such measures would no doubt complicate current practices but it is perhaps the best course of action presently available to improve the efficiency of the IMM.

6.13 Legal Synopsis

The international laws with respect to surveillance over exchange rate policies, cross-border monetary co-operation, orderly exchange rate conditions and financial stability have already been devised, but they are not being strictly followed. Although there is international consensus via the IMF *Articles of Agreement* to promote exchange rate stability and avoid competitive exchange depreciations[135], domestic laws have not fulfilled the mandates of international law. In essence, the problem rests with domestic legislators to implement laws that are complementary to existing international monetary law, are consistent between nations, and enforceable on a global scale.

Presently, the IMF *Articles of Agreement* do not specify how States should reach those objectives but according to Article IV, sections 3(a) and 3(b) the IMF can fulfil its obligations by overseeing the international monetary system in order to ensure its effective operation, exercise firm surveillance over the exchange rate policies of members, and adopt specific principles for the guidance of all members with respect to those policies. Those Articles give authority to the IMF to actually do something towards creating a stable system of exchange rates but it is yet to act on that authority.

Similarly, Western governments ~ particularly the G7 which direct the global economy ~ have done nothing dramatic since the end of the gold standard or the GFC to strengthen the

[135] Article 1(iii).

IMS or to prevent another economic meltdown. Hence, the international monetary and financial system is still susceptible to another crisis but next time ~ following the historical trend[136] ~ it will more than likely be bigger and more damaging than the last. Unfortunately the IMF's delay in addressing the issue compounds the problem and inaction on the part of national legislators adds to the perplexity and prolongs the disruption.

That situation raises more questions about the relationship between political, economic and legal forces. If we are to believe that law will preserve and enlarge freedom and perhaps even promote good order and economic efficiency, politics must be a crucial part of the equation. But international politics tends to be a matter of actual power-structures rather than about the beneficial use of law for some postulated sense of common good. In principle we may see law as a mechanism to set limits on the control and abuses of power, but also as a catalyst to shape international affairs and improve efficiency within the international monetary system. However ambitious that goal may be, the possibility of that scenario unfolding will only occur if those people and entities which hold power are willing to implement change. The next Chapter looks at some of the institutions within the IMS that might be instrumental in attaining exchange rate stability.

[136] Johnson, S. and Kwak, J. (2010) *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*, Pantheon, New York; Reinhart, C. and Rogoff , K. (2009) *This Time is Different*, Princeton University Press, New Jersey.

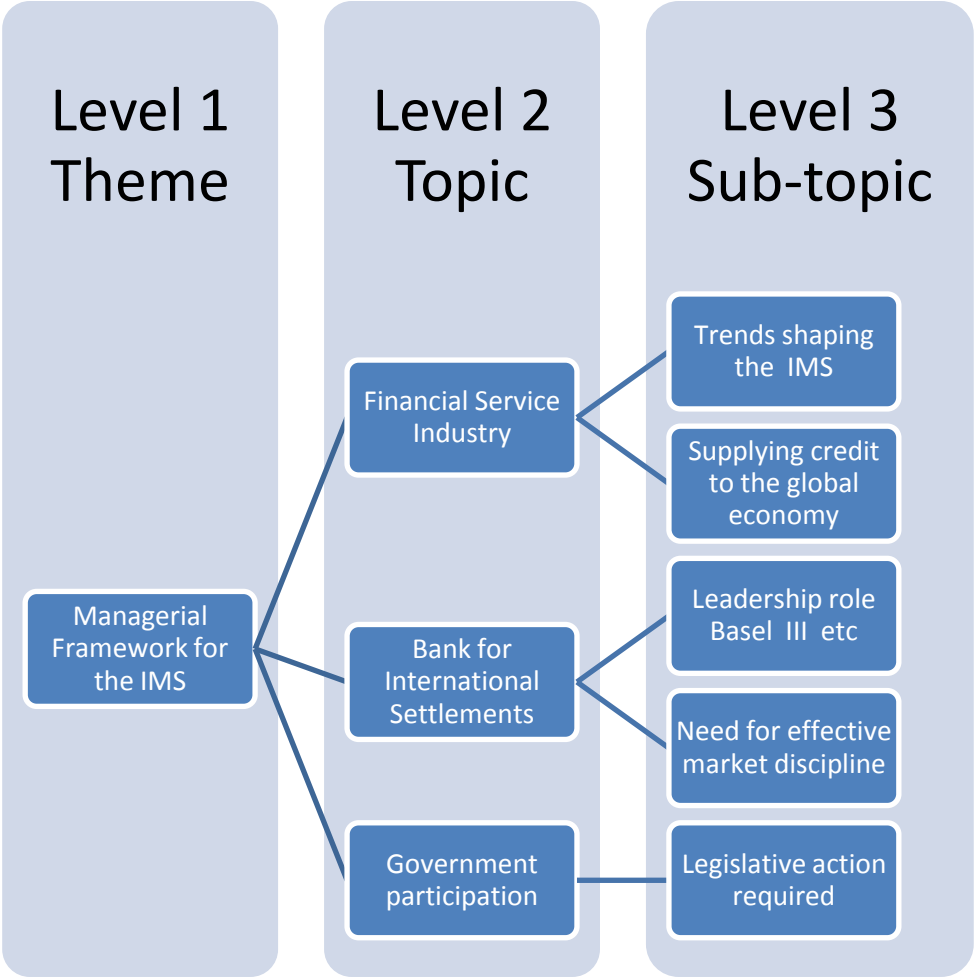
Summary of Chapter 6

This Chapter:

- investigated legal options to limit the negative effects of SCF
- analysed the Citigroup Coup and assessed the implications of under-regulated markets
- examined the legal interpretation of international agreements
- explained the doctrine of State Responsibility and applied that doctrine to the economic fallout caused by SCF
- identified how States could be held responsible if the State fails its obligation of due diligence to promote stable exchange rates
- identified practical problems which would impede the process of restitution
- discussed the difficulty of establishing the causal link between the wrongful act and the economic injury
- concluded that the existing law and treaty provisions provide virtually no legally enforceable solution to our problem
- suggested that a revamp of international monetary law is necessary to curtail the negative effects of SCF

Chapter 7

Institutions to Implement Change



Chapter 7

Institutions to Implement Change

Chapter Abstract

This Chapter identifies institutional mechanisms which could help minimise exchange rate volatility and examines whether the introduction of proper reporting and effective market discipline could allow governments to better manage exposures to foreign shocks that globalisation introduces. Because dealing in money has become an industry unto itself, the Chapter looks at the forces driving the financial services industry, the OECD Group of Ten (G10) and the role that the Bank for International Settlements (BIS) plays within the IMS. The BIS Committee on the Global Financial System and the Financial Stability Board are examined to determine what trends are in the making and whether central banks could co-ordinate their activities and adopt universal policies to improve IMS management. A key issue is to identify the information needs of those in charge of financial and macroeconomic stability and disseminate that information to regulators by establishing communication networks across supra-national regulatory agencies. After discussing the Basel III initiative, the Chapter concludes that broadening the reporting responsibilities of banks and financial institutions when they operate at an international level should be regarded as necessary practice to detect episodes of market abuse activity and to maintain some form of stability within the international monetary system. Proposals for universal monetary compliance between BIS members suggest that it might be possible in the future to implement further financial integration within the global economy to minimise currency volatility and un-necessary financial disruptions. An analysis of requirements for effective policy implementation are discussed in more detail in Chs 9 and 10.

7.1 Financial Services as an Industry

As much as the financial sector has played an important role in liquidity and world development, speculative capital flows have turned into a source of potential risk undermining global financial stability. Additionally, international financial markets have significantly weakened the ability of nation States to control foreign based participants (Pinda, 2010)[1]. Even for countries that have imposed limits on capital flows, no country can claim to be immune from a crisis happening elsewhere in the world. Because economies have become significantly more interdependent, restrictions based on geographical borders have become less effective. Contagion propagates a crisis from one country to another allowing economic mis-management of systemically important countries to have far reaching repercussions globally.

To allow for greater understanding of the implications and prospects of creating a more manageable IMS, this Chapter investigates an institution that plays a pivotal role within the international monetary framework; that being the Bank for International Settlements. It also provides a brief overview of the major forces driving the financial services industry. Because the US had the largest economy through most of the twentieth century, and had the greatest power to shape international monetary policy, any examination of global financial conditions must focus predominantly on US prudential regulation and its effect on the global economy. And of course, there is the invention of money itself and the banks which supply credit and financial products to the global market. Because those institutions are the mechanism through which global finance is influenced, any study of the IMS must take into consideration the impact their existence has on exchange rate stability. The next section examines the trends that have shaped the financial services sector. It provides a starting point to appreciating the

[1] Pinda, M.K.P. (2010) *Opening Speech at the 15th Conference of Financial Institutions*, Arusha International Conference Centre, Tanzania, 25th November 2010.

complexity of the international monetary and financial system and an understanding of the important role the Bank for International Settlements plays within the global economy.

7.2 Forces Driving the Financial Services Industry

Globalisation has allowed the more developed financial institutions to penetrate markets in less financially developed regions[2]. Ruding (2002) explored the trend in consolidation in the financial services industry and the implications for both financial institutions and regulatory supervisors[3]. He said the late 1990s and the beginning of the new millennium had seen enormous changes in the financial services industry: 'The impact of, amongst other things, information technology, deregulation and liberalisation has changed and reshaped the financial landscape forever'. Admitting that this change would continue he discussed some of the aspects driving the trend, in particular, the shift towards cross-category and cross-border consolidation[4]. By way of mergers and acquisitions, this period saw banks joining with insurance companies and other financial institutions both in a domestic and international setting[5].

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[2] This trend enabled well established financial corporations such as Citigroup, JPMorgan Chase, Bank of America, Britain's Hong Kong and Shanghai Banking Corporation (HSBC), the Union Bank of Switzerland (UBS AG), Japan's Mitsubishi UFJ Financial Group, Australia and New Zealand Banking Group Limited (ANZ) and France's Credit Agricole Group to offer their services to previously inaccessible but now developing financial markets.

[3] Ruding, H. O. (2002) *The Transformation of the Financial Services Industry*, Financial Stability Institute Occasional Paper. No 2, Basel, ISSN 1020-8461.

[4] See also Ruding, H. O. (2000) *Consolidation of Financial Institutions*, paper presented at the Tenth Annual Hyman P Minsky Conference on Financial Structures, conducted by The Jerome Levy Economics Institute, New York, 27th April 2000, p 9-13.

[5] Some examples are: ING's acquisition of Barings Bank after its debacle in 1995 which in turn was acquired by ABN AMRO in 2001. In 1998, the largest corporate merger in history (at the time) was recorded when banking giant Citicorp and insurance titan Travellers Group Inc merged to form Citigroup Inc. In 2008 Merrill Lynch & Co., was taken over by Bank of America; that acquisition made Bank of America the US's largest wealth manager as well as a major player in the investment banking industry.

The factors for consolidation identified by Ruding apply to financial institutions around the world. He said there were several motives for cross-category consolidation, one being the need for a large capital base. He said a large capital base serves as: 'a buffer to absorb losses and, therefore, provides the institution with credibility and its customers with confidence in the institution'[6]. Another motive for consolidation was 'the flight to quality', meaning investors tend to transfer their assets to institutions that are perceived to be more creditworthy. If the general public begins to question the strength and creditworthiness of a particular financial institution ~ or worse, the entire financial system of a country ~ this may lead to substantial movement of capital to the larger institutions resulting in default and closure of the smaller banks[7].

The move towards opening up domestic financial markets to global competition has had both positive and negative effects. Positive in that the new host country gains the expertise of experienced well funded institutions which lifts the standards of their own domestic institutions and negative in that the new arrivals are sometimes better equipped to take advantage of inefficiencies in the host country's domestic market (for instance, large capital flows and strong lending by foreign banks could be difficult for the inexperienced regulator to control).

[6] Bigger in banking or insurance is not always better, some disadvantages may exist such as problems with the span of management control or implementation and integration of the institutions. Merging two big but weak institutions may lead to one bigger institution but unless new management addresses the root of the problems, the new institution might still remain weak. The goal is not simply to be large, mergers should primarily be undertaken if they are profitable or can lead to a strategic advantage. And if consolidation does occur, it should be done as quickly as possible to achieve the anticipated cost savings by closing overlapping branches or re-branding new product ranges.

[7] Ruding gave the example of Japan during the Asian financial crisis in 1998. Japan, he said, was not at the heart of the crisis and did not suffer from any weakness in its external position, but nevertheless, there were long queues of Japanese customers wanting to transfer their deposits (both in yen and in foreign currency) from the top Japanese banks to larger foreign banks with retail branches in Japan.

Another aspect which could be considered either positive or negative ~ depending upon the perspective from which we view the situation ~ is that the newly arrived institutions must conform to the regulatory authority of their new host nation. Cautionary requirements by the host regulator might create obstacles by using capital controls or protection mechanisms that are not required elsewhere. In cases such as this, the foreign institution has restraints and reporting obligations both at home and abroad which in most instances adds to the cost of reporting and in some instances may even be counterproductive.

Accepting that foreign financial institutions enter new markets with the intention of returning a profit for their investors, their objectives would be to return any profits generated in the host nation to their country of origin. So while the concept of foreign direct investment might seem appealing, the extraction of wealth from the host nation can contribute to a drop in the value of its currency and subsequently trigger economic instability. If the extraction of capital is significant, or if the international financial markets and banks were reluctant to engage new loans that are essential to roll over maturing debt liabilities, the effect could result in a contagious meltdown, just as it did during the 1990s with the South American financial crises and Asian meltdown.

Stiglitz (2006)[8]wrote:

> Globalisation has unleashed market forces that by themselves are so strong that governments, especially in the developing world, often cannot control them. Governments that attempt to control capital flows may find themselves powerless to do so, as individuals find ways of circumventing the regulations[9]…

[8] Stiglitz, J. (2006) *Making Globalisation Work*, Penguin Group, London.

[9] *Ibid*. at p 20.

> In effect economic globalisation has outpaced political globalisation … the advanced industrial countries, whose governments dictate the direction of economic globalisation, have not yet developed the underlying sympathies which are necessary to make the global community work … It will entail thinking carefully about when we need to impose rules and regulations to make the global system work[10].

Apart from technological advances, the change towards greater liberalisation and freer markets in the US can be attributed to the partial repeal of the *Glass Steagall Act* [11] in 1999 and with the new rules of the *Gramm Leach Bliley Act* [12] which *inter alia*, eliminated the restrictions against affiliations between commercial and investment banks allowing both institutions to provide a broader range of services including foreign exchange underwriting. With the lifting of those restrictions and the liberalisation of markets, a new era emerged. The rapid expansion of hedge funds and private equity firms provided evidence that the international monetary market had become a profitable place to conduct business. But as the GFC demonstrated, freer markets and self regulation did not live up to the expectations that financial institutions would be prudent and protect their customers' investments. Consequently, the GFC re-affirmed the desirability of strengthening the power of the regulator to control market participants more stringently so as to avoid practices that have the

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[10] *Ibid*. at p 21 - 22.

[11] Consolidation was prohibited by the *Banking Act* of 1933 (US 48 Stat. 162 ~ *Glass Steagall Act*) which *inter alia*, prohibited commercial banks from owning brokerage firms. The 1956 *Bank Holding Company Act* (US Code, Title 12, Chapter 17) imposed a number of similar limitations ~ Chapter 3, s 371c, prohibited any subsidiary bank from lending to or investing in its parent holding company or a fellow subsidiary bank. The interstate restrictions of the *Bank Holding Company Act* were repealed by the *Riegle-Neal Interstate Banking and Branching Efficiency Act* (US) in 1994 which allowed interstate mergers between adequately capitalised banks. The mergers were subject to concentration limits, state laws and the *Community Reinvestment Act* 1977 (US*)* evaluations.

[12] Also known as the *Financial Services Modernization Act* of 1999, (Public Law 106-102, 113 Stat. 1338). After considerable industry lobbying, it was supposedly enacted to enhance competition in the financial services market by providing a less stringent prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers. The 2008 GFC highlighted the *faux pas* of this act of modernisation.

potential to compromise the stability of the entire financial system[13]. Those controls could include giving regulatory authorities power to monitor the market and bring to account institutions which undermine the integrity of the IMS.

Thus the crux to preventing financial instability of markets and currencies rests with national governments, central banks, prudential regulators (both national and supra-national) and financial institutions. But most importantly, it is the legislator who must first understand the intricate concept of money so that appropriate laws are enacted to increase economic efficiency.

7.3 Power to Create Money

Strange (1994) writing on the international monetary system, the process of financial intermediation and relations across national frontiers wrote: 'The financial structure really has two inseparable aspects. It comprises not just the structures of the political economy through which credit is created but also the monetary system or systems which determine the relative values of the different moneys in which credit is denominated'[14].

The US House of Representatives Committee on Banking and Currency investigated the American monetary system in 1964; it recognised:

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[13] The National Commission on the Causes of the Financial and Economic Crisis in the United States (2011) found that the: 'financial crisis was avoidable* … There were warning signs … The tragedy was that they were ignored or discounted … Widespread failures in financial regulation and supervision proved devastating to the stability of American financial markets … Dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis … The government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets. They did not have a clear grasp of the financial system they were charged with overseeing … The greatest tragedy would be to accept the refrain that no one could have seen this coming and thus nothing could have been done. If we accept this notion, it will happen again'. Cf: National Commission on the Causes of the Financial and Economic Crisis in the United States (2011) *The Financial Crisis Inquiry Report*, US Government Printing Office, Washington, DC., * starting at p xvii.

[14] Strange, S. (1994) *States and Markets*, second ed. Pinter, London, p 90.

> … by creating money, banks provide the exchange media which the economy needs to prosper and grow. Since the growth and proper functioning of [an] economy require[s] increasing amounts of money over the years, those who control the amount of money exercise great power over business activity, the incomes people earn and economic strength[15].

Because most of the world's money is primarily based on credit created through fractional lending, whoever is in the position to grant or deny lines of credit has incredible power to shape the economic future of the world. Not only do they have that power, but it ever increases exponentially because they also collect interest (ie usury income) on something that is essentially a figment of human naïveté and creative accounting.

Money comes into existence as a form of debt created purely as a book entry on a bank's ledger / journal upon condition of a borrower's commitment to repay a loan. Commercial banks, central banks, the Bank for International Settlements, the IMF and the World Bank: 'create money whenever they grant a loan, simply by adding new deposit dollars in accounts on their books in exchange for a borrower's IOU' [16]. 'We are completely dependent on the commercial banks. Someone has to borrow every dollar we have in circulation, cash or credit. If the banks create ample synthetic money, we are prosperous; if not, we starve'[17]. 'There is no money created without creating debt, they are one and the same'[18]. As long as there is a double entry bookkeeping procedure in place that shows a positive balance between liabilities created and assets due, the banks can ~ except for their statutory minimum reserve and

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[15] *Money Facts: 169 questions and answers on money - A supplement to A Primer on Money*, Subcommittee on Domestic Finance, Committee on Banking and Currency, House of Representatives, 88th Congress, 2d Session August 1964, answer to question 3. Why is the money-creating power important?

[16] Friedman, D.H. (2000) *I Bet You Thought*, Federal Reserve Bank of New York. NY, p 19.

[17] Robert H. Hemphill, quoted in; Morgan, D. (2002) The Significance & Sanity of Silver as Money, *Financial Sense Editorials*, 12th July 2002. At: http://www.goldseek.com/cgi-bin/news/SilverInvestor/1026749506.shtml

[18] Gnazzo,D.V. (2005) The Federal Reserve; Fractional Reserve Lending, *Financial Sense*, 29th November 2005.

prudential reporting requirements ~ do as they please. The process allows them to collect interest and grow wealthy on money that is basically created through book entries and their borrowers' promise to re-pay more than what was originally lent[19].

The Bank for International Settlements (2003) described the role of a payment system; it said:

> Contemporary monetary systems are based on the mutually reinforcing role of central and commercial bank money. To foster safety and efficiency in the financial system, central banks pursue policies to maintain the convertibility of commercial bank monies into central bank money at par (and vice versa). The singleness of the currency is thereby maintained and the public can use its different forms interchangeably when making payments[20].

But as the GFC demonstrated, some banks tended to be a little too creative in devising financial products which had very little or no social value. As toxic assets flooded the global market, prudential supervisors in the major economies failed to recognise the impending implosion facing the global economy. Again, the world economy had to struggle through another financial crisis as banks failed and governments plunged themselves into debt trying to prop up stalling economies. Financial markets were in turmoil, currency values bounced all over the place, banks were liquidated, stock markets crashed, businesses closed their doors, people lost jobs and foreclosures and bankruptcies escalated. It was not a good situation, and despite all the rhetoric being generated through the post GFC G20 summits, little had changed by July 2011 to prevent another wave of volatile market activity disrupting the

[19]Essentially there is always a financial deficit within society because the amount of money required to be paid back from borrowing (with interest) is always more than the actual amount lent and put into circulation ~ it is only sustainable if more and more people keep borrowing to put more money into circulation, other than that, the whole credit system would collapse.

[20] Bank for International Settlements (2003) *The Role of Central Bank Money in Payment Systems*, BIS Press & Communications, Basel, Switzerland, p 42.

global economy. Therefore a close examination of the institutions having influence over the global economy might identify what measures could be put in place to limit further volatility.

Since 1945 the international ledger has been controlled by the Bretton Wood Institutions largely under the directives of US policy. This allowed the World Bank and the IMF unprecedented power to grant international loans and allow countries to go into overdraft based on (typically politically motivated and conditional[21]) lines of credit. Notwithstanding that the line of credit is merely a book entry, the IMF and World Bank still impose interest on the money they lend out[22]. When this basic concept is understood, it permits one to comprehend the meaning of Nathan Rothschild's words where he said: 'The man who controls Britain's money supply controls the British Empire'[23]. It allows us to understand why the US Government, World Bank and IMF tightly guard their control of the IMS.

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[21] 'In IMF lending, the IMF management and staff have considerable influence over member countries and their policies, in effect, acting as policy regulators in the process … [M]uch of such lending and the associated regulatory activity is episodic and is not applied to all members equally'. Cf: Truman, E.M. (2009) *The International Monetary Fund and Regulatory Challenges*, Working Paper Series, Peterson Institute for International Economics, Washington.

Eg: At the behest of the US government, the IMF and World Bank denied lines of credit and froze assets against Zimbabwe. Section 4(c) of the *Zimbabwe Democracy and Economic Recovery Act* 2001 (US) outlined the multilateral financial restrictions:

> … the Secretary of the Treasury shall instruct the United States executive director to each international financial institution to oppose and vote against--
> (1) any extension by the respective institution of any loan, credit, or guarantee to the Government of Zimbabwe; or
> (2) any cancellation or reduction of indebtedness owed by the Government of Zimbabwe to the United States or any international financial institution.

Similar restrictions have been used against Panama, Columbia, Venezuela, Myanmar , Iraq and Libya.

[22] The SDR interest rate provides the basis for calculating the interest charged to members on regular (non-concessional) IMF loans, the interest paid and charged to members on their SDR holdings, and the interest paid to members on a portion of their quota subscriptions. The SDR interest rate is determined weekly and is based on a weighted average of representative interest rates on short-term debt in the money markets of the SDR basket currencies. Cf: IMF website: http://www.imf.org/external/np/exr/facts/sdr.htm

[23] Quoted in; Smith, D.B., and Hitchcock, A. (2005) The History of the House of Rothschild, *Looking Glass News*, 15th December 2005. At: http://www.lookingglassnews.org/viewcommentary.php?storyid=121

But America and the IMF did not always control the system. The precursor to the Washington based institutions was a European based consortium of governments and their central banks called the Bank for International Settlements.

7.4 The Bank for International Settlements

The Bank for International Settlements (BIS) was founded by the 1930 Hague Convention [24]. The governments and the privately owned central banks[25] of Germany, Belgium, France, the United Kingdom, Italy, Japan [26] and the Swiss Confederation assembled at the Hague Conference and agreed on the establishment of the International Bank with its head office based in Basel Switzerland. In the case of the United States of America, commercial banks including J.P. Morgan & Company, the National City Bank of New York, and the First National Bank of Chicago (major shareholders of the US Federal Reserve[27]), undertook the responsibility of financing the US proportion of paid up capital and assumed those voting rights. Following Article 1 of the BIS *Constituent Charter*, Switzerland was entrusted with

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[24] League of Nations Treaty Series (LNTS) 441 of 20th January 1930;*Convention respecting the Bank for International Settlements* including *Constituent Charter* and *Statutes*.

[25] The Reichsbank, Banque de France, Banque Nationale de Belgique, the Bank of England, Banca d'Italia, Nippon Ginkō (日本銀行, the central bank of Japan), Banque Nationale Suisse and the US Federal Reserve were all private corporations given monopoly to issue currency within their jurisdiction under national legislation.

The Reichsbank was seized by the Nazi Party during the years of the Third Reich. After WWII the occupation forces established a new two-tier central bank system in West Germany modelled on the US Federal Reserve System (ie with regional offices). The Bank Deutscher Länder was totally independent of political bodies, including the German government. In 1957, the Bank Deutscher Länder (and its state branches) was replaced by the Deutsche Bundesbank (and the Landeszentralbanken).

Banque de France and the Bank of England were nationalised in 1945 and 1946 respectively.

Banque Nationale de Belgique and Nippon Ginkō are still privately owned in partnership with government.

Banque Nationale Suisse, Banca d'Italia and the US Federal Reserve remain 100 percent privately owned.

[26] Japan renounced all rights, titles and interests acquired under the Convention in December 1952 but has since rejoined.

[27] J.P. Morgan & Company, The National City Bank of New York and First National Bank of Chicago were initial contributors to the US Federal Reserve System of Banks (ie: they were stakeholders in the Federal Reserve). J.P. Morgan & Company and First National Bank of Chicago are now part of JPMorgan Chase & Co. National City Bank of New York, after many mergers and acquisitions, now operates as Citigroup Inc.

the responsibility of handling the formation and administration of the incorporated Bank[28]. The BIS provided a forum for international monetary and financial co-operation and acted as an international clearing house for national central banks ~ performing the traditional banking functions of handling gold and foreign exchange transactions.

However, with the shift in the economic power base from Europe to the US, and the formation of the Bretton Woods Institutions after World War II, the Bank for International Settlements ended up taking a secondary position to that of the World Bank and the IMF. Nevertheless, through that period the BIS acted as the agent for the European Payments Union (EPU, 1950-58) which helped the European currencies restore convertibility after World War II. Additionally, the BIS acted as the agent for various European exchange rate arrangements, including the European Monetary System (EMS, 1979-94) which preceded the move towards the introduction of the euro. Like the IMF, the BIS also provides short-term overdraft facilities to central banks, but usually on a collateralised basis[29].

While the BIS may have been the first international financial arbitrator for central banks and provided the model upon which the Bretton Woods Institutions would follow, it subsequently played a lesser role in international monetary affairs for several decades. That position changed with the resurgence of economic prosperity in Europe, the establishment of the EEC, the collapse of the gold standard and the introduction of the euro. In the latter part of the

[28] Article 3 of the *Convention Respecting the Bank for International Settlements*.

[29] During the 1931-33 financial crisis, to support the international monetary system, the BIS organised emergency financing for the Austrian and German central banks. Despite the creation of the IMF in 1945, this tradition continued throughout the twentieth century. In the 1960s, the BIS arranged special support credits for the French franc (1968), and two Group Arrangements (1966 and 1968) to support the pound sterling. In 1982 and in 1998 the BIS provided finance in the context of IMF-led stabilisation programmes for Mexico and Brazil. The BIS also acts as a trustee for a number of international government loans and performs the usual agent functions for contracting governments. It offers asset management services in sovereign securities through the BIS Investment Pool (BISIP) and the two Asian Bond Funds (ABF1 and ABF2).

twentieth century, the Bank for International Settlements re-invented itself to cater for the banking needs of Europe while simultaneously expanding its services to over a hundred and twenty other nations; all within a framework that actively embraced the changing developments in information technology and the expanding nature of the international financial arena. While the BIS supports the Bretton Woods Institutions[30] it found itself as the leading force in shaping the international financial landscape. This came about mainly because of the Bank's close relationship with the OECD Group of Ten industrialised countries.

7.5 The OECD Group of Ten

The OECD Group of Ten[31] (G10) consult and co-operate on economic development, financial matters and international monetary reforms. The G10 Committee on Banking Supervision maintains its secretariat at the Bank for International Settlements in the city of Basel in Switzerland and hence is most commonly referred to as the Basel Committee. The Basel Committee consists of representatives from the central banks and regulatory authorities of the G10 countries plus Luxembourg and Spain, however as all countries wish to be part of the global economy, the other 187 countries of the world are inevitably drawn into conforming with the predominant framework.

Today the BIS fosters co-operation among central banks and other financial institutions and is aimed primarily in the pursuit of monetary and financial stability ~ something that some

[30] The BIS actively participates within the Bretton Woods framework having three thousand million* Special Drawing Rights with the IMF and total currency deposits amounting to nearly SDR 207.1 billion**, representing around 3.1 percent of world foreign exchange reserves. **Statute of the Bank for International Settlements*, Chapter 2, Article 4, as amended on 27th June 2005. **BIS (2011) *81st Annual Report of the Bank for International Settlements*, p 127.

[31] G10 is actually made up of eleven industrial countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

would argue the IMF and World Bank failed to adequately address[32]. The BIS currently has 55 member central banks, all of which are entitled to be represented and vote in the General Meetings proportionate to the number of shares held. Unlike the World Bank or IMF where the presidents of those organisations have traditionally been politically appointed US and European citizens respectively, the BIS *Statutes* provide for elections to the Board of Governors of candidates from all member States.

The BIS also provides a broad range of financial services and is a centre for monetary and economic research. To support the co-operation between central banks, the BIS developed its own research into financial and monetary economics and makes important contributions to the collection, compilation and dissemination of economic and financial statistics. These services contribute to a better understanding of international financial markets and the interaction of national monetary and financial policies.

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[32] Stiglitz (2006) wrote: 'the IMF has failed in its mission of ensuring global financial stability' and that when the IMF crafted policies to prevent financial crises, 'it seemed more often to focus on saving the Western Creditors than on helping the countries in crisis'. He said the IMF lacks: 'some of the basic rules of democratic institutions: namely, transparency … the democratic deficit in their governance has contributed to their lack of legitimacy'. Cf: Stiglitz, J. (2006) *Making Globalisation Work*, Penguin Group, London, at p 18 – 19.

Former US Treasury Secretary Robert Rubin said: 'The Bretton Woods system has become outmoded … It has served us very well for a long time, but these institutions haven't changed with the times. They need to be re-thought and re-structured'. Eckhard Deutscher, who served as the dean of the World Bank's directors, called for a re-examination of the role of all the Bretton Woods institutions. 'The biggest challenge of the World Bank is to restore its credibility … But the international community also needs to look at the whole system. There are governance problems across the board'. Cf: Weisman, S. (2007) Cracks in the Financial Foundation; Roles of 3 Institutions Questioned in a Changing Global Economy, *New York Times*, 23rd May 2007, p C8.

A 2008 internal audit of the IMF by its Independent Evaluation Office recommended that better governance and an institutional re-structure of the organisation's decision-making processes and activities could contribute to the IMF's overall legitimacy and effectiveness. Cf: IMF Independent Evaluation Office (2008) *Aspects of IMF Corporate Governance Including the Role of the Executive Board*, IMF Internal Audit Report, April 2008.

Thomas Bernes, head of the Independent Evaluation Office, said: 'In our view, if left unaddressed this could likely undermine effectiveness over time' Cf: Bernes, T. (2008) *IMF Press Conference on the Independent Evaluation Office report on Fund governance*, Washington, DC, Tuesday, 27th May 2008. Available at: http://www.imf.org/external/np/tr/2008/tr080527.htm

The Bank for International Settlements has also been the major facilitator in the implementation of various international financial agreements and has been the incubator of many well known committees and organisations. These include the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, the Committee on the Global Financial System, the Markets Committee, the Financial Stability Institute, the Financial Stability Forum (now the Financial Stability Board as a result of the 2009 London G20 Summit), the International Association of Deposit Insurers, the International Association of Insurance Supervisors and the Irving Fisher Committee on Central Bank Statistics. Many of these committees have their secretariats within the BIS under its supervisory umbrella. Of particular importance is the Basel Committee on the Global Financial System.

7.6 The Committee on the Global Financial System

The Bank for International Settlements' Committee on the Global Financial System (CGFS) monitors developments in global financial markets for the central bank Governors of the G10 countries. Established in 1971, under the former name of the Euro-Currency Standing Committee, the CGFS's initial focus was on the monetary policy implications concerning the rapid growth of off-shore deposit and lending markets, but demands increasingly shifted the Committee's attention to financial stability questions and to broader issues related to structural changes in the IMS. The Committee has a mandate to further understand the structural underpinnings of financial markets and identify and assess potential sources of stress.

The CGFS is supposed to devise improvements for the functioning and stability of the international monetary system. Presently, it has three major priorities: the systematic short-term monitoring of global financial system conditions, the long-term analysis of the

functioning of financial markets, and the articulation of policy recommendations aimed at improving market functioning and financial stability[33]. In order to fulfil its responsibilities, the Committee makes recommendations to the Governors of the G10 central banks placing particular emphasis on recognising, analysing and responding to threats to the stability of financial markets and the global monetary system.

In its *2011 Annual Report* the Bank for International Settlements said:

> The … international risks posed by gross financial flows are as important as those of current account balances. Financial flows result in the accumulation of large positions on interconnected balance sheets of financial institutions, firms and households around the world. Differences between the attributes of these inflows and outflows accumulate in the form of mismatches between assets and liabilities on these balance sheets. The mismatches, for instance in currency or maturity, can potentially lead to financial imbalances. Understanding and managing the risks associated with these mismatches is important for sustainable global economic growth and for financial stability[34].

Taking into account the correlations between monetary and financial stability, and the institutions, infrastructures and changing dynamics in financial intermediation with the incentive structures of the free market system, the Committee has sought to increase the transparency of the IMS by implementing appropriate disclosure standards on both the official and private sectors. Co-operating with other national, supranational and international institutions has facilitated the production and publication of specialised statistical information. Such information may provide some answers towards achieving financial stability. In conjunction with the statistics gathered by the other Basel Committees, this

[33] From http://www.bis.org/cgfs/index.htm

[34] Bank for International Settlements (2011) *81st Annual Report*, Basel, p 41.

makes the CGFS ideally positioned to address and solve problems relating to unrestrained foreign direct investment, disruptive foreign exchange transfers, liquidity issues and debt crises.

Another objective of the Committee's work has been to develop an international framework that would further strengthen the soundness and stability of the global banking system. The Committee seeks to secure international convergence on supervisory practices by promoting capital adequacy regulation and minimising competitive inequality among internationally active banks within a framework that can be applied as uniformly as possible at the national level. The Basel Committee also works with the International Organisation of Securities Commissions (IOSCO) on matters relating to international trading activities.

The Basel Committee is not vested with the authority to enforce its recommendations, but most member countries tend to implement their policies by adjusting central bank procedures. The Committee on Banking Supervision has been quite successful in initiating strategic reforms within the international banking community via the Basel Accords. The Accords are most commonly referred to as Basel I, II and Basel III. The first Basel Accord was issued in July 1988 and set out the basic parameters of international credit risk. The first Accord was updated in 1996 to include provisions for international monetary market risk. The key provisions of Basel I related to capital adequacy within the international banking system by ensuring that those financial institutions retained enough capital to protect themselves against unexpected losses [35]. Such precautionary measures were inevitably directed towards protecting investors' capital with the added bonus of creating a more stable international

[35] See Tier 1 Capital and Tier 2 Capital where there is a general requirement for banks to hold total capital equivalent to at least 8% of their risk-weighted assets.

banking platform. But as it has been witnessed, reducing volatility in financial markets has been an elusive goal.

The Basel Committee also recognises that the primary responsibility for good corporate governance rests with the boards of directors and senior management of banks[36]. The Committee's 1999 report on *Enhancing Corporate Governance for Banking Organisations* suggested several ways to promote corporate governance. These included: laws and regulations, disclosure and listing requirements by securities regulators and stock exchanges, sound accounting and auditing standards, and the voluntary adoption of industry principles of sound practices by banking associations. To those ends, the role of law is a crucial component for determining ways to improve corporate governance for international financial institutions. Some of these laws include provisions for enforcing international contracts by service providers, clarifying regulatory supervisors' and banking institutions senior management's roles, ensuring that corporations operate in an environment free from corruption and bribery, and aligning statutory regulations and other measures with the interests of managers, employees, and shareholders.

By far the biggest obstacle that the Basel Accords face is the implementation of universal standards and procedures across national boundaries in a timely manner. The need to accommodate differing cultures, varying structural models, the complexities of public policy and existing regulations tends to delay progress. But added to this is the complexity of the regulatory authorities and jurisdictions already in place within national borders[37].

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[36] Basel Committee on Banking Supervision (1999) *Enhancing Corporate Governance for Banking Organisations*, http://www.bis.org/publ./bcbs56.pdf (Sept. 1999) at p 10.

[37] For instance, prior to the formation of the US Consumer Financial Protection Bureau in 2011, there were four Federal agencies involved in the process of regulating the US banking sector. These were: the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit

The second Basel Accord was finalised and released in July 2006 after the preliminary draft of 2004 underwent an extensive consultation process. Basel II was aimed at making the capital measures within the international banking system much more risk sensitive[38]. Basel II focused on implementing procedures to protect investments in cross-border transactions by more extensively monitoring each bank's capital position. Basel II also identified several more categories of risk which were to be addressed by the more stringent reporting procedures[39]. After numerous delays Basel II was ready for implementation in late 2007 with an expectation that member countries would implement its recommendations by 2015. But that was before the GFC came along which forced another re-think of the entire system.

Insurance Corporation, and the Office of Thrift Supervision. Because of the sophisticated requirements of each agency, the US was forced to delay the implementation of Basel II by 12 months. The four agencies finally reached agreement in 2006 via the *Notice of Proposed Rulemaking** that allowed the Internal Ratings-Based approach to be used for their larger banks reporting requirements, and the standardised approach for the smaller banks. *Notice of Proposed Rulemaking, Basel II Capital Accord, 5th September 2006. US Federal Reserve press release, available at: http://www.federalreserve.gov/GeneralInfo/basel2/NPR_20060905

[38] To promote greater stability in the international financial system Basel II planned to use a *three pillar* concept incorporating minimum capital requirements, supervisory reviews and market disciplinary measures. It contained a detailed framework of rules and standards that regulatory supervisors could apply to the practices of senior management and the boards of banking groups. Bank supervisors had been given the discretion to approve a variety of corporate-governance and risk-management activities for internal processes and decision-making. This extended to the requirements for estimating capital adequacy and a disclosure framework for investors.

[39] Although the second Accord brought convergence to the international banking system there were still some areas that drew criticism*. Describing Basel II's reliance on the banking sectors' own risk assessment as a 'fundamental weakness', Jonathan Ward (2002) highlighted how large sophisticated banks were allowed to use their own internal ratings methodologies for assessing credit and market risk to calculate their capital requirements. This approach he said might not accurately reflect the bank's true risk exposure**.

It can also be considered that the sophisticated risk measures unfairly advantage the larger banks that are able to implement them over smaller banks in developing countries which are unable. Here Basel II could disadvantage the economically marginalised banks by restricting their access to credit or by making the cost of borrowing more expensive. Such arguments though tend to forget the capitalistic nature upon which the free market exists.

*George A. and Walker, G.A. (2001) *International Banking Regulation Law, Policy & Practice*, Kluwer Law International.

**Ward, J. (2002) *The New Basel Accord and Developing Countries: Problems and Alternatives*, (CERF Working Paper No. 04, 2002), at p 11; Ward, J. (2002) *The Supervisory Approach: A Critique*, (CERF Working Paper No. 02, 2002).

As announced at the April 2009 G20 Summit in London[40] the BIS Financial Stability Board (FSB) was given the task to explore information gaps and provide appropriate proposals for strengthening data collection. The FSB's October 2009 *Report* [41] highlighted how a lack of timely, accurate information hindered the ability of policy makers and market participants to develop effective responses to economic disruptions. After consultation with key players, consensus emerged over the information gaps that needed to be filled[42].

The Financial Stability Board recommended that it should strengthen data gathering initiatives on cross-border monetary flows, investment positions, and exposures, by recording the activities of non-bank financial institutions. Getting private equity, hedge and sovereign wealth funds to comply with new data collection rules would inevitably increase administrative and operational costs and lead to industry resistance but the FSB recognised the importance of ensuring that collection of statistical information remained adaptable in response to rapid changes in financial markets. To this end, the FSB is working closely with

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[40] G20 Summit, Final Communiqué, *The Global Plan for Recovery and Reform*, 2nd April 2009.
Available at: www.londonsummit.gov.uk/resources/en/PDF/final-communique

[41] Financial Stability Board (2009) *Report to the G20 Finance Ministers and Central Bank Governors*, Prepared by the IMF Staff and the FSB Secretariat, 29th October 2009.
Available at:https://www.financialstabilityboard.org/publications/r_091107e.pdf

[42] The Financial Stability Board made the following recommendations:

1. That the FSB should strengthen international reporting of Financial Soundness Indicators, by expanding the number of reporting countries.
2. That the FSB should develop measurements of aggregate leverage and maturity mismatches in the financial system and improve coverage of risk transfer instruments, including data on the credit default swap markets.
3. That the FSB should improve data collection on international financial network connections and enhance information on the financial linkages of systemically important global financial institutions.
4. That the FSB strengthen data gathering initiatives on cross-border monetary flows, investment positions, and exposures, in particular, to identify activities of nonbank financial institutions (ie private equity, hedge and sovereign wealth funds).
5. That the FSB should monitor the vulnerability of domestic economies to shocks by strengthen the sectoral coverage of national balance sheets and the flow of funds data. It should also promote timely cross-country standardised / comparable government financial statistics, and disseminate data on real estate prices.

the IMF to monitor Financial Soundness Indicators[43] and expand coverage to all G20 members.

The FSB suggested that with help from the international community and by investigating system-wide macro-prudential risk, the IMF, the BIS, the Committee on the Global Financial System and the Basel Committee on Banking Supervision should monitor leverage and maturity mismatches in the financial system. This would provide greater knowledge and understanding of risk transfers within the market between institutions so they could counter balance any possible negative effects caused by maturing liabilities or foreseeable financial disruptions. Simultaneously, the Committee devised strategies for the Basel III Accord.

Under Basel III, the Committee proposed enhanced capital requirements for banks to enable them to create adequate buffers to withstand unexpected cross-border shocks in times of economic and financial stress. Volatile exchange rates and contagion needed to be considered in the equation. The new minimum capital requirements will see common equity to total risk weighted assets increased to 4.5 percent from 2 percent, tier 1 capital to total risk weighted assets up to 6 percent from 4 percent and the total capital to total risk weighted assets increased to 8 percent for smaller banks but 9.5 percent for larger banks. It was planned that these measures would be implemented globally by 2019 but resistance from the market might delay its full implementation. The Basel Committee acknowledges that moving toward its adoption in the near future may not be a first priority for all non-G10 supervisory authorities but it is nevertheless a step in the right direction. Such universal compliance suggests that it might be possible in future to implement further financial integration within the global economy to minimise financial disruptions.

[43] See the *IMF's Financial Soundness Indicators Compilation Guide*.
Available at: http://www.imf.org/external/pubs/ft/fsi/guide/2006/index.htm

7.7 Discussion

The existence of proper reporting and effective market discipline is essential for managing exposures to foreign shocks that globalisation introduces. The possible effect of the rapid expansion of foreign currency lending to both households and businesses can be detrimental if that lending is quickly withdrawn. Up to date information is essential for the host country regulator in order for it to revise its laws and operations to minimise the risk of a financial crisis brought on by fluctuating currency values. Developing the infrastructure for well functioning financial markets is relevant for stimulating both foreign and domestic investment and stabilising currency values. Whether it is to be the BIS agencies or to a newly created over-arching entity, broadening the reporting responsibilities of banks and financial institutions when they operate at an international level must be regarded as necessary practice to detect episodes of market abuse and to maintain some form of stability within the international monetary market.

To achieve those objectives, it requires central banks to co-ordinate their activities and adopt universal policies when exposing their domestic financial systems to foreign participation. A key issue is to identify the information needs of those in charge of financial and macroeconomic stability and disseminate that information to regulators by establishing communication networks between host country and home country as well as linkages across supra-national regulatory agencies. Although it is acknowledged that there could be difficulties in implementing such mechanisms on a global scale in the immediate short term, the idea nevertheless has merit to reach longer term goals.

An effective strategy (and most probably the better choice at this stage) would be to speed up the process of international convergence towards standardised regulations and reporting

procedures by implementing the Basel III initiatives within a reduced timeline. Basel III plays a key role as the catalyst for generating co-operation among regulatory supervisors, central banks and market participants at an international level but its recommendations and policies for IMS management are not enforceable through law unless States voluntarily enact the necessary legislation. While the Basel III Accord aligns supervisory practice with current industry practice and includes mechanisms that are intended to reduce the risk of capital flow volatility in the international monetary system the mechanisms are not mandatory for States to follow. Given that the incentives for better risk management would strengthen domestic banking systems both in terms of operational efficiency through consolidation and in terms of international supervision, implementing the Basel III Accord and the recommendations of the FSB as quickly as possible would be an obvious advantage for the global economy.

Although Basel III focuses on issues such as capital adequacy requirements and self assessment procedures for banks, its provisions could be applied to all financial institutions that conduct business at the international level. This could mean that institutional investors such as hedge funds (both within and external to banks), private equity firms and sovereign wealth funds would also have to comply with the international monitoring rules. All that would be required, is for domestic legislators to acknowledge that institutional investors should comply with new international reporting rules if they are going to engage in international transactions. The ratification of an international treaty and the passing of a simple domestic bill through national parliaments could bring that change about[44]. What makes this proposition workable is that the treaty need not pass through the UN, IMF or World Bank. An international agreement could be initiated by the Bank for International

[44] Many countries base their tax information exchange agreements (TIEAs) on the OECD's 2002 Global Forum on Taxation which developed a model agreement for information exchange on tax matters. Non-transparent States that have secretive tax or financial systems which fail to adopt the new rules could be ostracised or that transactions to or from those countries could incur additional transaction fees when money either leaves or returns from one of those countries to a complying OECD State.

Settlements on a multilateral basis with its participating member central banks and with any other country that was prepared to make a positive change to the international monetary and financial system. It will only be through such processes as the adoption of international treaties or agreements and the passage of national legislation that the problems caused by SCF can be minimised or eliminated. The next Chapter explores the possible options that might help bring that change about.

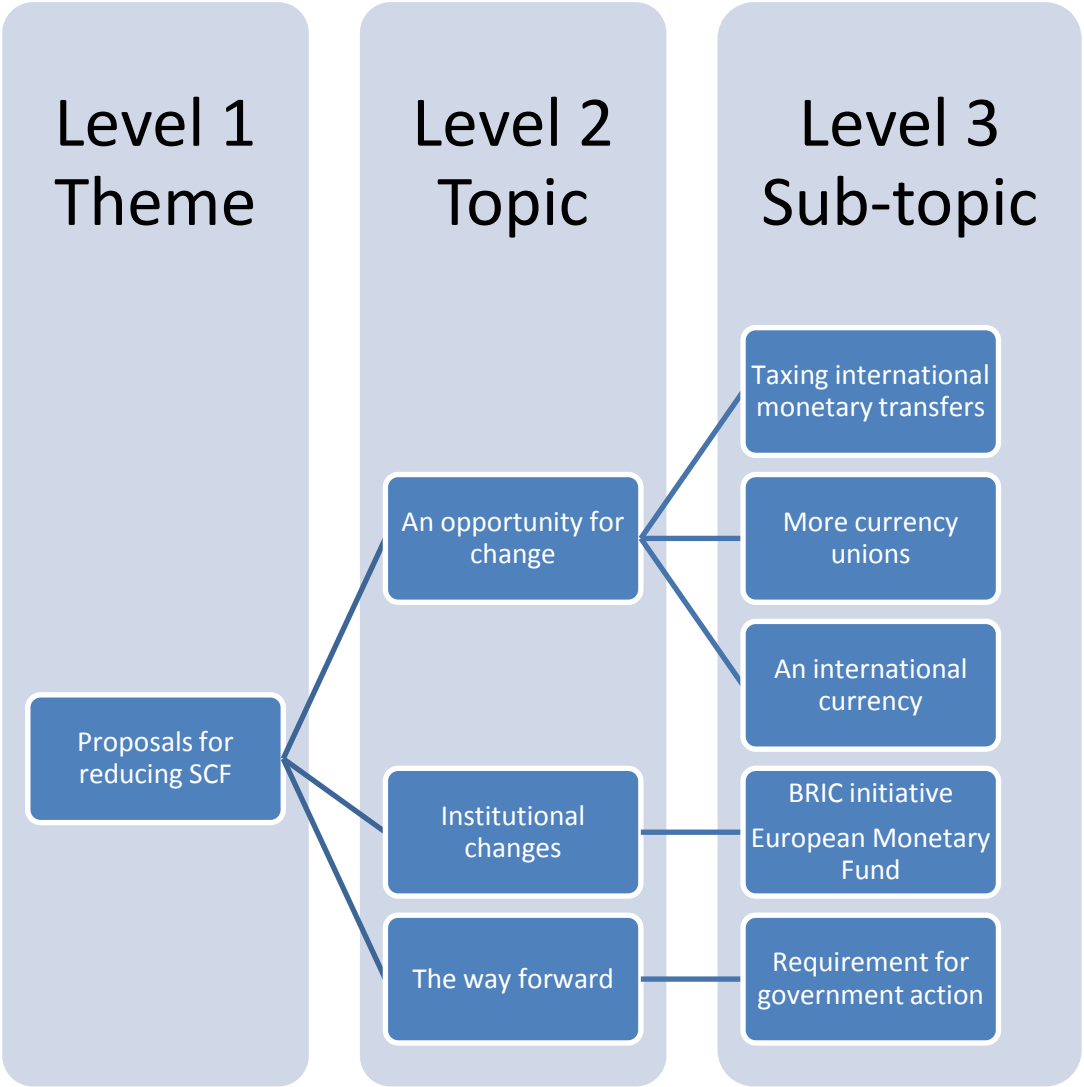
Summary of Chapter 7

This Chapter:

- examined the forces driving the financial services industry and coupled that to the banking sectors' power to create money
- identified how the Bank for International Settlements (with its agencies) is a clear leader in devising procedural and economic strategies to strengthen the stability of international financial markets
- discussed how proper reporting and effective market discipline is essential for managing exposures to foreign exchange shocks
- discussed the need to develop the managerial infrastructure to monitor and police well functioning financial markets
- discussed the need for central banks to co-ordinate their activities and adopt universal policies
- discussed the need for national legislatures to initiate the reform process

Chapter 8

Proposals for Reducing Speculative Capital Flows



Chapter 8

Proposals for Reducing Speculative Capital Flows

Chapter Abstract

This Chapter examines the major options that are available to reduce SCF. It evaluates the alternative policies and strategies in terms of effectiveness to determine which model would be most beneficial for the global economy. It looks at proposals for: taxing international capital transfers; creating more currency unions; the BRIC Initiative; the new European Monetary Fund; and the possibility of a new international currency. While the GFC presented an opportunity for change it was not taken advantage of to its full extent and much of the world economy is still exposed to the risk of further crises. Although the increase of currency unions, locked in currency values or even a single global currency have their merits in terms of reduced forex transaction costs and greater currency stability, the Chapter concludes that any proposal for initiating major changes to the IMS still requires serious political input which has not been forthcoming. Predominantly, the challenge for IMS prudential supervisors is to devise a regulatory framework that is capable of implementing, monitoring and policing a global monetary system which aspires towards economic efficiency and equality. That in turn directs us towards an investigation for a preferred regulatory model in the next Chapter.

This chapter starts by looking at the opportunity now available to implement change.

8.1 An Opportunity for Change

The introduction of the euro in 1999 redrew the international monetary landscape. In January 2002 when the euro notes and coinage went into circulation, it challenged the long time dominance of the US dollar as the world's most used currency for international trade. The creation of the euro led to its widespread adoption in Central and Eastern Europe as well as the Central African franc zone and the rim of the Mediterranean. Expansion of the wider euro area, counting not only countries entering with the enlargement of the European Union, but also currencies fixed to the euro, has given the euro a transactions base larger than that of the United States.

China's economic growth has been phenomenal over the past 35 years. With the death of Chairman Mao in 1976, China under the leadership of Deng Xiao Ping set about catching up to the rest of the world, both technologically and economically. With the world's largest population, and hence the largest labour force at its disposal, China became the manufacturing hub of the world. The steady flow of capital into China and its accumulation of foreign reserves now makes China the economic giant of the world. A 2005 study carried out by the World Bank placed China as the world's second largest economy[1]. At the end of March 2008, China's foreign-exchange reserves surged to US$1.68 trillion making it the world's richest economy in terms of foreign reserves[2]. By early 2010 it increased further to

[1] World Bank (2007) *China's Economy Smaller In New Study*, World Bank Headlines, 18th December 2007. Available at; http://web.worldbank.org/wbsite/external/news

[2] Piboontanasawat, N. (2007) *China's Currency Reserves Climb 40% to $1.68 Trillion*, Bloomberg.com. 18th December 2007. Available at: http://www.bloomberg.com/apps/news

over US$2.4 trillion[3] and by October 2013 China's foreign reserves had surpassed US$3.66 trillion[4].

With the introduction of the euro and China's growing economic fortunes, a tri-polar currency world involving the US dollar, euro, and yuan came into being. Because the US can no longer claim to be the world's strongest economy, a change in the structure of the international monetary system is now inevitable. We need only examine history or the work of Robert Mundell to validate that proposition; he says:

> … there is a constant phase relationship in the global financial structure due to the configuration of dynamics in the world economy and the special role played by the currency of the superpower … When one country has a super-economy, its currency often fulfils many of the functions of an international currency and plays a central role in the international monetary system[5].

Mundell said this has been as true for the Babylonian shekel, the Persian daric, the Greek tetradrachma, the Macedonian stater, the Roman denarius, the Islamic dinar, the Italian ducat, the Spanish doubloon and Dutch guilder, as it has for the more familiar pound sterling of the eighteenth and nineteenth century and the US dollar of the twentieth century. Mundell explains whichever super power we examine throughout history, 'it typically has a veto over the international monetary system'. Because it benefits from the international use of its currency, the superpower's interest is usually expressed by: 'vetoing any kind of global

[3] Lawder, D. and Chiacu, D. (2010) Factbox-China, the US Treasury's top foreign creditor, *Reuters*, 10th February 2010. Available at: http://www.reuters.com/article/idUSN1017254120100210

[4] Silk, R. (2013) China's Foreign Exchange Reserves Jump Again, *Wall Street Journal,* 15th October 2013.

[5] Mundell, R.A. (1997) *The International Monetary System in the 21st Century: Could Gold Make a Comeback?* Lecture delivered at St. Vincent College, Letrobe, Pennsylvania, 12th March 1997. Available at: http://www.columbia.edu/~ram15/LBE.htm

collaboration that would replace its own currency with [that of] an independent international currency'[6].

What Lietaer (1997) said about the US dollar being the 'linch-pin' for the international monetary system and by 'removing the linch-pin…boom!', is somewhat correct, but as there are now other major currencies in existence, there is less reliance on the US dollar to support the workings of the global economy. The size and stability of the Chinese economy has shown itself to be strong enough to weather the turmoil of the GFC and a shrinking US economy[7]. The term *shrinking* is not to say the US economy will grow smaller as such, but that other economies will grow larger relative to it, and thus diminish the influence of the US economy on global affairs. Just as Britain's economic supremacy faded rapidly at the beginning of the twentieth century, so too may the US lose its supremacy during the first part of the twenty-first century. This, as both Lietaer and Mundell suggest, would be the catalyst for a restructuring of the international monetary landscape. It is through this transformation that the ideal time arises to address many of the inefficiencies of the current monetary system. This Chapter examines the major options that are available to reduce the problems associated with SCF. It starts by looking at proposals which could tax cross-border capital flows.

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[6] *Id*.

[7] Wong, E (2008) Booming, China Faults US Policy on the Economy, *New York Times*, 17th June 2008, p IAP 1.

Edward Wong wrote: 'Not long ago, Chinese officials sat across conference tables from American officials and got an earful. The Americans scolded the Chinese on mismanaging their economy, from state subsidies to foreign investment regulations to the valuation of their currency. Your economic system, the Americans strongly implied, should look a lot more like ours. But recently, the fingers have been wagging in the other direction. Senior Chinese officials are publicly and loudly rebuking the Americans on their handling of the economy and defending their own more assertive style of regulation. Chinese officials seem to be galled by the apparent hypocrisy of Americans telling them what to do while the American economy is at best stagnant. China, on the other hand, has maintained its feverish growth'.

8.2 Taxing International Capital Transfers

Pigou (1920) proposed how governments could, via a mixture of taxes and subsidies, correct market failures[8]. Fifteen years later, John Maynard Keynes writing on the problems attributed to speculation in capital markets wrote:

> Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism …
>
> These tendencies are a scarcely avoidable outcome of our having successfully organised 'liquid' investment markets. It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges ... The introduction of a substantial Government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation[9].

Tobin (1978)[10] applied that concept to foreign exchange transactions when examining reform issues for the IMS. He suggested introducing a tax on currency speculation as a means to reduce the unproductive movement of capital. He made those suggestions after the effects of the abandonment of the gold standard became apparent. Like Pigou, a tax was subsequently named after him but it has never been implemented. Tobin's idea was that a small tax should

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[8] Pigou, A.C. (1920) *The Economics of Welfare*, Macmillan and Company, London. Part 1 Ch VIII Economic Welfare and Changes in the Distribution of the National Dividend , p 87.

[9] Keynes, J.M. (1936) *The General Theory of Employment, Interest and Money*, Macmillan, London, Chapter 12, section 6, at p 159. See footnote 5 where Keynes states: 'when Wall Street is active, at least a half of the purchases or sales of investments are entered upon with an intention on the part of the speculator to reverse them the same day. This is often true of the commodity exchanges also'.

[10] Tobin, J. (1978) A Proposal for International Monetary Reform, *Eastern Economic Journal*, Vol. 4(3-4) Jul/Oct., p 153-159.

be charged on the international movement of capital. It was initially proposed at 1 percent but after considerable criticism it was reduced to 0.25 percent. While the tax would be collected on all transactions, it would particularly affect the short term flow of speculative capital as the tax would be sufficient to erode the profit making opportunities attributed to the small variations in currency differentials. By the same method, the tax would be small enough not to penalise the legitimate movement of capital for goods and services or long term investments. The tax could then be used as a means for the UN to expand its humanitarian programmes in developing nations.

Tobin's idea was more or less forgotten until the financial crises of the 1990s prompted some academics to reconsider the idea. Numerous suggestions abounded both for and against the proposal. Economic editors Inge Kaul, Mahbub ul Haq and Isabelle Grunberg (1996) wrote: 'most good ideas take years, sometimes centuries to be recognised'[11]. Eichengreen and Wyplosz (1996) after weighing the case for and against the implementation of a Tobin tax said that taxes on international financial transactions could enhance the operation of the IMS. They went as far as recommending other ways for stabilising foreign exchange markets by means of dual exchange rates, administrative prohibitions and compulsory deposit requirements on bank lending and borrowing from non-residents[12].

The positive benefits expresses by various authors about the Tobin tax in turn motivated Ignacio Ramonet, editor of *Le Monde Diplomatique Magazine* to promote the concept with an article titled 'Disarming the Markets'. He wrote:

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[11] ul Haq, M., Kaul, I., and Grunberg, I. (Eds) (1996)*The Tobin Tax: Coping with Financial Volatility*, Oxford University Press, New York, Overview p 1.

[12] Eichengreen, B. and Wyplosz, C. (1996) Taxing International Financial Transactions to Enhance the Operation of the International Monetary System, in ul Haq, M., Kaul, I., and Grunberg, I. (Eds) (1996)*The Tobin Tax: Coping with Financial Volatility*, Oxford University Press, New York, p 15.

> The storm that has hit the money markets in Asia and affected the rest of the world is part of a wider danger. That is financial globalisation, which has become a law unto itself with its own powers, embodied by institutions such as the IMF, the World Bank, the OECD and the World Trade Organisation. Together, they threaten the power base of real States in the real world … The globalisation of investment capital is causing universal insecurity. It makes a mockery of national boundaries and diminishes the power of States to uphold democracy and guarantee the wealth and prosperity of their peoples …The task of disarming this financial power must be given top priority if the law of the jungle is not to take over completely in the next century [13].

Referring to the work of ul Haq *et al.* (1996)[14] Ignacio Ramonet wrote:

> Many experts have said there would be no particular technical difficulty about introducing this tax. It would spell the end of the liberal dogma subscribed to by all those people who love to tell us that there is no alternative to the present system[15].

Those experts included notable academics: James Tobin, Charles Wyplosz, Barry Eichengreen, Jeffrey Frankel, Peter Kenen, David Felix, Ranjit Sau, Yung Chul Park, Mahbub ul Haq, Inge Kaul, Isabelle Grunberg, Manuel Agosin and Ricardo Ffrench-Davis, all of whom acknowledge the Tobin tax is workable.

Jean-Francois Tardif, president of RESULTS Canada[16] said:

> Greater transparency and surveillance of the global financial system are not enough to control currency speculation … The Tobin tax is a common-sense solution and will

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[13] Ramonet, I. (1997) Disarming the markets, *Le Monde Diplomatique*, Available at: http://mondediplo.com/1997/12/leader

[14] ul Haq, M., Kaul, I., and Grunberg, I. (Eds) (1996)*The Tobin Tax: Coping with Financial Volatility*, Oxford University Press, New York.

[15] Ramonet, I. (1997) Disarming the markets, *Le Monde Diplomatique*, Available at; http://mondediplo.com/1997/12/leader

[16] A non-government organisation forming a national network of volunteers.

help to control the excesses of globalisation and at the same time, act as a mechanism to distribute wealth generated from the global economy[17].

Acting in response to public pressure in March 1999 the Canadian House of Commons passed Motion M-239 by a vote of 164 to 83: 'That, in the opinion of the House, the government should enact a tax on financial transactions in concert with the international community'. Finance Minister Paul Martin (as he was then) and most of the governing Liberal party supported the opposition New Democratic Party in favour of the Motion. Paul Martin was at the time a sitting minister on the G-7 and was correct about predicting the willingness (or lack thereof) from other G-7 members to support the idea. Nothing has happened since.

A Bill proposing such a tax was introduced by the National Assembly in France in 2001[18]. The Bill provided for a maximum tax of 0.1% on foreign exchange transactions but not for an extraordinary tax in the event of major exchange rate fluctuations. It was designed to enter into force if all other EC member States adopted the same legislative measures, however, it was rejected in March 2002 by the French Senate.

In July 2004 the European Central Bank (ECB) received a request from the Belgian Ministry of Finance for an opinion on a draft law introducing a Tobin tax on financial operations involving foreign exchange, banknotes and currencies. The ECB acknowledged the good intentions underlying the draft law however, for various reasons, considered that pursuing

[17] Life Media (1999) Visionary Vote for the Tobin Tax in Canadian Parliament, *Natural Life Magazine* - May/June 1999. At: http://web.archive.org/web/19991009092641/http://www.life.ca/nl/67/tobin.html

[18] See Article 235ter ZD of the French General Tax Code.

those intentions through the imposition of a tax as envisaged by the draft law raised serious economic and legal difficulties.

The ECB understood that the rationale for the draft law corresponded to three main arguments generally invoked for introducing such a tax. First, excessive short-term trading had often been blamed for extremely high volatility in foreign exchange markets. The tax had been proposed to mitigate exchange rate fluctuations not directly related to other economic fundamentals like GDP and inflation. Second, variants of the tax had been proposed as instruments to prevent and/or counteract speculative attacks. Third, the tax was considered as having great potential for raising revenue. The ECB said in terms of effectiveness, such a tax would fulfil the abovementioned expectations only if (i) excessive trading created significant excessive volatility; (ii) this volatility significantly affected other economic activities, such as trading or investment; and (iii) the tax could reduce this excessive volatility without creating excessive distortions.

The ECB then put forward an argument[19] that there was reasonable doubt with regard to the general validity of each of the three conditions. Surprisingly, the ECB's Opinion contained no figures or statistics, no reference to econometric modelling, no empirical evidence, was non-referenced and in stark contrast to the findings of many academic works. The ECB indicated that the tax would give rise to significant costs. One of the main legal arguments against implementing the tax was that the draft law was incompatible with the free movement of capital and payments between Member States of the EU, and between Member States and third countries. Such an imposition would hinder the execution and/or conclusion of capital payments involving foreign exchange which was a centrepiece of the *Treaty Establishing the*

[19] Opinion of the European Central bank of 4th November 2004, (CON/2004/34). Available at: http://www.ecb.eu/ecb/legal/pdf/en_con_2004_34_f_sign.pdf

European Community[20]. The President of the ECB, Jean-Claude Trichet said on the basis of the assessment, the ECB was of the opinion that the introduction by the euro zone of a Tobin type tax was not a good proposition[21].

So for the next few years it looked very unlikely that the idea of introducing such a tax would progress much further. In Europe, the need for a cross-border forex transaction tax was greatly diminished with the formation of the currency union so there seemed little benefit for the eurozone. But academics persisted. Theoretical models in behavioural finance developed by Wei and Kim (1997)[22] plus Westerhoff and Dieci (2006)[23] and others[24] demonstrated how transaction taxes could reduce volatility in foreign exchange markets. Ehrenstein, Westerhoff and Stauffer (2003)[25] investigated ~ by way of the Cont-Bouchaud model ~ whether a Tobin tax could stabilise foreign exchange markets. They discovered that a transaction tax-induced reduction in market depth could increase price responsiveness of a given order. Their findings

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[20] Commonly referred to as the 1957 *Treaty of Rome* as amended by subsequent Treaties.

[21] Opinion of the European Central bank of 4th November 2004, (CON/2004/34). Available at: http://www.ecb.eu/ecb/legal/pdf/en_con_2004_34_f_sign.pdf

[22] Wei, S-J. and Kim, J. (1999) *The Big Players in the Foreign Exchange Market: Do They Trade on Information or Noise?*, Harvard University Centre for International Development Working Paper No. 5, March 1999.

[23] Westerhoff, F. and Dieci, R. (2006) The effectiveness of Keynes–Tobin transaction taxes when heterogeneous agents can trade in different markets: A behavioural finance approach, *Journal of Economic Dynamics and Control*, Vol. 30(2), p 293-322.

[24] Cont, R. and Bouchaud, J-P. (2000) Herd Behaviour and Aggregate Fluctuations in Financial Markets, *Macroeconomic Dynamics*, Cambridge University Press, Vol. 4(02), p 170-196.

Sonnemans, J., Hommes, C.H., Tuinstra, J. and van de Velden, H. (2004) *The Instability of a Heterogeneous Cobweb economy: a Strategy Experiment on Expectation Formation*, *Journal of Economic Behaviour & Organisation*, Elsevier, Vol. 54(4), p 453-481.

Li, Y., Donkers, B. and Melenberg, B. (2006) The Econometric Analysis of Microscopic Simulation Models, *Quantitative Finance*, Taylor & Francis Journals, Vol. 10(10), p 1187-1201.

Chiarella, C., Dieci, R. and He, X-Z (2008) *Heterogeneity, Market Mechanisms, and Asset Price Dynamics*, Sydney University of Technology Quantitative Finance Research Centre Research Paper Series 231.

[25] Ehrenstein, G., Westerhoff, F. and Stauffer, D. (2003) *Tobin tax and market depth*, Cornell University Quantitative Finance Papers , p 1.

also showed that the imposition of a transaction tax could achieve a triple dividend: (1) a decrease in exchange rate fluctuations, (2) a reduction in mispriced currencies, and (3) the ability of central authorities to raise substantial tax revenues.

Not surprising, several years later the idea of a Tobin tax for Europe resurfaced. In December 2009, British Prime Minister Gordon Brown called for a global tax on financial institutions. He urged the IMF to consider the measure despite strong US opposition[26]. The European Union supported Brown's proposal saying a transaction levy should be contemplated as one of a range of options to renew 'the economic and social contract between financial institutions and the society they serve'[27]. In line with the European Council conclusions of October 2009, the Union sought to identify key principles which new global arrangements would need to respect. It also stressed the need to accelerate work on regulating alternative investment fund managers through legislative proposals to improve the stability and transparency of derivative markets[28].

In June 2011, the European Commission called for the introduction of Tobin-style taxes on the EU's financial sector to generate direct revenue starting from 2014. The Commission said it would look to raise up to €30 billion a year from imposing a levy on all financial transactions[29]. Sticking to his earlier decision, Jean-Claude Trichet urged European Union

[26] Taylor, P. (2009) EU backs Gordon Brown's call for global tax on financial institutions, *The Telegraph*, 11th December 2009, Banks & Finance p 1.

[27] Conclusions adopted by the European Council on 10/11 December 2009. At: http://europa.eu/rapid/pressReleasesAction.do?reference=DOC/09/6&format=HTML&aged=0&l

[28] *Id*.

[29] Aldrick, P. (2011) EU Parliament approves Tobin tax on transactions, *The Telegraph*, 8th March 2011, Economics p 1.

policymakers to ditch the plans for the transaction tax, warning that the bloc's financial centres would lose out unless the scheme was adopted globally[30].

In September 2011 the European Commission adopted its 'six pack reform package' which was initiated to strengthen economic governance. The plan, which had the strong support of France and Germany, was outlined by José Manuel Barroso, the president of the European Commission, to include an up-grade of the European Financial Stability Facility (bailout fund) and more stringent reporting requirements by members. In his State of the Union address Barroso stated:

> In the last three years, Member States ~ I should say taxpayers ~ have granted aid and provided guarantees of € 4.6 trillion to the financial sector. It is time for the financial sector to make a contribution back to society. That is why I am very proud to say that today, the Commission adopted a proposal for the Financial Transaction Tax. Today I am putting before you a very important text that if implemented may generate a revenue of above € 55 billion per year …
>
> Reforms … require a major effort from all parts of society. We all know these changes are necessary, so that we can reform our social market economy and keep our social model. But it is imperative that we hold on to our values ~ values of fairness, of inclusiveness and of solidarity[31].

London, Frankfurt and Paris would probably suffer a mass exodus of financial institutions if the tax was implemented solely within the EU. Given the significance of London as a major financial centre, it is highly unlikely the tax would be accepted by the British unless all the other financial centres, including New York, Tokyo and Hong Kong, implemented similar

[30] Pignal, S. (2011) Trichet urges EU to drop Tobin tax plan, *Financial Times*, 30th June 2011, World p1..

[31] Barroso, J. (2011) *European renewal* – President of the European Commission State of the Union Address, European Parliament, Strasbourg, 28th Sep 2011. http://ec.europa.eu/avservices/video/player.cfm?ref=79493

measures. The British government has a veto over any new Brussels legislation and has made it clear it would seek international agreement for any major changes to the banking industry[32].

US Treasury Secretary Geithner who indicated early opposition to the idea of a global Tobin tax[33] appeared to change his position at the G7 meeting in February 2010 saying: 'We are going to design this framework with great care and ... do so in ways that do not undermine prospects for recovery'[34]. To date, no economic bloc has actually implemented a Tobin style tax on capital transfers, and although it is a possibility ~ considering more wide-spread acceptance by the major economies ~ it is not yet guaranteed. If Europe can implement its proposal as suggested by 2014, it would add to the transaction cost of moving capital from one financial asset to the next and thus have a stalling effect on short term speculation of stocks, bonds, derivatives and currencies. The move towards achieving financial stability and economic efficiency would be somewhat enhanced by reducing SCF but the transaction tax would be counter-productive to economic growth and possibly decrease efficiency. Alternatively, monetary unions are another method and perhaps a natural progression towards alleviating destabilising currency movements.

8.3 More Currency Unions

In 1992 a series of speculative attacks destabilised the Exchange Rate Mechanism of the European Monetary System (EMS), forcing Italy and the United Kingdom to withdraw their participation from the pegged system of exchange rates. This was shortly followed by the

[32] Aldrick, P. (2011) *Supra*.

[33] Monaghan, A. (2009) US Treasury Secretary Timothy Geithner slaps down Gordon Brown's 'global tax', *The Daily Telegraph*, 7th November 2009, Finance p1. Geithner said: 'A day-by-day financial transaction tax is not something we're prepared to support'.

[34] Fifield, A. (2010) G7 warms to idea of bank levy, *The Financial Times*, 6th Feb 2010, Global Economy p 1.

Scandinavian countries. In 1993 the speculative attacks continued to other European currencies, forcing the European system to relinquish the narrow bands of the EMS. The destabilisation was not only disruptive to the European economies but it enhanced the motivation to implement the 1989 proposals of Jacque Delors[35] and expedite the introduction of a single currency for Europe.

Eichengreen (1994) wrote:

> In the summer of 1994, the US dollar depreciated sharply against the Japanese yen, deepening policymakers' dissatisfaction with floating exchange rates among the major currencies. Coming as they did, on the eve of the fiftieth anniversary of the Bretton Woods Agreement, these events did much to rekindle the debate over the future of the international monetary system[36].

Eichengreen argued that it would not be possible for governments to prevent exchange rate movements from exceeding pre-specified limits. Pegged systems would inevitably have to give way to fully floating exchange rates and then be subject to the volatility of that system. He went on to say that when policymakers are confronted with a choice between floating exchange rates or monetary unification, large and small countries in different political circumstances would respond in different ways. Unlike smaller economies, larger economies have relatively lower costs in maintaining fixed pegs between each other. This he says may force smaller economies to opt for a monetary union with a partner or partners.

For Europe the desirability of macroeconomic policy co-ordination and exchange rate stabilisation encouraged European countries to sacrifice some domestic economic objectives

[35] See the *Report on Economic and Monetary Union in the European Community*, submitted to the European Council by Jacques Delors, President of the European Commission on 12th April 1989.

[36] Eichengreen, B. (1994) *International Monetary Arrangements for the 21st Century*. Brookings Institution, Washington, DC. Forward p iii.

in the interest of stabilising currency values via the euro. The European Union was able to: 'establish international institutions with teeth sufficiently sharp to force significant adaptations of domestic economic policies'[37]. Similar compromises and political integration would be required elsewhere if currency unions were to become more popular.

Wyplosz (2001) said that it was not so long ago that the idea of a country ceding its monetary policy to another country, or to a supra-national authority, was a curiosity fit only for special cases. But the advent of monetary union in Europe, as well as a re-assessment of the relative weaknesses of floating exchange rates and the subsequent instabilities associated with them, a change in attitude about the desirability of monetary unions has come to light. Wyplosz made a compelling case for the importance of building collective institutions towards the implementation of monetary unions[38]. He stated that collective institutions become the advocates of integration; they move the debate from the purely political sphere to the technical level, allowing for professional assessments, which helps to minimise costly mistakes. Collective institutions provide analysis that would not be carried out otherwise. He said these institutions can prepare blueprints that can be readily put to use when critical occasions arise.

Logically, financial stability can only come to fruition through the gradual increase of co-operation between countries. In Europe it started with trade agreements among a small number of like-minded countries striving to restore trade links after World War II and ended in the formation of the European Parliament and a single currency being used (presently) in 17 countries. Financial integration, exchange rate stability, and ultimately a monetary union,

[37] *Ibid*. p 134.

[38] Wyplosz, C. (2001) *A Monetary Union in Asia? Some European Lessons*. Reserve Bank of Australia's conference held at the H.C. Coombs Centre for Financial Studies, Kirribilli, NSW on the 24th July 2001.

unified the greater proportion of Western Europe. By adopting this system the European countries enhanced price transparency /comparability between countries, increased convenience for cross border investment, lowered inflation, provided greater financial stability and suffered less at the speculators' hands[39].

Just as the EU developed its single currency for the eurozone, the Association of South East Asian Nations has been discussing alternative monetary plans over the past decade for its region through the Chiang Mai Initiative[40]. Likewise the Organisation for African Unity (OAU), has long promoted the idea of a common African currency as a pillar for African unity ~ a possibility made more achievable in 2001 when the OAU's 53 member States agreed to transform the intergovernmental organisation into the African Union (AU)[41] but that was somewhat diminished with the ousting of the Gaddafi regime[42]. In 2010, Tanzanian Central Bank Governor Benno Ndulu said that the East African Monetary Union Protocol was expected to be adopted in 2012 [43] but, with the turmoil of the Arab Spring,

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[39] See for instance: Feldstein, M. (2008) *Optimal Currency Areas*, paper delivered at the ECBs Fifth Central Banking Conference on 14th November 2008 in Frankfurt; Tapolczai, T., Wickert, I. (2011) Advantages and Disadvantages of the European Monetary Union, *Regional and Business Studies*, Vol 3, No 1, p 463.

[40] The Chiang Mai Initiative is the multilateral currency swap arrangement among the ten members of the Association of South East Asian Nations.

[41] Masson, P and Pattillo, C. (2004) A Single Currency for Africa?, *Finance & Development Magazine*, December 2004, p 9.

[42] Dan Glazebrook, a political analyst on the Middle East argued that Gaddafi's Libya was the engine uniting Africa which would have meant a final break from the centuries of Western colonial rule over the continent. He said: 'Gaddafi was the main driving force behind founding the African Union in 2002' and 'was the main financial contributor to the three major financial institutions of the African Union: the African Central Bank, the Investment Bank and the African Monetary Fund. Between them, they would have posed a huge challenge to the IMF hegemony in Africa'. Cf: Glazebrook, D. (2011) US biggest supporter of religious intolerance, interview on *Russia Today TV*, Veröffentlicht am 15th September 2011. Available at: https://huey3man.wordpress.com/2011/09/15/dan-glazebrook-on-rt-us-biggest-supporter-of-religious-intolerance/

[43] Ndulu, B. (2010) *Speech by Tanzanian Central Bank Governor at the 15th Conference of Financial Institutions*, 25th November 2010, Arusha International Conference Centre, Tanzania. The East African Community bloc ~ consisting of Kenya, Uganda, Tanzania, Burundi and Rwanda ~ covers a population of 133.5 million with a combined Gross Domestic Product of US$74.5 billion. It has a development strategy of growing up from a Customs Union, a Common Market to a Monetary Union and eventually a Political Federation.

implementation has been delayed. Nonetheless, with such plans on the drawing-board, the shape of the international financial landscape appears ripe for further innovations and integration ~ not least within North America itself.

Expanding the 1994 North American Free Trade Agreement, in 2005, the US and Mexican Presidents along with the Canadian Prime Minister signed an agreement which paved the way toward a North American economic and monetary union. The three leaders[44] met at Baylor University in Waco Texas in March 2005 to discuss tri-lateral co-operation in the areas of border security, trade and immigration. They signed an accord called the *Security and Prosperity Partnership of North America* [45].

Prime Minister Martin said:

> Essentially what we want to do is to make sure, given the threat that we face from rising economies elsewhere, primarily in Asia … North America is as strong and as competitive as it can possibly be [46].

President Bush described the significance of the *Security and Prosperity Partnership* as putting forward a common commitment: 'to markets and democracy, freedom and trade, and mutual prosperity and security'[47]. He said that: 'if there is a job opening which an American won't do, a Mexican ought to be able to cross the border into the US, work, and then go

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[44] President George Bush Jr, Canadian Prime Minister Paul Martin, and Mexican President Vincente Fox.

[45] White House Press Release (2005) *Fact Sheet on the Security and Prosperity Partnership,* Office of the Press Secretary, 23rd March, 2005. Available at; http://www.whitehouse.gov/news/releases.

[46] Authers, J. (2005) US, Canada, Mexico pledge new alliance, *Financial Times*, 23rd March 2005, p 1.

[47] Council on Foreign Relations (2005) *Building a North American Community*, Report of an Independent Task Force Sponsored by the Council on Foreign Relations with the Canadian Council of Chief Executives and the Consejo Mexicano de Asuntos Internacionales. Copyright © 2005 by the Council on Foreign Relations, Inc. p 3.

home'. The President indicated that he would continue to push for 'compassion as well as practicality' in US dealings with Mexico on border issues[48].

The *Security and Prosperity Partnership* established Ministerial-level working groups to address security and economic issues facing North America. The Working group submitted their Report in the latter part of 2005 recommending progress be made in several vital areas. While respecting the maintenance of each other's national sovereignty, the Committee Task Force offered a detailed set of proposals including the establishment of a North American economic and security community [49]. Their Report stated:

> A new North American community should rely more on the market and less on bureaucracy… Our economic focus should be on the creation of a common economic space that expands economic opportunities for all people in the region, a space in which trade, capital, and people flow freely…
>
> In short, important work remains to be done in creating a common economic zone through the elimination of remaining tariff and nontariff barriers to trade within North America. The three countries must also expand co-operation on trade-related areas, including border and transportation infrastructure; a concerted effort to reduce the many regulatory gaps and inconsistencies that hamper the flow of trade in North America; and co-ordinated investment in North America's human capital, both through education and training, and through improved labour mobility within the continent … The ultimate goal should be to create a seamless market for suppliers and consumers throughout North America[50].

It strongly suggests one thing; another monetary union in the making.

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[48] *Supra*, Authers, J. (2005).

[49] Council on Foreign Relations (2005) *Building a North American Community*, Task Force Report, p xvii.

[50] *Ibid*, p 6 – 21.

What appears to be taking shape is a new international monetary order based around five or six major currencies; a European, American, Asian, African, Pacific and Middle Eastern system of international payments which could eventually by-pass the *modus operandi* of the Bretton Woods Institutions. Significantly, a monetary system depends by and large on the arrangements that are most convenient to the entities that want to be part of a particular system. Most interestingly, sovereign States do not have to continue using the same banking institutions or the same unit of account. Like Russia[51], countries can discard the inefficient workings of the old system and create or adopt a totally new one. All that is needed is an alternative institution that is capable of creating its own unit of account and is credible enough to sell the concept to the global community. Some countries are already considering the possible options.

8.4 The BRIC Initiative

Issuing their first-ever communiqué shortly before the G20 London Summit in March 2009, finance ministers from Brazil, Russia, India and China called for a bigger voice in international financial matters signalling their growing political resolve to influence global affairs[52]. Those four countries account for about 40 percent of the world's population and 15 percent of the global economy in terms of GDP, but they have the largest holdings of foreign reserves and it is rising. Amongst other things, the BRIC group drew special attention to the

[51] When the Union of Soviet Socialist Republics (USSR) existed, it had nothing to do with the Western financial system. The USSR maintained its own completely separate form of international banking with like-minded communist countries. It was not part of the IMF nor did it use its services. That situation changed of course with the economic break-down of the USSR. Recalling the strategies of Ronald Reagan and Margaret Thatcher, the collapse of the USSR economy was greatly assisted by the deliberate economic pressure orchestrated by the West. The new Russian States then turned to the IMF for help and guidance to kick-start their capitalistic economies. From that point forward Russia became dependent upon the Western monetary system under terms the capitalistic powers stipulated but with its economic resurgence, Russia is regaining its monetary independence and collaborating with Brazil, India, China and South Africa in an effort to have greater say as to how the international monetary system is run.

[52] BRIC Joint Government Statement (2009) *Official Communiqué*. 14th March 2009. Available at: http://www.globalpolicy.org/component/content/article/214/44110.html

reform of international financial institutions. They asked for a review of the IMF's role emphasising the importance of a strong commitment to internal reform.

At the same time, People's Bank of China Governor Zhou Xiaochuan, issued a proposal for diversification away from the US dollar toward a supra-national currency based on something similar to the International Monetary Fund's Special Drawing Rights (SDR)[53]. With over US$1.3 trillion tied up in US Treasury Bonds (at that time) and other American securities, the Chinese were in a very strong position to insist that the IMF and other financial institutions start adopting some of their policies.

Simultaneously, the Chinese government announced a series of steps to increase the yuan's international role[54]: it would allow export firms in the Yangtze and Pearl River Deltas to settle their international trades in yuan; it approved currency swap arrangements totalling $95 billion with six countries; it is buying SDR-denominated bonds; it finalised an agreement with Brazil to encourage trade settlement in their own currencies ~ thus by-passing the US dollar and the IMF; it launched a 'net settlement system' to increase liquidity and trading volume in the domestic interbank currency market; and it introduced regulations for foreign banks to sell yuan-denominated bonds in Hong Kong.

In the absence of further financial upheaval within the US banking system, the mass exodus away from the US dollar as the preferred international trading currency is unlikely to occur abruptly because the dynamics of transition takes several years. If the process was too rapid, it could be as Professor Lietaer explained… *Boom*! The US dollar could fall in value with

[53] Zhou, X. (2009) *Reform of the International Monetary System*, People's Bank of China, Beijing.

[54] Kelly, B. (2009) China's Challenge to the International Monetary System: Incremental Steps and Long-Term Prospects for Internationalisation of the Renminbi, *Issues & Insights*, Vol. 09 - No. 11, p 1.

severe economic consequences for anyone left holding the currency or its derivatives[55] hence risk management strategies should be contemplated for that possibility.

8.5 A New International Currency

Robert Mundell believes the adoption of a single global currency could be a solution for all exchange rate problems. He concluded his Nobel acceptance speech by saying that flexible exchange rates are an 'unnecessary evil' in a world where each country has achieved price stability; any movement by one country in its exchange rate would necessarily affect the entire play. He said: 'there are two pieces of unfinished business, the most important is the dysfunctional volatility of exchange rates that could sour international relations in times of crisis and the other is the absence of an international currency'[56].

An international currency is an obvious mechanism that could stop currency speculation purely by the fact there would be only one medium of exchange. There would be no need to move forex speculative capital from one economy to another economy because there would simply be no variation in the currency's value and therefore no opportunity to profit from arbitrage.

A single currency or its equivalent would solve the currency stability problem, but that may not result in a better outcome overall in that it may force some countries [perhaps not all] to adjust in other ways which may be more costly. Increased stability in international currency markets may come at the cost of increased instability in say goods and labour markets or

[55] ie; long term bonds, interest premiums and credit default swaps.

[56] Mundell, R.A. (1999) *A Reconsideration of the Twentieth Century*, Acceptance speech delivered in Stockholm, Sweden, 10th December 1999, on receiving the Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel.

internal financial markets. As with the introduction / expansion of any currency union or single currency, major adjustments would be required on many fronts however, in the great scheme of things, liabilities usually prove insignificant when compared to the documented benefits over the long term. Those benefits were identified in the Ch 2 literature review which revealed how tighter government controls over currency can have positive effects in maintaining economic stability within the national setting.

Proposals for a global currency were seriously discussed between the US and England prior to the establishment of the IMF and World Bank. In the early 1940s, President Roosevelt told US Treasury Secretary Henry Morgenthau to make plans for an international currency for after the war [57]. Harry Dexter White and the staff at the US Treasury made a plan that involved the creation of a world currency to be called the *unitas*. John Maynard Keynes, in London, made a comparable plan for reform that included a world currency called the *bancor*. Initially both the White and Keynes plans endorsed the idea of an international currency having legal tender throughout the world, but the US delegation, realising the lucrative benefits to national interests of a world economy using the US dollar for international trade, shelved the idea.

Against that background and the falling significance of the US dollar, Stiglitz (2006) suggests revitalising the idea in a new form of Special Drawing Rights (SDR) ~ much the same as the existing IMF system ~ but different in that the units would be injected annually into the global economy in line with global economic growth and not in the sporadic manner which is

[57] Information in this section is derived from Eckes (1975), de Vries (1986) and Horsefield (1967).

presently the case. Patriotically Stiglitz calls his proposed currency the global greenback[58] which sort of indicates his preference for it to be implemented and controlled by the US.

Eichengreen (2009) writing on the possibility of establishing the SDR as a reserve currency said it would be a technically complex task given the past resistance to market acceptance, and enthusiasm for, composite currency units[59]. Understandably, there would be many contenders vying for the honour to supply that service to the global economy as it would give the institution a monopoly on the issuance of money throughout the world.

Edwin Truman (2009) says:

> … to establish the SDR as the principal reserve asset and to limit the use of national currencies in this role would require a thorough reconfiguration of the international monetary system. Many countries would have to agree to a substantial number of additional obligations with respect to their economic and financial policies that would require much more in the way of formal IMF regulation than anything currently contained in the IMF *Articles of Agreement* [60].

The short-fall of the invigorated SDR proposal is that the existing global banker would still control the global economy. The IMF would be able to continue to create, distribute and withdraw wealth from the IMS simply on a larger scale than it already does. Given the lacklustre track record of US money management, the new SDR would merely allow the IMF to continue business in the exact same manner that it has done so over the past four decades. The IMF could still create liquidity and wealth for the countries which support the system by

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[58] Stiglitz, J. (2006) *Making Globalisation Work*, Penguin Group, London, at p 260.

[59] Eichengreen, B. (2009) *Out of the Box Thoughts about the International Financial Architecture*, IMF Working Paper 09/116. International Monetary Fund, Washington.

[60] Truman, E.M. (2009) *The International Monetary Fund and Regulatory Challenges*, Working Paper Series, Peterson Institute for International Economics, Washington, p 12.

allowing them access to lines of credit based on loyalty and ledger entries but it could also restrict lending to countries which do not comply with the US agenda. Not surprising, it is evident not all States are enthusiastic about following the US push to allow the IMF to bailout Greece or the other countries facing financial difficulty in the eurozone. The European Parliament has its own idea that might help it re-gain monetary sovereignty for the EU.

8.6 A New European Monetary Fund

In response to the Greek, Irish and Portuguese debt crises, in March 2010 German Chancellor Angela Merkel backed the idea to create the European Monetary Fund (EMF)[61]. In July 2011, the European Council decided to transform the European Financial Stability Facility (EFSF) into the European Monetary Fund by allowing it to engage in precautionary programs to acquire sovereign debt at a discount on the secondary market[62]. The new EMF will allow the EMU to bail out members of the eurozone which run into financial difficulty by providing EU members with their own bank of last resort. France, Germany and the European Central Bank strongly rejected the idea that the IMF should offer budgetary support to Greece, saying that it was for the eurozone to manage its own financial affairs[63]. Daniel Gros of the Centre for European Policy Studies and Thomas Mayer of Deutsche Bank proposed the creation of the EMF arguing that setting up a fund to deal with euro area member countries in financial difficulties is superior to the option of either calling in the IMF or muddling through on the basis of *ad hoc* decisions. They said: 'Without a clear framework, decisions about how to organise financial support typically have to be taken hurriedly, under extreme time pressure,

[61] Mortished, C. (2010) German Chancellor Angela Merkel supports EU creating its own IMF, *The Times*, 9th March 2010. At: http://www.theaustralian.com.au/business/economics/story-e6frg926-1225838512378

[62] Gros, D. and Giovannini, A. (2011) *The EFSF as a European Monetary Fund: Does it have enough resources?*, Centre for European Policy Studies Commentaries. Available at: www.ceps.eu/ceps/download/5944

[63] Brunsden, J. and Taylor, S. (2010) Commission backs European Monetary Fund, *European Voice*. Available at: http://www.europeanvoice.com/article/2010/03/commission-backs-european-monetary-fund-/67349.aspx

and often during a weekend when the turmoil in financial markets has become unbearable'[64]. They see two key advantages of their proposal: first, the funding of the EMF should give clear incentives for countries to keep their fiscal house in order at all times. Secondly, the EMF could provide for an orderly sovereign bankruptcy procedure that minimises the disruption resulting from a default[65]. It would accomplish those objectives by by-passing the IMF and creating its own credit system.

The European Commission backed the proposal which would enable Brussels to better co-ordinate economic and fiscal policy among eurozone States. Wolfgang Schauble, the German Finance Minister, said the EMF would have a similar role in the eurozone to that of the IMF on the world stage in dealing with potential sovereign default[66] ~ in other words, a eurozone bank of last resort independent of US influence or IMF control. Although the European Commission see the obvious merits of controlling their own bank of last resort, this could in fact potentially divide efforts to create a more stable IMS by creating another barrier through which negotiations must pass. Contemplating the power struggles that might be played out by the EMF and the IMF to secure their hegemonic position, BRIC countries could sit on the side lines and watch the Western dominated global monetary system disintegrate.

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[64] Gros, D. and Mayer, T. (2010) *How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund*, Centre for European Policy Studies, Policy Brief, No. 202/February 2010, p 7.

[65] *Id*.

[66] Mortished, C. (2010) German Chancellor Angela Merkel supports EU creating its own IMF, *The Times*, 9th March 2010. At: http://www.theaustralian.com.au/business/economics/story-e6frg926-1225838512378

8.7 The Way Forward

If we consider that the goal of achieving monetary and financial stability within the global economy should be a primary objective of national governments, the IMF, the Bank for International Settlements and the Basel Committees, then the idea of a fixed value multiple pegged currency system or even a single global currency system would certainly go a long way towards realising that goal. Such implementation would provide a more stable financial environment and automatically alleviate the problems associated with currency differentials and speculative capital flows. The thing to consider however, is the mechanism through which those objectives could be achieved.

While the GFC presented an opportunity for change it was not taken advantage of to its full extent and much of the world economy is still exposed to the risk of further crises. Although the increase of currency unions, locked in currency values or even a single global currency have their merits in terms of reduced forex transaction costs and greater currency stability, typically any proposal for initiating major changes to the IMS still requires serious political input which has not been forthcoming. Predominantly, the challenge for IMS prudential supervisors is to devise a regulatory framework that is capable of implementing, monitoring and policing a global monetary system which aspires towards economic efficiency and equality.

The next Chapter explores the regulatory aspects of supervising, monitoring and policing financial institutions that operate in the international monetary market. It contemplates which regulatory model will deliver the most cost-effective efficient outcome.

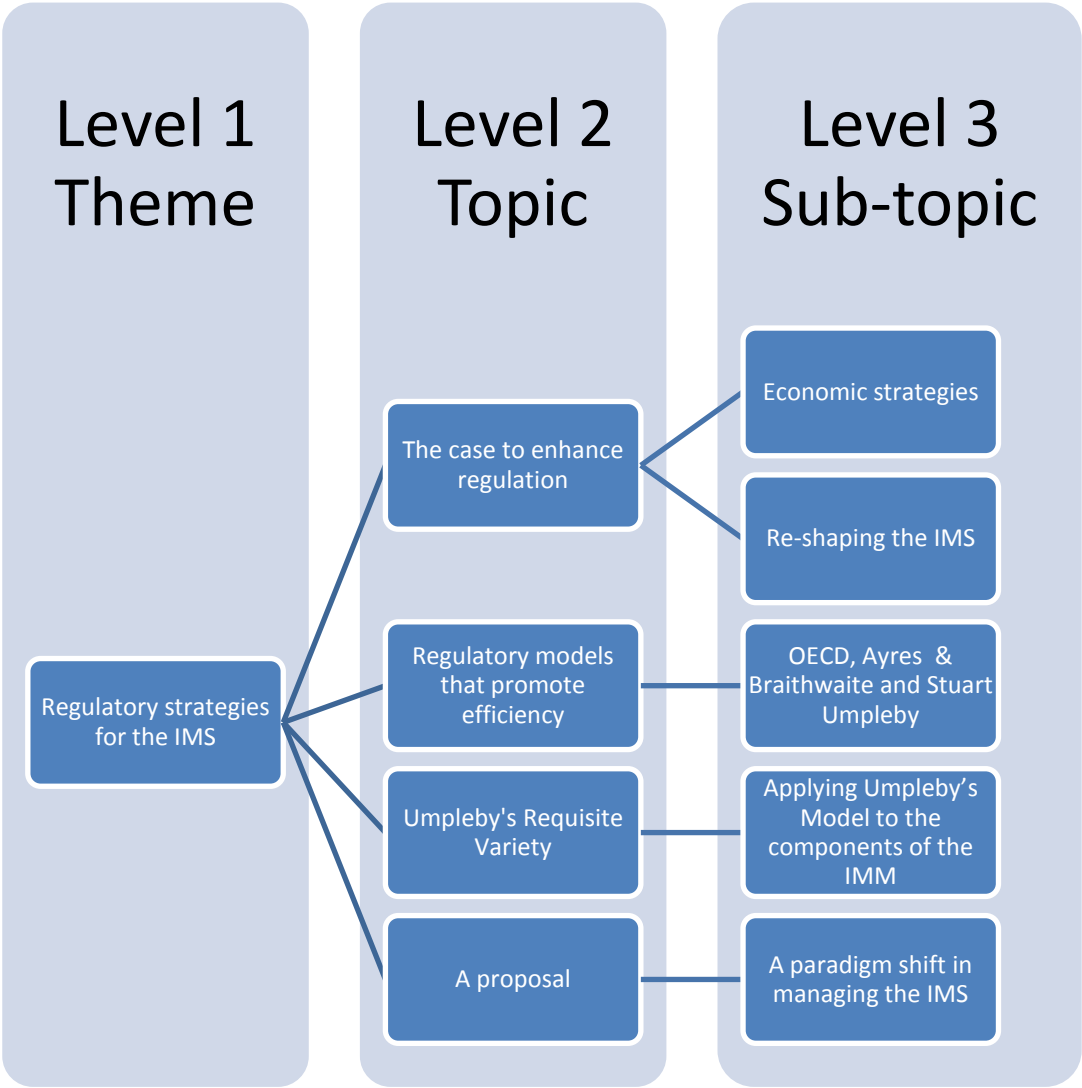
Summary of Chapter 8

This Chapter:

- explained how now is an ideal time to instigate change within the IMS
- examined economic strategies that could help reduce the effects of SCF
    - it looked at the possibility of taxing international capital transfers
    - it assessed the benefits of creating more currency unions
    - it assessed the tactics being employed by the BRIC countries
    - it found merit in the idea of a new international currency
    - it discussed the implications of a new European Monetary Fund
- recommended that the goal of achieving monetary and financial stability within the global economy should be a primary objective of national governments

Chapter 9

A Regulatory Model for the International Monetary System



Chapter 9

A Regulatory Model for the International Monetary System

Chapter Abstract

To help improve financial stability, reduce cross-border currency exchange rate transaction costs and maximise return on expended effort in managing the global economy, this Chapter examines an effective course of action for regulating the international monetary market. It examines the complex issues of prudential supervision and international financial regulation. It applies two theories for regulatory reform, these being: Ian Ayres' and John Braithwaite's *Regulatory Pyramid* [1], and Stuart Umpleby's application of *Requisite Variety*[2] and theorises which model might be better suited to implement change. These two models were chosen because one theory promotes the concept of privatised enforcement of responsible regulation while the other promotes that the level and depth of the regulator must match, if not exceed, the complexity and variety of the system being regulated. Both theoretical models are used to consider how best to manage the complex activities and practical implications of regulating the international monetary and financial system. The Chapter describes the components and infrastructure of the IMM which then guides us towards the elements needed for an effective framework suitable for minimising the negative effects of speculative capital flows.

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[1] Ayres, I. and Braithwaite, J. (1997) *Responsive Regulation: Transcending The Deregulation Debate*, Oxford University Press, Oxford, UK.

[2] Umpleby, S.(1990) Strategies for Regulating the Global Economy, *Cybernetics and Systems*, Vol. 21, No. 1, p 99-108.

Umpleby, S. (2001) What Comes after Second Order Cybernetics?, *Cybernetics and Human Knowing*, Vol. 8, No. 3, p 87-89.

The Chapter reveals that instead of monitoring millions of market participants or a thousand private banks trading on hundreds of different platforms (which is in practical terms, unlikely to be possible anyway), if the regulatory focus was shifted to the international banking institutions and central banks, to make those entities more sophisticated so that they could hold currency values within specified bands, it would strengthen the foundations of the present system. By taking advantage of innovations in information technology and statistical analysis, the collection and dissemination of financial information between international organs, central banks and prudential regulators would facilitate greater understanding and management of the IMS and allow for more stable currency values. If that could happen, arbitrage opportunities in foreign exchange markets might no longer become profitable or viable thus eliminating the problem once and for all.

9.1 The Case to Enhance Regulation

Before considering the details of regulation, it is desirable to understand the reasons why we need the international monetary and financial system to be regulated in the first place. So the preliminary question to answer is: is there sufficient reason to warrant government intervention in the free market to help stabilise currency values and reduce dead-weight losses? The second question we have to address is: who should be regulated? The third question to consider is: how should they be regulated? As it was demonstrated in previous Chapters, there are sufficient economic, legal and social reasons to warrant intervention in the IMS and IMM; so the first answer has already been answered in the affirmative. This leaves the 'who and how' questions to be resolved.

The case to enhance regulation covering capital controls gained momentum following the GFC. Evelyn de Rothschild speaking to CNBC on 14th December 2008 on global financial

overhaul and directing his comments towards US legislators said there is a need for more regulation and more supervision. He said:

> You have now got to realise that you have to get a better system going, and here is one of my main thrusts ... I think regulation is important. What has happened in the past is that you haven't had the regulation supervised. You know it is very easy to have regulation but you have got to have the supervisors. Two things #1: they have to know what they are supervising and understand what they are supervising and they have to have the chance to take action when they decide that so and so or an institution is not behaving correctly … I am amazed that here in the great US of A, you have not put more supervision into the institutions where you have put your money.
>
> … I think what we have to face up to is that it is not just regulation, we have to go back to basics and teach bankers and investment people, whether it is in hedge funds or whatever exists, that they have got to work within prescribed limits. They can't just do whatever they want. What we have had for the last ten ~ fifteen years is unlimited attitude: we can make money, we can do anything we like, we have tons of time to do what we want, without regarding the regulation or regarding the basics of how you run your business[3].

Because of the partial repeal of the *Glass Steagall Act* [4] in 1999 a lack of institutional accountability existed within American financial markets that allowed some institutions to develop, disguise and sell globally risky financial products with no social value (eg: credit default swaps[5], mortgaged backed securities[6] and option ARMs[7]) which lacked substance as

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[3] de Rothschild, E. (2008) Interview with CNBC, 14th December 2008. Available at YouTube: http://www.youtube.com/watch?v=7Fw1RMKWypo&feature=PlayList&p=3B4F5CE449A3966B&playnext=1&playnext_from=PL&index=85

[4] The *Bank Act* of 1933 US Code, Title 12, Chapter 3, Subchapter 1, Section 227, alternatively named after the two congressmen who introduced the bill.

[5] Credit Default swaps are a form of credit protection insurance to minimise certain risk or exposure of losing money on bad loans. It works so long as the seller of the swap has the cash to make good in case of a borrowers non-payment (default). The price of swaps is based on statistical percentages of bad loans; they work well in

worthy investments. Each time a financial institution re-sold the risky product, they would attempt to make a profit at the expense of the next purchaser. After this process occurred several times and because of the lack of regulation within the financial services market, it became apparent that Wall Street was entrenched into selling its own worthless products onto international investors, including private equity and sovereign wealth funds[8].

Stephen Green, Group Chairman of HSBC Holdings, speaking at an international financial summit said:

> The complexity and opacity of certain financial instruments reached a point where even senior and experienced bankers had trouble understanding them ... And when the securitisation market began to collapse, banks found themselves with assets that they could neither sell nor fund, so creating large losses on the asset side and a funding stretch on the liability side for which they were entirely unprepared …[9]

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the expansionary phase of an economic cycle but typically come undone in a contractionary phase ~ hence no social value.

[6] Mortgage-Backed Security (MBS) is a type of asset-backed security, originating from a regulated and authorised financial institution, that is secured by a mortgage or collection of mortgages. These securities are grouped and usually pay periodic payments that are similar to coupon payments. When you invest in a mortgage-backed security you are essentially lending money to a home buyer or business via the bank which acts as a middleman between the borrower and the investment markets. This type of security is also commonly used to redirect the interest and principal payments from the pool of mortgages to shareholders. These payments can be further broken down into different classes of securities, depending on the riskiness of different mortgages.

[7] An adjustable rate mortgage (ARM) is a loan where the interest rate on the note is periodically adjusted based on a variety of indices. An 'option ARM' is typically a 30-year ARM that initially offers the borrower four monthly payment options: a specified minimum payment, an interest-only payment, a 15-year fully amortising payment, and a 30-year fully amortising payment.

[8] As an example, China Investment Corp., China's $200 billion sovereign wealth fund got heavily involved in the US financial business in 2007, buying a $3 billion 9.9 percent stake in the Blackstone Group LP and a $5 billion 9.9 percent stake in Morgan Stanley. Neither of those investments turned out particularly well - Blackstone went down about 60 percent while Morgan Stanley went down about 40 percent. Cf: Hutchinson, M. (2010) The Chinese Are Selling Treasuries – So What Are They Buying? *Money Morning*, 19th February 2010.

[9] Green, S. (2008) Speech by HSBC Group Chairman at World Financial Summit, Dubai International Financial Centre, 20th October 2008. Available at:

http://www.hsbc.com/1/PA_1_1_S5/content/assets/newsroom/081020_the_financial_crisis_and_the_shift_from_west_to_east_27oct.pdf

The GFC demonstrated the re-active nature of politicians to confront matters of significant economic importance after the crisis had already arisen. The *Emergency Economic Stabilization Act* of 2008 (US), better known as the Troubled Asset Relief Program (TARP), authorised the Bush administration to engage in the largest financial intervention package since the Great Depression. Under the plan, the US federal government was given power to buy bad mortgage-related securities and other devalued assets from embattled financial institutions. Section 101(a)(1) of the *Emergency Economic Stabilization Act* granted the Secretary of the Treasury power to make and fund commitments to purchase, 'troubled assets' from any financial institution ~ including residential or commercial mortgages, any securities, obligations, or other instruments that were based on or related to mortgages, that originated or were issued on or before 14th March 2008. The purpose for approving the bailout plan was to help the banking sector resume lending to businesses and consumers, to prevent a widening credit crisis from driving the US economy into depression. The focus was on 'main street' or the private business sector to stimulate growth activity by being able to borrow from the banks which had received huge injections of public money. However, the crisis deepened because the banks kept that money for themselves allowing them to buy out their competitors and every other cheap asset on the market. In the end, main street did not receive the benefit and the banks made record profits[10].

[10] In a report released in November 2009 by Thomas DiNapoli, the Comptroller of New York State, Wall Street profits in 2009 would exceed the record set three years earlier. The Comptroller's report noted that the four largest investment firms in Manhattan ~ Goldman Sachs, Merrill Lynch, Morgan Stanley and JPMorgan Chase ~ earnt $22.5 billion in the first nine months of 2009. DiNapoli said: 'The national economy is slowly improving, but Wall Street has recovered much faster than anyone had envisioned'. Cf: Kouwe, Z. (2009) Wall Street on Track for Record in Profits, *New York Times*, 18th November 2009, p B3.

See also:
Senate Economics Reference Committee (2012) *The post-GFC banking sector*, Senate Printing Unit, Parliament House, Canberra.

Colebatch, T. (2012) Banks' recovery rate since GFC of awesome interest, *The Age*, 11 February 2012. Available at: http://www.theage.com.au/national/banks-20120210-1smgy.html

While technically flawed and ineffective, the political tactic to solving the domestic financial crisis was re-active, not pro-active. It was made hastily and without proper consideration of the root cause of the problem[11]. It touched slightly on government oversight[12], it did not identify systems failures, it did not contemplate the adequacy of its proposed solution nor consider the long term liabilities for future generations. The $700 billion bailout simply could not work[13]. Despite the government's bailout attempts, the US economy got worse[14].

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[11] Kroll (2009)* identifies six major failings of the Troubled Asset Relief Program (TARP).

> 1. By overpaying for its TARP investments, the Treasury Department provided bailout recipients with generous subsidies at taxpayer's expense.
> 2. As the government had no real oversight over bailout funds, taxpayers remained in the dark about how their money had been used and whether it had made any difference.
> 3. The bailout's programs heavily favoured the private sector, giving selected investors an opportunity to earn lucrative profits, leaving taxpayers with most of the risk.
> 4. The government had no coherent plan for returning failing financial institutions to profitability or maximising returns on taxpayers' investments.
> 5. The bailout's focus on Wall Street mega-banks ignored smaller banks serving millions of American taxpayers that faced an equally uncertain future.
> 6. Instead of overhauling the broken financial system and helping the individuals most affected by the crisis, the bailout encouraged the same behaviour that created the economic crisis in the first place.

*Kroll, A (2009) The Greatest Swindle Ever Sold, *The Nation*, 26th May 2009. Available at: http://www.thenation.com/doc/20090608/kroll

[12] Section 104(a) of the *Emergency Economic Stabilization Act* established the Financial Stability Oversight Board (FSOB) to be responsible for, among other things, reviewing and making recommendations regarding the Secretary's exercise of authority under the programme. The Office of the Special Inspector General for the Troubled Asset Program is responsible for, among other things, conducting audits and investigations of the program (section 121(a)). Section 119(a)(1) provides for judicial review of the Secretary's actions under the program pursuant to the *Administrative Procedure Act*.

Section 125(b)(1) of the *Act* established the Congressional Oversight Panel (COP) to be responsible for reviewing and reporting on the state of the financial markets and the regulatory system. This was something that the US Securities and Exchange Commission had been arguing for throughout the Bush Jr. presidency, but with no success.

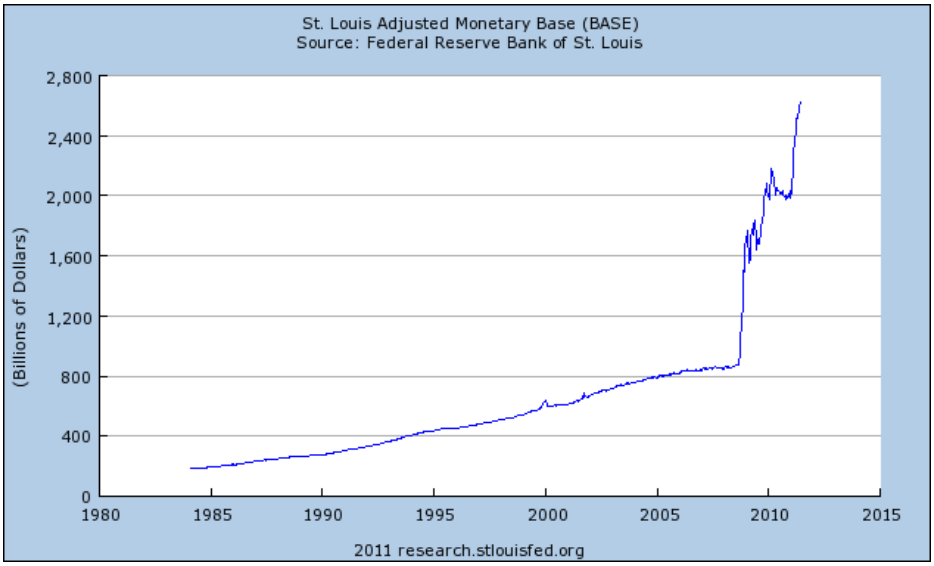
[13] Assoc. Professor Steve Keen explained why the bailout could not work. He said: 'the dynamics of debt are now swamping Bernanke's attempts to mount a Monetarist rescue. As financial institutions retreat from lending, the collapse in credit-created money will overwhelm his attempts to expand fiat money'. Keen estimated that if the private sector succeeded in reducing aggregate debt levels by as little as 5 percent per annum, that would reduce aggregate spending by US$2.7 trillion in the first year*. The $1.2 trillion bailout would have little impact in off-setting the economic decline. * Keen, S (2009) Bailing out the Titanic with a Thimble, *Economic Analysis & Policy*, Vol. 39 Issue 1, p 11.

[14] Professor Nouriel Roubini predicted greater losses in US markets, rising unemployment and generally tougher economic times. He said that the rest of the world could not decouple itself from developments in the United States *.

*Loungani, P. (2009) Seeing Crises Clearly: a profile of Nouriel Roubini, *IMF Finance and Development*, March 2009, Vol. 46, 1. Available at: http://www.imf.org/external/pubs/ft/fandd/2009/03/people.htm

Between October 2008 and June 2009, the $700 billion bailout grew to a $1.2 trillion commitment by the US government and Federal Reserve. It was later supported with other quantitative easing measures during 2010, increasing the supply of money to the US economy to $2.6 trillion; representing a 300 percent increase between 2008 – 2011.

Figure 9.1 US Monetary Base Expansion 1985 - 2011



Source: US Federal Reserve Economic Data (St Louis Branch)

Between 2008 and 2011, the massive injection of US liquidity led to a devaluation of the US dollar, increased the price of gold, and accelerated inflation of commodities around the world[15]. That in turn triggered a spate of currency wars in which countries tried to remain competitive by lowering the value of their own currency. Nations, including China, Japan,

On 8th June 2009, two icons of American business were removed from the Dow Jones Industrial Average. General Motors and Citigroup which were once leaders of their industries were reduced to wards of the State. General Motors went into bankruptcy and Citigroup was verging on bankruptcy. The two businesses survived due mainly to the 'too-big-to-let-fail' policies and billions of dollars of public bailout money. The contradiction is that State intervention in propping up business was something that was once the domain of the Communist Party. It seems ironic that the US government would even contemplate State ownership of enterprises since it has ridiculed such socialist doctrines in the past. The nationalisation of General Motors and the off-shoring of its jobs indicates that the US economy may experience long term unemployment through-out its recovery.

[15] O'Driscoll, G. (2011) Money, Inflation, and Rising World Commodity Prices, *The Freeman*, 28th February 2011. http://www.thefreemanonline.org/headline/money-inflation-and-rising-world-commodity-prices/

Brazil and South Korea, took steps to keep their currencies weaker to counter the US dollar devaluation. IMF chief, Strauss-Kahn said: 'The truth is that many countries use currencies as a political weapon. That is a real danger, as it threatens the recovery of the global economy'[16]. Arguably, those countries were just protecting their own interests in response to the unprecedented expansion of the US monetary base but it contributed to extra volatility in currency values.

The various stimulus packages initiated by governments the world over following the 2008 crisis were implemented after the damage to the global economy had already been done. What is rightfully needed is a pro-active stance, where important trends and potential problems are identified years in advance and acted upon in a timely constructive manner. Corrective decisions that are left to the last minute have a tendency to be knee-jerk reactions rather than well thought out solutions. The political debate that surrounded the US bailout program never focused on banking supervision or how this might most effectively be done, but rather it revolved primarily around what fiscal measures could be hastily implemented to avoid further economic calamity. Although the GFC drew attention to the systemic risks associated with capital adequacy requirements of major banks and the domino model of contagion, it did not identify an underlying mechanism which endogenously leads to financial stability. The volatility of global markets in August 2011 bore testimony that nothing had changed since the GFC.

[16] Strauss-Kahn, D. (2010) Interview with Stern Magazine, 18th November, 2010. Available at: http://www.imf.org/external/np/vc/2010/111810.htm

The International Centre for Monetary and Banking Studies (ICMBS)[17] holds the view that macro-economic analysis and insight has been insufficiently applied to the design of financial regulation. The ICMBS says:

> The crisis which began in the US sub-prime mortgage market in early 2007… was not the first banking crisis. It was closer to the 100th. We can draw a few important implications from this observation. If an event with widespread and severe economic and social consequences keeps on repeating itself, the onus is surely on the authorities to change something. Chiding bankers is satisfying; but insufficient. When a regulatory mechanism has failed to mitigate boom/bust cycles, simply re-enforcing its basic structure is not likely to be a successful strategy[18].

9.2 Economic Strategies for a Global Economy

In an open letter dated 31st January 2011 to US Treasury Secretary Timothy Geithner, Secretary of State Hillary Clinton and Trade Ambassador Ron Kirk, 257 economists from around the world, including Joseph Stiglitz, Dani Rodrik, Arvind Subramanian and Ricardo Huasmann argued against provisions in trade treaties that could limit the use of capital controls. The letter read:

> … Given the severity of the global financial crisis and its aftermath, nations will need all the possible tools at their disposal to prevent and mitigate financial crises. While capital account regulations are no panacea, this new research points to an emerging consensus that capital management techniques should be included among the "carefully designed macro-prudential measures" supported by G-20 leaders at the Seoul Summit ...

[17] The International Centre for Monetary and Banking Studies is known for its contribution to theory and practice in the field of international banking and finance reforms. In association with Geneva's Graduate Institute of International Studies the ICMBS fosters exchange of views between the financial sector, central banks and academics on issues of common interest.

[18] Brunnermeier, M., Crockett, A., Goodhart, C., Persaud, A. and Shin, H. (2009) *The Fundamental Principles of Financial Regulation*, International Centre for Monetary and Banking Studies, Geneva, p vii.

> This letter is at odds with a longstanding project of major financial firms: to allow them to move money across borders with no muss or fuss ...
>
> Although the danger of destabilising 'hot money' inflows has been well recognised since the Asian crisis of 1997, the thrust of US policy has been to continue to push for more capital market liberalisation, particularly in emerging economies. Yet the evidence has continued to mount that a high level of international capital movements isn't merely a potential threat to developing markets, but to economic stability …[19]

The idea of improving regulation to suit the needs of a globalised economy have circulated for a number of years. The Organisation for Economic Co-operation and Development (OECD, 1995)[20] made recommendations for improving the quality of government regulation, proposing good regulation should: (i) serve clearly identified policy goals, and be effective in achieving those goals; (ii) have a sound legal and empirical basis; (iii) produce benefits that justify costs, consider the distribution of effects across society and take economic, environmental and social effects into account; (iv) minimise costs and market distortions; (v) promote innovation through market incentives and goal-based approaches; (vi) be clear, simple, and practical for users; (vii) be consistent with other regulations and policies; and (viii) be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels.

A decade later, the OECD (2005) published its *Guidelines for Regulatory Quality and Performance,* saying:

> The goal of regulatory reform is to improve national economies and enhance their ability to adapt to change. Better regulation and structural reforms are necessary

[19] Available at: http://www.ase.tufts.edu/gdae/policy_research/CapCtrlsLetter.pdf

[20] OECD (1995) *Recommendation of the Council on Improving the Quality of Government Regulation*, 9 March 1995 - C(95)21.

complements to sound fiscal and macroeconomic policies. Continual and far-reaching social, economic and technological changes require governments to consider the cumulative and inter-related impacts of regulatory regimes, to ensure that their regulatory structures and processes are relevant and robust, transparent, accountable and forward-looking. Regulatory reform is not a one-off effort but a dynamic, long-term, multi-disciplinary process[21].

With best intentions, the OECD sought commitment at the highest political level to an explicit whole-of-government policy for regulatory quality[22]. The concept was that regulatory policy should have clear objectives and frameworks for implementation to ensure that, if regulation is used, the economic, social and environmental benefits would justify the costs. Additionally, that the distributional effects should be considered and the net benefits maximised. Despite those best intentions however, since 2005 very few countries have embraced whole heartedly the recommendations of this worthwhile strategy. The OECD *Guidelines for Regulatory Quality and Performance* does nevertheless provide a viable framework that can be applied to regulating speculative capital flows. Specifically, the cost of implementing the new regulatory framework must not outweigh the benefits to be realised by the new controls.

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[21] OECD (2005) *Guidelines for Regulatory Quality and Performance*, p 1. Available at: http://www.oecd.org/dataoecd/24/6/34976533.pdf

[22] The OECD *Guidelines* recommended that governments: adopt broad programs of regulatory reform that establish clear objectives and frameworks for implementation; assess impacts and review regulations systematically to ensure that they meet their intended objectives efficiently and effectively in a changing and complex economic and social environment; ensure that regulations, regulatory institutions charged with implementation, and regulatory processes are transparent and non-discriminatory; review and strengthen where necessary the scope, effectiveness and enforcement of competition policy; design economic regulations in all sectors to stimulate competition and efficiency, and eliminate them except where clear evidence demonstrates that they are the best way to serve broad public interests; eliminate unnecessary regulatory barriers to trade and investment through continued liberalisation and enhance the consideration and better integration of market openness throughout the regulatory process, thus strengthening economic efficiency and competitiveness; identify important linkages with other policy objectives and develop policies to achieve those objectives in ways that support reform; and ensure that programs designed to ease the potential costs of regulatory reform are focused and transitional, which should facilitate, rather than delay, the process of adjustment*.

*OECD (2012) Recommendation of the Council on Regulatory Policy and Governance, 22 March 2012 - C(2012) 37.

9.3 Re-shaping the IMS

In order to approach the task of redesigning the IMS to suit the needs of the current epoch, it is important to understand the frame of reference from which to view the task and also to be aware of the extent to which the frame of reference is shared by competing States. In addition to economics, focus has to be drawn towards the general process of regulation or the control of interacting forces within a complex international legal system so that desired objectives can be met.

Barth, Caprio and Levine (2006) use the phrase 'bank regulation and supervision' to encompass a wide range of policies and enforcement procedures that apply specifically to the banking sector. They say: 'Regulation typically refers to the rules that govern the behaviour of banks, whereas supervision is the oversight that takes place to ensure that banks comply with those rules'[23].

Brunnermeier, Crockett, Goodhart, Persaud, and Shin (2009) state: 'Traditional economic theory suggests that there are three main purposes for financial regulation'. They list the following reasons:

1. To constrain the use of monopoly power and the prevention of serious distortions to competition and the maintenance of market integrity;
2. To protect the essential needs of ordinary people in cases where information is hard or costly to obtain, and mistakes could devastate welfare; and
3. Where there are sufficient externalities that the social, and overall, costs of market failure exceed both the private costs of failure and the extra costs of regulation[24].

[23] Barth, J., Caprio, G. and Levine, R. (2006) *Rethinking Bank Regulation: Till Angels Govern*, Cambridge University Press, New York, p 4.

[24] Brunnermeier, M., Crockett, A., Goodhart, C., Persaud, A. and Shin, H. (2009) *The Fundamental Principles of Financial Regulation*, International Centre for Monetary and Banking Studies, Geneva, p 2.

In part, all three purposes for financial regulation can apply to speculative capital flows. Regulation is necessary to prevent serious distortions and maintain market integrity; it is necessary to protect the essential needs of ordinary people where mistakes can devastate welfare; and it is necessary to regulate financial markets when externalities adversely affect social order. As was demonstrated by the *Balance of Payments Equation* and the *Mundell Fleming IS-LM-BP Model*, there are significant negative effects from the unregulated movement of speculative capital into and out of an economy. The market failure and subsequent social disruptions caused by SCF were clearly evident in Indonesia in 1997 when the rupiah collapsed resulting in economic decline, liquidation of 16 large private banks, lost savings, high unemployment and rising food prices. That in turn triggered civil unrest, riots and murders[25].

Brunnermeier *et al.* (2009) commenting on the evolution of financial regulation wrote:

> There are good reasons for such an incremental approach under normal circumstances. Like the common law, it builds on the accrued wisdom of generations. It is practicable, do-able and (generally) common-sensical. Yet it is possible for such an incremental, and generally reactive, process to migrate over time in wrong, or just inferior, directions. When a major crisis erupts, such as that which has roiled financial systems in the world since August 2007, there is both a case and an opportunity for revisiting the underlying principles of (financial) regulation to examine whether the existing system is appropriately designed. There is a general willingness now to question existing regulatory practices and to consider, without prejudice, a wide range of alternative proposals. Nothing at this juncture is too hallowed by tradition and usage to escape questioning and to be off-limits to reform[26].

[25] US Department of State (1999) *Indonesia Country Report on Human Rights Practices for 1998*, Bureau of Democracy, Human Rights, and Labour. Available at: http://www.fas.org/irp/world/indonesia/indonesia-1998.htm

[26] Brunnermeier, *et al.* (2009) *Supra*. p 1.

Lowenfeld (2002) noted that a State's domestic economic policies cannot: 'be separated from its international economic policies, including the balance of payments and the value of its currency'[27]. Lowenfeld's study suggested that in order to maintain financial stability countries must properly engage the dynamics of the global market when considering its regulatory objectives. But on examination of the facts, it becomes evident that there are numerous variables to consider, the least of which is cross-border co-operation between States and then to a much larger extent, the animal spirit and political force of the free market

Cohen[28] (2008) writing on the dynamics of power and rule setting in the international monetary system said major developments have led to a greater diffusion of power in monetary affairs, both among States and between States and social actors. He wrote:

> … the diffusion of power has been mainly in the dimension of autonomy, rather than influence, meaning that leadership in the system has been dispersed rather than relocated ~ a pattern of change in the geopolitics of finance that might be called leaderless diffusion. The pattern of leaderless diffusion, in turn, is generating greater ambiguity in prevailing governance structures[29].

The important point to consider is the desired objective of achieving financial stability within the IMS while simultaneously improving economic efficiency; those outcomes can only be realised if the present system is allowed to change. This would logically necessitate a leadership role for a supra-national entity to develop strategies and implement policies with universal application. Coupled with that, there needs to be a regulatory model that is acceptable for multiple States. A few well known models that satisfy and complement the

[27] Lowenfeld, A. (2002) The International Monetary System and the Erosion of Sovereignty, *Boston College International & Comparative Law Review*, Vol. 25, No. 2, at p 261.

[28] Louis G. Lancaster Professor of International Political Economy University of California.

[29] Cohen, B.J. (2008) *The International Monetary System: Diffusion and Ambiguity*, UC Santa Barbara, Global and International Studies. Available at: http://www.escholarship.org/uc/item/97r5n8jx

criteria outlined in the OECD (2005) *Guidelines for Regulatory Quality and Performance* are examined below; namely: Ian Ayres' and John Braithwaite's *Regulatory Pyramid* [30] plus Stuart Umpleby's application of *Requisite Variety*[31]. Anne-Marie Slaughter's regulatory model of a *New World Order* [32] is presented in Chapter 10.

The three models were chosen because those authors had applied their concept to regulating the international monetary system before the panic of the GFC set in when everyone else joined the debate. Not only were they leaders in this particular area of regulatory reform, their models present novel concepts and demonstrate creative thinking not commonly applied to the rigid framework of international finance.

9.4 A Regulatory Model

John Braithwaite[33] has written extensively on the subject of regulation[34] and in conjunction with Ian Ayres developed a model of a regulatory pyramid with the hypothesis that it is normally best to start with less interventionist policies at the base of the pyramid and only

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[30] Ayres, I. and Braithwaite, J. (1997) *Responsive Regulation: Transcending The Deregulation Debate*, Oxford University Press, Oxford, UK.

[31] Umpleby, S.(1990) Strategies for Regulating the Global Economy, *Cybernetics and Systems*, Vol. 21, No. 1, p 99-108.

Umpleby, S. (2001) What Comes after Second Order Cybernetics?, *Cybernetics and Human Knowing*, Vol. 8, No. 3, p 87-89.

[32] Slaughter, A-M. (2004) *A New World Order*, Princeton University Press, New Jersey.

[33] Professor of Law at the Australian National University.

[34] Ayres, I. and Braithwaite, J. (1997) *Responsive Regulation: Transcending The Deregulation Debate*, Oxford University Press, Oxford, UK.

Braithwaite, J. and Drahos, P. (2000) *Global Business Regulation*, Cambridge University Press, UK.

Braithwaite, J. (2002) *Restorative Justice and Responsive Regulation*, Oxford University Press, New York.

move up to more interventionist strategies when those lower in the pyramid fail. My interpretation of their pyramid is presented in Figure 9.2.

Figure 9.2 Braithwaite – Ayres Regulatory Pyramid

Command and Control	Incompetent or Irrational Actors require the harshest penalties
Impose penalties	Regulators should be willing to escalate to more punitive options if there is no compliance. Rational Actors will weigh the cost of non-compliance with their bottom line profitability. Enforcement is a deterrent
Self-regulation	Most individuals and corporate entities comply with the law and are considered Virtuous Actors. They rely on Self-regulation via moral obligations or Codes of Conduct. The meta-regulatory approach emphasises systemic learning and self-regulation ~ it is the least expensive and requires the least amount of supervision

Ayres and Braithwaite (1997) attempted to resolve the stalemate between those who favour strong State regulation of business and those who advocated deregulation. They suggest:

> Good policy analysis is not about choosing between the free market and government regulation. Nor is it simply deciding what the law should proscribe. If we accept that sound policy analysis is about understanding private regulation ~ by industry associations, by firms, by peers, and by individual consciences ~ and how it is interdependent with State regulation, then interesting possibilities open up to steer the mix of private and public regulation. It is this mix, this interplay, that works to assist or impede solution of the policy problem[35].

[35] Ayres, I. and Braithwaite, J. (1997) *Responsive Regulation: Transcending The Deregulation Debate*, Oxford University Press, Oxford, UK, p 3.

They argued that by working more creatively with the interplay between private and public regulation, government and citizens could design better policy solutions. They discussed the idea of 'responsive regulation' as distinguished from other strategies of market governance by what triggers the regulatory response and what the regulatory response should be. They suggested that regulation should be responsive to industry structure in that different structures will be conducive to different degrees and forms of regulation. They continue:

> Government should be attuned to the differing motivations of regulated actors. Efficacious regulation should speak to diverse objectives of regulated firms, industry associations, and individuals within them. Regulations themselves can affect structure and can affect motivations of the regulated ... regulation should respond to industry conduct ...[36]

Ayres and Braithwaite (1997) contend that the achievement of regulatory objectives is more 'likely when agencies display both a hierarchy of sanctions and a hierarchy of regulatory strategies of varying degrees of interventionism'. The enforcement pyramid proposes a range of interventions of ever-increasing intrusiveness at each level of non-compliance. They argue that the greater the height on the pyramid for disobedience, the tougher the penalties should be. And that to make regulation effective, the tougher the enforcement provisions need to be. They say: 'Regulatory agencies will be able to speak more softly when they are perceived as carrying big sticks'[37].

It is suggested that regulators should take action as a response to the changing degrees of disruption or disobedience. The basic idea of responsive regulation is that authorities need to

[36] *Ibid*. p 4.

[37] *Ibid*. p 6.

monitor the conduct of those they seek to regulate and determine whether a more or less interventionist response is needed. Braithwaite says there: 'is a kind of a see-sawing back and forth between an approach to regulation that is based on persuasion and self-regulation and one that is based on rules and enforcement'[38]. He recommends that regulators ought to focus both on how to integrate persuasion-oriented regulation as well as on how to implement enforcement-oriented regulation. In this respect the regulatory pyramid allows the regulator to escalate to the tough penalties at the top, but in effect, it is pushing regulation down to the base of the pyramid.

The regulator could impose financial penalties either by reducing earning potential until the problem is fixed or by imposing fines. If the non-complying entity was restricted from the market until they rectified the problem, this would deprive them of revenue but it would not deplete their resources. It would also encourage the entity to rectify the problem as quickly as possible so that it could re-enter the market. However, if a fine was imposed, it would immediately reduce resources and therefore make the non-complier worse off; but it would not necessarily speed up the rectification process.

Take it as a condition of human nature to find the easiest solution, but Braithwaite suggests regulators would prefer to have a form of escalation that involves implementing internal controls as opposed to going as far as corporate capital punishment. He introduces the idea of meta-regulation; a term he describes as 'regulated self-regulation' within an organisation at the base of the pyramid where entities effectively regulate themselves.

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[38] Braithwaite, J. (2004) *Health System Regulation and Governance*, Chief Health Officer Seminar Series, 23rd June 2004. Available at :

http://healthstewardship.anu.edu.au/_documents/Chief_Health_Officer_Seminar_Series/2004/Braithwaite_trans.pdf

Because most corporate entities comply with the law, 'virtuous actors' require the least amount of supervision; hence it is the cheapest form of regulation. Using meta-regulatory strategies, an outside regulator can check that the internal self-regulation process is done properly. But where self-regulation fails, the regulator should be compelled to move towards the command and control mode at the peak of the enforcement pyramid.

Evidence suggests that there are some problems that are best dealt with by simple command and control models. Braithwaite cites an example in occupational health and safety in putting fencing around dangerous machinery in factories. He says: 'There's a century and a half of experience that shows it works. If you impose fines on companies that fail to fence dangerous machinery you will reduce accidents'[39].

A simple command and control system will work in a case of fencing off factory machinery because we are not dealing with a complex question. However, that is not the case with regulating the IMS. The trouble with command and control regulation is that it presumes legislators and regulators know the best way to solve difficult problems. Consequently, the State may prescribe un-tested remedies on the free market that may have little or even a negative effect; or alternatively, legislators might even turn a blind eye to the problem altogether. It is when complex technological systems are in a state of flux, that regulators need to co-operate with industry management more often to creatively devise new solutions. This, Braithwaite argues, is why policy makers should be taking meta-regulation more seriously[40].

[39] Braithwaite, J. (2004) *op. cit*., p 4.

[40] Braithwaite, J. (2004) *op. cit*., p 6.

Regulatory reform strategies increasingly focus on controlling the process of regulation rather than directly regulating social and individual actions. The idea of 'meta-regulation' has political implications in that it is characterised as an instance of non-judicial legality, situated at the intersection of two trends ~ the increasing legalisation of politics and a growing reliance on non-judicial mechanisms of accountability[41]. In effect it is an economisation of regulatory processes that subsequently lowers the quality of supervision.

A perspective put forward by Barth *et al* (2006) is that 'there is a risk that policies developed by official supervisors will unduly emphasise and empower official supervision. Too much trust may be accorded to government officials and too little attention devoted to the potential abuse of this trust or to inefficiencies introduced by excessive reliance on supervision'[42].

The regulatory policy guidelines contained in the OECD *Guidelines for Regulatory Quality and Performance* have led to the development of explicit strategies aimed at improving the quality of regulation through either a mix of deregulation, better quality regulation and new or improved institutions but specific areas of financial regulation required to improve efficiency in the global economy remain unco-ordinated between States.

On the matter of cross-border speculative capital flows, there are some things that are so vital to the global economy that they simply cannot be left to the free market meta-regulation or to local domestic regulators. In some situations, no amount of regulation will be sufficient.

[41] Morgan, B. (2003) The Economization of Politics: Meta-Regulation as a Form of Non-judicial Legality, *Oxford Journal of Social & Legal Studies*, Vol. 12, No. 4, p 489-523.

[42] Barth, J., Caprio, G. and Levine, R. (2006) *Rethinking Bank Regulation: Till Angels Govern*, Cambridge University Press, New York, p 5.

Irrespective of whether Briathwaite's Pyramid is used or whether the OECD's *Guidelines* are followed, with SCF, some form of market control would be needed which ranges from the domestic level through to the international level. So is it possible that an over-arching regulator positioned at the international level, will be capable of monitoring and policing private entities at the domestic level? If it were possible, how efficient would that process be, and could there be issues concerning moral hazards where some market participants are unfairly penalised while others slip through the regulatory radar? A regulatory model that spans the global market would require substantial compliance and reporting measures performed by market participants. Not only must market participants incur additional reporting costs, the international regulator would have to clarify the accuracy of the information and be able to impose penalties when market participants failed to fulfil their duties. Both regulator and the regulated incur costs; so from the outset, it is not likely to be a cost effective outcome.

Additionally, as Bakan (2005) points out, corporate entities have a tendency to by-pass costly compliance procedures whenever possible in order to maximise profits[43]. Corporate compliance might not be as accurate as the regulatory supervisor would envision, so additional costs are incurred to police the system. The conclusion to draw from this is that this type of regulatory model simply becomes too cumbersome and expensive to implement. So what sort of regulatory model would work for SCF?

[43] Bakan, J (2005) *The Corporation: the pathological pursuit of profit and power*, Free Press, New York.

9.5 Regulating the International Monetary System

The International Centre for Monetary and Banking Studies recognises that:

> There is a vast body of financial regulation in existence. This is normally extended incrementally [and] frequently to close a loophole which some earlier fraud or financial disaster had exposed … such measures … involve a discrete jump in the regulatory process, … the passage of the Basel I Accord in 1988, turn[s] out, after closer inspection, to have been largely an attempt to agree on, and to harmonise, pre-existing 'best practices' in the key nation States, without much overt attempt to rationalise them against fundamental principles, or underlying theory[44].

The original Basel Capital Accord classified various risk assets held by banks but did not introduce any rules with respect to SCF. Similarly, Basel II and III expanded the original rules by re-defining the grades of riskiness of assets but it did not address financial stability issues relating to SCF either. If the evidence points squarely at SCF as being a major source of financial instability, then one would imagine that that area of global financial management should attract substantial attention at the official level, but to-date that has not been the case.

Cohen (2008) says rule setting in monetary relations increasingly relies not on negotiations among a few powerful States, but rather on the evolution of custom and usage among growing numbers of autonomous agents which impact on governance structures at both the State and global levels. He wrote:

> At the State level, the dispersion of power compels governments to rethink their commitment to national monetary sovereignty. At the systemic level, it compounds the difficulties of bargaining on monetary issues. More and more, formal rules are being superseded by informal norms that emerge, like common law, not from legislation or statutes but from everyday conduct and social convention[45].

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[44] Brunnermeier, *et al.* (2009) Supra, p 1.

[45] Cohen, B.J. (2008) *The International Monetary System: Diffusion and Ambiguity*, UC Santa Barbara, Global and International Studies, p 2.

He reasons:

> Since States remain the basic unit of world politics, responsibility continues to reside with governments, which have little choice but to try to resolve their differences through negotiation. What is needed … is a change of bargaining strategy to conform more comfortably to the new distribution of power. With autonomy spread more widely among actors, it is becoming increasingly fruitless to aim for specific prescriptions for behaviour … Even the most insular governments are apt to recognise that there is a common interest in keeping potential externalities within bounds. If prevailing governance structures are to retain any practical influence at all, that is the direction in which the dynamics of rule setting must now move[46].

Lowenfeld (2002) does not condemn the erosion of sovereignty, but pointed out several years before the GFC even occurred that neither the member States nor the IMF had come up with a new theory to reflect the reality of a changing world economy[47]. No matter which area of international monetary affairs we examine, it could be considered that the method and scope of financial regulation has been lagging market forces at all levels. However, in the wake of the GFC and changing economic positions in global finance, a new boundary could be set between national and international concerns.

The International Centre for Monetary and Banking Studies says: '…there is a tendency, commonly observed amongst politicians, to review the structure of the regulatory system before considering the potential instruments to achieve better regulatory control'[48]. It could be argued that concentrating on increasing regulatory aspects of the IMS diverts attention

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[46] *Ibid*, p 29.

[47] Lowenfeld, A. (2002) The International Monetary System and the Erosion of Sovereignty, *Boston College International & Comparative Law Review*, Vol. 25, No. 2, p 252 – 275.

[48] Brunnermeier, M. *et al*. (2009) *Supra*, p ix.

away from the simplest solution. Focussing on increased regulation means that bureaucracy is increased along with all the inefficiencies that accompany State intervention. By shifting the thought process towards the instruments that will alleviate the problem at its root cause, we eliminate the need for long-term intervention and thus we also preserve scarce resources. And as Winston Churchill suggested: 'If you have ten thousand regulations, you destroy all respect for the law'[49]. Hence too much regulation undermines the value of law and to ensure that there is sufficient law without compromising the value of law, laws should be sparsely applied. Too much law confuses legislators and regulators alike. How then is it possible for private actors to be conversant with the law when even legislators and regulators do not know or understand what they are supervising?

The general belief for solving systemic risk within the banking and financial sector is to prevent potential crises by ensuring capital adequacy requirements are increased and that financial institutions monitor their activities in accordance with world's best practices[50]. Such a method adopts a bottom–up approach whereas what might alternatively be argued, is that a top-down approach would be more effective. That is, a command and control system would allow for more stringent management of institutions, provided of course, that the would-be-regulator did not grow complacent in its duties nor fail to strictly monitor financial intermediary activity. In either case, transparency, accountability and monitoring costs would be an expense that both regulator and institutions would have to bear. Again, the complexity of devising and implementing this prescriptive approach, would have significant costs and

[49] Quoted in: Jay, A. (ed.) (1996) *Oxford Dictionary of Political Quotations*, Oxford University Press, UK, p 94.

[50] See for instance, the Basel Committee on Banking Supervision *Core Principles for Effective Banking Supervision* and the *Concordat on Cross-border Banking Supervision*. See also, Basel III ~ Capital Adequacy Requirements; Acharya, V. and Richardson, M. (eds.) (2009) *Restoring Financial Stability: How to Repair a Failed System*, John Wiley & Sons, New Jersey; Tarullo, D. (2008) *Banking on Basel: The Future of International Financial Regulation*, Peterson Institute for International Economics, Washington.

there is still no guarantee that market participants and regulators will adequately or honestly perform or fulfil all their duties[51].

Evelyn de Rothschild (2009) expressed his concerns relating to some solutions being proposed about the future of financial reforms by saying:

> Personally I think that it is very dangerous for these remarks to be made now about a centralised regulating system and that the Fed here in America should take over the whole thing and become the chief regulator ... isn't it better to think it out carefully ... I think a lot of people would be frightened further if they thought that the regulators were not competent and not able to do their jobs[52].

Given the long track record of financial and economic mismanagement stemming from the US, is it likely that many sovereign States would support moves that further promote US institutions into regulatory leadership roles within the global economy? What is obvious though, is the fact that there is no decisive leadership within the IMS. Given the passive nature of the IMF to initiate reforms, it cannot be considered an effective leader. Nor is there any other entity with significant authority to implement international stability reform programs; the Bank for International Settlements has the credentials but it has not been given the authority. At present there is no regulatory supervisor which could monitor and police market participants on a global scale. Hence, the logical and cheapest thing to do would be to dispense with that necessity and follow Winston Churchill's advice; keep regulation to a minimum!

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[51] The present arrangements were incapable of detecting Bernard Madoff's thirty year US$50 billion fraud.

[52] de Rothschild, E. (2009) Interview with Maria Bartiromo of CNBC at the Clinton Global Initiative on the Future of Financial Reform, New York, 23rd September 2009.

Contemplating the cost and negative impact of repeated crises in the IMS, it becomes apparent that regulatory reform and financial stability are prerequisite to reducing economic losses. Applying Churchill's wisdom to SCF, the aim of legislators should be to moderate the recurring cycle of financial crises by pursuing strategies that eliminate financial instability at its root cause. But that does not mean that an over-arching regulatory supervisor needs to monitor and police market participants on a global scale. It could mean legislators and prudential supervisors could become more pro-active and examine their own internal performance first. The cheapest method of global financial regulation would be to dispense with the need for a higher over-arching entity to monitor and police transaction activities of millions of market participants. Removing these un-necessary costs from the financial equation would have positive effects and equate to higher utility to the wider economy. The key purpose of financial supervision should be to alleviate the social costs of market failure by removing the reasons why SCF occur in the first place. That is, minimise the volatility and differentials between currency values so that arbitrage opportunities no longer become necessary, profitable or viable ~ just like the European Parliament and the European Central Bank did with *Euroization*[53] in 2001.

Problems caused by speculative capital flows could be solved merely by the fact that a single entity consisting of a conglomeration of all central banks administers the international monetary system in a manner that eliminates currency differentials. Thus the onus of

[53] From 1999 to 2002 when the infant euro co-existed with the national currencies that operated within the EMU, the period of dual currency allowed some arbitrage opportunities to be exploited whenever the national currencies fluctuated away from the euro. During the transition period, the national central banks faced constraints and private speculators enjoyed opportunities very similar to those associated with conventional fixed exchange rate regimes. At the same time, commercial banks were free to denominate assets and liabilities in the new unit of account and the old currency unit. These contracts were the vehicles for profitable speculation. A relatively simple but unconventional policy initiative of *Euroization* reduced the vulnerability of currency boards and the transitional arrangements to speculative attacks. The European Parliament and the ECB achieved a credible result not to debase the new currency by enforcing the complete linking of banks' assets and liabilities to the euro, discouraging the use of national currencies as a unit of account for banks, which thus eliminated conversion risk during the transition.

protecting the public good of financial stability and currency values is on the government entities that provide liquidity to the global economy and not on the institutions or market participants whose activity is proven to undermine that stability. The *Euroization* strategy merely needs to be repeated.

Additionally, the structure of legislation should reflect the purposes and powers of the regulatory authorities. Macro-prudential and micro-prudential instruments are both needed, but differ in focus and in their complexity. Hence, prudential supervision should be carried out at both macro and micro levels, respectively by international bodies, central banks and by domestic financial service regulators. Inherently the degree of complexity is multiplied when specialty tasks are dispersed between micro and macro supervisors, hence the KIS principle[54] should be applied to financial regulation. In the case of SCF if government authorities were to minimise the variation in currency differentials, then there would be no need to regulate, supervise or monitor market participants with respect to cross border capital flows[55]. The most economically efficient out-come is achieved by focusing on the simplest solution. However, that responsibility is not shifted to market participants, but rather it rests squarely with legislators and prudential supervisors.

Dissimilar to the present arrangements in the US where the privately owned Federal Reserve controls market liquidity and profits from financial distortions, legislators need to question whether the responsibility of providing a stable medium of exchange to the global economy should be kept independent of private interests. As the 1907, 1929, 1987 and 2007 US bank induced credit squeezes have demonstrated, the supply of money to, and withdrawal of

[54] Keep it simple.

[55] United Nations Conference on Trade and Development (2011) *Trade and Development Report*, Chapter VI The Global Monetary Order and the International Trading System, UNCTAD/TDR/2011.

money from, an economy often succumbs to the frailties of human nature ~ and more so when it is subservient to profit-orientated corporations.

Repeated cycles of easy credit, monetary expansion, speculative bubbles and quick contractions have caused every major financial crisis. The contraction strategies result in reduced consumer spending, reduced market activity, lower employment, bankruptcy and widespread foreclosures among the general population while allowing the suppliers of credit to acquire substantial assets on the orchestrated misfortunes of common folk[56]. Surely by now it is apparent that the IMS must be protected from corporate predators and that the supply of money to the global economy must be strictly and scientifically controlled by national governments acting collectively.

Through international consensus, each nation should be able to maintain sovereignty over the issuance of currency within its jurisdiction even though the task of issuing its currency is organised by domestic prudential supervisors or central banks working closely together with other central banks at an international level. Hence the supply of money and financial stability is harnessed within the boundaries of political accountability even though that responsibility can be delegated to an autonomous conglomeration of government institutions.

[56] Goldman Sachs Group Inc., JP Morgan Chase & Co., Morgan Stanley, Citigroup Inc., Bank of America Corp., Wells Fargo Co., Merrill Lynch, Pierce, Fenner & Smith, Salomon Smith Barney Inc., UBS Warburg LLC, and US Bancorp Piper Jaffray Inc., all share ownership of the Federal Reserve (Barclays, a British bank, and USB, a Swiss bank, through their ownership of other US banks also share ownership). What is more interesting is the fact that they grew stronger through consolidation during the 2008 global financial crisis and represent the largest banks in America. There are six with market capitalisation above $1 trillion: Goldman Sachs Group Inc. (NYSE: GS), Morgan Stanley (NYSE: MS), JP Morgan Chase & Co. (NYSE: JPM), Citigroup Inc. (NYSE: C), Bank of America Corp. (NYSE: BAC) and Wells Fargo Co. (NYSE: WFC). The next largest bank with market capitalisation at about $300 billion is PNC Financial Services (NYSE: PNC). The six largest are at least three to four times the size of their nearest competitor. Their position of dominance is guaranteed because they hold a monopoly on the supply of money to the US economy. Clearly the golden rule applies; he who holds the gold makes the rules. Or in the American case, whoever controls the supply of credit at 33 Liberty Street, controls Wall Street and therefore the United States of America.

Regardless of whether the conglomeration of central banks form more currency unions, peg currency values to each other or adopts a single currency, it is still up to legislators to follow the advice of highly skilled prudential supervisors, implement their recommendations, adopt the controls supervisors see fit and fulfil the responsibility to which all legislators have been entrusted. Without the legislators' commitment to shoring up financial stability, nothing will change, and the world will continue to have financial crises indefinitely.

9.6 An Effective Model for Regulating the IMS

Umpleby[57] (1990) wrote about global financial regulation saying: 'A task as large as influencing the global economy requires that some thought be given to suitable strategies'[58]. He explains how: 'the science of cybernetics has identified four separate strategies for regulating complex systems composed of thinking participants'[59]. He proposed the use of history and science as an aid to thinking about the larger view thereby improving our sense of where we are, where we have been, and where we want to go. He says: 'Science … helps us to anticipate what actions may produce the results we desire'[60].

Umpleby's theory for global financial regulation is based on the *law of requisite variety* which was formulated by cybernetiçian William Ross Ashby in the early 1950s. Ashby's law states that in any regulatory process the variety in the regulator must be at least equal to, or greater than, the variety in the system being regulated[61]. In simple terms it means that the

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[57] Professor of Management Science at George Washington University.

[58] Umpleby, S. (1990) Strategies for Regulating the Global Economy, *International Journal of Cybernetics and Systems,* 21: 99-108, at p 99.

[59] *Id.*

[60] *Id.*

[61] Ashby, W.R. (1956) *An Introduction to Cybernetics*. John Wiley, New York.

level and depth of the regulator must match, if not exceed, the complexity and variety of the system being regulated ~ therefore, the controlling entity must be in a position to effectively communicate and exert influence over the entities being controlled.

Umpleby describes four strategies for amplifying regulatory capabilities, namely: 'one-to-one regulation of variety'; 'one-to-one regulation of disturbances'; 'ecological regulation' and; 'epistemological regulation'. He provides examples for each strategy to highlight the amplification process at each level of regulation. For the first strategy, 'one-to-one regulation of variety' he uses a football game where every player is matched with an opponent from the other team. The ratio of one-on-one is by far the most expensive form of regulation as it ties up manpower and adds to labour costs.

For the second strategy, 'one-to-one regulation of disturbances' he uses the example of crime control wherein the State's attempt to control crime is not necessarily focused on watching every move by every citizen, but rather by focusing on or pursuing only citizens who breach the laws. He says: 'In most cities around the world there are about two policemen for every thousand citizens'[62]. By relaxing the variety the authorities attempt to control ~ eg; from controlling all citizens to just the ones that break the law ~ an amplification of regulatory capability of a factor of about one to a thousand can be achieved. He says: 'By deciding to regulate less, we achieve more'[63].

Ashby, W.R. (1960) *Design for a Brain: The Origin of Adaptive Behaviour*, 2nd ed., Chapman and Hall, London.

[62] Umpleby, *op cit*. p101.

[63] *Id*.

The third strategy is 'ecological regulation'. His example is government regulation of industry whereby a government department controls the activities of people in business but only intervenes occasionally either to make adjustments in the laws or to enforce the provisions of business legislation ~ eg: outlawing price-fixing agreements or restraint of trade. Here the amplification ratio is increased one to six hundred thousand. Under this method of regulation, monitoring the system relies heavily on collected data provided by those who are governed and where enforcement of legislative provisions is usually only acted upon on receipt of a complaint or for public policy reasons. The scarce resources available to the regulator under this strategy sometimes means that only the complaints or cases that have the greatest public appeal, are newsworthy or set an example to the business community at large are acted upon. Under this strategy, the cost to society is minimised which is a plus, but the negative fall-out is that regulatory efficacy is reduced. It allows for breaches of legislative provisions to go unaddressed and forces complainants to launch their own civil litigation if the regulator lacks the resources, is too busy or unwilling to prosecute an offender.

The example for the fourth strategy, 'epistemological regulation', is the universal acceptance or implementation of an idea. Umpleby cites the change in world view that occurred in the early 1970s when humans stopped seeing the world primarily in terms of an ideological struggle with an associated military balance of power and instead focused on population, the environment and natural resources. He says: 'The fourth strategy entails not just an adjustment in the rules of the game but rather changing the game itself'[64] . To illustrate this conceptual shift, he recalls the first report by The Club of Rome[65] where approximately twelve people produced the report but it affected the lives of almost 4 billion people. By

[64] *Ibid*. p 102.

[65] Meadows, D. et al., (1972) *The Limits to Growth*, Universe Books, New York.

shifting away from institutions to concepts, it further amplifies regulatory capability by another factor of a thousand.

Umpleby says: 'These four strategies are recursive; that is, they can be used at any level of analysis, from managing our daily lives to attempting to influence the global economy'[66]. He emphasises that the different types of regulatory strategies can be used in combination with each other. He cites examples where ideals embodied within the civil rights movement and the environmental movement led to the creation of institutions which in turn promoted and enforced social justice. From ideas (the fourth strategy of changing the game) new institutions such as the US Food and Drug Administration, the US Environmental Protection Agency and the US Occupational Safety and Health Administration were created. The establishment of new institutions is an example of the third strategy 'institutional ecology', whereby a government department intervenes occasionally to control personal/market activities. As the new agencies carry out their mandate, they regulate deviant behaviour (the second strategy) to the point where eventually, private citizens see the results in their daily lives (the first level strategy).

At each stage in the process, requisite variety is controlled but not necessarily by the same people. One implication of this theory of regulation is that ideas can change society. However, ideas do not emerge from nowhere. 'Ideas are developed to deal with new problems or situations. Hence, there is a dialogue between ideas and society. Just as new ideas change society, changes in society lead to new ideas'[67]. To illustrate the fourth strategy of how the global economy has been shaped by ideas, Umpleby presents the following Table.

[66] Umpleby, *op cit*. p102.

[67] Umpleby, *op cit*. p102.

Table 9.1 The Interaction Between Ideas and Society

Ideas	Events
	1096 First Crusade
Interest in trade and in ancient learning	
	Marco Polo's trip to China
Science and technology stimulated by desire to improve trade	
	Traders accumulate wealth, nation-States develop and protect trade routes
The ideas of progress, people strive to produce more than mere subsistence	
	Industrial Revolution in England
Adam Smith's *Wealth of Nations*, 1776	
	Capital accumulation, urbanization, growing gap between rich and poor
Marx and Engles, *The Communist Manifesto*, 1848	
	Revolutions in Europe, demands for more equal distribution of wealth
Social reform movements in industrializing countries	
	World War I and Great Depression
Keynes's theory justifying government intervention in the economy	
	World War II, World Bank and IMF Established, decolonization of Third World
Friedman's monetary policy	
	Oil crisis in 1973 leads to abandonment of gold standard and fluctuating exchange rates
Environmental movement and futures research movement, many conferences on the "world problematique"	
	Economic progress in Asia, liberalization of communist regimes

Source: Umpleby, S. (1990) Strategies for Regulating the Global Economy

International Journal of Cybernetics and Systems, 21: 99-108, p 104.

Forgiving Umpleby's mistake about the 1973 oil crisis leading to the abandonment of the gold standard, (which happened in 1971 when Nixon closed the gold window), Tables 9.2 and 9.3 below expand upon his concept.

Table 9.2 Interaction Between Ideas and Events Leading to Improved IMS Regulation

Ideas	Events
	Vietnam War and over spending by US government depletes US gold reserves
Milton Friedman's theories on monetary policy shifts thinking	
	1971 abandonment of gold standard leads to floating exchange rate regimes, volatile currency movements and inflationary pressure ~These events diminish the role of IMF
Monetary stabilisation strategies are devised including: the snake, fixed peg, movable baskets, fully floating currencies and currency unions	
	Currency differentials create profit opportunities leading to the establishment of global currency markets
Competitive nature of international business demands advances in information technology	
	Creation of internet, electronic funds transfers, online trading and the surge in speculative capital movements compounds volatility in global financial markets
Push for freer open markets and trade liberalisation imbedded in US & IMF policies, Washington Consensus & WTO	
	Repeal of Glass Steagall Act & deregulation of financial markets increases hedge and sovereign wealth funds. Lack of reporting and bank accountability leads to 2008-9 Global Financial Crisis
Global financial regulation is scrutinized via interest groups, NGOs, international governments and G20 summits	
	Commitment to global financial stability becomes a priority. This leads to the adoption of strategies to implement reform in the IMS

Umpleby's theory of regulation can be applied to solving problems of financial stability directly related to speculative capital flows. Expanding Umpleby's Table allows us to identify our present position in history. We can see the interaction between ideas and events has positioned us at a time when there is broad commitment at an international level to prioritise financial stability. This presents a timely opportunity to devise new strategies and implement new reforms to improve the management of the global economy.

Table 9.3 Interaction Between Ideas and Events Leading to IMS Robust Stability

Ideas	Events
G20 Co-operation leads to agreement to reform certain aspects of the IMS	
	Financial Stability Board established to develop administrative protocols and make recommendations. IMF members voluntarily commit to policy adjustments for IMS stability.
Stronger regulatory requirements developed to ensure adequate collection of financial market information	
	Multilateral framework for capital flows established requiring States to more stringently police / restrict various capital flows
Emerging Market Economies seek greater influence in global monetary affairs allows for wider use of new SDR	
	Creation of more currency unions streamline data collection and improve efficiency in cross-border movement of labour and capital
Improved ideas and guidance to member States to limit currency volatility through adoption of global SDR	
	Creation of new global central bank leads to uniform adoption of version 3 SDR which helps align currency values of the major currency unions
Implementation of a unified international monetary and financial system	

By using the law of requisite variety as a foundation, we can review several possible courses of action to identify the most cost effective outcome. Taking advantage of historical lessons as well as scientific facts ~ ie data collection, statistical analysis and econometric modelling ~ prudential supervisors now have the power to re-conceptualise the system we are trying to fix.

9.7 Applying the Law of Requisite Variety to Regulating the IMS

Withstanding all the other possible solutions, the implication of the law of requisite variety is that whenever we are confronted with a situation that needs rectification, only one of two options may be used: either increase the variety in the regulator or reduce the variety in the system being regulated. The first impulse is usually to increase the variety in the regulator which is much easier to achieve within a domestic setting than it is in an international one[68]. Increasing the variety in the regulator has consequences though in that it increases the perceived prestige of the governing body, expands its bureaucratic power base and also substantially increases the cost of regulation (and therefore taxes). These matters may irritate market participants and lobby groups who oppose increased government spending or government intervention.

The second approach ~ reducing the variety in the system being regulated ~ also has its *pros et cons*. Just as an example: the introduction of the euro in 2002 reduced the variety in the European monetary system by eliminating thirteen currencies when the new notes and coins went into circulation. Since then, the European enlargement program has eliminated 4 more currencies and will eliminate another six when other applicant countries adopt the euro. Hence, the economic efficiency of a single European Central Bank is maximised because the regulatory efficacy in administering the continental monetary system is reduced to one central

[68] The development and delayed ratification of the draft *Articles* for the *Responsibility of States for Internationally Wrongful Acts* described in Chapter 7 attests to the long process of implementing treaties at the international level. Conditions of conflict and upheaval have a tendency to speed up the process of change.

governing body instead of 23 independent players. The drawback from such a process is that member States must relinquish their monetary sovereignty to an over-arching regulatory entity under which all participating States comply with a standardised monetary policy. Such a drawback limits member States from initiating their own strategic monetary policies and prevents their country from capitalising on that process. Such restrictions however do not mean that all States will comply by the rules[69].

Applying the law of requisite variety to the regulation of speculative capital flows, we must first estimate the size or complexity of the task to be performed and then devise strategies to achieve the desired outcome. Given the gravity of the problem of financial instability and the disruptive consequences of an unregulated IMS, it would not make sense to settle for anything less than optimal economic efficiency and regulatory efficacy.

As Umpleby noted:

> … the fourth strategy of regulation suggests, effective ideas sooner or later influence policy makers and the general public. However, the rate at which ideas are put into practice can be accelerated by paying attention to the basic cybernetic ideas of communication and control. That is, the new ideas need to be communicated to office holders and the public, and implementation needs to be monitored. From time to time, additional ideas and new means of implementation will need to be developed[70].

Such is the case with the present arrangements governing the IMS. The GFC convincingly exposed serious weaknesses within the existing system. This provoked accelerated

[69] The strict ECB framework did not prevent Greece's government from running a budget deficit in 2008-2009 which severely compromised the value of the euro and created turmoil in European bond markets. See: Attinasi, M-G., Checherita, C. and Nickel, C. (2009) *What explains the surge in euro area sovereign spreads during the financial crisis of 2007-09?* European Central Bank, Working Paper Series no 1131 / December 2009.

[70] Umpleby, S. (1990) Strategies for Regulating the Global Economy, *International Journal of Cybernetics and Systems,* 21: 99-108, p 107.

intervention by governments from all parts of the world, not only to implement domestic fiscal spending to stimulate economic activity, but also to meet and discuss with other nations suitable solutions that could prevent or minimise similar disruptions occurring in the future.

So what does Umpleby's theory of regulation suggest about how we should approach the modification of the global economy? Given the size of the system we are trying to influence and the inefficiencies of the current system, attention should probably focus on changing the rules of the game by either implementing new ideas and institutions (the fourth strategy) or on the existing institutions to improve present practises (the third strategy)[71]. Hence several activities would be useful to strengthen the foundations of the present global financial system.

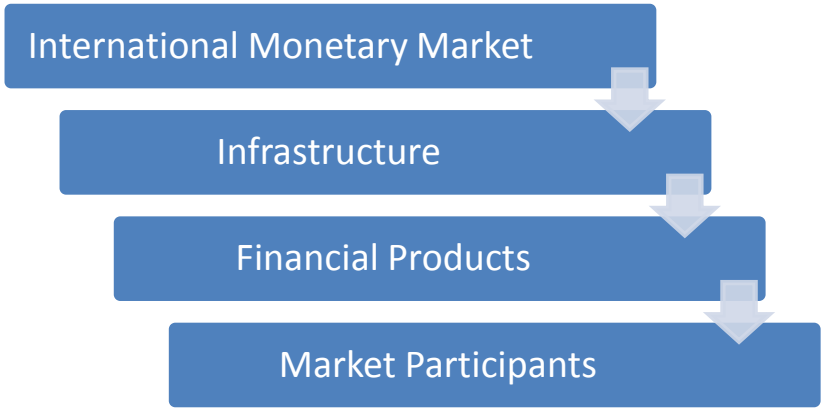
1. Develop new theoretical ideas about how to stabilise the value of major currencies. Consider cross-border equality, equity, efficiency, and sovereignty. Allow greater say for developing nations on international financial issues.
2. Collect and disseminate financial information between international organs, central banks and prudential regulators. Take advantage of innovations in information technology and statistical analysis. Share the results of research.
3. Devise new methods and tools to maintain fixed parity between major currencies. Allow smaller economies to lock into larger regional economies. Implement measures in accordance with new standards.
4. If necessary, create new supervisory bodies to co-ordinate, oversee and administer strategic policies.
5. Monitor the performance of new and existing institutions relative to the new framework.

[71] *Id.*

9.8 Applying Umpleby's Model to the Components of the IMM

Figure 9.3 below provides a schematic representation of the components which make up the international monetary market. The main components are: the infrastructure which facilitates the transaction process, the different financial products (namely spot, forward and futures contracts for currencies, commercial paper, treasury bonds, options and derivatives), and the participants which include institutional, wholesale, retail and professional investors.

Figure 9.3 Components of the International Monetary Market



9.9 The Infrastructure

The infrastructure for the forex market is divided into several different areas of operation and is illustrated in Figure 9.4 below. The following entities facilitate the functioning of the international monetary market: 1) national governments and prudential supervisors; 2) international administrative bodies involved in the collection of financial information and data analysis ~ ie: World Bank, IMF and BIS; 3) central banks ~ some of which actively participate in the forex market; 4) the private banking sector ~ representing approximately 80

percent of global foreign exchange trading; 5) the trading platforms[72]; 6) the exchange clearing houses; 7) the members of the exchange and approved merchants; 8) introducing brokers; 9) and finally, smaller market participants. Additionally, there are non-reporting entities such as hedge funds, private equity funds and sovereign wealth funds, located both within and outside of the banking sector, which to-date have escaped most regulatory controls; specifically in the US and to a lesser extent in the UK and Europe.

The trading platforms, central banks, private sector banks and clearing houses all interact with each other. Like the private banks, exchange clearing houses must settle their accounts daily and report end-of-day monetary flows to their respective national central bank. The central bank in turn generally pays interest on all monies held overnight and grants access to the banks and clearing houses to up-to-date information derived through the central bank's real time gross settlements network (RTGS). Thus the banks and trading platforms have access to relevant financial data which allows them to react promptly to ~ as much as possible ~ a fully informed market. Central banks also report to bodies such as the IMF and the BIS, thus the international data collection agencies have timely information compiled from daily national accounts.

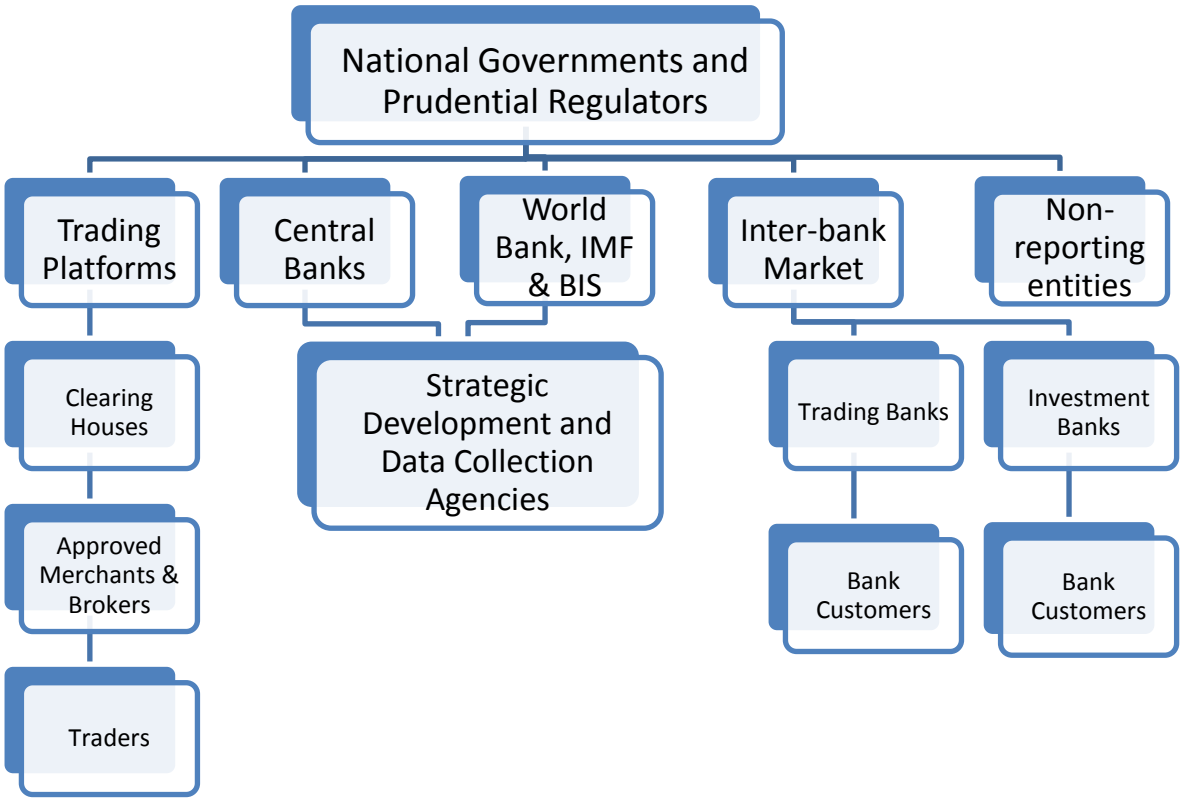
The international banking institutions, ie the World Bank, IMF and the BIS form part of the IMS infrastructure and are instrumental in facilitating the recording of financial information at the global level. These institutions also provide lines of credit for member States. BIS data collection sub-agencies[73] while not directly participating in the daily activities of the IMM,

[72] Deutsche Börse Eurex, Chicago Mercantile Exchange Globex and the New York Stock Exchange Euronext, through which over 89 percent of all forex activity passes to and from the global market.

[73] Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, the Committee on the Global Financial System, the Markets Committee, the Financial Stability Institute, the

play an indispensible role within the IMS in developing strategies and co-ordinating supervisory initiatives. The Financial Stability Board for instance has been authorised to develop administrative protocols and make recommendations to the G20. The Basel Committee on Banking Supervision was instrumental in developing the Basel Accords. Organisations like WTO, OECD, APEC, ASEAN, G7[74], G10 etc, being predominantly political forums, contribute little to the daily operations of the IMS; they have not been included in the schematic.

Figure 9.4 Infrastructure of the International Monetary Market



Financial Stability Board, the International Association of Deposit Insurers, the International Association of Insurance Supervisors and the Irving Fisher Committee on Central Bank Statistics.

[74] Canada, France, Germany, Italy, Japan, United Kingdom and the United States.

9.10 The Proposal

If we apply Umpleby's requisite variety to the above structure, it can be determined that there are seven focus points at which regulatory impact is maximised over the IMM; in order of influence those points being: national governments and prudential regulators; the international forum/ institutions; central banks; the inter-bank market; the trading platforms; the non-reporting entities such as hedge and sovereign wealth funds etc, and then smaller market participants. The implication of the law of requisite variety is that only one of two options may be used: either increase the variety in the regulator or reduce the variety in the system being regulated. As demonstrated by Braithwaite's pyramid, the first option (increasing the variety in the regulator) is more expensive to implement and will cost both industry and government alike. This leaves the more cost effective second option; to reduce the variety in the system being regulated.

As most central banks are already involved with reform programs such as the Basel III Accord, and the inter-bank market already complies to reasonably comprehensive prudential reporting standards (specifically within most advanced economies), it suggests that the next area for regulatory overhaul should be the trading platforms and the non-reporting entities. But that course of action would only be necessary if national governments failed in their duty to develop a stable international monetary system void of fluctuating currency differentials.

If the regulatory focus was shifted to the international banking institutions and central banks, instead of monitoring millions of market participants or a thousand private banks trading on hundreds of different platforms, the variety would be reduced to three international institutions (IMF, World Bank and BIS) and a hundred and eighty-five central banks. The best solution is to make those entities more sophisticated so that they can hold currency

values within specified bands. The answer is not to regulate the free market, but rather regulate central banks and make them conform to a new set of international monetary rules ~ ie: combine requisite variety's third and fourth strategy; change the rules of the game and focus on the existing institutions and improve present practises. This would strengthen the foundations of the present global financial systems while adopting new theoretical ideas about how to stabilise the value of major currencies. Cross-border equality, equity and efficiency could be improved. By taking advantage of innovations in information technology and statistical analysis, the collection and dissemination of financial information between international organs, central banks and prudential regulators would also facilitate greater understanding of the system being regulated. New supervisory bodies (the fourth strategy) like the Financial Stability Board could co-ordinate, oversee and administer strategic policies and also monitor the performance of existing institutions within the new framework.

9.11 Conclusion

The serendipitous discovery of this Chapter is that a reversion to a fixed peg currency system would reduce the variety in the system being regulated. By eliminating the ineffective social experiment of fully floating exchange rate values the global economy could become more efficient. But this time round, with the improvements of data management and co-ordinated efforts at the international level, it would no doubt be much more sophisticated than the old system. It could be a rule-based managed floating system[75] that is founded on adequate data collection, econometric modelling and inter-governmental co-operation. Like the EU when it locked in the currency values of member States participating in the EMU in the lead up to the introduction of the euro, similar measures could be expanded upon to suit the needs of the

[75] United Nations Conference on Trade and Development (2011) *Trade and Development Report*, Chapter VI The Global Monetary Order and the International Trading System, UNCTAD/TDR/2011.

IMS. It is a practical system that has already been developed, implemented and proven to work. All that is needed, is legislative consent to proceed with the initiative and expand the concept to the global economy. But more than anything, this is by far the biggest hurdle facing economic and financial stability; the willingness of political leaders to comprehend the gravity of the situation, reach agreement and say yes.

The next Chapter examines the current state of development in international financial regulation.

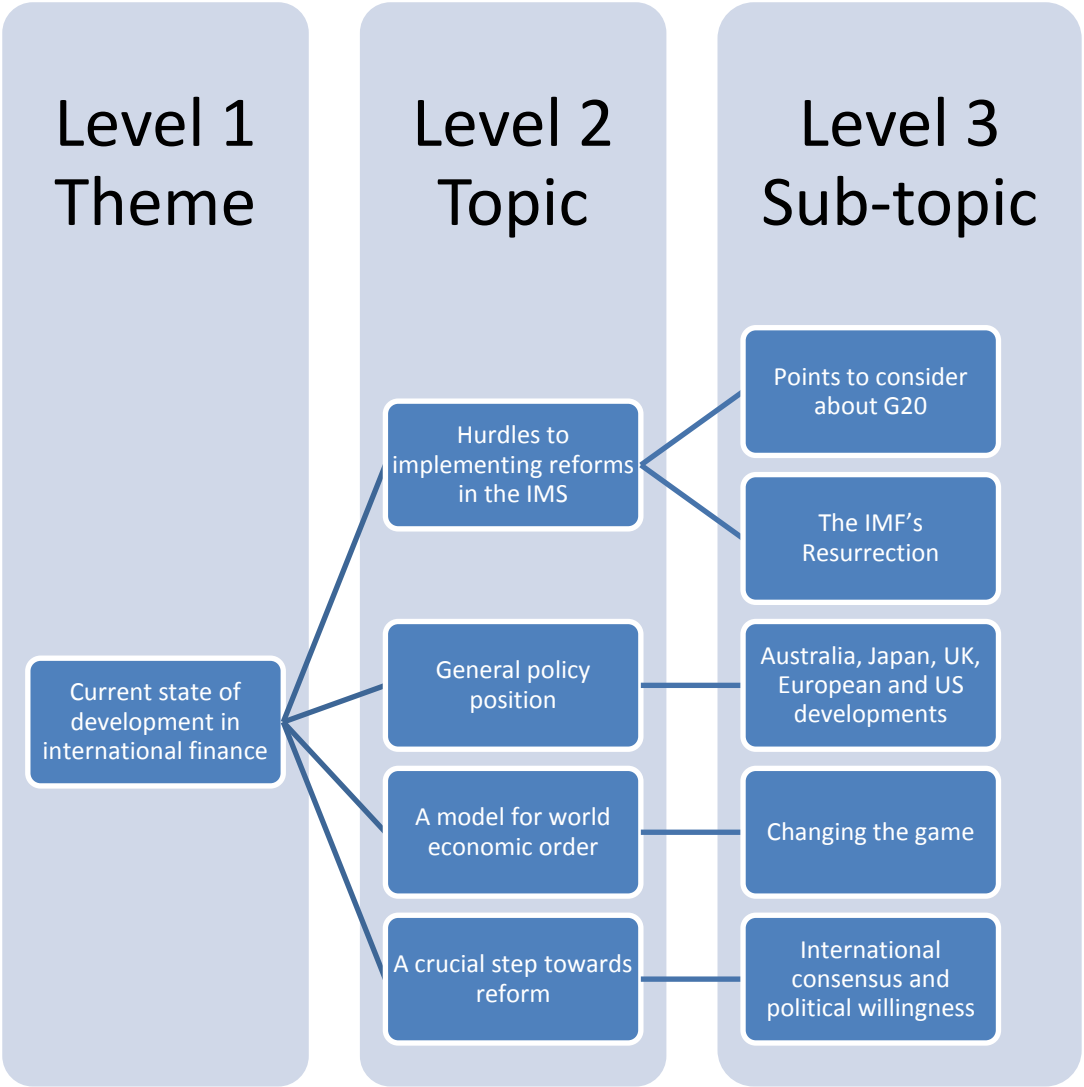
Summary of Chapter 9

This Chapter:

- discussed the rationale behind the need to supervise, monitor and police financial institutions that operate in the international monetary market
- examined strategies that could help regulate market participants in the IMS
- contemplated which regulatory model would deliver the most cost-effective efficient outcome to enhance regulation in financial markets
- reviewed Ayres and Braithwaite's *regulatory pyramid* to establish that regulating millions of market participants was the least efficient option
- applied Umpleby's third strategy of *Requisite Variety* to reveal that by shifting the focus to improving the efficacy of the existing regulatory institutions a more efficient outcome would be achieved
- used Umpleby's fourth strategy of *Requisite Variety* to focus on changing the rules of the game by implementing new ideas and/or creating new institutions to co-ordinate, oversee and administer strategic policies
- explained that if the regulatory bodies held currency values within specified bands or reduced the number of currencies in circulation, it would strengthen the foundations of the international monetary system

Chapter 10

An Analysis of the International Monetary System



Chapter 10

An Analysis of the International Monetary and Financial System

Chapter Abstract

With respect to the volatility of currency values, this Chapter examines possible hurdles to implementing new policies or strategies to reduce transaction costs and maximise efficiencies in the international monetary and financial system; hence it explains the position of the global economy and describes some of the actions currently being taken in response to the GFC to build a more stable IMS. But as it will be shown, reaching consensus at the international level is an awkward process. To demonstrate that reality this Chapter analyses post GFC Group of Twenty (G20) developments, the IMF's increased funding and modifications currently being made for the enhanced management of the IMS. It outlines moves towards creating a world economic order and focuses on the impact of recent reforms. It describes the general situation and then goes into further detail explaining the Swiss, Japanese, Australian, European, British and US positions and the steps those countries are taking towards implementing financial reform. Those countries were chosen, as explained in Chapter 4, because their currencies are the six most traded in the forex market and regulatory developments with respect to financial management in those countries would have a significant effect on stabilising currency values in the global arena.

The Chapter concludes that despite the realities of national interests dampening progress at the international level, the governments of the world must nevertheless reach a common vision for stabilising financial markets and perhaps create new rules and even new institutions and regulatory regimes to address the problem of volatile currencies. The Chapter

starts by examining what happened when the leaders of G20 met in London on 2nd April 2009 in the wake of the GFC. It demonstrates just how difficult it is to get countries to agree on policies that could possibly improve the management and stability of the IMS.

10.1 G20 under the microscope

At the 2009 Summit the G20 declared[1]:

> A global crisis requires a global solution … We start from the belief that prosperity is indivisible; that growth, to be sustained, has to be shared; and that our global plan for recovery must have at its heart the needs and jobs of hard-working families, not just in developed countries but in emerging markets and the poorest countries of the world too; and must reflect the interests, not just of today's population, but of future generations too. We believe that the only sure foundation for sustainable globalisation and rising prosperity for all is an open world economy based on market principles, effective regulation, and strong global institutions.
>
> We have today therefore pledged to do whatever is necessary to:
>
> - restore confidence, growth, and jobs;
> - repair the financial system to restore lending;
> - strengthen financial regulation to rebuild trust;
> - fund and reform our international financial institutions to overcome this crisis and prevent future ones;
> - promote global trade and investment and reject protectionism, to underpin prosperity; and
> - build an inclusive, green, and sustainable recovery.
>
> By acting together to fulfil these pledges we will bring the world economy out of recession and prevent a crisis like this from recurring in the future.
>
> The agreements we have reached today, to treble resources available to the IMF to $750 billion, to support a new SDR allocation of $250 billion, to support at least $100

[1] G20 Summit, Final Communiqué, *The Global Plan for Recovery and Reform*, 2nd April 2009, p 1. Available at: www.londonsummit.gov.uk/resources/en/PDF/final-communique

> billion of additional lending by the MDBs, to ensure $250 billion of support for trade finance, and to use the additional resources from agreed IMF gold sales for concessional finance for the poorest countries, constitute an additional $1.1 trillion programme of support to restore credit, growth and jobs in the world economy. Together with the measures we have each taken nationally, this constitutes a global plan for recovery on an unprecedented scale.

At face value the proposals outlined in the final communiqué of the G20 summit presented an image of unity and direction, however it was quite distant from reality. The leaders struggled to bridge the divide over how to revive the paralysed global economy. While they agreed to bail out developing countries, stimulate world trade and regulate financial firms more stringently, President Obama conceded that there were 'no guarantees' that those measures would restore a stable economy. At his press conference President Obama admitted that getting more than 20 countries to agree to common steps was particularly hard because 'each country has its own quirks'[2]. He continued: 'If there's just Roosevelt and Churchill sitting in a room with a brandy, that's an easier negotiation'. Nonetheless, he stated the meeting exemplified the power of developing nations, 'heralding a new age in which decisions about the future of the global economy would no longer be made by an elite club of Western powers that have set the global rules since Bretton Woods'[3].

Despite the content of the G20 Communiqué, disagreement between Europe and the US about extra fiscal spending and tighter regulation existed. A stubborn division between the EU and the US on the effectiveness of existing spending measures hindered progress on other important issues. Their disagreement focused on whether or not countries should commit to

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[2] President Obama's Post Summit Press Conference, 2nd April 2009, London.
Available at: YouTube http://www.youtube.com/watch?v=HaHaQ-d0T_8

[3] *Id.*

even greater fiscal stimuli than they had already enacted. France and Germany resisted US pressure, saying that their social safety nets already accomplished much of that goal. German Chancellor, Angela Merkel, fearing it could cause inflation with too much deficit spending made it clear that they were not going to give in on that issue. President Obama surrendered the point, 'agreeing to vague wording that allowed nations the leeway of promising to take whatever steps were necessary for sustained growth'[4]. No doubt, the cloud of blame hanging over the US for causing the economic meltdown is one reason President Obama faced reluctance among Europeans to follow his lead and pursue further fiscal stimulus plans. Logic would suggest that following the economic policies of the country that had largely caused the problem in the first place[5] might not be the most prudent step.

The stimulus spending debate was not the only area of fundamental disagreement. The Europeans came to the meeting stressing the need for comprehensive cross-border regulation of financial markets, participants and products. The Obama administration seemed more committed to domestic regulation than the previous Bush administration, but remained fiercely resistant to the idea of a global regulator. The European push for sweeping global regulation of financial markets ended in a stalemate. As mentioned in Chapter 7, the leaders agreed to create a new Financial Stability Board to monitor the financial system for signs of risks via transparency and early-warning systems, but the US stopped well short of giving regulators cross-border authority. Economist Simon Johnson from the Massachusetts Institute

[4] Lander, M. and Sanger, D. (2009) World Leaders Pledge $1.1 Trillion for Crisis, *New York Times*, 3rd April 2009, p A1.

[5] As explained previously in Chapter 5 section1, the January 2011 *Report* by the National Commission on the Causes of the Financial and Economic Crisis in the United States* confirmed, that the 2008 financial crisis was avoidable and widespread failures in financial regulation and supervision proved devastating to the stability of the global economy. * *The Financial Crisis Inquiry Report*, US Government Printing Office, Washington, DC.

of Technology, commenting on the outcome of the G20 summit said: 'The regulatory part was close to zero'[6].

While, the leaders agreed to the idea of co-ordinating domestic regulation of financial institutions, they did not agree on a mechanism to resolve cross-border disputes that might arise in the event of liquidating insolvent banks. If international banks such as Citigroup or the Royal Bank of Scotland did not improve their balance sheets, the possibility of cross-border insolvency might have forced participants to reconsider their position and submit to the European proposal. Nonetheless, both banks stayed afloat after the injection of billions from their respective governments[7].

The G20 leaders agreed that major failures in the financial sector and in financial regulation and supervision were fundamental causes for the crisis and that confidence could not be restored until trust was returned to the system. Therefore, much work is needed to build a stronger, more globally consistent, supervisory and regulatory framework. Not only do governments need to ensure that domestic regulatory systems are strong, but there must be greater consistency and systematic co-operation between States. The G20 communiqué stated:

> Strengthened regulation and supervision must promote propriety, integrity and transparency; guard against risk across the financial system; dampen rather than amplify the financial and economic cycle; reduce reliance on inappropriately risky sources of financing; and discourage excessive risk-taking. Regulators and supervisors must protect consumers and investors, support market discipline, avoid

[6] Lander, M. and Sanger, D. (2009) World Leaders Pledge $1.1 Trillion for Crisis, *New York Times*, 3rd April 2009, p A1.

[7] The US government rescued Citigroup by entering an agreement to guarantee up to $306 billion in problematic assets and inject $20 billion in capital to restore confidence in the bank. The British government bought into Royal Bank of Scotland Group as part of its bail-out package for £45.5 billion.

adverse impacts on other countries, reduce the scope for regulatory arbitrage, support competition and dynamism, and keep pace with innovation in the marketplace[8].

The G20 strategies and objectives were logically defined and if acted upon should result in enhanced financial stability. However, progress depends on whether or not the leaders of the world will pro-actively commit their efforts to achieving those goals. The G20 leaders/delegates must take that message home and ensure their central banks and prudential supervisors fulfil extra obligations to the global community. But that would entail enacting legislation at the domestic level in order to comply with a new set of rules being devised by a supra-national entity. That idea, in turn, may be opposed because it could be perceived by some as an erosion of State sovereignty.

Reporting to the new Financial Stability Board and following its directives is not necessarily a relinquishment of monetary sovereignty, if anything, it is a re-assertion of monetary sovereignty in that each country actively participates at the international level to maintain the value of its own currency in relation to all other currencies. To achieve that outcome, it should not be done by the obsolete method of central banks buying and selling their own currency in the open market, but rather by a new method where central banks irrevocably link the value of their currency to a new global standard and maintain the stability of the system by ensuring governments comply with a new framework of worlds' best practice for currency management via sophisticated monetary policy, fiscal spending and taxation. Arguably, if governments do not co-operate to achieve that goal, then there will never be financial stability at either the domestic or international level; hence the solution rests with government, therefore legislators must act accordingly to devise and implement a new economic order.

[8] G20 Summit, Final Communiqué, *The Global Plan for Recovery and Reform*, 2nd April 2009, p 3. Available at: www.londonsummit.gov.uk/resources/en/PDF/final-communique

10.2 Other Points to Consider about G20

A major finding of this thesis is that maintaining consistent currency values is a key factor to enhancing global financial stability, consequently and arguably, efforts should be made to bring that objective to fruition. The important thing to realise here is, the Bank for International Settlements and the Basel Committee on Banking Supervision had already been working towards those objectives since the mid 1990s. Those institutions had identified the weaknesses in the IMS and were working on ideas towards fixing the problem but with limited success. Getting national governments to commit to reform has been a drawback. But strategically the BIS institutions are ideally positioned to implement such reforms and assume the leadership role in this area of global financial regulation if given the go-ahead. It was an area of practice where the IMF had been seriously out of touch with market trends.

However the position of the IMF as the global central bank ~ be it acting largely in accordance with US policy ~ gives the Bretton Woods Institution an eminent role in global finance, but it does not guarantee that there will not be alternative competing forces working to by-pass or supersede it; for instance, BRIC countries contemplated the idea of an alternative institution prior to the London G20 Summit. Peoples' Bank of China Chairman Zhou Xiaochuan proposed a major reform to the IMS expressing his concerns that: 'an international reserve currency should first be anchored to a stable benchmark and issued according to a clear set of rules'[9]. Similarly the European Commission proposed creating a European Monetary Fund to help manage sovereign defaults within the EMU[10]. Sidelining the alternative options for solving stability problems for the moment, what is apparent is the

[9] Xiaochuan, Z. (2009) *Reform the International Monetary System*, Press release, Peoples' Bank of China, 23rd March 2009. Available at: http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178

[10] Brunsden, J. and Taylor, S. (2010) Commission backs European Monetary Fund, *European Voice*. Available at: http://www.europeanvoice.com/article/2010/03/commission-backs-european-monetary-fund-/67349.aspx

fact that the IMF ~ specifically the US ~ is losing its monopolistic grip over control of the global financial system.

Remembering that all money is based on the issuance of credit, whoever is in the position to grant or deny lines of credit has the ability to shape the economic future of the world. Knowing that basic monetary premiss, we can understand why the US pushed so hard to secure the position of the IMF at the London G20 Summit.

10.3 The IMF's Resurrection

One of the most important matters to arise at the London Summit was the commitment by the G20 to substantially increase the funding to the IMF. US Treasury Secretary Geithner, led the push to strengthen the capital base of the Fund. The US proposal to treble resources available to the IMF to $750 billion and support a new Special Drawing Rights (SDR) allocation of $250 billion, plus other funding initiatives, substantially increased the financial standing and importance of the IMF which had suffered from years of waning relevance[11].

The agreement to increase the resources available to the IMF allowed for expanded and more flexible borrowing arrangements for qualified members. Noting the similarity with the older mechanism of SDR, the new Flexible Credit Line (FCL) and its reformed lending and conditionality framework enables the IMF to provide another line of credit to countries facing balance of payments needs. In terms of journal entries, the sum of these measures provided an additional $1.1 trillion to the global economy, but in terms of fractional lending, it equated

[11] Since the abandonment of the gold standard, the IMF's role had significantly changed to that of the official bookkeeper of international banking and debt. It had also long been accused of doing too little, too late, in support of funding poor and developing economies. Internal audits within the IMF revealed the pressing need to improve effectiveness and accountability. Cf: IMF Independent Evaluation Office (2008) *Aspects of IMF Corporate Governance Including the Role of the Executive Board*, IMF Internal Audit Report, April 2008.

to a credit line of many trillions more. It was expected countries facing financial difficulties would draw against this fund to provide for domestic spending programs to counter balance the effects of the GFC.

The push by Geithner to re-assert the influence of the IMF appeared to diminish some of the criticisms the Fund had faced over the years with its infamous Structural Adjustment Programs and the much talked about Washington Consensus. But careful consideration to what it really meant is more important. By providing this expanded line of credit, it had the effect of encouraging many countries to go deeper into debt thus making them more subservient to the US - IMF monetary system[12]. Because all money originates from credit, and because the IMF charges interest on the money it creates and lends out, it further enhances the control of the global financial system into the hands of those who administer the IMF. Although the IMF had been criticised for its lethargic performance, the push by Geithner to increase the lending capabilities of the Fund indicated the desire by the US to hold on to its prestigious role as the world's over-arching banker. Support from the other members of the G20 to increase the reserves of the IMF suggested that they were willing to forgive the IMF and the US government over their failure to prevent the GFC, but there was very little discussion on the regulatory reforms for the private banking sector where a major flaw exists.

Considering the competitive nature of most American financial institutions, we should question whether the GFC was merely a repetition of proven strategies which make certain banks stronger through orchestrated credit squeezes or whether it truly was an economic

[12] Many governments went into or increased their debt by following the G20 directives to provide stimulus spending packages to their citizens. The Australian government for instance, went from a $20 billion surplus in 2007 to a $42.3 billion deficit and Net financial worth of -$146.1 billion at the end of 2010. At: http://www.budget.gov.au/2009-10/content/fbo/html/part_1.htm

blunder on the part of the US government. Charles Geisst (1997), who conducted a meticulous examination of previous financial crises[13], might consider that the GFC like the 1907 crisis which led to the formation of the Federal Reserve in 1913, was: 'nothing short of a massive conspiracy designed to ingratiate Wall Street to Washington and make more than a few dollars in the process'[14]. The record profits announced by Goldman Sachs, Merrill Lynch, Morgan Stanley and the investment banking arm of JPMorgan Chase in 2009 (the major stakeholders in the US Federal Reserve) confirm Geisst's assumptions[15]. Is it possible then that the IMF might also benefit from the GFC as well? Strengthening the IMF signifies that reality but it does not guarantee that the IMF will forever hold its monopolistic position as the global banker of last resort ~ especially now that other countries like Russia and China are exerting more influence in the global economy and devising their own monetary order[16].

10.4 Further Modifications to the IMS

The G20 realised much more needs to be done to increase the credibility and accountability of the Bretton Woods Institutions. To those ends, the G20 directed the IMF to implement quota and voice reforms giving more countries a greater say in the way the IMS is run. The G20 leaders agreed unanimously that the heads and senior leadership of the IMF should be appointed through an open, transparent and merit-based selection process. Sharing the leadership, and presumably the profits of the IMF from its lending activities, might help restore confidence in, and credibility of, the IMF.

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[13] See Appendix G for anecdotal evidence that financial markets are manipulated by banks.

[14] Geisst, C. (1997) *Wall Street: A History*, revised ed.(2004), Oxford University Press, New York, p 119.

[15] In a report released in November 2009 by Thomas DiNapoli, the Comptroller of New York State, Wall Street profits in 2009 would exceed the record set three years earlier. The Comptroller's report noted that the four largest investment firms in Manhattan ~ Goldman Sachs, Merrill Lynch, Morgan Stanley and JPMorgan Chase ~ earnt $22.5 billion in the first nine months of 2009. DiNapoli said: 'The national economy is slowly improving, but Wall Street has recovered much faster than anyone had envisioned'. Cf: Kouwe, Z. (2009) Wall Street on Track for Record in Profits, *New York Times*, 18th November 2009, p B3.

[16] http://www.aljazeera.com/indepth/opinion/2011/06/2011620115216348413.html

It would only be under very extraneous circumstances where the IMF would not play a crucial role in implementing any global solution. In conjunction with other organisations, like BIS and the Basel Committees, their co-operation and joint initiatives could help transform the IMS by stabilising currency values. But as it stands, the present system of exchange rates is still too volatile to minimise the effects of another economic crisis. The previous chapter demonstrated that effective regulation is a key factor towards any progress, therefore the next question is: How will the world make the transition toward a more stable efficient system and which regulatory institutions will be instrumental in bringing that change about? That question requires an answer before meaningful progress can be made. Until world leaders can agree on which regulatory platform best suits the needs of global financial reform, exchange rate volatility will continue to disrupt the global economy. Dealing with this type of problem requires a global perspective and multilateral co-operation, however that is an ambitious goal.

10.5 A New Model for World Order

One of the most challenging issues governments must deal with is how multiple countries can join together, reach agreement and make globalisation work. The thesis in general, and GFC unequivocally, demonstrated that global finance requires governance. In terms of administering and achieving global financial stability, there are presently only a few institutions that are capable of fulfilling the task. The Bank for International Settlements with its satellite agencies, the OECD, the G7 – G20, the World Trade Organisation and the IMF provide the basic forum for global financial development. But those institutions are useless if sovereign States do not actively participate in the evolution of the IMS. Hence greater understanding of governance structures is crucial to solving complex international problems.

Numerous crises have demonstrated that free markets cannot flourish without the 'visible hand' of government guiding and protecting the monetary system. Raghuram Rajan[17] and Luigi Zingales[18] (2003) suggest it is a case of saving capitalism from the capitalists by ensuring governments effectively regulate the dynamic forces within financial markets so that the entrepreneurial nature of capitalism can flourish[19]. Ayres and Braithwaite (1997) say that to make regulation effective, regulatory agencies should be perceived as 'carrying big sticks'[20]. From the previous Chapter, it is clear that governments must focus on the prudential regulation of global financial institutions and develop principles for global economic and financial stability, but will tighter regulation of market participants eliminate volatility?

Umpleby (1990) contemplates, it is a matter of integrating history, the science of regulatory theory, and policy considerations to provide a high-level, strategic treatment of financial regulation. This thesis argues that attention should focus on the international standards set by bodies such as the Basel Committee on Banking Supervision, the Financial Stability Board, the IMF and national central banks, but it must be administered by national governments working collectively. To help prevent financial crises from re-occurring, the justification for prudential regulation of private banks has been evident since the 1930s, but focus must now shift towards co-ordinating and regulating the prudential supervisors and central banks on a

[17] Former chief economist at the International Monetary Fund and Distinguished Service Professor of Finance at the University of Chicago.

[18] Professor of Entrepreneurship & Finance, University of Chicago Graduate School of Business.

[19] Rajan, R. and Zingales, L. (2003) *Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity*, Crown Publishing Group, New York.

[20] Ayres, I. and Braithwaite, J. (1997) *Responsive Regulation: Transcending The Deregulation Debate*, Oxford University Press, Oxford, UK, p 6.

global scale. That step requires greater cross border co-operation and co-ordination, and perhaps thinking along the lines of a new world order.

Anne-Marie Slaughter[21](2004) documents the communication rituals between governments to present a version of global governance that exemplifies the necessity to actively participate at the global level while simultaneously maintaining sovereignty and identity at the national level. Slaughter hypothesises how we can use multilateralism to solve issues that single nations cannot solve alone. Her concepts, drawn from many other authors, cover international law in particular, but are applicable to all manner of international economic and social problems.

For the greater part of the 20th century, Slaughter says the formulation of global public policy had been constructed largely by market forces, experts, enthusiasts, international bureaucrats and transnational people ~ everyone that is, except politically accountable government officials. Although Slaughter's ideas are not unique, she does present a logical perspective of what trends were taking place at the global level in the early part of the new millennium. She stressed the need for a self-conscious world order of government networks to handle the myriad of problems facing the global community. Her basic argument is that national governments should retain primary power over public policy, but work with other governments to formulate and implement those policies globally. Governments should delegate some power to supranational officials, but then work closely with those officials through vertical networks. And they should interact intensively with existing international organisations, corporations, NGOs and other actors in transnational society. Her main focus

[21] Dean of the Woodrow Wilson School of Public and International Affairs at Princeton University.

is that global governance must be done in such a manner: 'that makes it clear that government networks are the accountable core of these larger policy networks'[22].

Slaughter's model requires governments to interact intensively with one another, adopt codes of best practices and agree on co-ordinated solutions to common problems. She says: 'harnessing that capacity and strengthening it, is the best hope for a new world order'[23]. As a guide for IMS reforms, the new world order of network governance would enable broader participation by nation States and allow greater say in economic policy formulation. It would also promote transparency and increase accountability with respect to financial stability. With this system, governments and existing institutions form the foundations to IMS reform.

If we observe the outcome of the 2009 G20 meeting in London or that of Seoul in 2010, we can see that many of the ideas Slaughter described are already being employed. Recent development of policies and laws relating to the management of international and domestic prudential regulating bodies shows how governments are collectively working to converge rules and international standards. To see if the new world order model works, we should examine what progress has been made since the GFC; specifically in relation to regulatory supervision and financial stability, but also to SCF as all components are inextricably linked.

10.6 The Present State of Reform

Understanding that countries like Australia, Brazil, China, Hong Kong (Special Administrative Zone), India, Japan, Russia and Switzerland are member States of the IMF and have some say at the international level, their participation in the movement of

[22] Slaughter, A-M. (2004) *A New World Order*, Princeton University Press, New Jersey, p 262.

[23] *Ibid*. p 271.

speculative capital in comparison to that of the US or Europe is so insignificant that their impact is of little importance. While the US, Europe and Britain account for over 87 percent of the global market in forex trading, as a collective, the minor countries' (named above) participation level of SCF represents around only 10 percent[24]. Despite their low level involvement, some of those countries do nevertheless have strict regulatory requirements applying to hedge funds and capital flows within their national jurisdictions. Distinctively, the US which has the largest number of hedge funds operating within its borders and the largest dollar value of funds to put to work, is also the country which is least regulated and appears to be most reluctant to accept change[25]. Michael Barnier, the European Union's top official for banking regulation accused the Obama administration of being too lax and not putting in place capital rules fast enough. He warned that a failure to unify financial regulation between Europe and the US could give some banks an unfair advantage over their foreign rivals. Barnier wrote in a letter to Treasury Secretary Geithner: 'The level playing field must be a reality, not an empty slogan'[26].

10.7 General Position with respect to Capital Controls and Regulatory Developments

As pointed out in Appendix E, Chinese banking regulators maintain strict control of capital flows into and out of their country. Although part of China's Special Administrative Zone, Hong Kong still operates its own separate monetary system and allows for freer movement of

[24] Refer back to Chapter 4 section 3.

[25] 'Bringing order to the unregulated derivatives market has turned into one of the most difficult challenges in Dodd-Frank implementation. The rulemaking process has sparked a barrage of opposition, even from previously supportive legislators. In late April 2011, the Treasury Department proposed that some foreign exchange derivatives be exempted from the requirement that derivatives trade on exchanges. This could allow many transactions in the derivatives market to remain out of easy sight of participants, possibly encouraging banks to structure non-currency trades to fit the definition of a foreign exchange swap in order to qualify for the exemption'. Cf: Eisinger, J. and Bernstein, J. (2011) From Dodd-Frank to Dud: How Financial Reform May Be Going Wrong, *ProPublica*, 3rd June 2011. Available at: http://www.propublica.org/article/from-dodd-frank-to-dud?utm_source=socmed&utm_medium=twitter&utm_content=tweet1&utm_campaign=df

[26] Werdigier, J. (2011) European Regulator Criticizes US on Banker Bonuses, *New York Times*, 1st June 2011, At: http://dealbook.nytimes.com/2011/06/01/e-u-financial-regulator-criticizes-u-s-on-banker-bonuses/

capital. Hong Kong traditionally provided a gateway for capital flows into China but in late 2009 Chinese authorities tightened the in-flow of 'hot money' by placing strict limits on cross-border capital transfers[27]. Other BRIC members have also tended to concentrate on more productive capital movements such as investments in infrastructure and resource exploration in remote locations like Africa and South America[28]. Generally, they have not been heavily involved in speculative capital flows but rather focus on securing their growing demand for natural resources[29].

With the exception of Switzerland which remains independent of the EMU, other European countries such as Germany, France and Italy follow the directives of the European Commission and the ECB. (The European position is explained in more detail below). The Swiss franc (CHF) is the fifth most traded currency in the world. In Switzerland various authorities are involved in lawmaking for the financial sector, namely the Federal Department of Finance, as well as the Swiss Financial Market Supervisory Authority. Switzerland which had a notable reputation for discrete and confidential banking practices, found itself under pressure from the international community to disclose large capital transfers to respective foreign government departments in an effort to clamp down on international money laundering and tax evasion processes[30]. In an early effort to co-operate with the international

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[27] Chen, J. (2009) China Tightens Rules on Transfers to Stop 'Hot Money', *Bloomberg News*, 25th November 2009. Available at: http://www.bloomberg.com/apps/news?pid=206...ktlLM&pos=5

[28] Simpkins, J (2010) The Scramble for Africa: Profiting From World's Largest Cache of Commodities, *Money Morning*, 12th March 2010. At: http://moneymorning.com/2010/03/12/africa-commodities/

[29] See for instance, 'China's string of pearls strategy' as described in Booz Allen Hamilton Inc. (2005) *Energy Futures in Asia*, commissioned report for United States Department of Defence.

[30] A series of reports on Switzerland from the IMF reveals increased adherence to the Fund's *Code of Good Practices on Monetary Policy Transparency*. A 2009 report found most benchmarks in the Code being observed. A 2005 Article IV Consultation report by the IMF found that the 2003 Federal Act on the Swiss National Bank (SNB) removed a number of legislative uncertainties regarding the SNB's independence and objectives with respect to monetary policy. Under the new law, there is greater clarity as to the assignment of responsibilities

community, Switzerland complied with world's best practices on financial reporting matters[31]. The significance of this is that with more countries reporting cross-border monetary transfers in a prescribed format back to a central data collection entity, it would facilitate greater understanding of what is needed to help stabilise currency values on a global scale.

Similarly, Japan, whose currency (JPY) ranks forth as most traded, plays a minor role in SCF. Japan, as well as the smaller emerging Asian nations, has been building up its holdings of foreign currency assets for several decades[32]. The large share of US dollar assets held by these nations has made Asian central banks important players in US financial markets. During the GFC those reserves helped stabilise the Asian currencies, but it also led to investment losses for some Asian central banks and sovereign wealth funds. So far, the self-disciplined nature of Asian savings habits demonstrates a cautious reluctance to get too heavily involved in SCF. Japan has also demonstrated its willingness to comply with changing accounting practices. The International Accounting Standards Board and the Accounting Standards Board of Japan agreed to reduce differences between reporting standards. The convergence plan known as the 'Tokyo Agreement' was signed in August 2007 with the objective to eliminate all major differences by June 2011[33]. As one of the world's larger economies, Japan's active participation in enhanced reporting procedures and transparency issues signals the changing attitude in co-operation on international monetary

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and roles in monetary policy. CF: Financial Standards Foundation (2009) *Switzerland: Code of Good Practices on Transparency in Monetary Policy*, New York.

[31] Administration fédérale des finances (2005) *Guidelines for Financial Market Regulation*, Swiss Federal Department of Finance, Bern.

[32] Klitgaard, T. and Higgins, M. (2004) Reserve Accumulation: Implications for Global Capital Flows and Financial Markets, *Current Issues in Economics and Finance*, Vol. 10, No. 10, September/October 2004, p 1-8.

[33] Financial Standards Foundation (2009) *Japan: International Financial Reporting Standards*, New York.

reforms which may in turn lead to better collection of data to help maintain stable currency values.

10.8 The Australian Position

On a global scale, Australia is a relatively small economy but its dollar (AUD) ranks as the sixth most traded currency in the world. What makes Australia special ~ in terms of financial reporting standards ~ is the sophisticated level of banking supervision. The Australian Prudential Regulation Authority (APRA) supervises institutions authorised to take deposits from the public; this already includes insurance companies, private equity and, unlike the US, hedge funds. APRA is empowered to examine an institution's books and assess their risk management practices [34]. Another government body, the Australian Securities and Investments Commission (ASIC), does not have a mandate to go into businesses to make sure they are running correctly, but it does require that businesses disclose enough information so that investors can make good decisions and timely settlements[35].

Professor Ian Harper was one of the committee members who drafted the *Wallis Inquiry*[36] which helped streamline the way the Australian financial system operated in the late stages of the twentieth century. As one of the architects of the current system he said the system failed to withstand the stresses of the global financial crisis. He is now calling for another review, saying the intellectual underpinning of financial regulation had been shown to be wanting by investors who had lost their savings or had investments frozen during the GFC. Harper says:

[34] *Australian Prudential Regulation Authority Act* 1998 section 8 (2) empowers APRA to promote financial system stability.

[35] The *Australian Securities and Investments Commission Act* 2001 section 1(2) says ASIC must strive to: (a) maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty…

[36] Commonwealth of Australia (1997) *Financial System Inquiry Final Report*, Australian Government Publishing Service, Canberra.

‘One of the chief lessons of the global financial crisis is that markets turn out to be as much victims of information asymmetry as the financial intermediaries … Capital markets can suffer the equivalent of a run on the banking system’[37]. Consequently, this flight of capital which is at the core of fluctuating currency values adds to further economic instability.

In March 2009 Australian Prime Minister Kevin Rudd wrote:

> The core challenge here is that the current edifice of global institutions is not strong enough to carry the weight of the challenges we face … There is a yawning gap between the capacity of existing global institutions designed to deal with the challenges of the past, but insufficiently mandated, resourced or representative of emerging power realities to deal with the challenges of the future[38].

Seven months later, in response to calls for more urgent reform of financial markets, the Australian government re-stated its position with Treasurer Wayne Swan saying:

> The government ... remains vigilant in relation to our financial system and Australia is a full participant in current G20 reforms to the architecture of the international financial system. However, as this reform process is ongoing, the government is not contemplating any major systemic review of Australia’s financial system[39].

Australian Prudential Regulation Authority chairman John Laker highlighted the need to be flexible in applying new banking regulation, he said he was open-minded about global reform, but where the APRA had discretion, they always took the conservative position. Laker said when new capital adequacy rules emerge from the Basel Committee, they would be close to

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[37] Uren, D. (2009) Apostle loses faith in finance system, *The Weekend Australian*, 3rd October 2009, Feature Magazine p 12.

[38] Rudd. K. (2009) *Managing Global and Regional Interdependence: The Future of the G20 and an Asia Pacific Community*, at p 5. Rudd submitted this article to *Foreign Affairs Magazine* but failed to impress the editors and subsequently it did not get published. With the aid of the *Freedom of Information Act* 1982 (Cth), *The Age* newspaper acquired the article. Available at: http://www.theage.com.au/ed_docs/rudd-speech-G20.pdf

[39] Uren, D. (2009) *Supra*.

those already in place in Australia: 'Our banks go into the reform process having done some of the hard work anyway'[40].

Despite Australia's lead in prudential regulation, Reserve Bank governor Glenn Stevens said Australia would inevitably be a follower in the global regulation of banks. He said although Australia had a seat at the table at both the Basel Committee and on the Financial Stability Board, the G7 would dominate the decision-making process[41]. So for the moment, the Australian position is much the same as other minor G20 members. It appears nothing concrete will happen with international prudential regulation or macro-economic price stability until there is some form of broad consensus between G7 members first. At the present rate it is unlikely to be in the near future.

10.9 The European Position

Lord Turner, chairman of the UK's Financial Service Authority (FSA), presented a report on the global financial crisis which, *inter alia*, recommended regulatory changes in financial services[42]. He made reference to the 'shadow banking system' ~ investment banks, mutual funds and off balance sheet vehicles like hedge funds ~ performing credit intermediation and maturity transformation functions whilst not being subject to adequate capital and liquidity constraints. The *Turner Review* identified three underlying causes of the global crisis:

1. Macro-economic imbalances;
2. Financial innovation of little social value[43]; and

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[40] Uren, D. (2010) RBA boss slams international bank liquidity guidelines, *The Australian*, 2nd March 2010. At: http://www.news.com.au/national/story-e6frfkp9-1225835816655

[41] *Id*.

[42] Financial Service Authority (2009) *The Turner Review: A regulatory response to the global banking crisis*, Financial Service Authority, UK.

[43] Financial innovation of little social value refers to instruments like credit default swaps and other financial products that have little or no intrinsic worth. In essence a lot of financial products are merely a creation of an imaginative market maker who operates as book-maker offering gambling positions on stock market indices or

3. Important deficiencies in key bank capital and liquidity regulations.

Surprisingly, the FSA did not consider that there was any evidence that UK hedge funds made a significant direct contribution to the underlying causes of the GFC[44]. Nevertheless, it did say that the effective regulation of the potential systemic impacts of hedge funds, or clusters of hedge funds, should be considered as an important part of the future regulatory framework. The FSA considered the following areas as key components of an effective regulatory framework for hedge funds:

1. Mandatory authorisation and supervision of all hedge fund managers and systemically important hedge fund counterparties by regulators in their home domicile;
2. Enforcement regime in respect of fund managers creating a credible deterrence;
3. Regulatory powers to take remedial action where a hedge fund is itself domiciled offshore and poses a significant systemic risk;
4. Collection and sharing of data from hedge fund managers and other key market participants in systemically important or particularly vulnerable markets, for the purposes of identifying financial stability concerns; and
5. Convergence of industry good practice standards at a global level to support but not replace an enhanced regulatory framework.

Because the UK is part of the European Union, the Financial Service Authority will more than likely follow the developments currently being undertaken by the European Parliament.

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mortgage bundles. Unfortunately market makers operate throughout all sophisticated economies where prudential regulators appear to have absolutely no understanding of the products on offer or are ignorant to their operation. Many currency trading platforms operate this way offering leveraged positions to clients. In reality these platforms have no real connection to actual capital flows except for using the international market rate to determine win-lose positions. In reality they are no different than a book-maker at a race track but assume an air of authority and legitimacy by being involved in the money market industry.

[44] PricewaterhouseCoopers (2009) *Changing Rules: The regulation, taxation and distribution of hedge funds around the globe*. Interim Report, available at: www.pwc.com/hedgefunds

In July 2008, the European Parliament adopted some of the recommendations of the *Rasmussen Report*[45], giving authority to the European Commission to draw up plans to address issues relating to Alternative Investment Fund Managers (AIFM). Rasmussen and van den Burg (2007) submitted:

> Hedge funds and private equity funds have been operating for many years but their enormous growth is the most striking new challenge for our societies, and the structures, transparency and business practice on the financial markets. We regard it as a common responsibility to assure that this new development leads to higher efficiency on the capital markets, effective financing of long-term investment, and full transparency. And we are certainly aware of the related risks ~ i.e. financial instability, imperfections or abuse of the capital market[46].

In April 2009 the European Commission published its draft proposal[47] that it hoped would apply to all AIFM established in EU member States. In its investigations, the Commission identified important gaps and weaknesses in European and national approaches to the regulation and supervision of the AIFM sector. The core problems related to a failure to appreciate the cross-border nature of risks[48]. The Commission noted that:

> … the absence of a co-ordinated approach to the monitoring and supervision of the AIFM sector is a significant barrier to the effective macro-prudential oversight of the sector at the European level. The absence of consistent data collection from AIFM and of effective mechanisms to share and process this information prevents regulators from compiling a comprehensive picture of the potentially systemic risks arising from

[45] Rasmussen, P.N. and van den Burg, I. (2007) *Hedge Funds and Private Equity: A Critical Analysis*, Antilope Publishers, Belgium.

[46] *Ibid*. at p 11.

[47] EUROPA Press Release, 29th April 2009. Directive on Alternative Investment Fund Managers. Reference: MEMO/09/211.

[48] Commission of the European Communities (2009) *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers*, Commission Staff Working Document, Brussels.

AIFM activity. Enhanced and co-ordinated information gathering on AIFM activities would strengthen macro-prudential oversight and market discipline[49].

The effective regulation of the AIFM sector ~ both from a macro-prudential perspective and in relation to the protection of investors in AIF ~ requires greater consistency in regulatory procedures. Variations in national approaches to the registration and authorisation of AIFM, to risk management and the governance of internal processes and to the provision of key information to investors and regulators all contributed to a fragmented regulatory framework that did not provide sufficient assurance that consistently high standards were applied throughout the EU.

A main objection to the proposed *Alternative Investment Fund Managers Directive*[50] was the introduction of a passport for fund managers from third countries, which would allow them to distribute their non-European funds within the European Union. Hence, the *Directive* underwent a few changes in late 2010 before being adopted in May 2011[51]. Member States have until 2013 to transpose its provisions into national law. The *Directive* is intended to fulfil commitments made by the EU at the G-20 as well as the European Council's pledge to regulate all players in the market that pose a risk to financial stability.

Very similar the FSA's policies, the European framework aims to achieve:

1. Authorisation and registration requirements for all AIFM operating in the EU: specifically this would require all AIFM to respect and satisfy a common set of requirements (minimum capital, fit and proper, transparency, etc.) before operating across the EU.

[49] *Ibid*. p 24.

[50] Available at: http://register.consilium.europa.eu/pdf/en/10/st15/st15053-re01.en10.pdf

[51] Council of the European Union (2011) *Press Release: Council adopts EU rules*, 27th May 2011. Brussels, No 10791/11.

2. Improved monitoring of macro-prudential risks through the provision of relevant information to prudential authorities. To take due account of the cross-border dimension of these risks, relevant information would need to be pooled at European or global level. At operational level, this objective requires the collection of relevant data on *inter alia* leverage, trading activity, risk concentrations and performance, and appropriate information-sharing mechanisms to be established.

3. Enhanced management of micro-prudential risks through the imposition of strict risk management controls on market, liquidity, counterparty credit and settlement, (especially in case of short selling) and operational risks.

4. A common approach to protecting investors in AIFM-managed funds is required, including improvements in investor disclosures to ensure that due diligence can be performed effectively. Ensuring the proper management of conflicts of interest and imposing independent controls and processes in key risk areas, in particular valuation and custody functions, would also help to achieve this specific objective.

5. Greater public accountability of AIFM investing in and managing companies should be achieved so as to ensure that such activities are subject to an appropriate level of public scrutiny. The operational objective related to this is to impose additional transparency requirements on AIFM when they acquire controlling stakes in companies with the aim to actively engage in and influence these companies' future management.

6. The removal of barriers to the efficient cross-border distribution of AIF should allow an internal market in AIF in the EU to develop which is grounded in a robust and consistent regulatory supervisory framework[52].

[52] Commission of the European Communities (2009) *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers*, Commission Staff Working Document, Brussels, at p 28 - 29.

This effectively leaves the US in a class of its own when it comes to prudential regulation of hedge funds and private equity funds. As noted already, the US Administration has indicated that it has no immediate plans to regulate either type of fund and because the big banks have their own hedge fund departments, those banks escape the same accountability requirements as do the smaller hedge funds. Thus fund managers in the country with the greatest potential to influence or disrupt the global economy, are allowed to continue with practices that are proven to increase financial instability. The next section looks at possible developments in the US.

10.10 The US Position

The economic and financial management problems which originated in the US spilt into the global economy causing the GFC. The US economy has the largest debt of any country and is experiencing very slow growth ~ especially since the 2007 collapse of the housing bubble. Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) went from US$69 per share down to 30 cents, two major banks, Lehman Brothers Holdings, Inc. and Washington Mutual Investment Bank closed their doors in September 2008 losing in excess of US$1 trillion, 140 US banks failed in 2009, and General Motors and Chrysler filed for bankruptcy protection owing over US$100 billion. According to the Federal Deposit Insurance Corporation figures, 700 US financial institutions were in trouble[53], 161 US banks failed in 2010, 92 failed in 2011, 32 failed in 2012 and 34 failed in the first half of 2013[54]. US seasonally adjusted unemployment hovers around 7.6

[53] Federal Deposit Insurance Corporation (2010) Press Release 23rd February 2010. Available at: http://www.fdic.gov/news/news/press/2010/pr10036.html

[54] Federal Deposit Insurance Corporation (2013). At: http://www.fdic.gov/bank/individual/failed/banklist.html

percent[55] (down from 10 % in 2010) but in places like Detroit, it is several percent higher. The US current account deficit is in excess of US$16.74 trillion (approximately 106 percent of 2012's annual gross domestic product)[56]. In addition to those problems, other long term unfunded liabilities ~ like state and local government securities/municipal bonds, retirement entitlements and Medicare costs ~ add another $48 trillion to the US government's long term debt[57]. As a further example of poor economic planning, the Obama administration reported that at the present rate, Medicare's hospital fund will run dry by 2017 and that the Social Security trust fund will run out of assets by 2037[58]. President Obama called the current level of deficit spending 'unsustainable' and warned of skyrocketing interest rates for US consumers[59]. As has been the norm for the past 100 years, US monetary problems permeate across borders causing no end of trouble to the global economy. The stark reality is, the continuing economic problems in America are getting worse, which can only lead to a hard landing. That landing will seriously affect the global economy and just like the previous crises, the financial disruptions will increase volatility in currency markets. Hence to reduce currency volatility in the IMS, attention should focus on measures that can be put in place to enhance financial stability within the US.

In 2009 major economies agreed at the G20 meeting in Pittsburgh to find ways to limit incentives for excessive risk taking. Within the US, moves were made in the latter part of

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[55] Bureau of Labour Statistics (2013) Unemployment, http://data.bls.gov/timeseries/LNS14000000

[56] http://www.brillig.com/debt_clock/

[57] Peterson Foundation (2010) *State of the Union's Finances: A Citizen's Guide 2010*, Peter G. Peterson Foundation, New York, Figure 10, p 31. http://www.pgpf.org/Special-Topics/Download-the-Citizens-Guide.aspx

[58] Runningen, R. and Nichols, H. (2009) Obama Says U.S. Long-Term Debt Load 'Unsustainable', *Bloomberg News*, 14th May 2009. Available at: http://www.bloomberg.com/apps/news?pid=20601087&sid=aJsSb4qtILhg

[59] *Id*.

2009 to re-introduce some of the provisions within the *Glass Steagall Act* [60] that were repealed a decade earlier[61]. The law's repeal ushered in an era marked by big banks getting even bigger; (for instance, America's four largest banks ~ Bank of America, JPMorgan Chase, Citigroup and Wells Fargo ~ now control more than half of America's mortgages, two-thirds the number of credit cards and two-fifths of all bank deposits[62]). Because bank deposits were insured via the Federal Deposit Insurance Corporation and the taxpayer, some banks became overly confident about making risky bets through their investment arms. Any losses could be covered by taxpayer funded bailouts. And that is exactly what happened.

The purpose to re-introduce a partial return to *Glass Steagall* was to bring some form of accountability back into the financial services industry. Paul Volcker called for those laws to be re-introduced as a way to reduce 'moral hazards' and limit certain types of risk-taking activity by institutions that hold taxpayer-insured deposits. The drafters of the *Banking Integrity Bill* of 2009 [63] wished to prohibit banks from being affiliated with specified organisations engaged principally in the issue, flotation, underwriting, public sale, or speculation of stocks, bonds, debenture, currencies and other securities. But like most proposed legislation in America that seeks to limit free market activity, there is always strong opposition. Some officials within the Obama administration, including Treasury Secretary Geithner, argued against reviving portions of the *Glass Steagall Act*. Geithner told the Joint Economic Committee in November 2009 that he: 'would not support reinstating *Glass*

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[60] *Banking Act* of 1933 (US).

[61] The *Gramm Leach Bliley Act* of 1999 repealed the firewalls of the *Glass Steagall Act* and permitted the consolidation of banking, investment and insurance companies into financial service behemoths that inevitably became 'too large to let fail'.

[62] Nasiripour, S. (2009) Congressmen to call for Break-up of Biggest Banks, *HuffingtonPost*, 7th December 2009. Available at:http://www.huffingtonpost.com/2009/12/07/congressmen-to-call-for-b_n_383128.html

[63] *Banking Integrity Bill* of 2009. Introduced in the Senate, 111th Congress, 1st Session, S. 2886, 16th December 2009.

Steagall' and that he did not 'actually believe that the end of *Glass Steagall* played a significant role in the cause of the crisis'[64].

Despite the fall-out of the economic crisis which exposed the inherent weakness of prudential management of the US financial system, some people still believe governments should refrain from intervening in the free market. They believe governments are incapable of directing economies in an efficient and effective manner, yet they refuse to allow prudential supervisors authority to monitor and police banking activities which jeopardise financial stability. As an example, US Senator Sam Brownback delivered the minority view of the Joint Economic Committee Report saying:

> Despite our Nation's challenges, we maintain our confidence in our free market system … We are concerned that some … may … use calls for a regulatory overhaul of financial markets as a welcome mat for imposing overly onerous regulations that end up stifling growth and hurting American pursuits …
>
> … Smaller and less intrusive government offers hope for a new day of prosperity for the American people. We must remove the cloud of a bloated and growing national government policy that hangs over us …[65]

At the time of writing, the *Banking Integrity Bill* had made no progress through either House of Congress apart from being read twice and referred to the Senate Committee on Banking, Housing, and Urban Affairs. Notwithstanding the negative effects of the economic crisis, the US monetary and financial system has not evolved or improved. If anything it is actually worse than before the crisis because the banks that were deemed 'too-big-to-let-fail' during

[64] Sloan, S. and Hopkins, C. (2010) Obama Plan has Shades of Glass Steagall, *Investment Dealer Digest*, 27th January 2010. Available at: http://www.iddmagazine.com/news/obama-plan-has-shades-of-glass-steagall-202264-1.html

[65] 111th Congress (2009) *The 2009 Joint Economic Report of the Joint Economic Committee*, Congress of the United States, US Government Printing Office, Washington, p 121.

the crisis and needed rescuing, are now even bigger. Permitting large private banks to dictate the terms of US monetary policy and allowing them to continue unchecked will not prevent future crises nor will it solve instability problems. Risks and uncertainties will remain and continued turbulence in US financial markets will systemically affect the global economy.

Throughout the GFC, the major focus from the US standpoint, was on implementing various stimulus packages to prevent the collapse of the US economy. Inflationary effects of the initial US$1.2 trillion bailout and the following 'Quantitative Easing II and III' spilt-over into other economies. As a consequence of the massive injection of liquidity into the US economy, the US dollar declined in value and subsequently US debt liabilities diminished as a portion of GNP. It is here that the economic theories of Irving Fisher[66] and Hyman Minsky[67] would indicate that the US Treasury was pursuing a strategy of deliberately inducing inflation in order to reduce the national debt[68]. In simple terms if more money is created and put into circulation, it erodes the current value of money, thus allowing the US to re-pay its US dollar debts at a discount proportional to the rate of inflation. Chairman of the Federal Reserve Ben Bernanke acknowledged the strategic advantages of inflation when he was a Bank Governor, he said: 'people know that inflation erodes the real value of the government's debt and, therefore, it is in the interest of the government to create some inflation'[69].

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[66] Fisher, I. (1933) The debt-deflation theory of great depressions, *Econometrica*, Vol. 1, p 337-357.

[67] Minsky, H. (1977) The Financial Instability Hypothesis: An Interpretation of Keynes and an Alternative to 'Standard' Theory, *Nebraska Journal of Economics and Business*, Vol. 16, p 5-16.

[68] The reason why the US abandoned the gold standard was because successive administrations had depleted the gold reserves by over spending. It now appears that the US is using a similar tactic to lower the value of its international debts by deliberately creating inflation to eroding the value of the dollar. If the US pursues the inflation tactic, on paper GDP will increase, but the dollar liabilities will decline as a percentage of national income. In terms of productivity, the US economy will not increase output, but more money in circulation will mean asset prices rise and existing dollar liabilities decline in value. It is an effective strategy to eliminate debt, provided of course your international debts are in your own currency ~ which is uniquely the case with the US.

[69] Bernanke, B. (2002) *Deflation: Making Sure "It" Doesn't Happen Here*, remarks by Federal Reserve Governor before the National Economists Club, Washington, DC, 21st November 2002. Footnote 18.

Obviously some resentment might permeate the global economy if nations holding vast quantities of US Treasury notes find that their US dollar assets have been eroded by intentionally induced inflation[70]. It makes a substantial case on the side of the emerging market economies to move away from the US dollar as the international reserve currency and implement an alternative monetary system or a new global currency.

Peter Schiff, a global economic strategist and author of two *New York Times* best sellers[71] says:

> My gut feeling is that foreign governments are ... on the verge of finally imposing some discipline. That means the dollar's days as the world's reserve currency are numbered, and the days of American austerity are about to begin[72].

10.11 The G20 Position

When the G20 Finance Ministers and Central Bank Governors met in Moscow (in February 2013) to discuss global economic challenges, the participants agreed to address the weakness of the global economy by promoting ambitious reforms and co-ordinate policies to build a more resilient financial system. While the participants re-iterated: 'that excess volatility of financial flows and disorderly movements in exchange rates had adverse implications for economic and financial stability'[73] they nevertheless re-affirmed their commitment 'to move

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[70] For instance; China and Taiwan are major creditors of the US. China is the US's largest creditor with over US$1.2 trillion in dollar assets, and Taiwan ranks tenth with US$130 billion in assets. If the US dollar was to decline in value, it would substantially reduce the value of the US debt owed to those countries.

[71] Schiff, P. (2007) *Crash Proof: How to Profit from the Coming Economic Collapse*, John Wiley & Sons, Inc., Hoboken, New Jersey.

Schiff, P. (2008) *The Little Book of Bull Moves in Bear Markets*, John Wiley & Sons, Inc., Hoboken, New Jersey.

[72] Schiff, P. (2009) Is the Government Rehabilitating the Economy or Delaying the Inevitable?, *Money Morning*, 6th November 2009. Available at: http://www.moneymorning.com/2009/11/06/peter-schiff-economy/

[73] Official Communiqué of G20 Finance Ministers and Central Bank Governors, Moscow, 15-16 February 2013. Available at: www.g20.org/load/781209773 ~ point 5.

rapidly towards a more market-determined exchange rate system'[74]. The contradiction is that, according to the findings of this thesis and numerous authors[75], both goals are incompatible with each other. Market determination of exchange rates actually exacerbates volatility, so it is illogical to pursue both paths. What this demonstrates is a lack of understanding on the part of G20 Ministers to the intricate nature and effects of fluctuating exchange rates.

While it is probably the easiest option to palm the responsibility of determining the value of exchange rates onto the market, it more or less signals a form of irresponsibility by the key people who should be resolving this problem. Although the task of managing the IMS is a large one, it nevertheless requires the greatest attention by financial policy makers the world over. For the reasons already expressed in earlier Chapters, allowing the free market to determine the value of exchange rates is a mistake.

The findings of this study reveal that it is not in the best interests of the international monetary and financial system or to the global community at large to let the free market currency traders continue to have their unregulated way with the international monetary market ~ least of all determine the value of national currencies. As this thesis explains, multi-lateral government intervention, management and regulation of the IMM is critical for maintaining stable currency values. Any other prescription left to the speculative hands of the free market is an invitation for further economic instability.

Another issue for concern is that the G20 leaders (2013) stated that they would: 'refrain from competitive devaluation[s], … resist all forms of protectionism and keep markets open'. That

[74] *Id*.

[75] Lietaer, 1997; Krugman, 1998; Grenville, 1999; Kaplan and Rodrik, 2001; Rogoff, 2002; Gibson and Tsakalotos, 2003; Soros, 2003; Kamer, 2004; Demir, 2009; Ostry, Ghosh, Habermeier et al, 2010.

was stated with commitment despite having full knowledge of the US's on-going $2 trillion quantitative easing measures and Japan's 27 percent devaluation of the yen. In the midst of a stealth currency war, it appears that what the major G20 members agree to, does not necessarily equate to full global implementation.

Gordon Brown (2012), former chairman of the G20, stated:

> … the pre-eminent international issue is whether we can develop a level of global co-operation that matches the global dimension of our problems. …[Since the crisis] we have seen evidence that international co-operation on economic issues is not working well. The year 2009 should have brought an era of enhanced co-operation. Instead, that co-operation hit a high-water mark, then receded. Global co-ordination is still regarded by too many countries as an optional extra, a sideshow compared with domestic issues.
>
> Given the global financial crisis ~ which cost $4 trillion in lost output and an estimated 28 million jobs, as well as surging debt and deficits (much of the cost borne by countries, businesses and individuals who did not directly cause the crisis) ~ the case for global financial co-ordination is indisputable.[76]

The market failures highlighted by the GFC demonstrated that the free market does not always deliver the best outcome ~ a realisation poignantly re-confirmed by Alan Greenspan when he appeared before the Congressional Oversight Panel on Regulatory Reform[77].

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[76] Brown, G. (2012) Let's Stick Together, *The International Herald Tribune*, Special Report, 30th November 2012. Available at: http://www.nytimes.com/2012/11/30/opinion/global/gordon-brown-global-economic-problems-need-global-solutions.html?ref=globalagenda2012&_r=0

[77] Alan Greenspan, a fervent proponent of deregulation* before Capitol Hill in October 2008, conceded serious flaws in his own philosophy. Facing criticism from the Congressional Oversight Panel on Regulatory Reform for having refused to consider cracking down on credit derivatives in an unchecked market, Greenspan admitted: 'I made a mistake in presuming that the self-interests of organisations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms'**.

*An attempt by Brooksley Born, the former chairperson of the Commodity Futures Trading Commission, to regulate OTC-traded derivatives in 1997-98, was blocked by Alan Greenspan allegedly on the grounds that such regulation could precipitate a financial crisis. Subsequently in 2000, Congress rejected any form of regulation for most derivatives. Cf: Congressional Oversight Panel Special Report on Regulatory Reform (2009)

Leaving the free market to determine exchange rate values is merely allowing the current system to prevail which has already demonstrated its critical weaknesses. Subsequently, the significant correlation between compounding instability of exchange rates with increased speculative capital flows has been overlooked by G20 leaders. Maintaining stability of exchange rate values is the specific area of reform that needs the most attention, yet it remains the least understood.

10.12 A Crucial Step Toward Reform

As demonstrated in the previous Chapter, Umpleby's requisite variety could improve financial stability by amplifying regulatory capabilities. The fourth strategy, 'epistemological regulation', is the universal acceptance or implementation of an idea. It entails not just an adjustment in the rules of the game but rather changing the game itself. The governments of the world must come to a common understanding of the causes of the GFC and then reach a common vision for stabilising currency values and financial markets. There needs to be global consensus on the key values and principles that will promote sustainable economic activity. Somewhere in this process, governments acting jointly will need to create new rules and perhaps even new institutions and regulatory regimes to address the problem. But regulating free market participants is inefficient, therefore governments should shift their focus on regulating the institutions which are responsible for maintaining not only currency values but also monetary supply and price stability. Simply put, governments must improve

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Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability, Senate Committee Prints, US Government Printing Office, p 14.

**House Committee on Oversight and Government Reform, Testimony of Alan Greenspan, *The Financial Crisis and the Role of Federal Regulators*, 110th Cong., 23rd October 2008. Available at : oversight.house.gov/documents/20081023100438.pdf

the efficiency of their own departments; their central banks, their prudential authorities and their communication and data transfer networks with other sovereign States.

In addition to reforming international financial institutions, the other important step is to monitor the implementation of its decisions within a timetable. Umpleby says:

> Indicators are most useful when accompanied by theories linking measurement with action … Any new conceptual system requires a control system for implementation. A control system requires a set of indicators so that we can know whether we are making progress and, if so, by how much. Creating new ideas is only part of the process. We also need to devise means to ensure that the new ideas are acted on[78].

Following the same logic, the G20 Finance Ministers set out an *Action Plan* at the London Summit whereby they asked the FSB and the IMF to monitor progress by working closely with other relevant bodies and to report annually to the G20. To date, no concrete measures have been devised that would significantly change the present arrangements[79]. At present, the global economy is no better off than it was before the GFC.

10.13 The Next Move

The journey so far brings us full circle to the present date and reinforces the idea that only a mutually agreed and enforced version of international monetary regulation can fix the problem addressed in this thesis. This Chapter analysed the present position of the global economy, and described some of the actions being taken in response to the GFC. Clearly

[78] Umpleby, S. (1990) Strategies for Regulating the Global Economy, *International Journal of Cybernetics and Systems*, Vol. 21, p108.

[79] Apart from proposals to implement a global Legal Entity Identifier (LEI) system that will uniquely identify parties to international financial transactions, the focus of the Financial Stability Board seems to be more about creating a bureaucratic edifice rather than implementing meaningful policy. At the G20 Cannes Summit (November 2011), the heads of State and member governments agreed to strengthen the Financial Stability Board's capacity, resources and governance thus strengthening its co-ordination role vis-à-vis other standard-setting bodies. Cf: *Report to the G20 Los Cabos Summit on Strengthening FSB Capacity, Resources and Governance* 18-19 June 2012. Available at http://www.financialstabilityboard.org/publications/r_120619c.pdf.

there is an urgent need for sensible reforms to ensure less volatility in currencies and a more stable IMS[80]. Effective financial management and foreign exchange stability would certainly go a long way towards stabilising prices, moderating long-term interest rates, maintaining full employment, increasing production, enhancing wider economic prosperity and higher standards of living among most people in most countries.

The inability of US legislators to solve inherent weaknesses within the US financial system is a major hindrance to global economic progress. G7 countries must reach agreement before the system can be improved. The remaining G20 countries wait in anticipation but some countries are growing impatient. For the first time in history, it looks like the rest of the world needs to band together to put pressure on the US government to overcome its internal regulatory difficulties or otherwise take matters into their own hands. The examples given of the BRIC alliance (as mentioned above in sections 8.4 and 10.3) supporting its own international settlement bank or the European Commission starting its own Monetary Fund (as mentioned above in sections 8.6 and 10.9) could be the catalyst for radical change.

As the world comes to terms with what went wrong with the GFC, it is tempting to blame the financial crisis solely on US bankers who took irrational risks with their depositors' funds which left US taxpayers and the rest of the global community to pay for the mistake. But necessarily, it is the serious flaw within the international monetary and financial system that is to blame. The present system was overly dependent on American consumption to power the global economy. The up and coming nations of the world used the US Treasury as a depository for their growing wealth, to which the US willingly obliged but failed to fully understand the ramifications of having too much foreign capital at its disposal ready to lend.

[80] United Nations Conference on Trade and Development (2011) *Trade and Development Report*, Chapter VI The Global Monetary Order and the International Trading System, UNCTAD/TDR/2011.

The influx of liquidity into the US allowed US banks to grow complacent about the importance of bottom line profitability and risk management. The 'pathological pursuits'[81] of corporate greed took over, financial intermediaries created ever more complex instruments of little social value and toxic assets flooded the global market.

Attempts by US prudential regulators to impose more stringent reporting procedures and restrictions on the financial service industry were hampered not only by industry lobby groups[82] but also by successive government administrations which had formed symbiotic relationships with Wall Street[83]. In the US, big banks have too much influence over government monetary policy[84] and a private corporation still supplies money and collects profits on every US dollar that is put into circulation. In 1913 the US government relinquished control of its own monetary supply and if the current situation persists, it seems unlikely that US legislators will ever be able to get it back. The US monetary system is driven

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[81] Bakan, J. (2005) *The Corporation: the pathological pursuit of profit and power*, Free Press, New York. p 93.

[82] *Business Roundtable and Chamber of Commerce of the USA v SEC,* No. 10-1305 United States Court of Appeals (D.C. Cir. 2011). In July 2011, the United States Court of Appeals rejected the Securities and Exchange Commission's proposal for certain limitations placed on speculative commodity trading. The SEC proposed the new rules in response to the requirements of the *Dodd-Frank Act* of 2010 but industry lobby groups including the United State Chamber of Commerce and the Futures Industry Association challenged the restrictions. The court determined that the Commission failed to adequately consider the rule's effect upon efficiency, competition, and capital formation, as required by applicable laws.

See also: Lambaton, S. (2007) Officials Reject More Oversight of Hedge Funds, *New York Times*, 23rd February 2007, p C4.

[83] Four of the Bush Jr. Administration's most senior economic policy-makers: Treasury Secretary Henry Paulson Jr, his top deputy Robert Steel and White House chief of staff Joshua Bolten were all past CEOs or senior executives of Goldman Sachs. John Thornton was president of Goldman Sachs when Henry Paulson was its chief executive, and Glenn Hubbard was a former chairman of the President's Council of Economic Advisers. Other past Goldman Sachs (GS) employees who held influential positions included: Robert Ruben Vice Chairman of GS became Secretary of Treasury. Stephen Friedman a Chairman of GS became Chairman of the Economic Council. John Corzine became Governor of New Jersey before becoming a US Senator. Robert Zolick former Vice Chairman of GS became President of the World Bank. John Whitehead from GS was a former Chairman of Lower Manhattan Development Committee, became a Chairman of the NY Federal Reserve before becoming Deputy Secretary of State.

[84] Scott O'Malia, a member of the Commodity Futures Trading Commission noted the broad influence Wall Street was exerting on regulators; he said "I think the industry has a huge impact on the rule-writing process". Cf: Protess, B. (2011) Regulators Fear Legal Challenges to Derivatives Rules, *New York Times*, 13th September 2011. At: http://dealbook.nytimes.com/2011/09/13/regulators-fear-legal-challenges-to-derivatives-rules/

not by a conspiracy or corruption, but by an ideology which has proven itself to be unmanageable. It is a social experiment that went wrong which must now be contained[85].

Winston Churchill said minimal regulation maintains the respect for law, however, when regulatory issues are so vitally important to the global economy, command and control systems, as Ayres and Braithwaite contemplate, are sometimes un-avoidable and probably extremely necessary. According to Umpleby, cost efficiencies are enhanced if the variety in the system being regulated is reduced. Hence efficiency could be improved if international government bodies regulate domestic government departments which are given responsibility to perform certain tasks. Cross-border co-operation is necessary in a new world order but global governance must be done in such a manner that makes government networks accountable for core policy and not the private banks which has typically been the case in the past. Getting central banks and other prudential supervisors to work together to fix and maintain currency values is one possible solution to the problem. If that was to transpire, financial stability could be improved at the national level, which would flow on to the IMS as a whole. If the supervision of central banks is co-ordinated at an international level but administered at a national level, what benefits may be realised throughout the global economy?

The next Chapter analyses the findings drawn from this work and explains the contribution this dissertation has made to the existing body of knowledge.

[85] Reflecting on the loss of political control to elite capitalists who owned the new Federal Reserve in 1913 President Woodrow Wilson wrote: '… we have come to be one of the worst ruled, one of the most completely controlled and dominated, governments in the civilized world ~ no longer a government by free opinion, no longer a government by conviction and the vote of the majority, but a government by the opinion and the duress of small groups of dominant men'. Cf: Wilson, W. (1913) *The New Freedom: A Call For the Emancipation of the Generous Energies of a People*, Doubleday Page & Company, New York and Garden City, p 201.

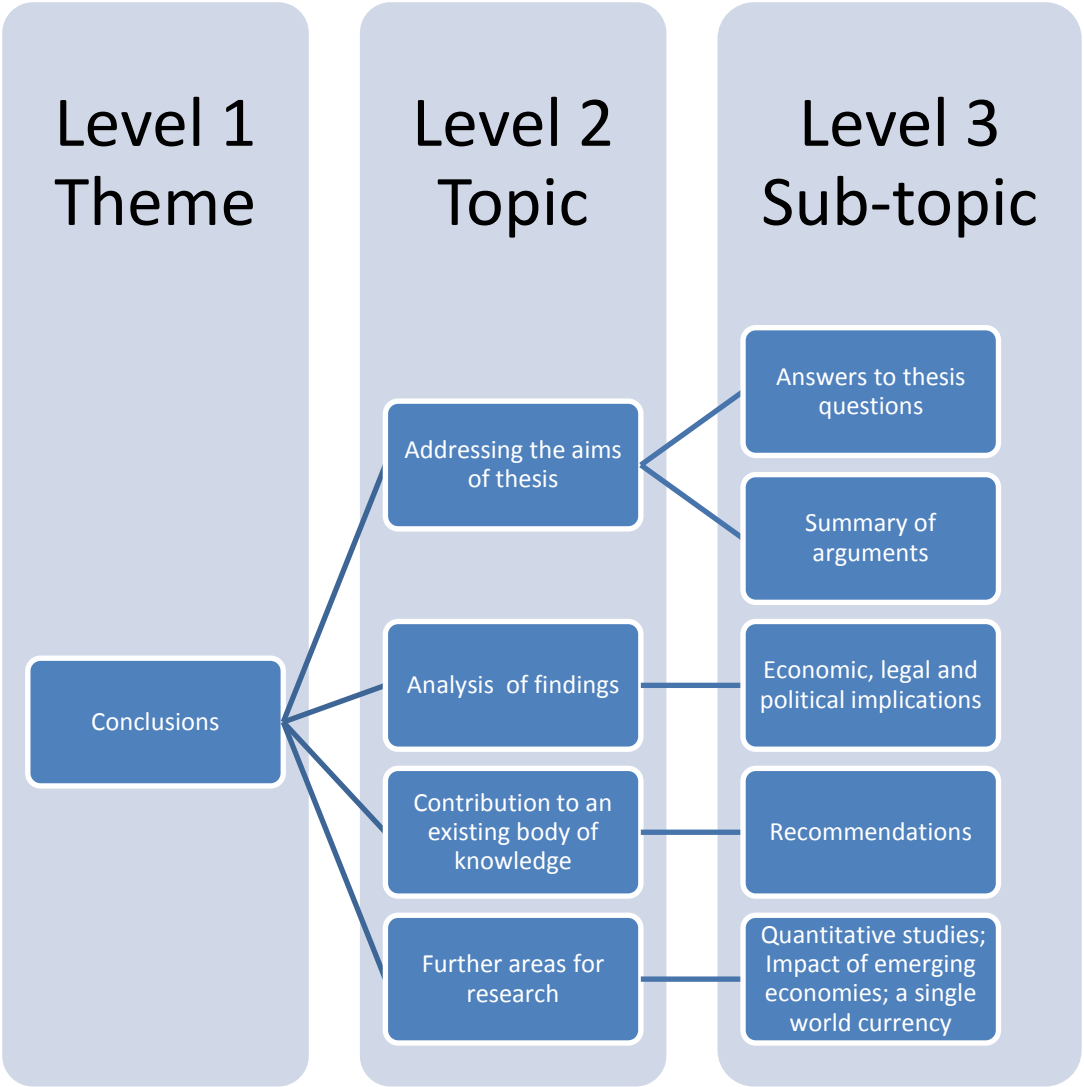
Summary of Chapter 10

This Chapter:

- contends that multi-lateral government intervention, management and regulation of the IMM is critical for maintaining stable currency values
- analysed post GFC G20 developments, the IMF's resurrection and outlined moves towards creating a model for world economic order
- described the general policy position of the six nations whose currencies are most traded and the steps those countries are taking towards implementing financial reform
- reported that the G7 countries which have the greatest influence to initiate reforms within the IMS are the least motivated to implement change
- argued that maintaining stability of exchange rate values is the specific area of reform that needs the most attention, yet it is not considered a priority by Western governments
- revealed the biggest hurdle to implementing reform in the IMS was non-agreement between States and inaction by legislators
- argued that even though it might be G7 policy, allowing the free market to determine the value of exchange rates is a mistake

Chapter 11

Conclusions



Chapter 11

Conclusions

Chapter Abstract

This Chapter summarises the findings of the thesis and puts forward recommendations that could minimise the negative economic consequences of speculative capital flows. It provides answers to the four questions presented in Chapter 1 and consolidates the argument for reform. It addresses the aims of the thesis recapping on the history and evolution of the international monetary market demonstrating where it went wrong, where it presently stands and what prospects may lie ahead for the global economy. It amalgamates the economic facts that warranted the research and reiterates how existing international monetary laws are not being fully utilised to find a solution to currency volatility. It revisits the economic, philosophical and legal arguments supporting improved regulation of financial markets and looks at State Sovereignty, State Responsibility and international co-operation as a means to reducing instability in currency markets. It recaps on the possible strategies available to reduce speculative capital flows and shows how the growing importance of the Bank for International Settlements (and its agencies) is allowing for greater collaboration between monetary authorities at the global level.

The thesis applied Ayres and Braithwaite's *Regulatory Pyramid* and Umpleby's *Requisite Varie*ty model of regulation to deduce that it is most cost effective to interfere less with the free market but concentrate more on improving the managerial infrastructure of the IMF, World Bank, BIS and central banks to reduce currency differentials. Those arguments are reconciled below.

This Chapter also explains the contribution this research made to the existing body of knowledge and proposes several areas for further research. It recommends that international structural reforms are essential if the problems caused by speculative capital flows are to be solved. International co-operation is a prerequisite to stable, efficient, open capital markets, but control must ultimately rest with the individual State (acting collectively with other States) and not with the free market; but first there must be an international institution that is capable of making cross-border co-operation a reality which is proficient in devising, implementing and policing sound financial management directed at maintaining stable currency values. It will only be after such measures are in place that the global economy will function at its optimum level.

11.1 Answering the Questions

In Chapter 1 four questions were put forward to be answered by this research. In brief, ~ but in further detail within this Chapter ~ the answers to those questions as demonstrated in the body of this thesis are:

1. Speculative currency trading adversely affects the stability of national economies. There is a net migration of wealth out of the targeted economy; that induces higher interest rates, lower output, lower income, less money in circulation and higher unemployment. Speculative capital flows undermine efficient economic outcomes; they jeopardise the best allocation of scarce resources; dead weight losses are incurred; therefore it would be in society's best interest to limit the negative effects of SCF.

2. International monetary law has not kept pace with market forces. Globalisation and technological progress within financial markets has circumvented the intent of international monetary law and compromised global financial stability. Consequently, new laws and new rules are needed at the international level to cater to the new paradigm. Political leaders and policy makers need to recognise the benefits of adopting procedures that may help minimise volatile currency values. Doing away with fully floating exchange rates and maintaining currency values within econometrically calculated fixed bands would help stabilise financial markets; something that has to be achieved through international monetary law.

3. The philosophical doctrines and principles which shape the nature and spirit of law should be employed to improve the efficacy of the international monetary and financial system. The philosophical, economic and legal under-pinnings of society warrant tighter regulatory control over the international financial sector particularly with respect to stabilising currency values. Focus should shift to the international bodies which monitor and manage the IMS giving them more power to police the system while simultaneously making them more accountable to maintain a stable monetary system. Those goals would likely necessitate the creation of an overarching entity that could direct central bank activities on a global scale.

4. The imperfections within the current system can be rectified provided national governments come together and pro-actively co-ordinate

strategies that keep the creation and flow of money in the market under tighter government control. There are however political and market force agendas in existence which adversely affect and frustrate the smooth operation and stability of the international monetary and financial system. Therefore legislative and regulatory controls should be implemented to reduce market induced currency differentials to curtail the speculative opportunities that currency traders exploit under present conditions.

The research established that the existing financial architecture does not require a total re-build but it does require substantial reform. International law has the mechanisms to secure a more efficient international monetary system but it has not been utilised to its full potential. However, there are options available to facilitate that reform. If international prudential institutions, national governments, their central banks and domestic regulators can reach agreement, several strategies could be implemented to reduce the negative effects of speculative capital flows. The concluding analysis of the feasibility of implementing capital controls, taxing international transfers, locking in or pegging currency values, creating more currency unions and the adoption of a global currency is presented below.

11.2 Addressing the Aims of this Thesis

This dissertation focused on the problems revolving around financial instability and economic deficiency attributed to speculative capital flows and unregulated markets and banking practices. The literature review in Chapter 2 highlighted the problem. Lietaer (1997) expressed his concerns about the alarming increase in global currency speculation. He said the potential implications were: 'truly explosive, threatening global power arrangements, the sovereignty of nation-states, and the abilities of

ordinary people to survive'[1]. Paul Volcker said the: 'deep-seated problems of international finance … have been too little recognised in either the world of academia or that of policy makers'[2]. He also said: 'Should we ... have worked harder to maintain the Bretton Woods system and the stability its exchange rates provided?'[3].

Another Federal Reserve manager, Robert Hemphill (2002), stated: 'we are absolutely without a permanent money system'[4]. Currency speculator George Soros (2003) wrote: 'instability is cumulative, so that the eventual breakdown of freely floating exchanges is ensured. Exchange rate misalignments have become a major source of disruption for the world economy ... The market mechanism fails to bring currencies back into alignment'[5]. Mahathir bin Mohamad as chairman of the 1998 APEC Summit expressed major concerns about the role of currency traders and the need for global regulation of financial markets[6]. Hong Kong's Chief Executive Tung Chee Hwa said that these speculative funds: 'have caused so much damage to economies' and that there was a great need for 'ongoing international efforts to strengthen

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[1] Lietaer, B. (1997) Global currency speculation and its implications, *Third World Resurgence*, Vol. 87/88 (1997), p 15-17.

[2] Volcker, P. (2003) *Forward*, to Soros, G. (2003) *The Alchemy of Finance*, 3rd ed., John Wiley and Sons Inc., New Jersey, at p xiii.

[3] Volcker, P and Gyohten, T. (1992) *Changing Fortunes: The World's Money and the Threat to American Leadership*, Crown Publishers, New York, p xvi.

[4] Quoted in: Morgan, D. (2002) The Significance & Sanity of Silver as Money, *Financial Sense Editorials*, 12th July 2002.

[5] Soros, G. (2003) *The Alchemy of Finance*, 3rd ed., John Wiley and Sons Inc., New Jersey, at p 337.

[6] Asian Economic News (1998) APEC leaders want disclosure from hedge funds, *Kyodo News International, Inc.*, 23rd November 1998, available at:
http://findarticles.com/p/articles/mi_m0WDP/is_1998_Nov_23.

prudential supervision to enforce higher standards of transparency, disclosure and accountability'[7].

The above authors agreed that there are many people who have a vested interest in profiting from volatile currencies. The problem with speculative currency flows is that they exacerbate financial instability, are economically detrimental to the targeted country and contribute to a less efficient global economy. With the growing recognition that SCF create undesirable distortions within the IMS, in 2012 the United Nations Conference on Trade and Development accepted this reality saying: 'Re-regulation of global finance and the establishment of a multilateral international monetary order remain the order of the day'[8]. Yet Gordon Brown (2012), writing post-GFC on the delayed co-ordination of a globalised financial management strategy, said:

> In 2009, when world leaders agreed on a bold strategy, I and others insisted that first aid measures were not enough. The G20's Action Plan included a commitment by its members to co-ordinate fiscal, monetary, trade and structural policies and to use the IMF's mutual assessment process as its vehicle. What was intended to be a global growth pact quickly bogged down in 'currency wars'…
>
> … Nevertheless, international institutions built in 1945 are now wholly inadequate for the challenges of a global economy. We must make the IMF a more effective tool for global surveillance, give the G20 teeth to co-ordinate international economic policy, ensure that all non-G20 countries are included

[7] Khor, M. (1998) APEC meetings end with call for hedge funds review, *SUNS - South-North Development Monitor*, 19th November 1998, available at: http://www.sunsonline.org/trade/process/followup/1998/11200298.

[8] United Nations Conference on Trade and Development (2012) *Development and Globalization: Facts and Figures 2012*,UNCTAD/WEB/GDS/DSI/2012/2 at p 39.

> in consultations; and set detailed timetables for agreements on global bank rules … [9]

Moisés Naím (1999) wrote:

> … the only consensus that seems apparent is that no sweeping redesigns of the global financial architecture are imminent and that the system today is only marginally better prepared to deal with large-scale, highly contagious financial crashes. This means that in the next crisis we should expect that, again, policy responses will be largely improvised and the institutional arrangements to deal with it will essentially be ad-hoc. This will be especially true if the next financial crisis is not in an emerging market but in a large industrial country deeply integrated into the global economy [10].

In hindsight of the 2008 global financial crisis, Naím's prediction about: 'no sweeping redesigns of the global financial architecture' turned out to be correct. Despite numerous short-falls and complaints about the international monetary system coping with volatile currencies, nothing extraordinary has been done (both pre and post GFC) to enhance financial stability. What was identified as a major weakness within the IMS in the 1970s is still a major weakness today. Consequently, the global economy continues to be critically exposed to the risk of further financial melt-downs and economic crises.

To help solve that weakness, this thesis conducted an analysis of the effects of speculative capital flows. The findings, which identified areas where improvements can be made to help stabilise currency values and reduce exchange rate volatility,

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[9] Brown, G. (2012) Let's Stick Together, *The International Herald Tribune*, Special Report, 30th November 2012. Available at: http://www.nytimes.com/2012/11/30/opinion/global/gordon-brown-global-economic-problems-need-global-solutions.html?ref=globalagenda2012&_r=0

[10] Naim, M. (1999) *Fads and Fashion in Economic Reforms: Washington Consensus or Washington Confusion?*, Working Draft of a Paper Prepared for the IMF Conference on Second Generation Reforms, reproduced in *Foreign Policy Magazine*, 26th October 1999.

should compel legislators, policy makers and concerned citizens alike, to understand the machinations and complexities of the IMS. Those findings demonstrated that the existing regulatory framework exerts insufficient and largely inadequate controls on capital markets. Without those controls, volatile currency values will persist. The thesis therefore argues for improvements to the present system by not only changing the rules of the existing international monetary framework, but also by changing the framework itself. Those ideas and consequent recommendations are set out below.

11.3 The Historical and Evolutionary Perspective Argument

The dissertation described the evolution of the international monetary market from its origins with the Chicago Mercantile Exchange and showed the preference for *laissez faire* capitalism, the abandonment of the gold standard and its impact on the global economy. It provided an overview of forex trading identifying the components of the international monetary market and introduced the main trading platforms. The process of currency trading was explained which identified the areas of weakness within the system. The conclusions drawn from the analysis is that as currency speculation increases in volume, instability in forex markets also increases. The correlation between the two variables logically draws us to a conclusion that to improve financial stability in currency values, speculative capital flows need to be reduced. Consequently, strategies need to be implemented so as to either outlaw the practice through legislative channels or re-design the system (through administrative channels) and make SCF financially unviable. The thesis analysed the various options to reveal the most cost effective solution (this is expanded upon in following sections).

The dissertation examined the evolution of hedge funds and the accountability problems associated with those types of funds. It was revealed that the divide between investment banking, commercial banking and insurance companies in the US was removed with the repeal of certain portions of the *Glass Steagall Act* in 1999. That allowed US savings banks (as opposed to the former exclusivity of US investment banks) to do business on Wall Street and vice versa. It meant US savings banks could invest their depositor's funds in derivatives and other risky financial assets that proved to have little social benefit. Subsequently, the partial repeal of the *Glass Steagall Act* contributed to the sharp rise in the number of hedge funds as savings banks and other financial institutions used those mechanisms to enter the bond, futures and foreign exchange markets. As a result, many US banks now have their own in-house hedge funds investing in financial securities and currencies around the globe with little supervision. Further, because the US has the largest number of hedge funds participating in the global market, its impact on currency values is significant.

Logically, attention should be drawn towards increasing prudential management of US financial institutions so as to maximise the effect of corrective strategies designed to promote exchange rate stability. However, as was demonstrated throughout the thesis, resistance from the US banking and financial sector is so powerful that even attempts by the Securities and Exchange Commission and the Commodity Futures Trading Commission to tighten regulation has been blocked at almost every front[11].

[11] At the time of writing, the proposed *Credit Default Swap Prohibition Bill* (H.R. 3145, 111th Congress, House of Representatives, 1st Session, 9th July 2009) which sought to provide the US Securities and Exchange Commission with the authority to regulate swap agreements had not proceeded. Similarly, S. 1682 of 111th Congress: *Derivatives Market Manipulation Prevention Bill* of 2009 which was to provide the Commodity Futures Trading Commission with antimarket manipulation authority also met a dead end. More successful however was the Dodd–Frank *Wall Street Reform and Consumer Protection Act* (Pub.L. 111-203, H.R. 4173) passed in July 2010. The Dodd-Frank legislation gives the Federal Reserve oversight of the largest financial institutions, including non-banks to improve accountability and transparency while also reversing the "too big to let fail" doctrine. It also

Additionally, the fallout of the GFC proved comprehensively that tighter control of financial markets is needed to help avert typically re-occurring financial meltdowns. The analysis draws us to a conclusion that corrective strategies should be implemented first in the State where the bulk of the problem originates but that also other States need to co-operate in the development of those strategies at the international level.

Because the problem is of a global nature, all countries should participate fully in the reform process. And although it is something that is happening in a sporadic fashion, this is what we saw with the progress being made by the British Financial Service Authority[12] and the European Commission introducing harmonised EU rules for entities engaged in the management of alternative investment funds[13]. Having two out of the three major contributors to global financial management (ie the UK and Europe) devising strategies for tougher financial market regulation, it might generate a co-ordinated effort and eventually persuade the other major player, the US government, to adopt similar measures. However, the US government has a symbiotic relationship with Wall Street which makes financial reform within the US a challenging task (Ferguson, 2010).

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gives the Fed a prominent role in the Financial Stability Oversight Council, a body of regulators with the power to liquidate a systemically important financial company if its insolvency threatens the economic stability of the US. Although the *Dodd-Frank Act* initiated these steps, sorting out the finer points of the *Regulations* has delayed its implementation. Industry lobby groups including the United States Chamber of Commerce and the Futures Industry Association have challenged the proposed changes. See *Business Roundtable and Chamber of Commerce of the USA v SEC,* No. 10-1305 United States Court of Appeals (D.C. Cir. 2011).

[12] Financial Service Authority (2009) *The Turner Review: A regulatory response to the global banking crisis*, Financial Service Authority, UK.

[13] Council of the European Union (2011) *Press Release: Council adopts EU rules*, 27th May 2011. Brussels, No 10791/11.

Devising and implementing strategies to maximise the stability of currencies at the global level is expanded upon below but other hurdles and arguments have been considered as well. Examples include: opposition for reform from the financial services industry which is likely to reject additional obligations that reduce the industries' earning potential (Ch 4.5) or conflicts with State sovereignty (Ch 5.6) and deciding which regulatory model offers the best outcome (Ch 9.10). Those variables and numerous other points are combined in the following analysis.

11.4 Philosophical Argument to Reduce Speculative Capital Flows

The dissertation provided a philosophical argument as to why disruptive currency trading should be curtailed by showing how the laws that govern society change with the level of economic development. As society changes so must its laws. The more technologically complex and sophisticated society becomes, the more complex its laws need to be. Just as the bourgeois revolutions of the eighteenth and nineteenth centuries prompted the development of laws relating to the security of commercial transactions[14], in the twenty-first century globalisation and international laws should also perhaps do the same for the security of national wealth.

[14] As societies developed capital-pooling and complex banking systems, property laws clarified the distinction between basic possession and ownership entitlements. Property interests took on new dimensions. During the development of these laws the importance of possession was de-emphasised, while that of ownership rights was elevated. To protect the ownership rights attributed to the new types of property, the law was adjusted and modified to fit the new parameters. King George II's 1757 *Act* of *Obtaining Money by False Pretences* (30 Geo. II, c. 24) enlarged the scope of property offences to cover any acquisition of property by false pretences with the intent to cheat or defraud the owner. On several occasions the English courts were not capable of enunciating a legal theory that could accommodate the new dimensions of property interests. Two historic UK cases to highlight this point were *R v Pear* (1779) 1 Leach 212 (4th ed.); 2 East PC 685; 168 ER 208 and *R v Bazeley* (1799) 2 Leach 973 (3rd ed.) (Case CCCXI); 168 ER 517. Pear's Case demonstrates how the court took a step towards criminalising conduct involving an interference with a property right over that of a trespassory invasion of possession. The court took a pro-active stance to expand the scope of larceny to ensure justice was achieved. The decision in *Bazeley's Case*, led to the enactment of the *Embezzlement Act* of 1799 (39 Geo. III, c. 85) which henceforth extended the concept of a breach of trust into the realm of criminal law.

The philosophical argument for reform in Chapter 5 covered a spectrum of views. The discourse deduced that the harmful effects of SCF should be curtailed, which warranted an adjustment to the present international financial arrangements, but finding a practical solution may be harder to implement because of competing State and private interests. Currency trading is motivated by the intention to make a profit through the inefficiencies of the present international monetary system, but the effect of unrestricted capital flows is to deprive a State's economy of the benefits and true value of its currency through the subtle extraction of wealth made possible by varying exchange rates.

In an era of globalisation and rapid change, financial instability and economic crises highlight why more attention needs to be paid to enforcing the rules of international monetary law. If modern States were prepared to follow the IMF *Articles of Agreement* to foster stable exchange rates, review the practice of speculative currency trading and introduce suitable rules and penalties for entities which destabilise currency values, that prescription might provide a useful deterrent to would-be traders and help preserve the wealth of nations. However, the thesis delved deeper to identify the root cause of the problem and went on to propose that it would not be cost effective to monitor and police free market traders; rather, the focus should shift towards improving the global management structure of the IMS.

Another finding of the philosophical research was that there is no clear leadership structure in place to facilitate a co-ordinated effort among State parties. That draws us towards the need for world leaders to assign authority to an over-arching entity that can implement effective change at the global level. Such a proposal however opens

the way for more upheaval and confusion as State, political and private entities compete to secure their own power structures and protect their interests.

The thesis went on to examine the institutions that could possibly contribute to the enhanced management of the international monetary system. While the IMF is the figurehead of international monetary co-operation, the Bank for International Settlements (along with its agencies) is clearly the leader in strategic policy development for enhanced financial management. But the BIS is a for-profit entity and while many national governments share ownership and contribute time, effort and money into its operation and supervision of the global monetary system, the BIS does not have any law-making ability or mandate to enforce its management techniques (and data collection requirements) onto national governments. At best, all the BIS can do is encourage State members to willingly participate in the collective endeavours with other governments (via their prudential supervisors) to devise stabilising strategies to be implemented by governments to both central bank and private bank entities at the national level.

From a philosophical and political point of view, the ramifications of an IMS without clear leadership poses numerous problems, the least of which is who should take control? The competing forces of major players trying to secure their power base ~ and their seigniorage-making capabilities ~ makes for a strategic battlefield in terms of supplying money ~ via the issuance of credit and fiat currencies ~ to the global economy. The entity which prevails will wield significant power; so the stakes are high. But to paraphrase the first principle of Sun Tsu's *Art of War*: 'without conflict,

there is no growth'[15]. Somewhere in the evolution of the IMS, the conflicts associated with leadership, management and power will have to be addressed.

Following the historic rise and decline of economic superpowers from the West, the tendency is to follow the lead of the more powerful economy (Mundell, 1997). For the past 80 years it has been the US; before that for 180 years it was Britain; before that Spain for 250 years. As each successive overlapping economic superpower rose, plateaued and declined, it had a shorter period of dominance. This leads us to the probability that the US is coming to the end of its dominant position. The introduction of the euro and the rising fortunes of China and other BRICS countries could now force another direction in global economics but in the interim, globalisation has taken effect which presents an era of interconnectedness that has never existed before.

The new era of globalisation means that States are no longer isolated economic islands; they are now more politically and economically integrated than at any other time in history. Following this trend, it is likely that no one economic superpower will dominate the global economy or dictate the rules of international finance like they have in the past. The new paradigm is that national economies are so integrated with each other that international political co-operation on monetary affairs (and other strategic issues) has become a priority. This means that new rules will be required and probably new financial institutions created to cater for this new era of economic

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[15] Sun Tsu, the Chinese military strategist explains the most important insight for would-be-leaders: 'Conflict is essential to the development and growth of man and society. It leads either to the construction or destruction of an entire group or State…If there is no conflict…there can be no growth…If you do not understand the need for conflict, then you should not be in control of the society you presume yourself to be in charge of'*. Cf Sun Tsu (c.500 BC) *The Art of War*, translated by S.F. Kaufman, (1996) Tuttle Publishing, Boston Mass., at p 3.

integration. And as the EEC and EMU experiments proved, commercial and economic integration is followed closely by political integration which further promotes harmonisation at the international level. Applying the EMU concept to the global economy, the likely evolution of the IMS is that, because no one economy will (be allowed to) dominate global finance, developing rules for the management of the IMS will lead to cross-border collaboration in creating a new overarching financial structure capable of supplying credit (ie like the IMF does) to the global economy. Whether it is a new global central bank, similar to what European governments created with the ECB, or an expansion of the IMF combining the BIS and national central banks, whatever institution is formed, it will need to cater to the interests of all the world's people. And while that is a challenge in itself, it remains to be seen how world leaders will rise to the occasion.

11.5 The Economic and Political Implications of Speculative Capital Flows

The process of speculative currency trading reveals how capital movements substantially equate to a planned disruption of financial markets. To justify that assertion the thesis used the *Balance of Payments Equation*, the Mundell Fleming *IS-LM-PB* model and the *Efficient Market Hypothesis* to highlight the economic damage caused by speculative capital flows[16]. The higher interest rates being paid by the central bank to attract capital to the country, in order to maintain the BOP, means that long term liabilities are increased for the entire nation and future generations. Intergenerational fairness must be added to the complex equation. Not only do the citizens of an economy find themselves worse off, but the dynamics and additional costs of maintaining stability within an economy must also be taken into account.

[16] Ch 3 identified that the damage caused to the national economy can include higher interest rates, lower output, lower income, less money in circulation and higher unemployment.

The thesis highlighted how the costs of speculative capital flows to an economy are therefore varied and wide but the solutions are even more varied and problematic. It explained how the international monetary market came into existence in a regulation-free environment as it was something that had never existed before, and hence, there were no laws that catered to the new paradigm. Consequently the present international monetary system does not cater to, assist or protect the best interests of impoverished, developing or first world nations alike. The design and management of the international monetary market is in need of an overhaul, but resistance from the financial service industry in general and reaching concensus between competing national governments bowing to their own internal pressures has significantly stifled the reform process.

The thesis described how the US banking system (including the Fed) has proven itself to be self serving[17]. The influence of Wall Street on US government policy perhaps explains why nothing concrete has been done to address the complaints about the inefficiencies of the IMS that have circulated since the abandonment of the gold standard. Consequently it is a recommendation of this research that an urgent

[17] The manner in which credit is granted and money is created within the US is dependent on the US Federal Reserve; a privately owned corporation which is not a government controlled institution*. The eight largest banks in America, which share ownership of the US Federal Reserve, actually became bigger as a process of the GFC. Bank of America, JPMorgan Chase, Citigroup and Wells Fargo ~ now control more than half of America's mortgages, two-thirds the number of credit cards and two-fifths of all bank deposits**.

* *Lewis v United States*, 680 F.2d 1239 (1982) Court of Appeal, Ninth Circuit; Also *United States v Hollingshead*, 672 F.2d 751 (1982) Court of Appeal, Ninth Circuit. See Appendix C.

** Nasiripour, S. (2009) Congressmen to call for Break-up of Biggest Banks, *HuffingtonPost*, 7th December 2009. Available at:http://www.huffingtonpost.com/2009/12/07/congressmen-to-call-for-b_n_383128.html

overhaul of the IMS be initiated by governments working collectively while conditions are still favourable and not leave it till the next financial crisis hits. That might mean that other States have to apply pressure on the US government to take command of its banking sector and regulate it more stringently.

The dilemma however is that the problems associated with speculative capital flows and exchange rate volatility have been too little recognised especially by political leaders and policy makers who have the power to initiate improvements but have failed to act despite the fact that there are international laws and institutions in place that can be readily utilised to implement change. The thesis revealed how international monetary management practices are inadequate and that the institutions which are in place have very little effect in administering the smooth operation of the IMS. Additionally, indifference on the part of legislators in failing to act adds to the problem and prolongs the disruption. Consequently, generating greater awareness of the problems associated with volatile currency values should be a priority of academics, policy makers, prudential regulators and legislators alike.

The one positive aspect to emerge from the GFC was that governments of the G20 countries appeared to finally take note of the problem. Although the immediate reaction was to improvise fiscal spending measures to stimulate economic growth, which forced many governments further into debt, the longer term benefit was that policy makers and prudential supervisors witnessed first-hand the fragility of the existing system. The G20 Summit meetings following the GFC made governments recognise that the international monetary and financial system needs far better

management. And although the initial enthusiasm for reform has waned since the crest of the crisis, it is nevertheless, still necessary to pursue that change.

The fact that the governments of those leading economies ~ along with the BRIC delegations ~ actually came together to commence dialogue and initiate a reform process should be marked as an historical turning point. Withstanding the fact that the Bretton Woods Conference in 1944 primarily catered to the interests of the Anglo-American alliance, the G20 London Summit of 2009 expanded the input to include many emerging economies. Significantly, the GFC was really the first crisis to occur that forced the G7 countries to address the monetary and financial concerns of the governments of the emerging economies which represent nearly half the world's population.

So what was officially recognised as the 'global financial crisis', was in fact a starting point for reforming the IMS. And although the leaders of the major economies did not agree on every issue raised during the Summit meetings, they did cement the foundations for cross-border co-operation for financial stability by bringing into existence the Financial Stability Board and semi-restoring the importance of the IMF. Those institutions ~ along with input from the BIS ~ have been given a directive by G20 leaders to devise strategies to strengthen the global economy. Their recommendations will no doubt make some State parties disagree with other States, but the fact that they are all discussing the issues and not turning a blind eye to the problem should have positive flow-on effects.

Although bank risk minimisation, prudential supervision and capital reserve ratios rank as priorities for implementation, currency stability will also work its way into the financial matrix. Because prudential supervision of internationally active financial intermediaries will necessarily encompass market integrity concerns and reporting procedures, data on capital movements will become easier to collect. It is this data that becomes so important because it will allow institutions like the IMF and BIS to recognise exactly why currency values become so volatile[18]. Monitoring that real time information will help identify which type of transaction causes what type of currency fluctuation. Having a platform through which to monitor currency movements will also provide a base for international enforcement efforts in respect of illicit activity and abusive market behaviour. While that might sound like an undue encroachment on the rights of the free market, it is a vital step towards shoring up the IMS.

If or when the above scenario eventuates, it will be dependent upon the collective efforts of governments coming together and following the recommendations of the Financial Stability Board. But while it is hard to get governments to agree, and even harder to get governments to relinquish monetary sovereignty, it is not impossible. As the introduction of the euro demonstrated, monetary and political integration generally follows commercial integration, and because the world is becoming increasingly connected with international trade and commerce, the natural progression

[18] Dickey, D.A. and W.A. Fuller (1979), Distribution of the Estimators for Autoregressive Time Series with a Unit Root, *Journal of the American Statistical Association*, Vol. 74, p 427–431.

Hacker, R. and Hatemi-J, A.(2010) The Properties of Procedures Dealing with Uncertainty about Intercept and Deterministic Trend in Unit Root Testing, *CESIS Electronic Working Paper Series*, Paper No. 214. Centre of Excellence for Science and Innovation Studies, The Royal Institute of Technology, Stockholm, Sweden.

See also: vector auto-regression (VAR) and the Johansen test for co-integration. Johansen, S. (1991) Estimation and Hypothesis Testing of Cointegration Vectors in Gaussian Vector Autoregressive Models, *Econometrica*, Vol.59, No.6, p 1551–1580.

should lead to further political consensus, regulatory control and disciplinary measures with respect to trade and more importantly to regulating financial markets.

Advancement of the IMS is invariably an evolutionary matrix where each component of the equation interacts and reacts to the forces being exerted upon it. A disruptive crisis ~ in any form whether it is a natural disaster, political upheaval or a financial melt-down ~ has the effect to speed up the evolutionary process[19]. The next financial crisis, whether it is the fall out of the anticipated fiscal cliff or a bank-induced credit squeeze or a currency war, will certainly destroy significant wealth, but it will also be an opportunity to implement some radical and monumental changes. At this stage, what those changes will be is unknown, but it should hopefully lead to further monetary harmonisation and political integration. That result may bring us a step closer to a new world order or at a minimum, a newly created overarching entity that is more capable of managing the international monetary and financial system. That possibility compels us to examine jurisdiction issues.

11.6 Jurisdiction Issues relating to Cross-border Capital Flows

The British Financial Service Authority (FSA) versus Citigroup discussion in Chapter 6 highlighted a myriad of issues that need to be addressed if a solution to disruptive capital transfers is to be found. The FSA was able to fine Citigroup for its failure to properly perform its duties in accordance with the provisions of the *Financial Services and Markets Act* 2000 (UK) but the limitation with the FSA is that its jurisdiction only applies to matters concerning Britain's own affairs or conduct originating within its borders. The other problem with the FSA is that it cannot award

[19] Levchenko V.F. (1997) Ecological Crises as Ordinary Evolutionary Events Canalised by the Biosphere. *CHAOS. International Journal of Computing Anticipatory Systems*, Vol. 1, p105 -117.

compensation to nations or investors who are deprived of their wealth as a result of market abuse activity or other financially disruptive trading practices originating either domestically or internationally. The FSA can only fine offenders who breach an obligation under its *Codes of Conduct* or act contrary to the *Financial Services and Markets Act*; it cannot grant relief to a victim who suffers an economic loss due to manipulative or market abuse activity.

The British Financial Service Authority and the International Court of Justice are two institutions which are able to address disruptive capital flows but they can only become involved after the detrimental events have occurred. Such *ex post facto* remedies demonstrate the need for the legislator's pre-emptive involvement to minimise disruptive capital flows before they occur.

Nevertheless, the lesson from the Citigroup example is that nationally enforced remedial measures can work provided laws are in place to start with. The British government had initiated this with the introduction of the *Financial Services and Markets Act* 2000 (UK). Power to impose penalties in cases of (cross-border and domestic) financial market abuse activity was given to the FSA under section 123 of that Act which could be used as a framework for other jurisdictions to emulate. But as stated previously, the problem is global and it requires a global response, not just an *ad hoc* implementation at the national level. Further, this is where the international community has to acknowledge that a problem does exist and take steps towards improving the system through co-operation and long term planning. Without that long term planning, the IMS will remain unmanageable and continue to expose the world to volatile currency values and future financial crises. Consequently States, or at least

the majority of States (including those with the greatest financial power and influence), must act in unison which necessitates collaboration and perhaps adjustments to State sovereignty.

11.7 Sovereignty and State Responsibility relating to Speculative Capital Flows

The discussions on State sovereignty (Ch 5) and international law (Ch 6) explained that the present legal framework has within it the ability and mechanisms to bring the negative effects of disruptive currency trading to an end. That discourse focused on the interpretation and application of international agreements, uniform statutes, international jurisdiction, monetary sovereignty, responsibility of States for internationally wrongful acts and damages and restitution in international law.

The draft *Articles* on *State Responsibility for Internationally Wrongful Acts* sought to formulate a global code of basic rules concerning the responsibility of sovereign States. The emphasis was on the general conditions under international law by which a State could be considered responsible for acts or omissions and the economic consequences which follow them. Whether there has been an internationally wrongful act or omission depends first, on the requirements of the obligation which is said to have been breached and, secondly, on the qualifying conditions for such an act or omission[20]. As noted previously, the duty imposed on States under Article IV(1) of the IMF *Agreement* is that States should 'endeavour' to direct their policies towards fostering orderly economic conditions. So, if States do not 'endeavour' to create or

[20] International Law Commission (2001) *Draft Articles on Responsibility of States for Internationally Wrongful Acts,* with text adopted by the International Law Commission at its fifty-third session, and submitted to the General Assembly as a part of the Commission's report. Commentary on Article 1, at p 32.

maintain a stable system of exchange rates they are arguably acting contrary to international law which could invoke the tenets of State responsibility.

Even though the draft *Articles* on State Responsibility were devised and based on existing international law, they have not yet been officially embodied into an international Convention. The proposed adoption would no doubt clarify the existing body of international law relating to reparations into a more understandable format. There is also the fact that the International Court of Justice is already applying the content of the draft *Articles* into its decisions[21]. So although the proposed Convention is not yet ratified by the UN General Assembly, the evolutionary nature of international law already provides the mechanisms through which a plaintiff State could commence an action for restitution of economic loss due to disruptive capital flows originating from another State.

Elements of governmental authority are considered as acts of State. Numerous ICJ cases[22] have held States responsible for the effects of conduct by parties under their control (See Ch 6 Corfu and Tehran examples). Under draft Article 5 of *State Responsibility* the conduct of a person or entity which is not an organ of the State but which is nevertheless empowered by the law of that State to exercise or conduct its affairs contrary to the State's international obligations invokes State Responsibility.

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[21] See for instance: Case Concerning the Application of the Convention on the Prevention and Punishment of the Crime of Genocide (*Bosnia and Herzegovina v Serbia and Montenegro*) , 26 Feb. 2007; The ICJ cited an earlier text of the draft Articles in *Gabčíkovo-Nagyamaros Project (Hungary/Slovakia)*, ICJ Reports 1997, 7 at para 52.

[22] *Corfu Channel Case* (1949) ICJ Reports, 4; *United States Diplomatic and Consular Staff in Tehran* (1980) ICJ Reports, 3; *Tadić Case,* ICTY, Judgment of the Appeals Chamber, The Hague, Case No.: IT-94-1-A, 15 July 1999; *Application of the Convention on the Prevention and Punishment of the Crime of Genocide* (*Bosnia and Herzegovina v. Serbia and Montenegro*), Judgment, I.C.J. Reports 2007, p. 43.

Additionally, draft Article 8 says that the conduct of a person or group of persons shall be considered an act of a State if the person or group of persons is in fact acting under the direction or control of that State. But that has been interpreted to apply only where there is real control. For clarification, the ICJ devised the 'effective control' test as enunciated in *Nicaragua v United States of America*[23]; consequently, and presently, international law might not extend liability to a State due to the activities of free market traders (partially) under the State's control.

However, where a State fails to fulfil its international 'due diligence' obligation to foster stable economic conditions, or endeavour to direct its economic and financial policies towards orderly exchange arrangements free of erratic disruptions that allow it to gain an unfair competitive advantage over other members, then any country which allows its banks and currency traders to disrupt global financial markets could possibly find itself liable for the actions of its traders if it took no steps to limit their disruptive activities.

While the due diligence principle has not been tested in international law in an economic sense[24], the ICJ is not bound (like common law courts) by the doctrine of *stare decisis*[25]; therefore international monetary law has the potential to develop very rapidly without being restricted by prior precedents which no longer fit the current era

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[23] *Military and Paramilitary Activities in and Against Nicaragua*, (Merits), (*Nicaragua v United States of America*), Judgment of 27 June 1986, I.C.J. Reports 1986, at p 55.

[24] The duty of due diligence was applied in the context of human rights violations in *Velasquez Rodriguez v Honduras* (Inter-American Court of Human Rights, Judgment of 29th July, 1988, Series C No. 4) wherein the Inter-American Court of Human Rights held that a State must take action to prevent human rights violations, and to investigate, prosecute and punish them when they occur.

[25] Article 59 of the *International Court of Justice Statute* makes it clear that the common law doctrine of *stare decisis* does not apply to the ICJ.

or paradigm[26]. Those conditions would allow the ICJ to determine the level of control States actually have over their currency traders and decide what obligations the State should perform[27] or fulfil to ensure non-repetition of a wrongful act or omission[28]. The ICJ could make orders for full reparation[29] in the form of restitution, compensation or satisfaction[30], to re-establish the situation which existed before the (alleged) wrongful act was committed[31].

A possible benefit following the historical trend where laws are enacted due to the outcome of a prominent court case[32], is that the initiation of international court proceedings might arouse interest and trigger action on the part of national legislators to solve the problem caused by disruptive capital flows. However that is not likely to happen in the near future given the complexity of identifying the responsible party, collecting meaningful data and proving the exact amount of economic loss. Such quantifying measures are extremely complex and near impossible to precisely calculate; therefore the following recommendation should be considered first.

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[26] The International Court of Justice is vested with the power to make its own rules. Court procedures are set out in the *Rules of Court of the International Court of Justice* 1978 (as amended 29th September 2005).

[27] *Responsibility of States for Internationally Wrongful Acts*, Article 29.

[28] *Responsibility of States for Internationally Wrongful Acts*, Articles 30 (a) & (b).

[29] *Responsibility of States for Internationally Wrongful Acts*, Article 31.

[30] *Responsibility of States for Internationally Wrongful Acts*, Article 34.

[31] *Responsibility of States for Internationally Wrongful Acts*, Article 35.

[32] For instance: the decision in *R v Bazeley* (1799) 2 Leach 973 (3rd ed.) (Case CCCXI); 168 ER 517 led to the enactment of the *Embezzlement Act* of 1799 (39 Geo. III, c. 85) which extended the concept of a breach of trust into the realm of criminal law; the High Court of Australia in *Mabo and Others v Queensland (No. 2)* (1992) 175 CLR 1 determined the doctrine of native title applied to Aboriginal land which prompted the Keating government to introduce the *Native Title Act* 1993 (Cth) a year later.

The importance of collecting international monetary transfer data cannot be overstated. Expanding the scope and collection of financial data is critical but presently, only the Bank for International Settlements (via its agencies[33]) is actively pursuing that work. Additionally, the BIS can only collect that data from States volunteering the information; it is not mandatory for any State (or financial intermediary within a State) to supply that information. Consequently, the information that is required to better monitor capital transfers and hold currency values within specified bands is not being collected to the necessary level needed for accurate econometric calculations.

Hence, the reluctance of State parties, central and private banks to volunteer this information without being forced to do so hinders the effective management of the IMS. Subsequently, leadership, authority and policing data collection needs to be implemented within financial markets on a global scale. It is an area of law where all States must take responsibility, but as the next section reveals, there are impediments to applying even existing laws, yet alone creating new ones and getting all States to follow them.

11.8 The IMF rules are not being implemented

Chapter 5 (sections 5.10 to 5.12) explained how member States of the IMF are directed under Article IV of the *Agreement* to follow policies that are compatible with the undertakings of general exchange arrangements. Member States are obliged to collaborate with the Fund and other members to foster orderly economic growth with reasonable price stability. This is to be done without erratic disruptions or

[33] *Inter alia*, the Basel Committee on Banking Supervision, the Committee on the Global Financial System, the Committee on Payment and Settlement Systems, the Irving Fisher Committee on Central Bank Statistics and the Financial Stability Board.

manipulating exchange rates to gain an unfair advantage over other members. Yet, as Chapter 5, sections 12 to 14 explain, most G7 countries have done little to implement those undertakings.

11.8.1 Implications of Ignoring International Monetary Law

The economic consequence of not implementing the IMF rules fully is that the speculative currency traders' activity can bring significant revenue to the home State[34]. Recognising that Europe, the UK and the US are home to the ten major banks responsible for over 77 percent of forex trading at the global level[35], it can be said with confidence that those banks and traders contribute significantly to their respective country's gross national product. Because the major States are empowered economically by the activity of their banks and currency traders, that may be one of the reasons why those governments do not see the need to restrict SCF. By continuing to allow their traders to carry out activities which are known to destabilise currency values, those States are not fostering conditions which promote financial stability. This omission by numerous States not to fulfil the mandates of the *IMF Articles of Agreement* does not help maintain orderly exchange arrangements nor does it prevent competitive exchange depreciations.

The responsibility for maintaining the stability of the international monetary system was assumed by the US in 1944 at Bretton Woods and by the IMF in 1945 (after its

[34] For instance see where US hedge fund investor George Soros gained about $1 billion between November 2012 and February 2013 betting against the yen. CNBC Report, Thursday, 14 Feb 2013 Available at: http://www.cnbc.com/id/100459569

[35] Table 4.1 Top Ten Participants in Forex Trading (2011).

creation) when they informed the world how they intended to manage the IMS[36]. The volatility of global financial markets was magnified in 1971 because the US reneged on its duty[37] to maintain a viable and stable global monetary system based on the value ratio between gold and the US dollar. Subsequently, the US government failed in its obligations to the international community and to the IMF which were powerless to do anything about it (Shelton, 1994)[38].

Additionally, the US Administration's power to influence World Bank and IMF policy results in those institutions over-looking the economic hardship caused by currency traders and letting the present arrangements prevail (Strange, 1998[39]; Niam, 1999[40]; Williamson, 2000[41]; Perkins, 2005[42]). But that attitude on the part of the US Congress has contributed to growing frustration and resentment among other

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[36] Although the 45 signatories to the IMF Agreement signalled their willingness to participate with the new rules, Eckes (1975), Garritsen de Vries (1986), and Horsefield (1967) explained how Harry Dexter White (US Treasury) more or less dictated the terms of the Agreement in favour of the US.

[37] Article IV of the 1944 version of IMF *Articles of Agreement* read:

> Par Value of Currencies, Section 1. Expression of par values.
>
> a) The par value of the currency of each member shall be expressed in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944.
>
> b) All computations relating to currencies of members for the purpose of applying the provisions of this Agreement shall be on the basis of their par values.

[38] Shelton cites numerous instances where countries like Germany and France were forced to accept initiatives imposed by the US that were contrary to the original IMF Agreement. See Shelton, J. (1994) at p 78 ~ reproduced in Ch 5 p 167 footnote 35.

[39] Strange, S. (1998) *Mad Money: When Markets Outgrow Governments*, University of Michigan Press, Michigan.

[40] Naim, M. (1999) Fads and Fashion in Economic Reforms: Washington Consensus or Washington Confusion?, *Foreign Policy Magazine*, 26th October 1999.

[41] Williamson, J. (2000) What Should the World Bank Think about the Washington Consensus?, *The World Bank Research Observer*, Vol. 15, No. 2 (August 2000).

[42]Perkins, J. (2005) *Confessions of an Economic Hitman*, Ebury Press, Great Britain.

countries and world leaders who have begun forming alliances (ie ASEAN + 3, BRICS, African Union) similar to those the Eurozone nations formed in the 1990s to defend their collective national interests. For instance, China was contemplating a new international monetary regime that could possibly provide greater say and equity among State parties with the added advantage of enhancing exchange rate and financial stability[43]. People's Bank of China Governor Zhou Xiaochuan, issued a proposal for diversification away from the US dollar toward a supra-national currency based on the International Monetary Fund's Special Drawing Rights (SDR)[44]. Another example is the EU contemplating forming its own European Monetary Fund to by-pass the IMF[45]. Clearly the American dominance and ability to dictate terms for the management of the present system has come to an end and during the evolutionary development of the next generation IMS new rules and institutions will no doubt be created and come into effect (Lichtenstein, 1993[46]). But, as stated in the limitations of this thesis in Chapter 1, without access to the intentions and strategies of numerous State players in the global economy, comment is only possible on the situation as it presently stands according to the (publicised) Euro-Anglo-American position.

Countries that wish to partially protect their economies from the negative impact of SCF are forced to implement capital controls and/or peg their currency to a major

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[43] BRIC Joint Government Statement (2009) *Official Communiqué*. 14th March 2009. Available at: http://www.globalpolicy.org/component/content/article/214/44110.html

[44] Zhou, X. (2009) *Reform of the International Monetary System*, People's Bank of China, Beijing. Available at: http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178

[45] Brunsden, J. and Taylor, S. (2010) Commission backs European Monetary Fund, *European Voice*. Available at: http://www.europeanvoice.com/article/2010/03/commission-backs-european-monetary-fund-/67349.aspx

[46] Writing on themes of globalisation and sovereignty, Lichtenstein (1993) noted how monetary globalisation would reshape the architecture of power among States.

currency or a basket of currencies. As an example, when the US government debased their currency by expanding the US money supply by US$1.7 trillion between 2008 and 2011 (over 300 percent), nations, including China, Japan, Brazil and South Korea were drawn into a currency war; each reducing the value of their own currency in line with the USD to stay competitive. For that, they were belittled and chastised. Presidential candidate Mitt Romney (2012) went as far as declaring China to be a currency manipulator[47]. Yet a few years earlier, Michael Pento (2010), senior economist at Euro Pacific Capital in New York, called the US 'the chief currency manipulator'[48]. Clearly, opinions are divided as to which country is the biggest offender, but it demonstrates the existence of widespread currency manipulation by State parties across the globe.

The economic implication from the paragraph above is that most countries engage in some form of currency re-valuation or de-valuation at some time or other to suit their particular needs[49]. Contrary to the requirements of the IMF *Articles of Agreement* for members to 'endeavour' to maintain stable economic conditions, no one country can be singled out for manipulating their exchange rate to gain an unfair advantage over other States because almost every central bank has been given the directive by its national legislature to ensure that the monetary and banking policy of its nation

[47] Buckley, L.T. (2012) China's Response to US Pressure to Revalue the RMB, *China Research Centre*, Vol. 11 No. 1. Clearly Romney was ignorant to the fact that China had slowly increased the value of the CNY against the USD by 40 percent over the preceding 7 years in response to US and European pressure to revalue its currency.

[48] Cox, J. (2010) Currency War? Why Countries Are Rushing to Devalue, *CNBC*, Wednesday 6th October 2010. Available at: http://www.cnbc.com/id/39539787/

[49] This could be carried out by central bank intervention in the currency market ~ sometimes called dirty floating ~ or through monetary policy increasing interest rates to attract overseas investment in capital markets ~ to make BOP equal zero via the Capital Account. Alternative methods could be by increasing/decreasing monetary supply to debase/strengthen the currency in floating currencies or by fixing a lower/higher peg for pegged currencies.

favours the welfare of its own people[50]. Manipulating the value of the national currency (via the activities of the central bank) can have a positive economic effect for the home country but under those conditions it is contradictory to the directives of the IMF *Articles of Agreement*.

Largely, the problem rests with the fact that the international obligations imposed by the IMF *Articles of Agreement* are incompatible with national interests. That might explain why international laws are being ignored but it does not help resolve the problems associated with SCF. Nevertheless, there are several options available to remedy this deficiency in international law which are expanded upon below.

11.8.2 The need to change the status quo

If States continue to do nothing (as they have already been doing) and pretend that international monetary laws are being fulfilled, then financial and currency volatility problems will persist. Maintaining the status quo may seem less challenging for the immediate future but the next financial crisis is likely to be more devastating than the last (Reinhart and Rogoff, 2009; Johnson and Kwak, 2010). To ignore that established economic trend and not make improvements while conditions are favourable, equates to extremely poor risk management for the global economy (Brunnermeier, Crockett, Goodhart et al., 2009), and any government that neglects this duty is being irresponsible not only to the international community, but also to its own citizens. Therefore, international monetary laws should be followed because the net result of

[50] These tasks include: an efficient allocation of resources, maintaining economic growth, maximising employment, stabilising prices and moderating long-term interest rates. As examples see: *Statute of the European System of Central Banks* (Europa) Article 2.; *Federal Reserve Act* 1913 (US) section 2A, US Code, Title 12, Ch. 6, 38 Stat. 251; *Bank of England Act* 1946 (UK) section 11; *Reserve Bank Act* 1959 (Commonwealth of Australia) section 10(2).

all member States following pre-set guidelines should ~ in an ideal world ~ lead to a condition of enhanced financial stability with the greatest good for the greatest number being realised. The next sections show how that might be possible.

11.8.3 Enforce and/or Amend the Laws

The simplest option to ensure international monetary laws are being met would be to enforce the specific clauses in the IMF *Articles of Agreement* which restrict member States ~ and by extension, via the State's international due diligence obligations, to its currency traders ~ from manipulating exchange rates by either limiting short term speculative capital flows or locking in exchange rates. Because States are required to co-operate with the IMF and 'endeavour' to develop policies that foster orderly economic conditions (*Article* IV sections 1, plus 3(a) & (b)) it should be possible to extend the authority of the IMF to police the IMM or devise new strategies to improve the operation of the IMS. An option could be to amend international monetary laws ~ or clauses within the IMF *Articles of Agreement* ~ whereby States could be sanctioned or fined for non-conformance. If States did not curtail SCF or hold their currency within specified bands, then other members could use economic sanctions as a tool to encourage international compliance. All that would be required is the adoption of a modified version of the IMF *Articles of Agreement* that existed prior to the abandonment of the gold standard which forced amendments to the *Articles* in the 1970s.

The other point to consider with the introduction of penalties and sanctions is that the IMF or some other supervisory institution would have to be given the authority to

monitor and police the system. That discussion is expanded upon below in section 11.10, *The Rise of Alternative Institutions*; but now let's examine how effective sanctions might be.

11.8.4 Use of sanctions and penalties

To impose economic penalties or sanctions on States that allow their exchange rate to move beyond specified bands is not a new concept. Prior to the abandonment of the gold standard, countries which re- or de-valued their currency beyond a specified value without the prior approval of the IMF were penalised by the IMF (Ch 5.7 Monetary Sovereignty). The system of sanctions and penalties as implemented by the IMF under *Articles* V and XXVI of the IMF *Articles of Agreement* could be enforced upon States to encourage them to restrict the activities of speculative traders within their jurisdiction or under their control.

Under IMF *Article* V section 3, and *Article* XXVI section 2(a), if a member fails to fulfil any of its obligations under the *Agreement*, the Fund may declare the member ineligible to use the general resources of the Fund. That could include denial of overdraft facilities and other special drawing right privileges. If the member does not rectify its breach within certain time limitations, that member may be required to withdraw from membership in the Fund (XXVI section 2 (c)). Under those circumstances and by a decision of the Board of Governors carried by a majority of the Governors having eighty-five percent of the total voting power, non-conforming members could be ostracised. Additionally, the fact that a country's international credit facility could be halted due to non-conformance, would likely cause economic difficulty for the affected State. And although it is possible (but uncommon) for

countries to choose to withdraw from IMF membership, the potential of the above penalties being applied more or less forces those countries wanting membership to adhere to the obligations of the IMF *Articles of Agreement*. Among those obligations it does include the requirement that members refrain from engaging in destabilising exchange rate practices that produce erratic disruptions or an unfair competitive advantage over other members[51]. And because of the due diligence obligations imposed by the draft Articles on *States Responsibility for Internationally Wrongful Acts*, (as explained in Ch 6.7, 6.8 and Appendix F which could extend the State's international obligation onto its citizens), it should pressure the State into restricting the disruptive speculative activities of citizens and corporate entities subject to the State's legislative control. So while the international laws do exist to restrict destabilising exchange practices, any proposal to impose penalties upon IMF members for non-conformance would be feasible provided most States supported the IMF to enforce the provisions.

Re-inventing a system of pegging national currencies to a tangible unit of account (for instance a special drawing right as opposed to the value of gold or a single currency) could be introduced via international consensus and amendments to the IMF *Articles of Agreement* (as allowed by Article XXVIII)[52]. If consensus was reached, that would provide an agreed value from which to monitor performance. Then if any State moved outside the prescribed limits of their exchange rate, or allowed their currency traders to push the value of another State's currency beyond the specified bands, they could

[51] Article I(iii) and (iv), plus Article IV (1) (i to iv) of the IMF *Articles of Agreement*.

[52] Members may propose modifications to the *Article of Agreement* and if adopted by three-fifths of the members, having eighty-five percent of the total voting power, those amendments shall be adopted.

be penalised. As Ayres and Braithwaite (1997) suggested, if the regulatory agencies are 'perceived as carrying big sticks' they 'will be able to speak more softly'.

Because that was one of the general enforcement roles of the IMF before the abandonment of the gold standard, it would propel the IMF back into a position of monitoring and policing the IMS. In all likelihood, whether it occurs via the IMF, the BIS, the Financial Stability Board or some newly created institution, the prospects of that scenario unfolding would have positive managerial effects in stabilising currency values. Because this option can reduce dead weight losses (as explained in Ch 3.4 and 3.7) by limiting movements in currency values and lead to efficiency gains with measurable benefits, it qualifies as a utility maximising strategy which subsequently provides a strong argument for implementation.

However, to implement new procedures within the IMS, the IMF *Articles of Agreement* would have to be changed. That then leads into the challenge of getting 85 percent of the voting members of the IMF to agree to the new rule change. As Chapter 10.10 demonstrates, unless the US supports any proposal for change within the IMF, no change will occur. That is because the US government holds 17.69 percent of the voting rights in the IMF[53] and can therefore prevent all other members reaching the required 85 percent mark to implement change. So, to initiate a restructure of the IMS, the US must first agree to the proposal along with 67.31 percent of all other members.

[53] http://www.imf.org/external/np/sec/memdir/members.aspx

The additional hurdle to changing IMF policy in relation to penalising States for not preventing or minimising exchange rate volatility is the fact that the governments of the US, Eurozone and UK are happy with the existing exchange rate system. Consequently, even though changing the penalties and sanctions imposed by the IMF is a legal possibility, the likelihood of it happening is low. That then forces us to think about how it would be possible to force a restructure of the IMS to cater to the needs of globalisation which would require new rules and perhaps new institutions to manage and monitor the IMS. That, in turn, would require agreement and co-operation at the international level never before experienced[54].

While the task of amending the old laws and devising new rules for the improved management of the international monetary and financial system may be a major project, world leaders are the ones responsible to implement that change. But as Brown (2012) identified, despite the GFC and the likelihood of bigger and more destructive financial meltdowns occurring in the future, the sense of urgency on the part of legislators to improve the IMS has waned. Nevertheless, because financial crises will persist under the present arrangements, there will be plenty more opportunities available to implement practical reforms when conditions become so intolerable.

To persuade legislators to act on the goal of improving financial stability, pressure should be exerted at the domestic level so that momentum eventually works its way into the international arena. It will only be after the international monetary laws are amended, monitored and enforced that the required changes for improved financial

[54] The example of implementing the Draft Articles on *State Responsibility for Internationally Wrongful Acts* (Ch 6.5), demonstrated how a 19 page Convention took well over sixty years to formulate.

stability will come to fruition. An alternative could be to induce legislative change through the courts.

11.8.5 Rely on legal action through the International Court of Justice

As explained in Chapter 6, a State that finds itself exposed to a speculative currency attack could use the international legal system to try to seek restitution from the State responsible for their economic loss[55]. The draft Articles on *State Responsibility for Internationally Wrongful Acts* have not restricted the expansion of international law to include individuals or corporations in international civil responsibility ~ hence under draft *Article* 58[56], that possibility may open the way for currency manipulators to be held accountable to the international community via the State in which they reside. While the IMF *Articles of Agreement* do not specifically state that reparation is a possible remedy for a State's failure to fulfil the obligations required to avoid acts which destabilise the IMS, the offending State may nevertheless be held responsible for the economic loss suffered by another State if it can be shown that the offending State breached an engagement or failed to apply a binding convention[57] that required domestic laws or procedures to control certain activities of its citizens.

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[55] The Statute of the International Court of Justice provides that 'a State may recognise as compulsory, in relation to any other State accepting the same obligation, the jurisdiction of the Court in legal disputes'. Cases may be brought before the Court by means of written applications. The conditions on which such compulsory jurisdiction may be recognised are stated in paragraphs 2-5 of Article 36 of the Statute. Since October 2001, the Court has also issued Practice Directions for use by States appearing before it.

[56] International Law Commission (2001) *Draft Articles on Responsibility of States for Internationally Wrongful Acts*, with text adopted by the International Law Commission at its fifty-third session, and submitted to the General Assembly as a part of the Commission's report; commentary on draft *Article* 58, at p 142 point (2).

[57] *Factory at Chorzów* (1927) P.C.I.J., Judgment No. 8, Series A, No. 9, p 21.: 'Reparation ... is the indispensable complement of a failure to apply a convention and there is no necessity for this to be stated in the convention itself'.

See also, draft *Articles on State Responsibility for Wrongful Acts*, Articles: 12, 31, 32, 33, 34 and 35.

Although it is not always possible to connect a State directly to the wrongfulness of an action that affords an award for reparation, the International Court of Justice cases mentioned in Chapter 6 demonstrated States can be held responsible for the acts of their constituents if the State omits to fulfil its due diligence obligations under an international treaty in preventing certain activities which affect the economic or legal interests of other States. Provided there is a positive obligation on the part of the State which is breached, reparation could be enforced, however the causal connection of proving the State's loss to that of the speculator's trading activity would be very complex and almost impossible to calculate[58] without properly recorded capital movement data. Consequently the likelihood of those matters being resolved through the international legal system in the near future is extremely remote.

However, if a country was prepared to calculate the damage (as the UK did after its currency attack in 1992) and build a case against another State for failing its due diligence obligation to prevent financial disruptions caused by the offending State's citizens, it would at least force the issue into the international domain and perhaps ignite public awareness. Another option is for legislators to be pro-active and devise and implement laws before events thrust *ad hoc* solutions after the fact. Trying to avoid eleventh hour bail-outs to prevent re-occurring financial meltdowns might motivate policy makers to consider restructuring the IMS framework before necessity forces it upon them.

[58] It took the resources of the Bank of England and the British Treasury six years to calculate Britain's losses after the 1992 speculative attack on the pound.

11.8.6 Restructuring the IMS Framework

Restructuring the IMS Framework to cater to the conditions of globalisation can only be achieved through the application of suitable international laws at the domestic level. Understanding that laws (according to Locke *et al*) were enacted by men to 'expand and enlarge freedom', allowing international law to be made subordinate to national interests and domestic law while at first instance may appear to preserve State sovereignty, it does not however prioritise international co-operation or promote global economic and political integration. In the absence of harmonisation or dialogue between States, under time restraints with economies in turmoil, it could lead to disagreement or some measure of conflict.

Nevertheless, history demonstrates that it generally eventuates that the more broadly applied law ~ in our situation international law ~ becomes the more enduring. If more States adopt the new rules, it becomes, as Kelsen (1973)[59] put it, the *grundnorm* which is the widely accepted dominant law. Similar to Aristotle's explanation[60] of how the family's interests gave way to the tribal interest, the tribal interest to that of the village, the village to the city state and continuing through to the modern State, the three thousand year trend suggests that the modern Westphalian nation State will eventually comply with the legal framework of the international community or that of a global government. The creation of the United Nations and the expansion of its governing agencies since 1945 indicates that progress towards the new world order is well under way, so it is possible at least, to visualise the concept of a global

[59] Kelsen, H (1973) *The General Theory of Norms*, published posthumously in 1979 in German under the title *Allgemeine Theorie der Normen*, by MANZ verlag Wein, translated by Michael Hartney (1991) Oxford University Press, New York. Kelsen's interpretation of *grundnorm* is the *valid foundation of commanding rules* which is expressed in English legal theory as simply the *basic norm*.

[60] Aristotle (350 BC) *Politics*, translated by Project Gutenberg 2009, Salt Lake City, UT, Book 1.

government which could assume control of the international monetary and financial system.

Along with the centralised power structure, new rules and institutions would need to come into existence which would shape and further advance society. The post GFC G20 summit meetings which established the Financial Stability Board represents a significant turning point in the evolution of the IMS. The FSB has a mandate to explore and devise strategies to improve financial stability, so currency volatility should be included in its terms of reference. But more importantly, the FSB could be tasked with examining the existing managerial framework of the IMS to assess its potential. Ideally, steering away from the temptation to impose more rules and obligations on the free market, but rather ~ as the application of Umpleby's theory in Ch 9.6 to 9.10 demonstrated ~, concentrating more on the structures which (until now) have not adequately governed the IMS and improve their efficacy. Hence, the evolution of international monetary law is a necessary step for advancing the IMS and the sooner sovereign States accept this fact and actively participate in the development of meaningful and effective monetary laws, the quicker the problems associated with volatile currency values will be reduced. The positive complement to all of the above is that economic and managerial strategies already exist which would not be too difficult to implement ~ provided of course the G7 countries could agree to implement them. Those strategies are presented below.

11.9 Mechanisms to Reduce the Negative Effects of Speculative Capital Flows

11.9.1 Capital Controls

The thesis examined various options for solving the problems associated with speculative capital flows. It analysed capital controls but determined that the US, UK, Europe, Japan, Switzerland and Australia (countries of the six most traded currencies) had very little desire to implement such controls. In fact, it is an unwritten convention that the G7 countries prefer the fully floating exchange rate system[61]. Yet, despite the unwritten convention, those countries have all been involved with dirty floating and currency manipulation practices to some extent on a regular basis[62]. It seems the governments and monetary authorities of the Western economies apply the rules to suit their particular needs as and when they see fit.

On the other hand, countries such as China, South Korea, India and Brazil have implemented capital controls to limit hot money entering their economies. Although those controls may relieve the volatility of their currencies, the effect is mainly domestic in orientation ~ consequently the flow-on effect with respect to stabilising currency values in the global economy is minimal. The thesis explained how capital controls are predominantly a counteracting measure implemented in response to exogenous forces; they are re-active not pre-emptive therefore they are not a practical long term solution that would enhance the overall management, stability or efficiency

[61] This was reaffirmed in February 2013 at the G7 meeting in Brussels where the seven top industrial nations pledged to let foreign exchange markets determine the value of their currencies. Lael Brainard, the Treasury under-secretary for international affairs of G7 emphasized that: 'the Group of 7 had a "longstanding set of rules" committing its members to float their currencies except during rare instances of market turbulence'. Cf: Kanter, J. and Lowrey, A. (2013) G-7 Leaves Currencies to Markets, *New York Times*, 12th February 2013, p B3.

[62] Examples include: the US expanding money supply by 300 percent between 2008 – 2012; Japan devaluing the yen to stay competitive in 2012; and Australia's Reserve Bank (and most other central banks) investing in and trading foreign currencies.

of the IMS. Something more widely applicable should be adopted so that all countries follow the same set of rules.

11.9.2 Taxing International Capital Transfers

Taxing international capital transfers is another possible solution to limit the negative effects of SCF. Numerous experts[63] argued that such a tax would be possible to implement, yet the European Central Bank on assessing this concept in 2004 was of the opinion that the introduction by the euro zone of a Tobin type tax was not a good proposition. One of the main legal arguments against implementing the tax was that the draft law was incompatible with the free movement of capital and payments between Member States of the EU, and between Member States and third countries while giving rise to significant costs[64]. Withstanding the ECB's earlier rejection of a Tobin tax, recent developments within the European Parliament with its 2011 initiative to introduce a tax on financial transactions could dramatically change the international financial architecture. If Europe can implement its 'six pack reform package' as suggested by 2014, it would add to the transaction cost of moving capital from one financial asset to the next and thus have a stalling effect on short term speculation of stocks, bonds, derivatives and currencies. Introducing a new tax would also have the effect of increasing the perceived prestige and work load of the regulator which in turn imposes more costs on taxpayers. The move towards achieving financial stability would be somewhat enhanced by reducing SCF but the transaction tax would be counter-productive to economic growth and possibly decrease efficiency. Applying

[63] Arthur Pigou, John Maynard Keynes, James Tobin, Charles Wyplosz, Barry Eichengreen, Jeffrey Frankel, Peter Kenen, David Felix, Ranjit Sau and Yung Chul Park amongst others.

[64] The ECB's opinion contained no figures or statistics, no reference to econometric modelling, no empirical evidence, was non-referenced and in stark contrast to the findings of many academic works.

Umpleby's *requisite variety*[65] to the situation indicates that adopting a Tobin tax is not a cost effective solution therefore any idea about introducing this type of tax should be abandoned.

11.9.3 More Monetary Unions

The thesis provided meaningful evidence on the benefits of creating more monetary unions. The *Security and Prosperity Partnership of North America* [66] and other possible currency unions in Asia and Africa were discussed. The thesis reveals how some countries have already reduced their monetary sovereignty even beyond the limitations imposed by the IMF's *Articles of Agreement*. For instance, in the European Economic and Monetary Union the euro has replaced the national currencies of 17 EU member countries with another 6 working towards implementation[67]. Similarly, West African and Central African Monetary Unions have their respective common currencies where the member States do not issue separate national currencies. The Association of South East Asian Nations is another example of a potential currency union in the making ~ as is the Australia – New Zealand – Pacific alliance.

Subsequently, there are today different levels of monetary sovereignty operating throughout the world. None of which is necessarily superior to any other but specifically that they are most beneficial to the region in which they apply. And

[65] The implication of the *law of requisite variety* is that whenever we are confronted with a situation that needs rectification, only one of two options may be used: either increase the variety in the regulator or reduce the variety in the system being regulated.

[66] White House Press Release (2005) *Fact Sheet on the Security and Prosperity Partnership,* Office of the Press Secretary, 23rd March, 2005. Available at: http://www.whitehouse.gov/news/releases.

[67] The euro is currently in use in 17 of the 28 EU Member States plus five Franco-African territories (Mayotte, Saint Pierre, Miquelon, Akrotiri and Dhekelia). Other States using the euro are: Andorra, Monaco, San Marino, The Vatican, Martinique, Guadalupe (Caribbean), Reunion (Indian Ocean), Montenegro and Kosovo.

despite the negative press (originating from US media[68] and minority dissidents within Germany[69]) about the impending doom of the euro, monetary unions are growing in number and size; they are clearly successful in terms of managerial practices and efficiency gains, therefore will likely continue expanding in the foreseeable future. Additionally, applying Umpleby's theory indicates currency unions are more efficient and more robust than individual currencies.

Employing Umpleby's *requisite variety* to the strategy of creating more currency unions the efficiency of global financial markets is improved by either reducing or eliminating forex transaction costs. It is here that the variety in the system being regulated is reduced by the creation of a new set of international monetary rules ~ ie: requisite variety's fourth strategy; changing the rules of the game and creating new institutions to help align the value of major currencies. Additionally, cross-border price transparency is clearer and the productive movement of capital more easily achieved. Those economic gains preserve scarce resources and allow those savings to be diverted to more worthwhile causes.

Consequently, the creation of more currency unions would significantly reduce the scope for SCF and their impact on individual economies. The political implication to that scenario is alliances would need to be formulated and agreed upon between (usually neighbouring / regional) nations. That in turn requires the same level of commitment as realised with the Treaty of Maastrich but getting countries to

[68] US media has predominantly discredited the euro from its inception (without proper justification) as it posed a viable alternative to the USD as credible international trading currency. Because the euro diminished the hegemony of the USD, America would not mind if the euro collapsed ~ hence all the up talk of the euro's demise even though the EU remains stead fast that the euro is here to stay.

[69] Connolly, K (2013) Leading German economist calls for dissolution of eurozone to save EU, *The Guardian*, Monday 15th April 2013. http://www.guardian.co.uk/world/2013/apr/14/german-economist-eurozone-eu

relinquish monetary sovereignty to an external entity could stimulate resistance or unwillingness of States to participate. The incentive to participate however rests in the knowledge that there are benefits to being part of a larger economic bloc in terms of greater financial stability, less currency volatility, plus freer movement of capital and (usually) labour.

When countries use a single currency, there are significant economic gains which include: currency convenience, price comparability, easier cross border investment and preserved low inflation (Feldstein, 2008; Tapolczai and Wickert, 2011). Following the reasoning of Richard Posner (1973), the economic advantages should always be considered in the legal decision making process; rational maximising behaviour suggests the same thing; that in turn would signify that the cost savings associated with the adoption of more currency unions should be utilised and implemented through law even though some States may initially resist the idea.

So apart from the sovereignty issues which might compel some nations not to be part of a currency union[70], all that really needs to be done is to follow the procedures the EU developed in the lead up to the introduction of the euro and replicate those steps. The 1992 Treaty of Maastrich, the 1993 Copenhagen Criteria and the 2003 Treaty of Nice provide the guidelines for EMU membership which *inter alia*, allows for member States to impose sanctions on non-conforming States. And despite minor financial troubles emanating from Portugal, Ireland and Greece in recent years, the eurozone remains the largest and most successful form of political and economic integration in history. The next step past more currency unions is a global currency.

[70] Denmark and the United Kingdom while being members of the European Union have opted not to adopt the euro for national reasons.

11.9.4 A Global Currency

The implementation of more currency unions seems a likely step towards the probable adoption of a world currency. And as imaginative as that scenario may be, the possibility of a single unit of exchange and accounts being established on a global scale offers the most efficient and transparent outcome. If the recognised benefits of the introduction of the euro or the multiplication of currency unions were replicated, significant efficiencies could be gained. As more regions implement currency unions, it would become much easier to link the currency values of a few major economic blocs instead of locking-in hundreds of separate national currencies.

Robert Mundell encourages the idea of a global currency and Joseph Stiglitz goes as far as naming one. That scenario also falls in line with Umpleby's *requisite variety* by reducing the variety in the system being regulated ~ ie reducing the number of currencies in existence reduces the amount of regulation required to manage the system which henceforth leads to further efficiency gains. Hence, the best case situation in terms of efficiency for the global economy would be the adoption of a single world currency.

However the essence of any reform relating to the IMS is international consensus and internationally enforceable laws. That condition will only come about through negotiations resulting in legally binding treaties. The additional problem with issuing a single global currency is who will hold the monopoly on the supply of money? If we are experiencing currency wars now, imagine the wars that might be fought and lost over the supply of credit to the global community. No doubt, future generations will have to contemplate the strategic, political, legal and economic implications of such a feasible, but grand strategy. When this option comes closer to reality, they will need

to devise plans to suit the needs of their epoch. But like today, the obstacles to implementing a global system of financial management is reliant upon there being an effective agency in place that can monitor and penalise entities which do not abide by the rules. Consequently the focus must be drawn back to the question of who will manage and police the international monetary system?

11.10 The Rise of Alternative Institutions

Evidence was presented relating to the slowness on the part of the IMF to implement change to resolve international financial instability problems (Ch 5.1 and Ch 5.13). Additionally, internal audits within the IMF revealed the pressing need to improve effectiveness and accountability[71]. Because of the failures of the IMF to fulfil its mandate to the global community, the dissertation looked at other institutions within the existing monetary framework that could capably implement the necessary changes to enhance currency stability. If the IMF cannot or will not take a pro-active stance to solve disruptive currency problems other institutions probably will. A poignant example is the establishment by the EU of the European Monetary Fund to by-pass the IMF. BRICS collaboration might be another. This mounting pressure from external sources could be the catalyst that the IMF needs to re-invigorate itself.

Ideally, the IMF should no longer watch the evolution of the IMS slip from its control. Recognising the valuable input that the IMF has had in shaping global monetary affairs over the past sixty years, its continued involvement in devising the new framework for the IMS is imperative. Because the IMF is an agency of the United Nations, it gains the advantage of having the [almost] obligatory support of

[71] IMF Independent Evaluation Office (2008) *Aspects of IMF Corporate Governance Including the Role of the Executive Board*, IMF Internal Audit Report, April 2008.

UN members who could help push through the reforms that the IMS needs. The problem however, seems to be that the IMF lacks the leadership and determination to act but this is where the BIS agencies have shown commitment to the continued improvement of the IMS.

Recognising that the European-based BIS existed over a decade before the IMF was created, the European system of international banking has a longer tradition of dealing with central banks and governments. Additionally, the BIS is a privately owned corporation whereas the IMF is a UN agency, consequently the BIS is able to implement management decisions much faster than the IMF which has to cater to the demands of global public scrutiny and accountability. Hence the BIS is in a better position to devise and implement strategies for improving the management of the IMS. Another advantage that the BIS has over the IMF is its ability to modify its operations to suit its own management requirements. This allows the BIS to instruct its member central banks how they should follow international banking protocols. While the BIS cannot make or impose international monetary laws, it can however encourage its members to follow the procedural rules for international banking and financial management; consequently we can see that initiatives undertaken by the BIS (like the Basel Accords and its supervision of cross-border electronic banking activities[72]) are having a positive effect on the improved management and stability of the IMS.

The creation of the Financial Stability Board, the expedient adoption of the Basel III Accord and the ratification of a new international treaty locking in currency values or

[72] BIS Committee on Payment and Settlement Systems (2008) *Progress in reducing foreign exchange settlement risk*, BIS Publications, Basel.

the implementation of a global currency could all help to minimise the disruptions caused by speculative capital flows. The challenge therefore is to get governments to commit time, money and energy into collaborating with ~ and financially supporting ~ institutions like the IMF and BIS giving them the mandate to streamline the operation of the IMS. But again, that progressive development could possibly re-ignite State sovereignty issues, arguments and power plays of competing interest and predictably stifle the reform process. Subsequently, the best solution to overcome those problems is to employ Umpleby's fourth strategy and change the structure of regulatory control.

11.11 A Global Regulatory Model

Political leaders should acknowledge the way in which the global financial system can be ~ and has been ~ disrupted by current banking practices[73]. Predominantly, US, UK and European banks created the conditions for economic disruption experienced through the GFC but regulators on both sides of the Atlantic failed to monitor or effectively supervise the activities of their banks. The GFC was the penultimate affirmation that banking supervision and financial regulation needs improving.

Given the size of the system we are trying to influence, there is need for new ideas and institutions as well as improvements in existing institutional practices. Prudential regulators could pay attention to the basic cybernetic ideas of Stuart Umpleby; to approach the modification of the global economy by examining their own performance first. Strategies to improve banking supervision and government oversight should encompass effective ideas that accelerate communication and

[73] Appendix G shows how the recent financial crisis was merely a repetition of previous strategies to increase the power of the major US banks.

control, not so much with the private market but with the regulatory system itself. Consequently, the regulatory focus should shift to the international banking institutions and central banks. Instead of monitoring millions of market participants or thousands of private banks trading on hundreds of different platforms, the variety in the system could be reduced to a handful of international institutions and all national central banks. By creating an over-arching tier applying vertical integration techniques to co-ordinate central bank activity to minimise currency fluctuations a more cost effective and efficient regulatory network is brought into existence. Because the variety in the system being regulated is reduced, administration and transaction costs are also reduced which in turn leads to economic gains.

Reducing the variety in the system being regulated not only applies to the number of prudential supervisors in the system, it can also apply to the number of currencies in circulation. It is under these conditions that reducing the number of currencies or reducing the variance in value between those currencies, that we eliminate the need to monitor speculative capital flows. If the prudential supervisors concentrate on one of the most important aspect of monetary supply ~ that of eliminating currency differentials ~ there would be no need to regulate that part of the market. Strengthening the foundations of the present global financial system and developing new ideas about how to stabilise the value of major currencies should be a priority of all regulators. All that needs to be done is to replicate the procedures the EU developed for the introduction of the euro. Once that is achieved, the over-arching supervisor should then monitor the performance of the existing institutions relative to the new framework and make sure stability targets are being met. There is nothing extraordinary about implementing these improvements within the IMS as the

economic mechanisms and legal framework already exists; all that is needed is a desire by legislators to initiate the reform process.

11.12 Contribution to an Existing Body of Knowledge

The thesis contributed to the existing body of knowledge by bringing together the disciplines of economics and law to demonstrate the instability of financial markets attributed to SCF and the additional expenses associated with transaction and administrative costs. It described the problems that jeopardise the existing system; namely the volatility of currency markets; the inefficiencies of free floating currencies; the negative impact of those inefficiencies and; the lack of international co-operation in global banking and monetary regulation. It provided relevant historical information to enable an appreciation of the setting and evolution of the present financial system. That, in turn, provided an understanding of the complexities of finding solutions that could be accepted at a global level.

It described the shortfall of the present international monetary system and argued for the need to regulate financial markets more stringently. It identified ways in which the IMS could be improved. There is a need for legal control over hedge and similar type funds because typically their speculative capital flows destabilise economies and are against the interests of the broader international community. Prudential supervision of the banking industry in general needs to be improved, particularly in the US, but that also a co-ordinated approach at the global level must be adopted.

It also established a valid rationale in terms of cost efficiencies, legal justification and regulatory efficacy to minimise currency differentials between national economies to

create a more prosperous global economy. The discourse argued that the market practices which have potential to disrupt the IMS could be eliminated by engaging the existing supervisory institutions (ie: the IMF, BIS, FSB and the other Basel Committees, plus national central banks and prudential supervisors) to implement reforms. Those institutions could co-ordinate and facilitate strategic objectives aimed at improving efficiency by minimising the volatility of currencies. Creating a comprehensive reporting system, not only for international banks but for all institutional investors participating at an international level, would provide important data that could be used to monitor and stabilise currency values.

The thesis described the philosophical, economic and legal underpinnings for justifying the need to improve present practices. Nevertheless, a major problem lies with finding the best regulatory model that incorporates cost efficiencies with acceptable and binding legal practices between States. The dissertation makes its contribution to this body of knowledge by identifying an effective way to regulate the IMS; it is not that the free market should be overly regulated, but rather that present practices in maintaining stable currency values should be improved by the collective efforts of national and international supervisory agencies.

Those national and international supervisory agencies must collaborate their efforts towards establishing a new global monetary regulator which can demonstrate leadership, has the authority to implement change and the ability to police financial activities on a global scale ~ even though the administrative operations should be carried out at the national level. This new era of international financial co-operation and management is probably the best option available for reducing volatility,

stabilising currency values and securing the wealth of nations, but it requires the active support from legislators the world over.

A major recommendation of this thesis is to require all central banks and international banking institutions (including hedge and sovereign wealth funds) to report financial data relating to cross-border capital movements back to a central management centre. Whether it is a newly created institution or an existing institution with wider powers is irrelevant; getting the data and processing the data in such a manner as to identify the causal link between capital movements and volatile currency values should be the main focus. Having that information will help the central co-ordinator to monitor and inform the individual States as to the best way to maintain the value of its currency within a specified band. Just as the eurozone countries achieved currency price stability in the lead-up to the introduction of the euro, that strategy could be repeated on a global scale to bind the currency values of the major economic blocs.

11.13 Recommendations

To reduce the negative effects of speculative capital flows, a re-adjustment of the present international monetary and financial system is necessary. That will require not only changing international rules but also institutional changes. If the work of the IMF, the BIS and the FSB is to take effect, governments should implement their recommendations by legislating domestic laws to comply with a new paradigm shift. Without the State's active participation in creating those new rules nothing will be achieved, hence it is the national legislator's responsibility to understand the complexities of the IMS and adopt a willingness for meaningful change. This thesis

has analysed the various facts and components which will contribute to the improved efficiency of the IMS and recommends the following reforms.

The proposed reforms should encompass these strategic points:

- As the IMS lacks leadership, a new over-arching supra-national entity needs to be created to manage, monitor and police the IMS. In all likelihood, it should be a UN based agency with superiority over the Bretton Woods Institutions and national central banks.
- The new agency should be controlled by international governmental consensus, not private banking interests.
- The new agency should adopt strategies which facilitate full participation by all sovereign States.
- Monetary sovereignty should be co-ordinated and shared between the new agency and all States.
- The new agency should adopt a strategy that reduces the *variety* in the system being controlled and be perceived *as carrying a big stick*.
- The new agency should concentrate on improving the efficacy of the existing international monetary supervising institutions ~ specifically the FSB, the IMF, the BIS (with its agencies), central banks and national prudential supervisors.
- The new agency should require all central banks and international banking institutions to report financial data relating to cross-border capital movements back to a central management centre.

- The new agency should devise a strategy with the goal to eliminating currency differentials as a key priority; whereby currency values could be kept within prescribed bands thus reducing volatility and arbitrage opportunities.
- The new agency should not attempt to control the free market, but rather encourage sovereign States to implement domestic monetary practices that assist with currency stability.
- The new agency should be given power to fine States for non-conformance and/or enforce sanctions when necessary.
- The new agency should implement a strategy that promotes the expansion of currency unions and the reduction of multiple currencies.
- The new agency should implement a long term strategy that promotes the eventual adoption of a single world currency within an agreed timeframe.

Throughout the thesis, reference is made to the implications associated with enacting new rules for managing the IMS. The limitations and drawbacks of getting national governments to agree on strategies to improve exchange rate stability by far posses the largest hurdle towards solving the problem examined in this thesis. Implementing the recommendations of this analysis would prove beneficial to the global economy but the reality is, very few governments have demonstrated their willingness, desire or power to reshape the IMS. Without the united support of all major economic blocs, the recommendations of this thesis will never come to fruition.

11.14 Further Areas for Research

Although this dissertation provided the theoretical foundations and used economic models to explain the detriment to national economies caused by SCF, it did not provide actual figures to quantify the actual amount of damage done. To calculate the

precise amount by which an economy is made worse off, relevant information is required that was beyond the scope of this research. That data would have to be acquired ~ with the resources of the present system ~ by way of the Bank for International Settlements, the IMF and national central banks. If researchers had access to information about the volume of capital movements they could do more in depth studies by way of forensic accounting, econometric modelling and financial / statistical analysis. However at present, the Basel Institutions[74] are the only bodies pro-actively pushing for the collection of this meaningful data. Without that data, empirical studies about the impact of speculative capital flows at a global level cannot be undertaken.

If and when that data is available, numerous studies could be undertaken. These could include: partial correlation tests between capital movements and currency values by using multivariate Gaussian algebraic number theory[75]; or the Pearson product-moment correlation coefficient[76] that could measure the strength of linear dependence between currencies; or the Dickey Fuller Test [77] for unit roots in auto regressive models to determine forecast accuracy relative to prevailing conditions. The various econometric tests are boundless but their results could make significant contributions to help stabilise currency values.

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[74] The Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, the Committee on the Global Financial System, the Markets Committee, the Financial Stability Institute, the Financial Stability Board, the International Association of Deposit Insurers, the International Association of Insurance Supervisors and the Irving Fisher Committee on Central Bank Statistics.

[75] Gauss, C. (1801) *Disquisitiones Arithmeticae*, translated, 1965, *Arithmetical Investigations* by A. Clarke, Yale University Press.

[76] Pearson, K. (1901) On Lines and Planes of Closest Fit to Systems of Points in Space, *Philosophical Magazine*, Series 6, Vol. 2, Issue 11, p 559–572.

[77] Dickey, D. and Fuller, W. (1979) Distribution of the Estimators for Autoregressive Time Series with a Unit Root, *Journal of the American Statistical Association*, Vol. 74, p 427–431.

Studies in international monetary law could delve into the regulatory framework associated with business transactions linked to international banking and foreign investment. Or aspects of negotiation, drafting and implementing international treaties that address the technical issues relevant to monetary integration. Other studies could be conducted relating to the international monetary institutions and their internal processes or their relationship with member States. In an era of expanding international monetary law, there will be few limitations to the various fields of study.

Further research could focus on learning the psychology and motivation behind developing nations' growing importance in international monetary affairs. Such insights derived through social science statistical programs might provide an understanding as to what policies should be pursued to incorporate BRICS objectives into the existing international monetary system. It is an area of global governance where multilateral negotiations would need to be handled in a very diplomatic manner so as to foster successful and constructive outcomes. The delicate balance of finding an acceptable economic policy mix in a world where Asian, African, Eastern European, Middle Eastern, and South American interests must now be considered, makes for a very interesting area of political science and psychological research.

11.15 Final Comment

International structural reforms are essential if the problems caused by disruptive capital flows are to be solved. The observations described in this dissertation demonstrate the importance of strengthening co-operation between the central banks and governments of the world. The conclusions to emerge from this discourse are in

favour of policies based less on national self-interest and short-term remedies and more on international co-operation towards achieving a comprehensive strategy designed to facilitate economic stability void of disruptive monetary practices. There are solutions available which have long been proposed for rectifying this current and long recurring problem. Those solutions represent prescriptions that enhance advantages at the national economic level, as well as in international relations. As noted throughout the thesis, there is a current trend towards the growth of regional and other multi-State groupings which focus on economic security and financial co-operation. Those institutions are driven by similar reasoning towards eliminating monetary instabilities. By their very existence, those institutions subtly curtail their members' activities in scope as well as in policy. Expanding those regional efforts to the global arena will no doubt have positive long term effects, therefore time, money and energy should be invested towards improving communication and financial data collection networks between prudential regulators, nation States, the IMF and the BIS agencies.

A mixture of ideas between the Bretton Woods, European and BRICS Institutions may lead to a model with more robust qualities. It requires a fundamental shift in thinking, from one dominated by a single nation, to one in which wealth (ie credit and money) is created, managed and shared much more widely. International co-operation is prerequisite to ensure stable, efficient, open capital markets, but control must ultimately rest with the State and not with the free market.

In the wake of the GFC with economic uncertainty and confusion, it is also a time when governments are more open to creative collaboration than at any other time in

history. Maximising cost efficiencies must be paramount to international monetary theory. Since the time of John Maynard Keynes and Harry Dexter White there have been proposals about alternative solutions that would shore up global financial stability. Their idea of a single world currency still has merit. Such a mechanism could be used to implement the common monetary needs of humanity. It is a possibility that draws ever closer but first there must be an international institution that is capable of making it a reality. At present there is no such entity.

The international monetary and financial system moves from one crisis to another without leadership or guidance. The real challenge therefore lies in the creation of an over-arching organisation that can manage the IMS; that is representative of the global community, for the benefit of the global community and accountable to the global community, and most importantly has within its structure mechanisms to remain immune to political corruption and corporate influence. It must be an international monetary and financial system that is owned and fully shared by the people of the world (through their governments) and not the private banks.

To maximise the benefits of financial reform to the global community, academics, policy makers and legislators have to think long term. The global economy should not depend on *ad hoc* bailouts after the fact. The sensible thing to do is to create a new paradigm where economic and financial crises become a thing of the past. To help achieve that goal, volatility in exchange rates must be reduced if not eliminated altogether. Political leaders have to admit to the fragility of the global economy and implement strategies to tackle financial instability. There must be a willingness: to make informed and calculated changes; to be innovative to solve these recurring

problems; to build new international institutions to co-ordinate central bank activities; to regulate the international monetary market; to improve the operational effectiveness of the international monetary and financial system; and to ensure the global economy functions at its optimum level without the disruptions caused by speculative capital flows and volatile currencies.

Summary of Chapter 11

This Chapter:

- provided answers to the 4 questions presented in Chapter 1
- re-capped the aims of this thesis and gave a summary of the arguments
- combined the findings of each Chapter and analysed the implications that State sovereignty, State responsibility, jurisdiction issues and the fact that existing international monetary laws are being ignored have to the overall complexity of the IMS
- discussed the rise of alternative institutions and the possibility of a new global regulatory model
- explained the contribution this thesis made to the existing body of knowledge
- provided recommendations
- identified further areas for research

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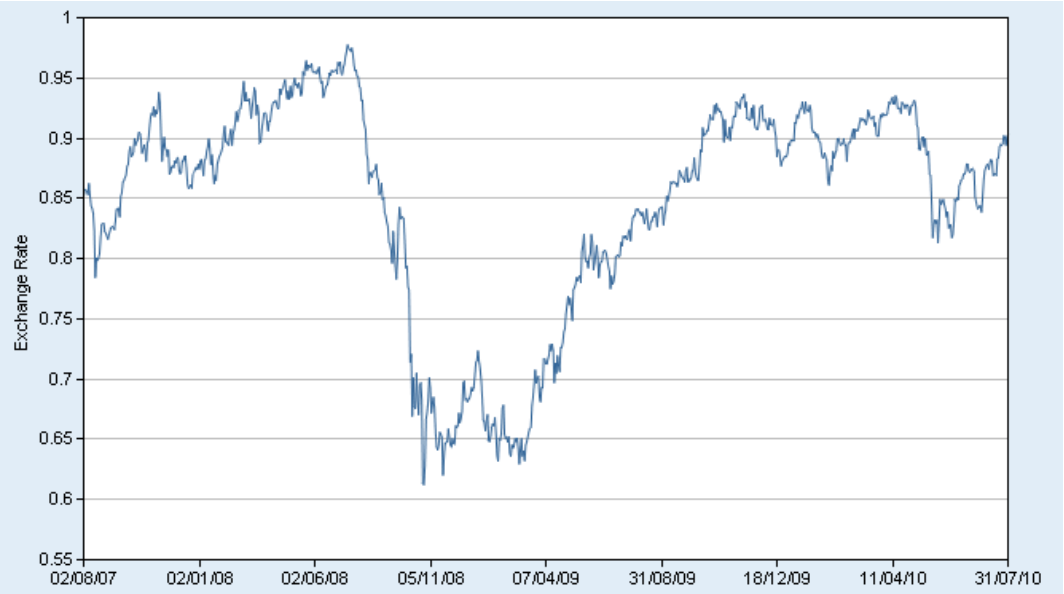
Appendix A

Fall of the Australian Dollar During the GFC

Figure 1. shows the volatility of the AUD/USD currency pair from August 2007 to July 2010.

Figure 1. AUD / USD Currency Pair August 2007 to July 2010



Source: Interbank exchange rate

In July 2008, the Aussie was trading at 98 cents US. By end of September the Aussie had fallen to 84 cents in value against the US dollar. By 20th October it traded at a little over 61 cents. In response to some critical mismanagement problems originating from the US banking sector, a decline in forex market activity and a net migration of wealth out of Australia, within three months the Aussie plummeted by 38 percent. It was the largest and quickest decline in the value of the Australian dollar in its then 42 year history. The decline in the AUD was more severe than that experienced by most countries during the Asian Meltdown a decade earlier. It meant that every asset held in Australian dollars was reduced in

value by 38 percent if compared to its value in US dollars terms only three months earlier. Common Australians who had nothing to do with currency trading had their international net worth reduced by exogenous forces. Australian exports earnt less and imports were dearer. Typically, this volatility is not restricted to months or even weeks but extends down to virtually every second of each trading day. Although the rapid devaluation of the Australian dollar was partially off-set by a gradual rise over the ensuing months, the critical questions to ask are: what can stop such volatility and the subsequent devaluation of wealth, and who can implement that change and how quickly can it be achieved?

Research conducted by Evans and Lyons (2006)[1] using 'order flow' data, which reports the size, price and direction of individual foreign exchange market transactions, has made some progress in modelling exchange rate movements but at present it is not an exact science[2]. The Reserve Bank of Australia (2010) states: 'Movements in the exchange rate over the very short run (e.g. intraday) have proved difficult to explain in a modelling framework'[3]. Generally, the lack of full market data prevents accurate determination for the reasons behind actual currency values, but monitoring capital movements in response to market forces provides a useful insight.

The Australian dollar is heavily traded in forex markets making it the sixth most traded currency in the world. Additionally, the AUD/USD currency pair ranks forth as the most commonly traded currency pair following the EUR/USD, USD/JPY, GBP/USD.

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[1] Evans, M. and Lyons, R. (2006) Understanding Order Flow, *International Journal of Finance and Economics*, Vol. 11, p 3-23.

[2] Engel, C. and West, K. (2005) Exchange Rates and Fundamentals, *Journal of Political Economy*, University of Chicago Press, Vol. 113, No.3, p 485-517.

Froot, K. and Ramadorai, T. (2005) Currency Returns, Intrinsic Value, and Institutional-Investor Flows, *Journal of Finance*, American Finance Association, Vol. 60, No. 3, p 1535-1566.

[3] Reserve Bank of Australia (2010) *The Exchange Rate and the Reserve Bank's Role in the Foreign Exchange Market*. Available at: http://www.rba.gov.au/mkt-operations/foreign-exchg-mkt.html#three

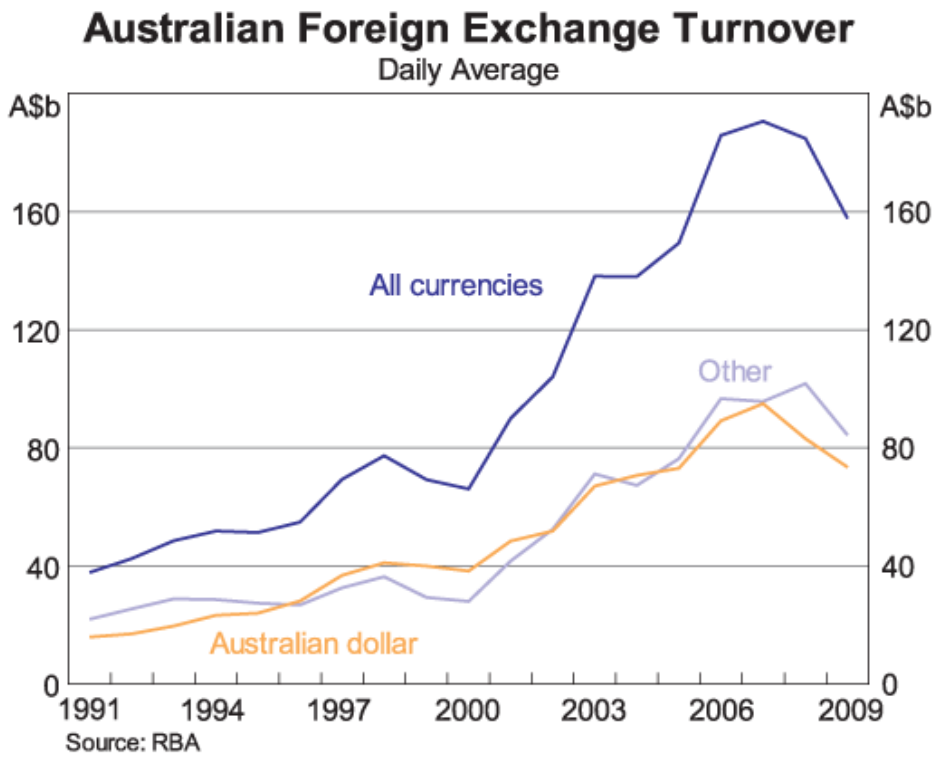
Figure 2

The AUD is largely a commodities based currency and therefore its value is influenced when commodities prices rise and fall. This in turn leads to volatility in the current account deficit especially when global prices for minerals change. The sudden drop in the mining sector during the GFC deteriorated the current account deficit and because Australia has persistently had low levels of national savings, the high levels of investment spending in the mining industry was typically from overseas. With the sharp downturn in the commodities markets much of that overseas investment rushed back to the perceived strength of the greenback. There was a net migration of wealth out of Australia which helped devalue the AUD with record speed.

The RBA explains:

> Following the onset of the global financial crisis, turnover in foreign exchange fell in Australia and in other major markets. This was initially seen by a fall in FX swaps turnover related to reduced cross-border investment activity. Subsequently, the collapse in international trade in late 2008 saw turnover in the spot market fall sharply… The size of the market indicates that the exchange rate is being determined in a liquid, active and competitive market place[4].

Figure 3



The sharp fall in the value of the Australian dollar in the latter half of 2008 corresponds directly with the sharp decline in turnover of spot, outright forwards, foreign exchange swaps and exchange derivatives. Thus, in the short term, speculative activity has much greater influence over exchange rate prices than fundamentals indicators like GDP growth, interest rates and fiscal policy.

[4] *Id.*

Appendix B

Currency Pair Volatility

The following Figures demonstrate the volatility of currency pairs. The charts are based on interbank exchange rates for various periods throughout December 2010. It can be seen from the charts that the market price is only stable over the weekend when the markets close and no trades are made. The rest of the time ~ from Monday morning Sydney time to closing time in New York on Friday evening ~ volatility exists between currency values because every trade affects the market. Because the market never settles, the second requirement of the Efficient Market Hypothesis that states all profit opportunities must be expended is never reached. Therefore, according to the EMH, the market cannot be described as efficient.

Figure 1. AUD / USD Currency Hourly Spot Rate to 1st Dec 2010

Figure 2. EUR / USD Currency Hourly Spot Rate to 1st Dec 2010

Figure 3. CAN / HKD Currency Hourly Spot Rate to 6th Dec 2010

Figure 4. EUR / JPY Currency Hourly Spot Rate to 14th Dec 2010

Figure 5. GBP / JPY Currency Hourly Spot Rate to 15th Dec 2010

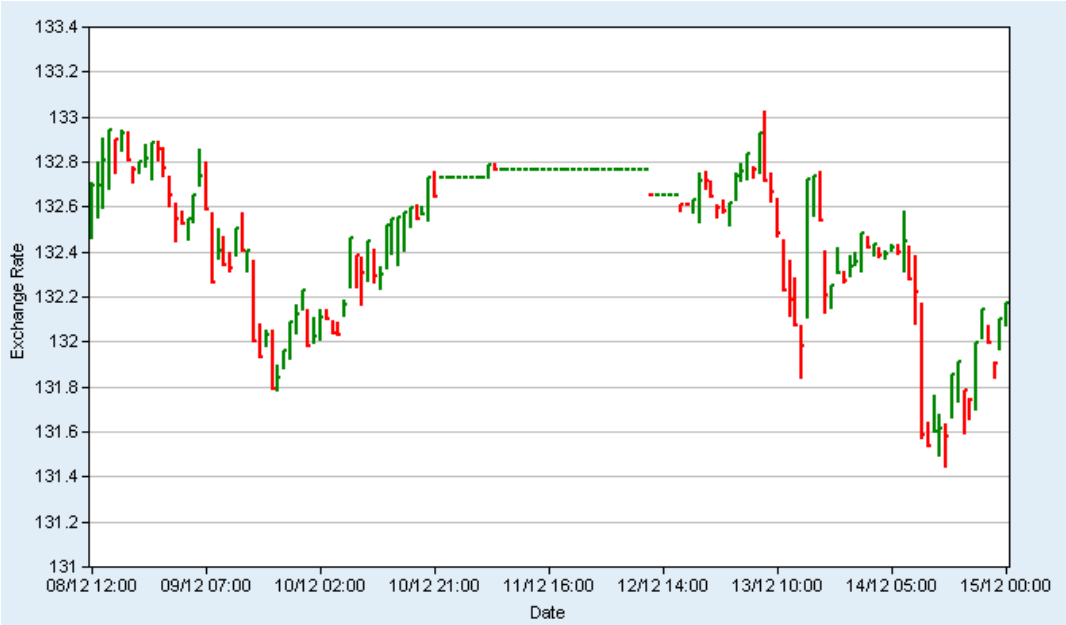


Figure 6. AUD / CHF Currency Hourly Spot Rate to 17th Dec 2010

Figure 7. GBP / USD Currency Hourly Spot Rate to 18th Dec 2010

Appendix C

The US Federal Reserve is privately owned

As the title of this article suggests, the US Federal Reserve Bank which has operated in America since 1914 under the common belief of being part of the US government, is in fact privately owned by a small group of banking dynasties. Both the name of the *Act* [1] which created the Fed, and the name of the Bank itself, convey a message of Federal legitimacy and ownership. The fact that the central bank of America has the word 'Federal' in its title has misled the great mass of a nation ~ and for that matter the rest of the world ~ into thinking the Federal Reserve is part of the US Federal Government and therefore answerable and subservient to the US Congress and the people of the United States. That is not the case, this article highlights a few realities.

Amongst other things, Article 1, Section 8, of the US Constitution grants power to Congress to 'coin money and regulate the value thereof'. Article 1, Section 10 of the Constitution states in part, 'No state shall...make anything but gold and silver coin a tender in payment of debt'. In line with the US Constitution, we would expect that the sovereign entity of the Federal Government would have control of the issuance of all notes and coins within the US, however that is not correct. In stark contrast to ultimate supremacy of the sovereign State to coin its own money, in 1913 the US Government relinquished monetary sovereignty to a new entity called the Federal Reserve System of Central Banks.

[1] *Federal Reserve Act*, 12 US Code, Ch. 3, Sub-Ch. 6, 38 Stat. 251, enacted 23rd December, 1913, otherwise known as the *Owen-Glass Act*.

In *Lewis v United States*[2] the United States Court of Appeals, Ninth Circuit ruled: 'Federal Reserve Banks are not federal instrumentalities … but are independent, privately owned and locally controlled corporations', and that 'there is not sufficient federal government control over detailed physical performance and day to day operation of the Bank for it to be considered a federal agency'. The judgement continues:

> Federal reserve …banks are listed neither as 'wholly owned' government corporations nor as 'mixed ownership' corporations; federal reserve banks receive no appropriated funds from Congress and the banks are empowered to sue and be sued in their own names. . .
>
> Each Federal Reserve Bank is a separate corporation owned by commercial banks in its region. The stockholding commercial banks elect two thirds of each Bank's nine member board of directors. The remaining three directors are appointed by the Federal Reserve Board. The Federal Reserve Board regulates the Reserve Banks, but direct supervision and control of each Bank is exercised by its board of directors. 12 U.S.C. Sect. 301. The directors enact by-laws regulating the manner of conducting general Bank business, 12 U.S.C. Sect. 341, and appoint officers to implement and supervise daily Bank activities. These activities include collecting and clearing checks, making advances to private and commercial entities, holding reserves for member banks, discounting the notes of member banks, and buying and selling securities on the open market. See 12 U.S.C. Sub-Sect. 341-361. Each Bank is statutorily empowered to conduct these activities without day to day direction from the federal government.

In *United States v Hollingshead* [3] the US Federal Court stated:

> While we would like to think that the federal government and the Fed work co-operatively with each other, and they may on occasion, the Fed is by no means required to do so.

[2] *Lewis v United States*, 680 F.2d 1239 (1982) Court of Appeal, Ninth Circuit.

[3] *United States v Hollingshead*, 672 F.2d 751 (1982) Court of Appeal, Ninth Circuit.

To clarify the ownership of the Federal Reserve and inform congressmen about the true situation of American monetary supply, the Committee on Banking, Currency and Housing, presented to the House of Representatives, a staff report titled *Federal Reserve Directors: A Study of Corporate and Banking Influence*. The report was tabled at the 94th Congress, 2nd Session, in August 1976. It outlined how the *Federal Reserve Act* created a private, for profit, central banking corporation owned by a cartel of private banks: The Rothschilds of London and Berlin, Lazard Brothers of Paris, Israel Moses Seif of Italy, Kuhn, Loeb and Warburg of Germany, and the Lehman Brothers, Goldman Sachs and the Rockefeller families of New York.

Figure 1 below shows the linear connection between the Rothschild's Bank of England, and the European banking houses which ultimately control the Federal Reserve Banks through their holdings of bank stock and their subsidiary firms in New York. The two principal Rothschild representatives in New York, JP Morgan Co., and Kuhn Loeb & Co. were the firms which set up the Jekyll Island Conference at which the *Federal Reserve Bill* was drafted. Those banks then directed a campaign to have the plan enacted into law by Congress. Not surprising, in 1914 JP Morgan Co., and Kuhn Loeb & Co. acquired major interests in the Federal Reserve Bank of New York and had their principal officers appointed to the Federal Reserve Board of Governors and the Federal Advisory Council. They also purchased controlling shares in the Federal Reserve regional banks giving them total control of the supply of money and credit within the US. An examination of Figure 1 identifies the inter-connection of the respective banking establishments.

Figure 1. Controlling Interests of the Federal Reserve System of Banks

```
                                N.M. Rothschild , London - Bank of England
                                 _____________________________________
                                |                                     |
                                |                           J. Henry Schroder

                                |                             Banking | Corp.
                                |                                     |
                           Brown, Shipley - Morgan Grenfell - Lazard - |
                            & Company        & Company       Brothers  |
                                |               |              |      |
             --------------------|        -------|              |      |
             |                  |        |      |              |      |
 Alex Brown - Brown Bros. - Lord Mantagu - Morgan et Cie -- Lazard ---|
 & Son       |  Harriman       Norman     |    Paris          Bros     |
             |                  |        /      |            N.Y.     |
             |                  |       |       |              |      |
             |            Governor, Bank | J.P. Morgan Co -- Lazard ---|
             |            of England    /  N.Y. Morgan       Freres    |
             |            1924-1938    /   Guaranty Co.      Paris     |
             |                        /    Morgan Stanley Co.  |      /
             |                      /           |              \Schroder Bank
             |                     /            |              Hamburg/Berlin
             |                    /      Drexel & Company         /
             |                   /       Philadelphia            /
             |                  /                               /
             |                 /                           Lord Airlie
             |                /                               /
             |               /     M. M. Warburg       Chmn J. Henry Schroder
             |               |      Hamburg ---------  marr. Virginia F. Ryan
             |               |         |               grand-daughter of Otto
             |               |         |                Kahn of Kuhn Loeb Co.
             |               |         |
             |               |         |
Lehman Brothers N.Y -------------- Kuhn Loeb Co. N. Y.
             |               |     -------------------------
             |               |       |                       |
Lehman Brothers - Mont. Alabama   Solomon Loeb           Abraham Kuhn
             |               |     __|_____________________|________
Lehman-Stern, New Orleans   Jacob Schiff/Theresa Loeb  Nina Loeb/Paul Warburg
-------------------------    |       |                       |
             |               | Mortimer Schiff        James Paul Warburg
_____________|_______________/       |
|            |          |   |        |
Mayer Lehman |     Emmanuel Lehman    \
|            |          |              \
Herbert Lehman     Irving Lehman        \
|            |          |                \
Arthur Lehman \    Phillip Lehman     John Schiff/Edith Brevoort Baker
              /          |             Present Chairman Lehman Bros
             /  Robert Owen Lehman    Kuhn Loeb - Granddaughter of
            /           |             George F. Baker
           |           /               |
           |          /                |
           |         /           Lehman Bros Kuhn Loeb (1980)
           |        /                  |
           |       /             Thomas Fortune Ryan
           |      |                    |
           |      |                    |
      Federal Reserve Bank Of New York |
           ||||||||                    |
  ______National City Bank N.Y.       |
  |        |                          |
  |   National Bank of Commerce N.Y ---|
  |        |                           \
  |   Hanover National Bank N.Y.         \
  |        |                             \
  |   Chase National Bank N.Y.             \
  |                                         |
  |                                         |
Shareholders - National City Bank - N.Y.   |
----------------------------------------  |
  |                                       /
```

```
James Stillman                            /
Elsie m. William Rockefeller             /
Isabel m.  Percy Rockefeller            /
William Rockefeller          Shareholders - National Bank of Commerce N.Y.
J. P. Morgan                 ----------------------------------------------
M.T. Pyne                    Equitable Life - J.P. Morgan
Percy Pyne                   Mutual Life - J.P. Morgan
J.W. Sterling                H.P. Davison - J. P. Morgan
NY Trust/NY Edison           Mary W. Harriman
Shearman & Sterling          A.D. Jiullard - North British Merc. Insurance
|                            Jacob Schiff
|                            Thomas F. Ryan
|                            Paul Warburg
|                            Levi P. Morton - Guaranty Trust - J. P. Morgan
|
|
Shareholders - First National Bank of N.Y.
------------------------------------------
J.P. Morgan
George F. Baker
George F. Baker Jr.
Edith Brevoort(Baker)Schiff
|
|
|
|
|
Shareholders - Hanover National Bank N.Y.
-----------------------------------------
James Stillman
William Rockefeller
|
|
|
|
|
Shareholders - Chase National Bank N.Y.
---------------------------------------
George F. Baker
```

Source: *Federal Reserve Directors: A Study of Corporate and Banking Influence*. Staff Report, Committee on Banking, Currency and Housing, House of Representatives, 94th Congress, 2nd Session, August 1976.

Creating the Federal Reserve

Although there were substantial historical accounts [4] against handing over monetary sovereignty to private banking interests, the campaign to launch the Fed received substantial financial backing. Political donations from the National City Bank of New York, JP Morgan Company, First National Bank of New York, and Kuhn Loeb Co. encouraged key political figures to endorse the Bill[5]. Forgetting the lessons of history and ignoring the warnings from vociferous opponents[6], the Senate passed the Federal Reserve bill, 54-34 on 19th December 1913 with virtually full Democratic support[7]. The conference committee agreed and on 23rd December President Wilson signed the *Federal Reserve Act*[8] into law.

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[4] The concept of government central banks being at the forefront of national banking needs was not new to America. She had on three previous occasions allowed for the creation of a national central bank, all of which depended predominantly on Rothschild capital to kick-start the banks and fund government. This meant private entities had controlling interests in the central bank and also profited on the paper money it lent to the government. Thomas Jefferson's comment to John Eppes on 24th June 1813 expressed his concerns: 'Bank-paper must be suppressed, and the circulating medium must be restored to the nation to whom it belongs'*. Jefferson held this view for a long time. In 1816 he wrote to John Taylor and remarked: 'I sincerely believe, with you, that banking establishments are more dangerous than standing armies; and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale'**.

* Cf. Ford, P.L.(ed.) (1904) *The Works of Thomas Jefferson*, G.P. Putnam's Sons, New York, Vol. 11, p 303.

** *Ibid*. p 533.

[5] Woodrow Wilson's 1912 presidential campaign was heavily funded by these bankers.

[6] Congressman Charles A. Lindberg worked on the US House Committee on Banking and Currency* which conducted an investigation into financial and monetary conditions in the US. He was an unwavering opponent to the Aldrich plan and expressed his views not only in Congress but he also wrote a book** on the subject. In 1917 Lindberg brought articles of impeachment against members of the Federal Reserve Board including Paul Warburg and W.P.G Harding, claiming that the Federal Reserve Board members were involved '...in a conspiracy to violate the Constitution and laws of the United States'***.

* Subcommittee of the Committee on Banking and Currency (1913) *Money Trust Investigation: Investigation of Financial and Monetary Conditions in the United States*, House Resolutions Nos. 429 and 504, 62nd Cong., 3rd sess., 1912–13, Vol. 15, p 1019–1024; 1049–1052.

**Lindbergh, C. (1913) *Banking and Currency and the Money Trust*, C.A. Lindberg, Little Falls Minnesota.

*** Congressional Record 12th February 1917, p 3126-3130.

[7] The record shows that there were no Democrats voting "nay" in the Senate and only two in the House. See Vol. 51 Congressional Record, p 1464, 1487-88.

[8] US Code, Title 12, Chapter 3.

Appendix D

The Main Trading Platforms

In order of turnover volume the main trading platforms are the Deutsche Börse Eurex, The Chicago Mercantile Exchange (CME) Globex, and the New York Stock Exchange (NYSE) Euronext. However in terms of turnover, there is not much separating the major players so it is quite probable that the order will swap a few times over the coming years. While the three largest platforms account for over 89 percent of the entire market, the next group comprising of the Swiss Exchange, Tokyo, Singaporean, Hong Kong and Sydney Exchanges accounts for approximately 8 percent of the market. The remaining 3 percent of the market is divided among the emerging market economies; which includes exchanges operating out of such places as Azerbaijan, Brazil, China, Georgia, India, Kazakhstan, Korea, Poland, Russia, Saudi Arabia and the United Arab Emirates.

The Deutsche Börse

The Frankfurter Wertpapierbörse, otherwise known as the Frankfurt Stock Exchange, is one of the oldest Exchanges in the world. The Frankfurt Autumn Fair which dates back to 1150 AD allowed for commercial trading activity during the fair. In 1330 Emperor Ludwig the Bavarian promoted a Spring Fair and thus helped to establish Frankfurt as an important centre for commercial and monetary transactions. By the beginning of the sixteenth century merchants from all over Europe went to the Frankfurt Fairs in order to engage in trade. Because there was such a variety of coinage in circulation at the Fair merchants met in 1585 to establish uniform exchange rates. That event is regarded as the starting point of the Frankfurt Exchange.

The first official exchange rate list appeared in 1625 and presented the conversion prices of twelve currencies. In 1682, the first Exchange Rules and Regulations were enacted, which led to the establishment of an official stock exchange administration. Trading in promissory notes and private bonds followed shortly afterwards. Trading in government bonds began on the Frankfurter Wertpapierbörse at the end of the eighteenth century and the Bankhaus Bethmann and Bankhaus Rothschild propelled Frankfurt into a centre for international capital.

The German *Stock Exchange Act* [1] of 1896 helped to bring uniform organisation to Germany's 29 Exchanges[2] but when the Nazi Party came to power in 1933, Stock Exchange supervision became the domain of the central government and the number of Exchanges reduced to 9. After World War II, the Frankfurt Stock Exchange rebuilt its reputation as a leading international financial centre and by 1969 the Exchange had began processing some of its data electronically. In February 2011, the Deutsche Börse Eurex entered negotiations to acquire the New York Stock Exchange.

[1] Deutsche Börsengesetz.

[2] Emery, H.C. (1898) The Results of the German Exchange Act of 1896, *Political Science Quarterly*, Vol. 13, No. 2 (June 1898), at p286.

Figure E.1 The Deutsche Börse

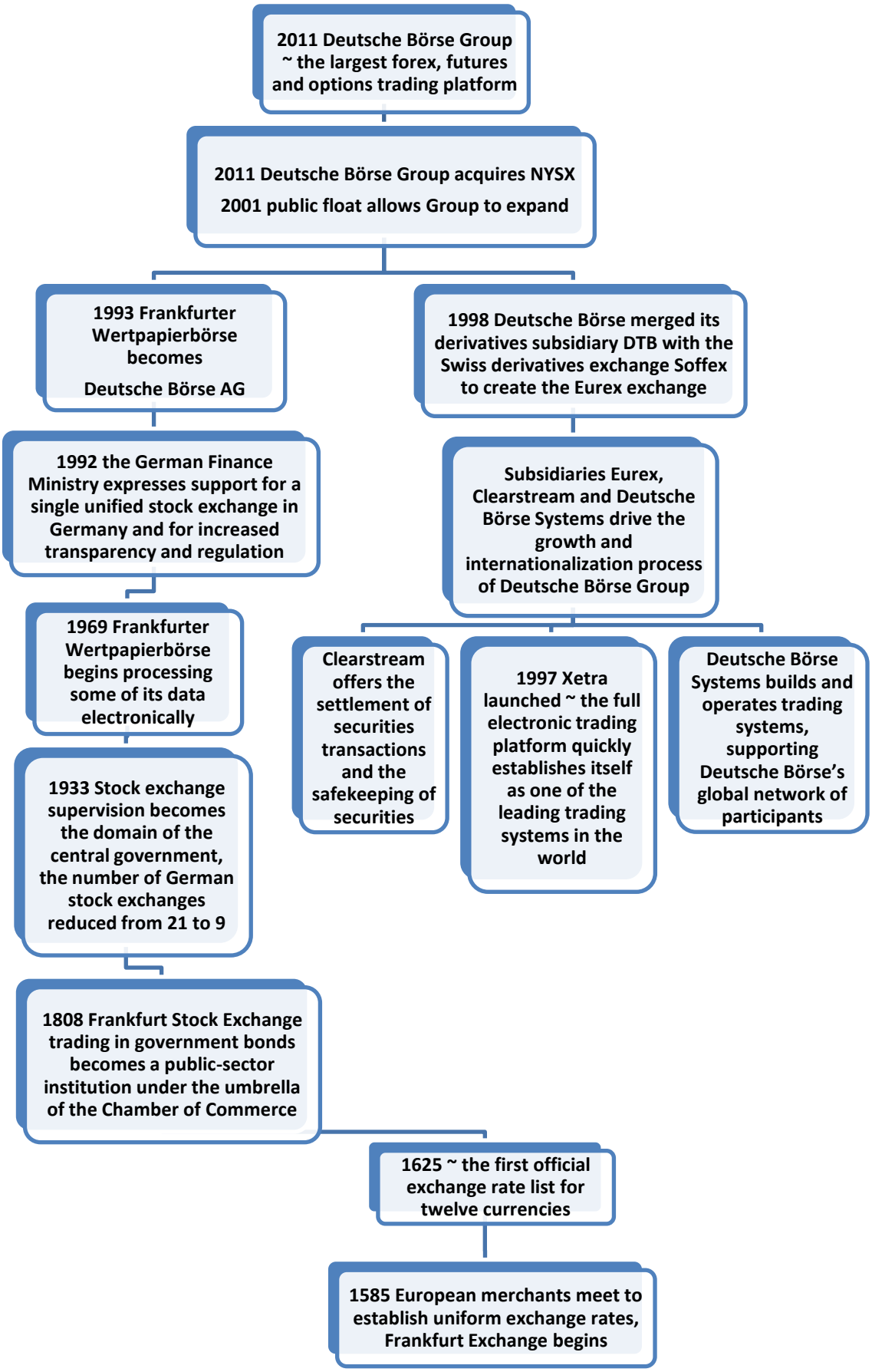


Figure E.2 The Chicago Mercantile Exchange

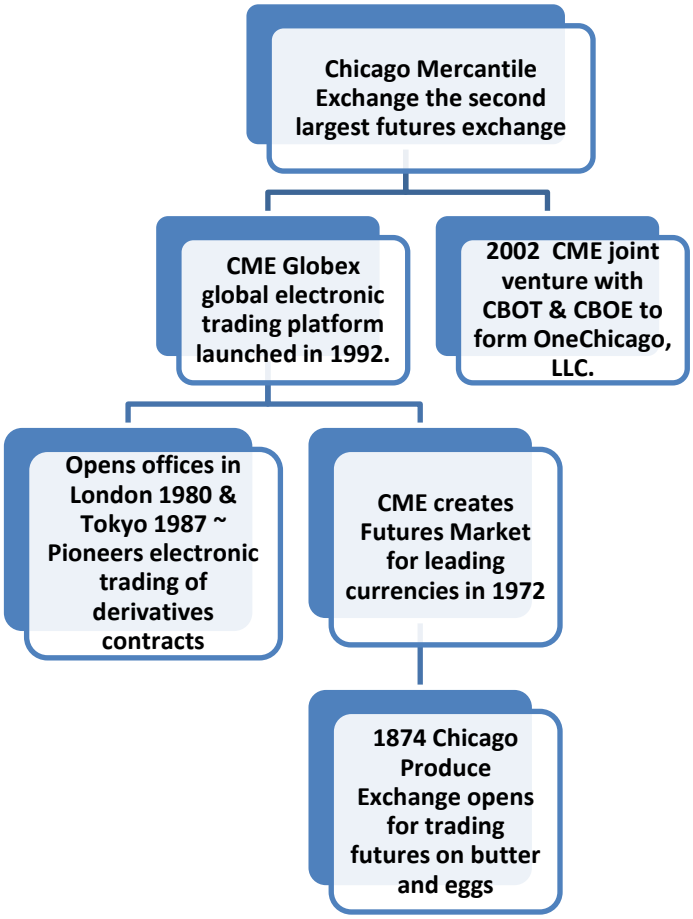
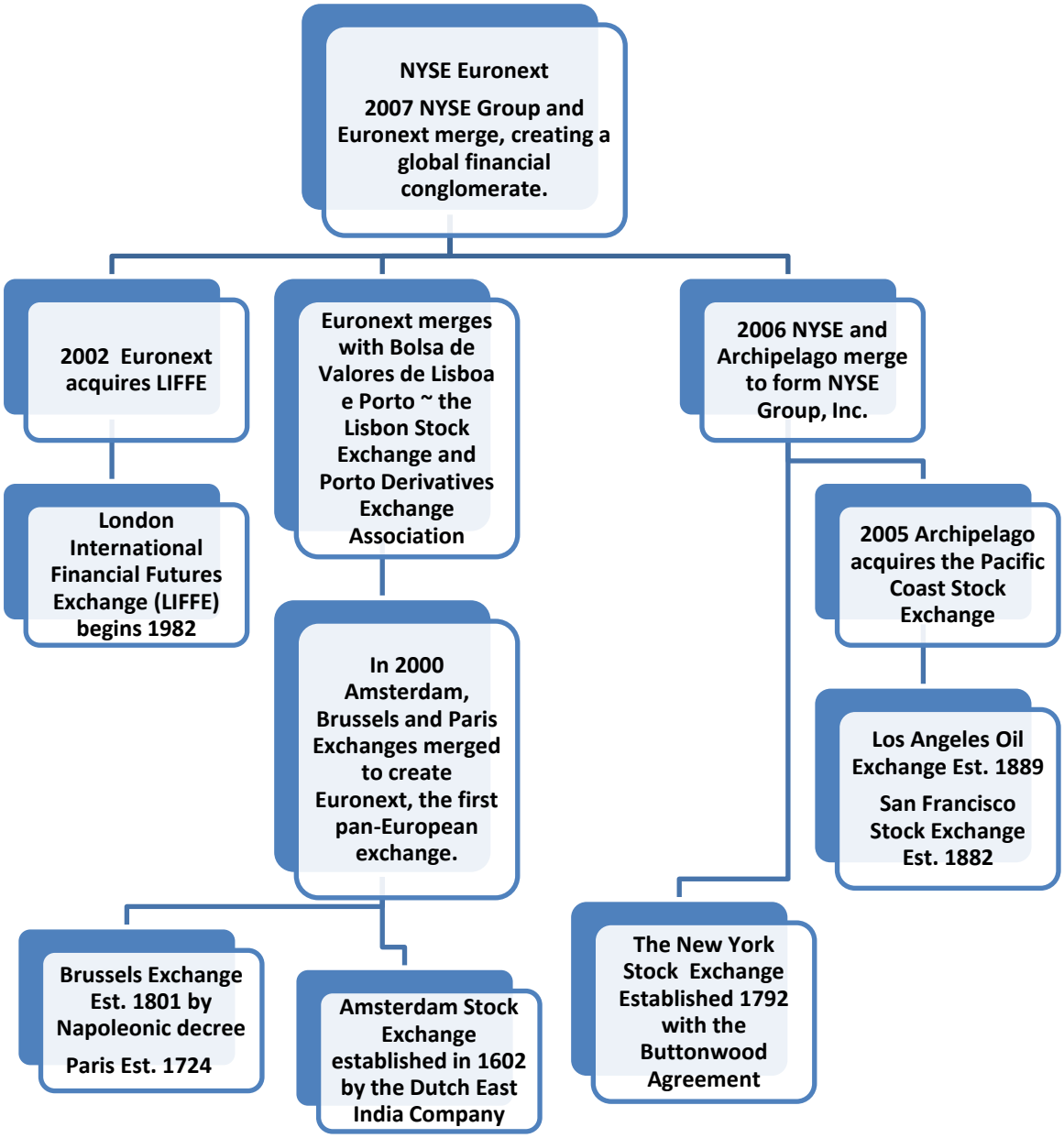


Figure E.3 NYSE Euronext



Appendix E

No Speculative Currency Trades in China

At present the Chinese renminbi[1] ~ but correctly the yuan CNY[2] ~ is convertible on the current account, but not on the capital account. In other words, the Chinese authorities only allow the yuan to be converted for the purposes of paying for traded goods and services and not for allowing foreign money/capital flows to enter their economy unless it is for long-term capital works. This strategy works well for China as it prevents the quick injection and withdrawal of capital which is a major cause of financial instability. Unlike South Korea, Thailand, the Philippines and Indonesia which were adversely affected by the migration of capital out of their economies during the Asian financial crisis of 1997-98, China was not exposed to such activity[3].

Because China has a fixed but movable peg currency valuation system tied to a basket of currencies it has little reason or ambition to develop a domestic forex exchange at this point in time.

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[1] Renminbi (人民币) translates as *peoples' money* but the actual currency is called *yuan* (元).

[2] 'CNY' (Chinese Yuan) is the official ISO 4217 abbreviation.

[3] Despite claims that the Asian financial crisis was caused by domestic corruption and heavy reliance on foreign capital by the Asian nations, other evidence points squarely back to the conditions of the *Washington Consensus* imposed by the US, the World Bank, the IMF, and the Structural Adjustment Programmes. The Japanese attempt to mitigate the economic fall-out from the 1997financial crisis by lending its foreign reserve surplus to the distressed economies was squashed by the US which only deepened the crisis. This made the Asian countries more determined to launch their own monetary framework with the Chiang Mai Initiative. In 2000 the Finance Ministers of the South East Asian Nations plus China, Japan and Korea (ASEAN+3) agreed to establish a network of bilateral swap agreements among the ASEAN+3 members to provide liquidity support to countries experiencing balance of payments difficulties. A primary objective of the Chiang Mai Initiative was to create the Asian Monetary Organisation/Union and by-pass the American system altogether.

Cf. Asami, T. (2005) *Chiang Mai Initiative as the Foundation of Financial Stability in East Asia*, Indian Institute of Management Ahmedabad, available at http://www.aseansec.org/17905.pdf.

From 1994 to 2005, yuan was pegged directly to the value of the US dollar at a rate[4] of about 8.3 to 1 which made many products from China extremely cheap for US consumers. In July 2005, after considerable pressure from the US and Europe, China revalued its currency by 2.1 percent against the US dollar and moved to an exchange rate system that references a basket of currencies instead of just the US dollar. Cumulative appreciation of the yuan against the US dollar since the end of the dollar peg reached 21.7 percent by June 2008[5]. Since July 2008 Chinese authorities have kept the yuan at about 6.8286 per dollar.

The December 2007 - January 2008 trade imbalance between the US and China had been running at about US$26 billion each month in favour of China[6]. That equated to about US$84 per month per person living in the US buying goods from China. That figure did not include the other $32 billion per month which the US went into debt with the rest of the world. Needless to say the US tried to apply pressure on China to increase the value of the yuan even further and make it fully convertible, but the Chinese government resisted out of concern it would expose domestic banks to currency risks. Post GFC the US trade imbalance reduced to about US$20 billion per month but still in favour of China[7].

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[4] China / US Exchange Rate: Available at: http://www.economagic.com/em-cgi/data.exe/fedstl/exchus+2.

[5] CIA World Fact-book. Available at; https://www.cia.gov/library/publications/the-world-factbook.

[6] US Census Bureau, Bureau of Economic Analysis (2008) *International Trade in Goods and Services,* Press Release, 11th March 2008, Department of Commerce, Washington. Available at: http://www.census.gov/foreign-trade/Press-Release/2008pr/01/ftdpress.pdf

[7] If Purchasing Power Parity is considered and given that China has foreign exchange reserves of US$2,273billion* and does not have international debts nor the $45 trillion long term debt liabilities like the US does, it gives a good indication just how close China actually is to moving to the number 1 economic position.

* Source: State Administration of Foreign Exchange, People's Republic of China, as of Sep 2009.

Zhao Qingming, a senior analyst in Beijing at China Construction Bank Corp., estimates more than $200 billion of speculative capital entered China between 2005 and 2009[8]. In November 2009 China tightened rules on individuals transferring yuan and foreign exchange between bank accounts after speculation that the nation's currency would strengthen as a result of a surge in the balance of payments. The Chinese Administration of Foreign Exchange restricted individuals and institution from converting foreign currencies into yuan exceeding 20,000 yuan per day[9]. Zhao said: 'The main aim of the new rules is to control inflows of hot money'[10]. Exposing their economy to the draw-backs of un-regulated capital flows is something the Chinese authorities are not currently prepared to allow.

---

[8] Chen, J. (2009) China Tightens Rules on Transfers to Stop 'Hot Money', *Bloomberg News*, 25th November 2009. Available at: http://www.bloomberg.com/apps/news?pid=206...ktlLM&pos=5

[9] These rules do not apply to capital works programmes, they are directed specifically at speculative capital flows.

[10] Chen, J. (2009) *Supra*.

Appendix F

Responsibility of States for Internationally Wrongful Acts

Excerpt *Articles* from the draft convention on *Responsibility of States for Internationally Wrongful Acts*. These Articles can be applied specifically to the currency trading problem.

Part 1 General Principles

Article l Responsibility of a State for its internationally wrongful acts

Every internationally wrongful act of a State entails the international responsibility of that State.

Article 2 Elements of an internationally wrongful act of a State

There is an internationally wrongful act of a State when conduct consisting of an action or omission:
(a) Is attributable to the State under international law; and
(b) Constitutes a breach of an international obligation of the State.

Article 3 Characterization of an act of a State as internationally wrongful

The characterization of an act of a State as internationally wrongful is governed by international law.

Article 4 Conduct of organs of a State

1. The conduct of any State organ shall be considered an act of that State under international law, whether the organ exercises legislative, executive, judicial or any other functions, whatever position it holds in the organization of the State, and whatever its character as an organ of the central Government or of a territorial unit of the State.
2. An organ includes any person or entity which has that status in accordance with the internal law of the State.

Article 5 Conduct of persons or entities exercising elements of governmental authority

The conduct of a person or entity which is not an organ of the State under article 4 but which is empowered by the law of that State to exercise elements of the governmental authority shall be considered an act of the State under international law, provided the person or entity is acting in that capacity in the particular instance.

Article 8 Conduct directed or controlled by a State

The conduct of a person or group of persons shall be considered an act of a State under international law if the person or group of persons is in fact acting on the instructions of, or under the direction or control of, that State in carrying out the conduct.

Article 9 Conduct in the absence or default of the official authorities

The conduct of a person or group of persons shall be considered an act of a State under international law if the person or group of persons is in fact exercising elements of the governmental authority in the absence or default of the official authorities and in circumstances such as to call for the exercise of those elements of authority.

Article 12 Existence of a breach of an international obligation

There is a breach of an international obligation by a State when an act of that State is not in conformity with what is required of it by that obligation, regardless of its origin or character.

Article 13 International obligation in force for a State

An act of a State does not constitute a breach of an international obligation unless the State is bound by the obligation in question at the time the act occurs.

Article 22 Countermeasures in respect of an internationally wrongful act

The wrongfulness of an act of a State not in conformity with an international obligation towards another State is precluded if and to the extent that the act constitutes a countermeasure taken against the latter State…

Part 2 Content of the International Responsibility of a State

Article 28 Legal consequences of an internationally wrongful act

The international responsibility of a State which is entailed by an internationally wrongful act in accordance with the provisions of part one involves legal consequences as set out in this part.

Article 29 Continued duty of performance

The legal consequences of an internationally wrongful act under this part do not affect the continued duty of the responsible State to perform the obligation breached.

Article 30 Cessation and non-repetition

The State responsible for the internationally wrongful act is under an obligation:

(a) To cease that act, if it is continuing;

(b) To offer appropriate assurances and guarantees of non-repetition, if circumstances so require.

Article 31 Reparation

1. The responsible State is under an obligation to make full reparation for the injury caused by the internationally wrongful act.
2. Injury includes any damage, whether material or moral, caused by the internationally wrongful act of a State.

Article 32 Irrelevance of internal law

The responsible State may not rely on the provisions of its internal law as justification for failure to comply with its obligations under this part.

Article 33 Scope of international obligations set out in this part

1. The obligations of the responsible State set out in this part may be owed to another State, to several States, or to the international community as a whole, depending in particular on the character and content of the international obligation and on the circumstances of the breach.
2. This part is without prejudice to any right, arising from the international responsibility of a State, which may accrue directly to any person or entity other than a State.

Article 34 Forms of reparation

Full reparation for the injury caused by the internationally wrongful act shall take the form of restitution, compensation and satisfaction, either singly or in combination, in accordance with the provisions of this chapter.

Article 35 Restitution

A State responsible for an internationally wrongful act is under an obligation to make restitution, that is, to re-establish the situation which existed before the wrongful act was committed, provided and to the extent that restitution:
(a) Is not materially impossible;
(b) Does not involve a burden out of all proportion to the benefit deriving from restitution instead of compensation.

Article 38 Interest

1. Interest on any principal sum due under this chapter shall be payable when necessary in order to ensure full reparation.

Part 3 The Implementation of International Responsibility of a State

Article 48 Invocation of responsibility by a State other than an injured State

1. Any State other than an injured State is entitled to invoke the responsibility of another State in accordance with paragraph 2 if:
(a) The obligation breached is owed to a group of States including that State, and is established for the protection of a collective interest of the group; or
(b) The obligation breached is owed to the international community as a whole.

Article 56 Questions of State responsibility not regulated by these articles

The applicable rules of international law continue to govern questions concerning the responsibility of a State for an internationally wrongful act to the extent that they are not regulated by these articles.

Article 57 Responsibility of an international organization

These articles are without prejudice to any question of the responsibility under international law of an international organization, or of any State for the conduct of an international organization.

Article 58 Individual responsibility

These articles are without prejudice to any question of the individual responsibility under international law of any person acting on behalf of a State.

Article 59 Charter of the United Nations

These articles are without prejudice to the Charter of the United Nations.

Appendix G

Evidence Financial Markets Are Manipulated

In 1907, the Knickerbocker Trust Company's funds were being used in an attempt to corner the copper market, drive up the price and make a profit. This speculative gamble was not successful however, due to the dumping of millions of dollars of copper onto the market by a competitor. Knickerbocker's losses became public knowledge, and in October the National Bank of Commerce announced that it would no longer accept cheques drawn against the Knickerbocker Trust Company. This triggered a run of depositors demanding their funds. The president of Knickerbocker, Charles Barney requested a meeting with JP Morgan to discuss financial assistance for the bank, but was rejected. Barney shot himself a month later. Despite the suicide, Knickerbocker was able to pay all its depositors with interest and still remain viable[1].

Wall Street historian Professor Charles Geisst wrote about manipulation in the market referring to the Knickerbocker Trust Company's credit crisis:

> ...the Wall Street community, led by JP Morgan, put together a rescue package designed to prop up the other trust institutions. Morgan, Jacob Schiff of Kuhn Loeb, George Baker of the First National Bank, and James Stillman of the National City Bank banded together to ensure that the banking system remained intact. Schiff especially had been an advocate of banking reform for some time and considered the way in which American banking was conducted to be nothing short of disgraceful. After the Knickerbocker failed, this group stepped in to prevent others from doing so. They met in New York with President Roosevelt's secretary of the Treasury, George

[1] Perine, E.T. (1916) *The Story of the Trust Companies*, GP Putnam's Sons, re-printed (2006) by Adamant Media Corporation, Boston.

Cortelvou, who provided them with Treasury funds of $25 million to keep the system from collapsing. The money was deposited in the national banks in New York with the intent of adding funds to a system sorely in need of more liquidity. It was the job of the large New York banks to apply the funds as they saw fit to prevent further panic and runs by depositors.

In many ways the act was an extraordinary gesture. Roosevelt's faith in Morgan and the more serious of the Wall Street contingent only underlined the vacuum in the financial system. The Treasury of the largest emerging economy in the world had to transfer funds to private bankers in order to prevent a financial collapse. More than one detractor claimed that those bankers had orchestrated most of the panics themselves in order to make speculative profits. The panic of 1907 was nothing short of a massive conspiracy designed to ingratiate Wall Street to Washington and make more than a few dollars in the process'[2].

Do banks distort or compromise the market?

In 2003, Bear, Stearns & Co. Inc., Credit Suisse First Boston LLC, Goldman, Sachs & Co., Lehman Brothers Inc., JP Morgan Securities Inc., Merrill Lynch, Pierce, Fenner & Smith, Incorporated (Merrill Lynch), Morgan Stanley & Co. Incorporated, Citigroup Global Markets Inc., Salomon Smith Barney Inc., UBS Warburg LLC, and US Bancorp Piper Jaffray Inc. simultaneously entered into a settlement with the US Securities and Exchange Commission (SEC), the Office of the New York State Attorney General and various other securities regulators, regarding undue influence over each firm's research analysts by their investment-banking divisions[3]. Specifically, all ten firms failed to maintain appropriate supervision over their research and investment banking operations in violation of NASD Rule 3010 and NYSE Rule 342. Regulators alleged that the firms had improperly associated analyst compensation

[2] Geisst, C (1997) *Wall Street: A History*, revised ed.(2004), Oxford University Press, New York. p 119.

[3] See Generally: US Securities and Exchange Commission factsheet on Global Analyst Research Settlement, 28th April 2003. Available at: http://www.sec.gov/news/speech/factsheet.htm

with the firms' investment-banking revenues, and promised favourable, market-moving research coverage, in exchange for underwriting opportunities.

Credit Suisse First Boston LLC, Merrill Lynch and Salomon Smith Barney Inc., issued fraudulent research reports in violation of Section 15(c) of the *Securities Exchange Act* of 1934 as well as various state statutes. All ten firms issued research reports that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about the covered companies, and/or contained opinions for which there were no reasonable bases in violation of NYSE Rules 401, 472 and 476(a)(6), NASD Rules 2110 and 2210, as well as state ethics statutes.

The settlement between the ten banks and the SEC became known as the 'global settlement' and imposed total financial penalties of $1.4 billion. In May 2009 the Goldman Sachs Group agreed to pay another $60 million to end an investigation by the Massachusetts Attorney General's office into whether the firm helped promote unfair home loans prior to the housing bubble burst of 2007[4]. Multi-million dollar settlements are an accepted norm of regulatory activity but the penalties are administered because banks do manipulate markets.

Jon Markman, a financial analyst and award winning journalist reveals other stories of market manipulation[5]. In 1987 he recorded how the events of 14th October 1987 were created by manipulation of the market by the giant financial institutions. He demonstrated how events were choreographed precisely minute by minute which allowed him to win the prestigious

[4] Wayne, L. (2009) Goldman Pays to End State Inquiry Into Loans, *New York Times*, 12th May 2009, p B3.

[5] Markman, J. (2005) *Swing Trading: Power Strategies to Cut Risk and Boost Profits*, John Wiley & Sons Inc., Hoboken, New Jersey.

Markman, J. (2008)*The New Day Trader Advantage*, McGraw Hill, New York.

Gerald Loeb Award. Again, in 2008 he reported how the global financial crisis simply did not happen; it was planned. He writes:

> At 11:00 a.m. September 18, $550 billion was drawn out of money market accounts in a matter of minutes. The Federal Reserve stepped in with $105 billion but quickly realised this was not enough to stem the tide. In panic, Bernanke and Paulson closed money market accounts. If they had not done so, $5.5 trillion would have been drawn out by 2:00 p.m., collapsing the entire economy. We were, by my estimate, 27 minutes from total monetary destruction. Now, the first question you may have is: who did it? One answer being whispered is that this operation had Goldman Sachs' fingerprints all over it[6].

The $550 billion withdrawal was a co-ordinated event. A dollar decision of that type is planned; it is not a whim of the market. As the 2004 Citigroup coup against the European bond market demonstrated[7], even a €12 billion sell-off took weeks to organise. Prolonged and careful planning would have been required for the $550 billion withdrawal.

The 18th September 2008 withdrawal was an example of the power the banking sector can employ to influence government via the market. With the help of the media, within the following fortnight, losses had been realised and panic had set in. The Dow Jones average, the Standard & Poor's 500 index and the Nasdaq composite index all plunged. The market forces displayed on Wall Street made the House of Representatives realised that the US was in the midst of a spiralling credit and economic crisis. By early October the House of

[6] Markman, J. (2010) Become One of the 'New Masters of the Universe', *Money Morning*, 4th February 2010.

[7] In 2004 Citigroup's London-based European-bond traders placed sell orders for almost €13 billion worth of EU bonds within 18 seconds ~ prices instantly tumbled across the board on the massive sell orders. The British Financial Services Authority, after investigations for market abuse activity, fined Citigroup £13.9 million. See Chapter 6 section 2.

Representatives approved a $700 billion bailout packaged for the banks[8]. Although the bailout money was supposed to be passed on to Main Street to generate economic activity and help keep American business going[9], the banks capitalised on the extra liquidity to buy out competition and make record profits[10]. The US economy was in serious trouble yet bank executives took million dollar bonuses. The misconceived notion of being 'too big to fail' pressured Congress into passing a law that not only compromised the position of the US taxpayer, but also allowed some banks to get even bigger. Withdrawing $550 billion from the market was not a random event. It was designed to shake the system and allow some players to reap substantial benefits. That activity equates to market abuse and manipulation.

Now consider the inter-twined relationship between, Goldman Sachs, the Federal Reserve and the US administration. Former Treasury Secretary Henry Paulson Jr, his top deputy Robert Steel and White House chief of staff Joshua Bolten were all past CEOs or senior executives of Goldman Sachs. John Thornton was president of Goldman Sachs when Henry Paulson[11] was its chief executive, and Glenn Hubbard was a former chairman of President Bush Jr's Council of Economic Advisers. John Thornton and Robert Hubbard were also on President Bush's Panel on Capital Markets Regulation. Treasury Secretary Timothy Geithner was past president of the Federal Reserve Bank of New York, a senior fellow in the Council

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[8] The *Emergency Economic Stabilization Act* of 2008, better known as the Troubled Asset Relief Program (TARP), authorised the Bush administration to engage the largest financial intervention package since the Great Depression.

[9] President Bush encouraged the House of Representatives to pass the Wall Street rescue plan saying: 'This is an issue that is affecting hard-working people...they are worried about their savings. They're worried about their jobs. They worried about their houses. They're worried about their small businesses'. Cf: Reynolds, M., Simon, R. and Gaouette, N. (2008) Bush implores House to pass amended bailout plan, *Los Angeles Times*, 3rd October 2008.

[10] Inman, P. (2009) Goldman to make record bonus payout: Surviving banks accused of undermining stability, *The Observer*, 21st June 2009.

[11] Based on SEC filings for the year ending 31st May 2008, Henry Paulson took his annual bonus entirely in Goldman Sachs stock. http://en.wikipedia.org/wiki/Goldman_Sachs#cite_note-37

on Foreign Relations as well as director of policy development at the International Monetary Fund. Chairman of the Federal Reserve, Ben Bernanke previously served as chairman of Bush's Council of Economic Advisers.

Does history repeat itself?

Charles Geisst wrote about market manipulation referring to, *inter alia*, the Knickerbocker Trust Company credit crisis which occurred in 1907[12]. That situation has remarkable similarities to the 2007 – 08 global financial crisis. Substituting different names and dates we can use Geisst's exact words to describe recent history:

> ...the Wall Street community, led by Goldman Sachs, put together a rescue package designed to prop up the other financial institutions. Goldman Sachs, Bank of America's Kenneth Lewis, Robert Benmosche of American International Group Inc., and Vikram Pandit of Citigroup Inc., banded together to ensure that the banking system remained intact. Senator Ron Paul especially had been an advocate of banking reform for some time and considered the way in which American banking was conducted to be nothing short of disgraceful. After Bear Stearns, Lehman Brothers, Wachovia, Washington Mutual, failed, this group stepped in to prevent others from doing so. They met in New York with President Bush's secretary of the Treasury, Henry Paulson, who provided them with Treasury funds of $700 billion to keep the system from collapsing. The money was deposited in the national banks in New York with the intent of adding funds to a system sorely in need of more liquidity. It was the job of the large New York banks to apply the funds as they saw fit to prevent further panic and runs by depositors.
>
> In many ways the act was an extraordinary repetition of history. Bush's faith in Goldman Sachs and the more serious of the Wall Street contingent only underlined the vacuum in the financial system. The Treasury of the most indebted economy in the world had to transfer funds to private bankers in order to prevent a financial

[12] Geisst, C (1997) *Wall Street: A History*, revised ed.(2004), Oxford University Press, New York. p 119.

collapse[13]. More than one detractor claimed that those bankers had orchestrated most of the panics themselves in order to make speculative profits[14]. The panic of 2008 was nothing short of a massive conspiracy designed to ingratiate Wall Street to Washington and make more than a few dollars in the process[15].

Perhaps we can conclude, history does repeat itself and confirm markets are manipulated.

In February 2010 *The Wall Street Journal* reported that big euro bets had been placed following meetings between hedge funds. It was suspected that the funds had banded together to capitalise on the declining value of the euro resulting from Greece's economic problems. By way of letter dated 26th February 2010, the US Justice Department asked hedge funds including SAC Capital Advisors, Greenlight Capital, Soros Fund Management and Paulson & Co to retain trading records and emails relating to their euro activities. The Department's letter said the antitrust division had 'opened an investigation into agreements among various hedge funds that trade euro contracts', including contracts in the 'cash or the derivatives market'[16].

The legal question is whether such information-sharing constitutes collusion? Charges relating to collusion about Wall Street activities are rare because of the difficulties in proving that firms intentionally act together nefariously. The move by the Justice Department

[13] The *Emergency Economic Stabilization Act* of 2008 (US).

[14] 'A House Oversight Committee had called Bank of America's chief executive, Kenneth E. Lewis, to testify about his interaction with the government after he threatened to walk away from the purchase of Merrill Lynch. The deal, which initially involved no federal assistance, closed only after Bank of America secured $20 billion in federal aid and a government guarantee to limit losses on $118 billion in toxic assets'. Cf: Applebaum, B. (2009) Smoke Clears on Shotgun Merger, *Washington Post*, 12th June 2009.

[15] Moore, M. and Kearns, J. (2009) Citigroup Rescue Earns Three Times as Much as S&P 500, *Bloomberg.com*, 12th June 2009. Available at: http://www.bloomberg.com/apps/news?pid=20601087&sid=avZXeLctFmME

[16] Pulliam, S. and Kelly, K. (2010) US probes hedge fund bets on euro, *Wall Street Journal*, 4th March 2010.

highlights the inadequacy of prudential regulation. The Department's investigation alluded to the possibility that banks, hedge funds and others financial institutions had exacerbated the financial difficulties in Europe by helping some EU members to mask their debts through swaps and other derivatives from which they are now benefiting by forcing down the value of securities related to them.

Reporting to the Senate Banking Committee, Federal Reserve chairman Ben Bernanke said the Fed is examining derivatives transactions financial firms made with Greece. 'We are looking into a number of questions related to Goldman Sachs and other companies and their derivatives arrangements with Greece'[17]. He said the Securities and Exchange Commission is also exploring the matter. When three US regulators act together on the same subject matter, it tends to suggest there might be some substance to the allegation that collusion and market manipulation is a reality.

[17] *Id*.