



# Policy Briefing Paper

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## **Financial Crisis An Opportunity for a New Global Order**

*By John Dillon*

*“The crisis is unprecedented in the truly global reach of both its origins and its effects. Surpluses in emerging countries powered western bubbles. When they burst, the crisis struck the core of the global system, leaving no country sheltered from its consequences. We have learnt at great cost the need to manage the global economy better - global financial markets in particular.”*

*“Lessons learnt for capitalism’s future” *Financial Times*  
April 13, 2009*

**T**he current financial crisis has created an exceptional opportunity for transforming the global economic order. In this report we shall first explore the proximate causes of the crisis that began with excessive speculation in the US housing and financial markets. In Part II we shall examine how global imbalances and the absence of a cooperative financial order set the stage for the crisis and continue to make the system crisis prone. Thirdly we shall discuss how viable proposals for a new international monetary system have emerged from the crisis.

### **I. Proximate Causes of the Financial Crisis**

While the present crisis can be traced to a multitude of factors, two inter-related causes stand out: globalized markets and speculative bubbles made possible by financial innovation.

Neither of these phenomena is new. Although this crisis has its own unique features, it has followed the sequence aptly described by the title of Charles Kindleberger’s

historical study on *Manias, Panics and Crashes*. Drawing on the work of Hyman Minsky, Kindleberger explains how speculative manias are fed by an expansion of credit that is often abetted by the development of new financial instruments. He describes how “At a late stage, speculation tends to detach itself from really valuable objects and turn to delusive ones. A larger group of people seeks to become rich without a real understanding of the process involved. Not surprisingly swindlers and catchpenny schemes flourish.”<sup>1</sup>

The immediate precipitating cause of the current crisis, the collapse of the US housing market, fits into the classic pattern described by Kindleberger. In the mania stage an \$8 trillion housing bubble was financed by cheap credit made possible by the globalization of financial markets as will be explained below. Homebuyers were seduced by so called “teaser loans” offering low interest rates for an initial period. These purchasers, who were disproportionately members of the black and Latino communities, were not always informed of the fine print in their contracts regarding future interest rate increases. Those who did know that their payments would rise were reassured that they could always refinance or sell their properties for a profit as housing prices seemed destined to rise endlessly.

Paul Krugman reports that at its peak in the summer of 2006 US housing was “probably overvalued by more than 50 percent, which meant that to eliminate the overvaluation, prices would have to fall by a third. In some metropolitan areas, the overvaluation was much worse. In Miami, for example, home prices appeared to be at least twice as high as the fundamentals would justify.”<sup>2</sup>

What made this housing bubble different from earlier speculative manias was the dramatic growth in the use of innovative financial derivatives that encouraged excessive risk-taking. One innovation, devised by bond traders at Salomon Brothers in New York in 1983, allowed mortgage lenders to repackage loans of dubious quality for sale as collateralized debt obligations (CDOs) to investors such as banks, hedge funds or pension funds located anywhere in the world. Bundled consumer loans and home mortgages became “the biggest US export business of the 21<sup>st</sup> century. More than \$27 trillion of these securities” were sold between 2001 and October 2008.<sup>3</sup> As lenders sold packages of loans to other financial institutions, regulators allowed them to make more loans – pumping more credit into the market.

Some of these CDOs for mortgages and other types of debts (for example, credit card receivables or auto loans) were sold to hedge funds that borrowed as much as one hundred times their own capital to invest in innovative financial instruments. Some CDOs were sold to banks’ own off balance sheet entities known as conduits or strategic investment vehicles (SIVs) or simply left on the banks’ books. As *Financial Times* analyst Gillian Tett has observed “That made a mockery of the idea that innovation had helped to disperse credit risk” or that these CDOs were being sold at market prices. Banks “typically valued them by using theoretical calculations from [complex computer] models.”<sup>4</sup>

Another innovative financial instrument, Credit Default Swaps (CDSs), was supposed to spread the risks inherent in ownership of assets like CDOs. CDSs are akin to insurance policies. Buyers purchase them to protect themselves against the risk of default. Sellers of CDSs collect fees for taking on the risk that a loan will not be repaid.

CDSs are a type of derivative, that is a financial contract whose value is “derived from” the value of other contracts for tradable items, in this case CDOs. There can be multiple CDS contracts issued on a single CDO. Since these CDSs can be bought and sold among parties that have no direct interest in the original loans themselves they are more like other speculative assets, such as pork belly futures, than insurance policies. As long as markets remained calm and loans were mostly repaid on schedule, issuers of CDSs earned substantial fees relative to their capital investments. Since CDSs are technically not insurance policies they do not fall under regulations requiring insurance companies to have sufficient capital on hand to cover claims.

By the end of 2007 the nominal value of CDSs had ballooned to an extraordinary \$62 trillion which was more than the Gross Domestic Product of the entire world, estimated at US\$54 trillion. But “the maximum amount of debt that might conceivably be insured through these derivatives was \$5 trillion.”<sup>5</sup> When the US market for subprime mortgages collapsed the CDS market was thrown into turmoil. As CDS issuers had insufficient capital to cover their losses, markets seized up. For example, insurance giant American International Group (AIG) had to be rescued by the US government because it could not cover its exposure to CDSs.

When panic and fear swept through financial markets in 2008 the ensuing market crash spread to Europe and into the global South. Investors seeking to cover their suddenly vulnerable positions in financial markets started to pull capital out of developing countries, including those with small levels of perceived risk, causing their stock markets and currencies to plunge. Commodity prices and export earnings for developing countries tumbled slowing growth in some and pushing others into recession.

Falling remittances from family members who had migrated to the North were an added burden for populations who had done nothing to cause the crisis. As a result of the crisis the number of chronically hungry people in the world will increase to over one billion in 2009. Up to 51 million are expected to lose their jobs in 2009. The World Bank’s chief economist for Africa predicts that 700,000 children may die over the next few years.

### ***Regulators Failed to Restrain Risky Financial Practices***

The financial crisis was, in part, the consequence of the failure of regulators to rein in practices involving highly risky transactions financed by borrowed funds. As the size of the market for CDSs grew, US officials, with one notable exception, refused to consider putting regulations on credit derivatives. At an April, 1998 meeting of the President’s Working Group on Financial Markets, Brooksley E. Born, the head of the Commodity Futures Trading Commission, warned of the need to regulate financial derivatives. Ms Born’s efforts were stubbornly resisted by Treasury Secretary Robert Rubin and his then deputy, Lawrence Summers, who told Congress that Born’s efforts to expose the risk posed by derivatives were “casting a shadow of regulatory uncertainty over an otherwise thriving market.”<sup>6</sup>

Wall Street executives lobbied furiously against new regulations. Federal Reserve Board chairman Alan Greenspan told Congress that “Regulation of derivatives transactions that are privately negotiated by professionals is unnecessary.”<sup>7</sup>

Then in September of 1998 a hedge fund called Long-Term Capital Management (LTCM) announced that it could not cover \$4 billion in losses on its highly leveraged deals. LTCM was founded in 1994 by two mathematicians who later won a Nobel prize in economics for inventing a formula that claimed to accurately predict market behaviour. For a while it seemed to work earning the firm returns of over 40% per year. LTCM invested borrowed funds that were many times larger than its own capital. At the time of its demise “LTCM had accumulated \$1.2 trillion in notional positions on equity of \$5 billion.”<sup>8</sup>

LTCM’s undoing was precipitated by external events reflecting the globalization of financial markets. Their supposedly sophisticated computer models could not have predicted the fall out from the 1998 Russian default that occurred in the wake of the Asian financial crisis. At the time Federal Reserve Board chairman Alan Greenspan acknowledged that he did not fully understand the rapidly changing dynamics of global financial markets.<sup>9</sup>

Immediately after the fall of LTCM, Brooksley Born told a Congressional committee that its demise should serve as a wake-up call. Despite her warnings, in 1999 the US Congress repealed the Depression-era Glass-Steagall Act which had separated commercial banks where deposits are government insured from more lightly regulated investment banks. Commercial banks took advantage of this opportunity by expanding their off balance sheet operations that are not accountable to regulators. Then Congress passed the Commodity Futures Modernization Act of 2000 that exempted derivatives such as CDSs from regulation.

A 2004 decision by the US Securities and Exchange Commission (SEC) allowed investment banks to set their own net capital requirements enabling them to incur debt-to-net-capital ratios as high as 40 to 1.<sup>10</sup> Moreover, rules adopted by the Basel Committee on Banking Supervision at the behest of the financial industry enabled commercial banks to set their own capital reserve requirements, “based on subjective factors of agency ratings and the banks’ own internal risk assessment models.”<sup>11</sup> US regulators not only failed to block widespread predatory lending practices but also stopped individual states from enforcing consumer protection laws against predatory practices. The Credit Rating Agencies Reform Act of 2006 prevented the SEC from regulating credit rating agencies even when the SEC knows their standards are flawed.<sup>12</sup>

Krugman describes how in addition to the financial assets held by banks whether on their own books or in arms-length off balance sheet entities like SIVs, there is

a whole other “shadow banking system” involving what he calls “non-bank banks.” This shadow system entails transactions involving lightly supervised or unregulated markets for such things as asset-backed commercial paper, auction rate preferred securities and tender option bonds.<sup>13</sup> The riskiest assets were often traded by highly-leveraged hedge funds.

The end of the housing bubble triggered a classic run within the shadow system where declining values forced asset sales in a self-reinforcing process.

Although in theory the new innovative products were supposed to make investment less risky as the risks would be spread among many investors, Gillian Tett observes that “Many of these new products were so specialized that they were never traded in free markets at all.”<sup>14</sup> She concludes that the “wave of innovation reshaped the way markets work... [It was] so intense that it outran the comprehension of most ordinary bankers – not to mention regulators.”<sup>15</sup>

### ***Speculation overtook investment in real goods and services***

Light-weight regulation of the official banking sector and the lack of regulation over the shadow system allowed highly-leveraged speculative activities to become further detached from the real economy of goods and services.

But expectations of double-digit returns on financial investments could not continue while real economies were expanding at less than 5% per year.

Marcos Arruda cites a study by François Morin concerning how “the value of speculative transactions worldwide reached a new plateau of US\$1,122.7 trillion” in 2002. This included US\$699 trillion in derivative transactions; US\$384.4 in exchange transaction; and US\$39.3 trillion in financial investments. “The total is 34.76 times the US\$32.3 trillion in goods and services, i.e. the real economy” produced that year. “In 2002 hedge fund products accounted for 50% of ... business in London and New York.”<sup>16</sup>

As John Maynard Keynes famously remarked: “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.”<sup>17</sup>

As the 2008 market meltdown demonstrated, exotic derivatives like CDSs proved to be what Warren Buffett aptly called “weapons of mass financial destruction.”<sup>18</sup>

### ***Blind Faith in Markets***

The speculative frenzy that bid up US housing prices to unrealistic levels and the wild over-investment in derivatives were justified by a fundamentalist belief in the infallibility of markets and driven by human greed. As former Federal Reserve Board chair Alan Greenspan belatedly admitted: “Once a bubble emerges ... an inbred propensity in human nature fosters speculative fever that builds on itself, seeking new unexplored leveraged areas of profit. Mortgage-backed securities were sliced into collateralised debt obligations and then into CDOs squared. Speculative fever creates new avenues of excess until the house of cards collapses.”<sup>19</sup>

Archbishop Celestino Migliore, the Vatican’s Special Representative to the United Nations observed: “At its root, the financial crisis is not a failure of human ingenuity but rather of moral conduct. Unbridled human ingenuity crafted the systems and means for providing highly leveraged and unsustainable credit limits which allowed people and companies alike to pursue material excess at the expense of long-term sustainability.”<sup>20</sup>

The blind pursuit of excessive wealth through the manipulation of financial assets is an exercise in what is known as “chrematistics”. Cobb and Daly define chrematistics as “the branch of political economy relating to the manipulation of property and wealth so as to maximize the short-term monetary exchange value to the owner.”<sup>21</sup> They draw a sharp distinction between chrematistics and oikonomia, that is, “the management of the household so as to increase its use value to all members ... over the long run.”<sup>22</sup>

“Unlimited accumulation is the goal of the chrematist and is evidence for Aristotle of the unnaturalness of the activity. True wealth is limited by the satisfaction of concrete need[s]. ... For oikonomia there is such a thing as enough. For chrematistics, more is always better.”<sup>23</sup>

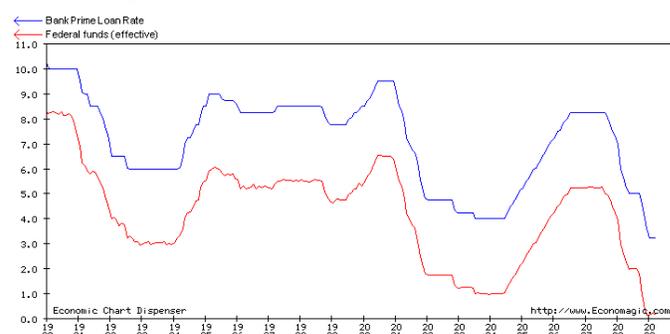
## **II. Global Imbalances and the Absence of a Cooperative International Monetary System**

While the failure of US authorities to properly regulate their own domestic financial institutions is a proximate cause of the financial crisis, its roots lie deeper in the neoliberal model of global capitalism. As the UNCTAD Task Force on Systemic Issues and Economic Cooperation recounts, it was not only “blind faith in the efficiency of deregulated financial markets” but also “the absence of a cooperative financial and monetary system [that] created an illusion of risk-free profits and licensed profligacy through speculative finance.”<sup>24</sup>

The real estate bubble’s growth was aided by the historically low interest rates prevalent in the United States between 2002 and 2004. The Federal Reserve Board kept interest rates low in order to stimulate the economy in the wake of the collapse of the technology stock bubble which wiped out some \$7 trillion worth of assets and contributed to the recession of 2001-02. The Federal Reserve also wanted to counter fear of a recession following the September 11, 2001 attacks on New York and Washington.<sup>25</sup> However, when US federal funds rate was increased seventeen times between 2004 and 2006, from 1% to 5.25%, commercial interest rates also rose. As a result servicing floating-rate mortgages became more difficult, leading to as many as six and a half million foreclosures.

What enabled the US Federal Reserve Board to cut its federal funds rate to a 45-year low of just 1% in June of 2003 without fear of sparking inflation was the ability of the United States to borrow vast sums at very low rates from Asian countries, particularly China, to finance its trade and fiscal deficits.

**Figure 1 US Interest Rates 1990 - 2009<sup>26</sup>**



As Niall Ferguson succinctly put it: “Chinese imports kept down US inflation. Chinese savings kept down US interest rates. Chinese labour kept down US wage costs. As a result it was remarkably cheap to borrow money ... . [G]lobal real interest rates – the cost of borrowing after inflation – sank by more than a third below their average over the past fifteen years ... . The Asian ‘savings glut’ ... was the underlying reason why the US mortgage market was so awash in cash in 2006 that you could get a 100 percent mortgage with no income, no job or assets.”<sup>27</sup>

Developing economies emerging from the financial crises of the 1990s tried to shelter themselves against currency speculators and destabilizing capital flight by amassing large foreign exchange reserves. As shown in Figure 2 the foreign exchange reserves accumulated by

developing countries outweighed their total debts, making them in fact net creditors. The largest pools of reserves are concentrated in a few Asia countries and Middle-East oil exporters while most developing countries are still net debtors. In contrast the US keeps only a very small amount of foreign currency reserves due to its privileged status as the issuer of the world's principal currency, enabling it to print money to spend abroad.

As of September of 2008 China's foreign exchange reserves were worth almost US\$2 trillion. India, South Korea, and Brazil each had accumulated more than US\$200 billion in reserves. As Figure 3 on page 6 shows the ten so-called "emerging countries" invited to the first Group of Twenty (G20) summit in Washington in November of 2008 held almost \$3 trillion worth of reserves or approximately twice as much as all the G7 countries combined.

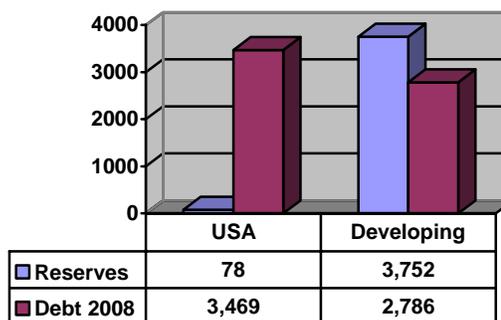
Instead of using the foreign exchange built up through trade surpluses to meet urgent national needs, developing countries lend trillions of dollars to the US at very low interest rates. Thus the hard earned savings of low-income countries are misdirected to subsidizing over-consumption in the US.

In 2007 developing countries lent US\$3.7 trillion to developed countries at low interest rates while they borrowed money from these countries at higher rates. The result was a net transfer of resources from the South to the North that was ten times greater than the value of all Official Development Assistance.

Surplus Asian savings reinvested in US assets reflect the asymmetry of the post Bretton Woods monetary system based on the US dollar as the principal reserve currency. As Jane D'Arista explains "the international reserve function of the dollar-based key currency system creates a uniquely ironic imbalance in the global economy as the current account surpluses of emerging economies are loaned to the US to finance the public and private borrowing that supports its growth."<sup>28</sup>

D'Arista adds "one of the more pressing issues in dealing with global imbalances is to find ways to recycle these countries' savings back into their own economies in support of development strategies that increase demand and income more equitably across their household and business sectors and reduce dependence on exports for growth."<sup>29</sup>

**Figure 2**  
**US and Developing Countries External Debts**  
**And Foreign Exchange Reserves<sup>30</sup>**  
(Billions of US dollar equivalent)



As the UNCTAD Task Force notes the absence of a co-operative international monetary system for managing exchange rates facilitated increased global imbalances. Just as occurred in Asia in the late 1990s, currency speculation brought a number of countries to the verge of default and dramatically fuelled the current crisis. Developing countries had to pay risk premiums to access credit from the same financial markets that spread the crisis to innocent bystanders. A new global reserve system and exchange rate regime is urgently needed to maintain global stability, to avoid the collapse of the international trading system and to avoid the imposition of pro-cyclical policies on crisis stricken countries.

#### ***IMF Part of the Problem – Not the Solution***

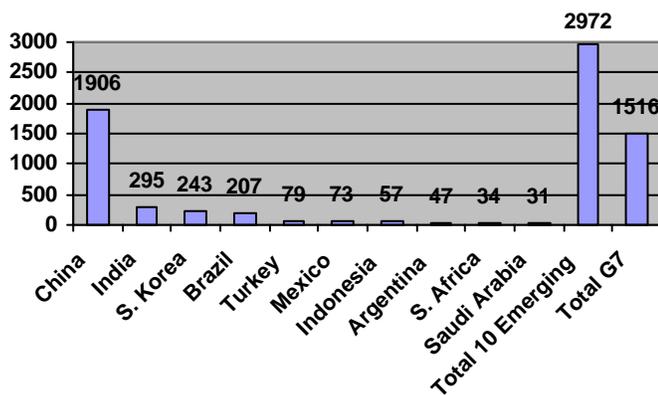
The International Monetary Fund must bear part of the responsibility for the crisis due to the deregulation and liberalization policies it has promoted. Prior to the 1980s the IMF primarily advocated policies of fiscal restraint and currency devaluation as the way to address balance of payments deficits. However, during the 1980s the IMF also began to urge countries with balance of payments problems to adopt measures to attract private foreign investment. Accordingly its Structural Adjustment Programs removed obstacles to the entry or exit of foreign capital. Thus the IMF neglected its own Articles of Agreement which authorize member countries "to exercise such controls as are necessary to regulate international capital movements."<sup>31</sup>

In the late 1990s the IMF managing director, Michel Camdessus, even tried to amend the Articles of Agreement to allow the Fund to demand the liberalization of capital account transactions in addition to the power it already held to prevent restrictions on current account payments.<sup>32</sup>

An analysis published by the IMF itself in 2006, *Safe-guarding Financial Stability*, warned that although liberalized financial policies have tremendously benefited the private sector, their inherent market imperfections also created the potential for “fragility, instability, systemic risk and adverse economic consequences.”<sup>33</sup>

By 2007 the IMF was undergoing a severe crisis of legitimacy. Its reputation was at an all time low due to the failure of the Structural Adjustment Programs imposed on debtor countries to achieve even the Fund’s own stated goals. The neoliberal policies imposed between 1980 and 2005 resulted in Southern countries experiencing lower rates of economic growth and declining social development indicators relative to what was achieved in the two prior decades from 1960 to 1980.<sup>34</sup> Robin Broad and John Cavanagh succinctly summarize their failure: “Structural adjustment in practice has damaged environments, worsened structural inequalities, failed even in the very narrow goal of pulling economies forward, and bypassed popular participation.”<sup>35</sup>

**Figure 3 G20 Foreign Exchange Reserves**  
Billions of US Dollar equivalent (September 2008)



Many countries repaid loans from the IMF in order to escape from its dictates. In 2006 Brazil and Argentina were the first to pay off their loans. They were soon followed by Bolivia, Serbia, Indonesia, Uruguay and the Philippines all of whom either immediately repaid their debts or announced their intention to escape from dependence on the Fund. The trend continued into 2007 when Russia, Thailand and Ecuador decided to pay off what they owed and Angola ended talks on new loans.

As the financial crisis grew in scope and devastation during 2008, IMF managing director Dominique Strauss-Khan recognized an opportunity to rescue the Fund from its crisis of legitimacy. He prepared a “global regulation strategy” for the November G20 summit in Washington.<sup>36</sup> The key elements include:

1. A new loan facility within the IMF to relieve the short-term liquidity problems;
2. Increased resources for the Fund;
3. A role for the IMF in drafting new financial regulations.

Mr. Strauss-Kahn explicitly welcomed a plan proposed by UK Prime Minister Gordon Brown for persuading developing countries to lend substantial amounts of their foreign exchange reserves to the Fund. Brown’s initiative echoes proposals advocated by prominent private financiers who also advise the softening, but not the elimination, of IMF conditions in order to win support from developing countries.<sup>37</sup>

Mr. Strauss-Khan once told the *Wall Street Journal*: “The legitimacy of the IMF relies upon the capacity to have everyone on board, including those countries with which there have been problems in the past.”<sup>38</sup> The financial crisis presented an opportunity to bring even those countries that had distanced themselves from the Fund back into the fold by promising them more voting power when the next quota review is completed in 2011.

When the G20 Finance Ministers met in São Paulo prior to the Washington summit, they produced a communiqué referring to the need to reform the Bretton Woods Institutions “in order to **increase their legitimacy** and effectiveness.” Hence Brazil and Argentina that just two years earlier were the first to pay off their loans and proclaim their wish not to have any future dealings with the Fund, endorsed calls to enhance its legitimacy.

When the G20 leaders met for a second time in London in April of 2009, they promised to treble the lending resources available for the IMF to \$750 billion.<sup>39</sup>

While the G20 proclaimed their intent to promote counter-cyclical policies as a way of overcoming the global recession, the IMF in practice continues to follow a double standard – advising stimulus for the global North while still imposing austerity on developing countries. Whereas the Fund encourages developed countries to use expansionary fiscal policies and cut interest rates to avoid recession and to protect the private financial sector, it continues to force developing countries to slash government spending and raise interest rates for fear of even low rates of inflation. This double standard will only prolong the crisis for the global South.

Although the Fund claims that it will no longer apply structural performance criteria to its loans, austerity conditions are still in effect. IMF credits go to countries that have “strong fundamentals”, that is, a willingness to

adopt austerity measures involving constraints on public spending, high interest rates and other measures to attract foreign investors. Moreover, borrowers' performances are reviewed every 12 months, when credits can be suspended.

In recent loans the IMF demanded the same "pro-cyclical" policies that accentuate a downturn in a recession, as in the past. Pakistan was advised to reduce its fiscal deficit from 7.4% of GDP to 4.2%. Hungary was told to freeze public sector wages and cap pension payments. The IMF advised Latvia to raise its official interest rate by a full six percentage points.<sup>40</sup> Latvia also had to reduce its civil servants' incomes by 15%.

The rationale behind the IMF austerity advice to low-income countries is the need to avoid capital flight by creating conditions favourable to investors. The IMF still rejects the use of capital controls to deter capital flight despite the fact that the original Bretton Woods system explicitly allowed for national controls over capital movements. As Keynes had declared in 1941 "Nothing is more certain than that the movement of capital must be regulated."<sup>41</sup>

#### ***Breakdown of Bretton Woods System and Failure to Heed Keynes' Advice***

The Bretton Woods system based on fixed, but adjustable exchange rates and the US dollar as the central reserve currency appeared to give relative stability to the world financial system from the mid-1940s until the late 1960s. However, after President Nixon decoupled the dollar from gold in 1971, a new era of financial market liberalization began. It was characterized by the removal of capital controls, deregulation of domestic banking systems and massive increases in private international capital flows. As Gillian Tett has observed, after 1971 "credit creation spiralled completely out of control."<sup>42</sup>

This post-Bretton Woods era was marked by recurring financial crises. By some accounts there have been twenty major financial crises and over 100 minor ones since the early 1970s.

The present crisis might have been avoided had the original 1944 Bretton Woods Conference adopted the plan for a stable and cooperative international monetary system put forward by John Maynard Keynes. Before the 44 national delegations met in New Hampshire, Keynes had drafted several versions of a proposal for what he called an International Clearing Union. He subtitled one draft "a plan for financial disarmament." His intent was to design a system that would allow national

governments to pursue such goals as full employment without worrying about disruptive capital flight.

Keynes summed up his vision when he wrote "We intend to keep control of our domestic rate of interest, so that we can keep it as low as suits our own purposes, without interference from the ebb and flow of international capital movements or flights of hot money. ... [E]very government [should have] the explicit right to control capital movements."<sup>43</sup>

Keynes wanted to prevent a recurrence of what had happened during the 1930s when countries running short of foreign exchange reduced spending and restricted imports deepening the Great Depression.

Political economist Duncan Cameron describes the essence of Keynes proposal:

*"Under his plan, Keynes foresaw financial relationships among nations taking place much like relations between domestic banks and a central bank. Each country would have an account with a world central bank [the International Clearing Union]. Accounts would be dominated in a world monetary unit -- bancor -- from the French "bank gold." Surplus countries would lend to the clearings union, and deficit countries could draw upon it. All transactions would take place in bancor. As assets would equal liabilities, the clearings union itself would always remain solvent.*

*Under the Keynes plan all countries in deficit within the clearings union would have access to credit in the form of bancor. As members of the union they would not have to fear running out of foreign currency.*

*Keynes foresaw banks in union members countries using domestic money to settle up overseas accounts with their central bank. Using bancor, central banks then settled outstanding overseas accounts within the clearings union. Instead of countries being indebted to each other, each country was a debtor or creditor with the union.*

*The difference was hugely important. Without access to bancor credit, indebted countries were forced to cut back spending, increase taxes, devalue their currencies and raise interest rates. With access to bancor -- they could spend on domestic priorities."<sup>44</sup>*

Despite several modifications made to accommodate domestic and international interests, Keynes' plan did not become the basis for the Bretton Woods system. Rather the proposal drafted by Harry Dexter White, the Assistant Secretary at the US Treasury, became the basis for the Bretton Woods system. Under pressure from Wall Street, the US Treasury wanted a system based on

the dollar as the principal means of payment and reserve currency.

As Michael Moffitt explains “at Bretton Woods the decisive factor was not the intellectual merits of the White plan versus the Keynes plan but the reality of American power.”<sup>45</sup> Canada’s delegate to the Bretton Woods conference, Louis Rasminsky, later wrote about witnessing “a spectacle of American domination and domineeringness through their financial power which has to be seen to be believed.”<sup>46</sup>

In 1944, just as today, the Wall Street bankers did not want a truly international monetary system that would cost them all the lucrative fees they earn from managing transactions. Moreover, the US Treasury was then, and is now still, unwilling to give up what Charles de Gaulle called the “exorbitant privilege” that accrues to the nation that issues the world’s principal reserve currency. This privilege enables it to print money at will and pay for imports or overseas assets with dollars whose future value may well deteriorate.

### III. A New Financial Architecture is Possible

Fortunately, viable alternatives exist to continued reliance on the US dollar as the central reserve currency. Starting in 1969 the IMF began to create Special Drawing Rights (SDRs) as a type of international reserve asset that can be held by central banks.

The 1984 report on *The International Financial System: An Ecumenical Critique* drafted by the World Council of Churches Advisory Group on Economic Matters explained the advantages of a reserve system based on SDRs:

- “It can be internationally managed” (unlike the US dollar where domestic needs may lead to policy decisions detrimental to the international community);
- The “initial acquisition [of SDRs] does not entail a real cost in the way acquiring a reserve currency does” for any country or monetary union that does not issue a hard currency. (Entities that issue hard currencies can print more dollars, euros or yen etc.); and
- “It is possible ... that within globally agreed SDR issues, a bias in favour of poor and vulnerable economies can be built into SDR allocation to make a contribution to redistributing global access to liquidity in favour of poor and vulnerable economies thus linking prudent international reserve creation and economic development of poor and vulnerable economies.”<sup>47</sup>

Whereas in the 1970s there was an active discussion of establishing a “link” between any new issue of an international currency and the needs of low-income countries, the recent decision by the G20 to approve a one-time issue of SDRs worth \$250 billion has ignored this possibility. Instead the SDRs will be distributed according to each country’s share of IMF voting rights with 60% of this new money going directly to developed countries. If low-income countries were to receive a larger share of SDR allocations, they could exchange them for dollars, yen, euros and sterling to spend on urgent needs.

Under the G20’s plan only \$19 billion worth of the new allocation of SDRs would potentially go to the poorest countries because of their low quotas within the IMF. However, many low-income countries may not be able to access even a portion of this amount because they would have to pay market interest rates on any funds used and “the latest Fund programmes for low-income countries ... prohibit poor countries from borrowing at market interest rates.”<sup>48</sup> According to Eurodad, low-income countries “borrowing is limited to thresholds of what the Bank and the Fund consider to be sustainable debt loads” as calculated by the Bank/Fund Debt Sustainability Framework.<sup>49</sup>

#### *Proposals for a New Reserve System*

While a new allocation of SDRs could serve a moderate redistributive function in the near term, an important discussion has begun concerning the role that an SDR-like asset might play in a new Global Reserve System. Zhou Xiaochuan, governor of the Peoples’ Bank of China, has proposed an expanded role for the SDR going beyond its role as a reserve currency held by central banks. He suggests that the SDR also be used:

- as “a widely accepted means of payment in international trade and financial transactions”;
- for “commodities pricing, investment and corporate book-keeping. This will ... effectively reduce the fluctuation of prices of assets denominated in national currencies and related risks”; and
- in “SDR-denominated securities”.<sup>50</sup>

Zhou Xiaochuan further proposes that “the basket of currencies forming the basis for SDR valuation should be expanded to include currencies of all major economies.”<sup>51</sup> Currently only the euro, pound sterling, yen and US dollar are used as the basis for determining SDR valuation. Widening this basket to include the Chinese renminbi would be a step towards recognizing it as a hard currency in its own right.

The Chinese proposal for a new reserve system is slowly gaining adherents. Russia, India Pakistan and Venezuela have signalled their support. On the eve of the 2009 G8 Summit meeting in L'Aquila, Italy, French Finance Minister Christine Lagarde also indicated her support, challenging the dollar's supremacy "in a world that has changed because of the crisis and the growing role of emerging countries."<sup>52</sup>

The Commission of Experts on Reforms to the International Monetary and Financial System, appointed by Rev. Miguel d'Escoto as President of the UN General Assembly, recommends the use of an international asset like the SDR in a new Global Reserve System. The UN expert panel, chaired by Joseph Stiglitz, says a new reserve system is needed to overcome two problems: first, the imbalance created by developing countries' excessive accumulation of foreign exchange reserves and second, the instability of the current international reserve system with its overdependence on the US dollar whose future value is likely to deteriorate given the USA's enormous international debt.

In Stiglitz' words: "The existing system, with the US dollar as reserve currency, is fraying. The dollar has been volatile. There are increasing worries about future inflationary risks. At the same time, putting so much money aside every year to protect countries against the risks of global instability creates a downward bias in aggregate demand weakening the global economy."<sup>53</sup>

While Wall Street financial firms have dismissed the idea of replacing the US dollar with the SDR as unfeasible, the UN panel of experts says that a new Global Reserve System is "feasible, non-inflationary, and could be easily implemented". Pedro Páez Pérez, Ecuador's former Minister of Economic Policy Coordination, told a UN hearing that such a reserve system could be implemented within six months.

The UN Commission of Experts report suggests a new reserve system should involve either a new global currency or an expanded use of the IMF's Special Drawing Rights. It says that an expanded use of SDRs could be a step towards a global currency whether under the IMF or a new Global Reserve Bank.<sup>54</sup>

### ***Other Building Blocks of a New Financial Architecture***

The current crisis has reawakened a debate on the appropriate relationship between the World Bank, the IMF and the United Nations. On the 50<sup>th</sup> anniversary of the UN in 1995 a Commission on Global Governance tabled a report entitled *Our Global Neighbourhood* that con-

tained visionary proposals for more democratic oversight over international financial institutions. Among its proposals was a call for a "new Economic Security Council [that] would ... consist of 23 members who would have responsibilities for international financial and development activities. The IMF, World Bank and [the World Trade Organization] – virtually all finance and development activities – would be under the authority of this body. There would be no veto power by a nation, nor would there be any permanent member status for any nation."<sup>55</sup>

Not surprisingly the wealthy, industrial countries resisted such a wide-ranging proposal preferring to hold on to their dominance of economic policy making through their control over the Bretton Woods Institutions. However, in the wake of the financial crisis the UN Commission of Experts once again called for subordinating the Bank and the Fund to a more democratic body. The Stiglitz Commission proposed the establishment of a Global Economic Coordination Council that would operate "at a level equivalent with the General Assembly and the Security Council. Its mandate would be to assess developments and provide leadership in economic issues while taking into account social and ecological factors. Based on this mandate it would promote development, secure consistency of policy goals of major international organizations, and support consensus building among governments on efficient and effective solutions for issues of global economic, social and environmental governance. The Council could also promote accountability of all international economic organizations..."<sup>56</sup>

The Stiglitz Commission also recommended the establishment of a new lending facility to assist developing countries that would bypass the IMF and instead operate through a new institution "with very different governance and objectives" than what prevails at the IMF.<sup>57</sup> Similarly the Commission discusses mechanisms for channelling savings from "countries that have accumulated large reserves ... [into] direct investments in developing countries ... [through] a facility [that] would be governed quite differently from existing global financial institutions."<sup>58</sup>

The Commission's recommendation for the creation of an International Debt Restructuring Court explicitly rejects the assumption that it should be housed either within the IMF or the World Bank: "In earlier discussions of sovereign debt restructuring mechanisms, it was presumed that the IMF, or a separate and newly established division of the IMF, would act as the bankruptcy court. However ... the IMF in its current form is unlikely to be the appropriate institution, as it is also a creditor

and subject to disproportionate influence by creditor countries. It is therefore unlikely to be seen as a 'neutral' mediator. The arbitration process of the International Centre for the Settlement of Investment Disputes (ICSID) within the World Bank has similarly failed to generate confidence from the developing countries as a fair arbitrator of investor-state disputes under bilateral investment agreements."<sup>59</sup>

### ***End Illicit Capital Flight***

Another issue on which the Stiglitz Commission challenges the wealthy Northern countries concerns their unwillingness to deal seriously with banking secrecy or illicit capital flows. The financial crisis has exposed the enormous cost of tax evasion and tax avoidance by wealthy individuals and transnational corporations. Yet the G7 countries have protected private financial interests at the expense of international action to put an end to illicit capital flight from developing countries.

It is estimated that in 2006 alone developing countries lost between \$859 billion and \$1.06 trillion in "illicit capital outflows".<sup>60</sup> This broad category includes both money accumulated through illegal activities such as trade in contraband goods and transactions that may be legal in some instances or illegal in others that avoid capital controls or shelter wealth abroad out of the reach of a country's tax authorities. Tax evasion by wealthy individuals costs developing countries an estimated \$64 billion to \$124 billion a year.<sup>61</sup> Christian Aid calculates that corporations that avoid taxes through transfer pricing and false invoicing annually cost developing countries US\$160 billion in lost corporate tax revenue.<sup>62</sup>

These illicit transactions annually cost developing countries many times more than what they receive in Official Development Assistance (ODA). Reversing the massive outflows of illicit capital from the South would go a long way towards eliminating dependence on unreliable ODA and on conditional loans from International Financial Institutions. Moreover, a new wave of IFI lending threatens to cause a renewed debt crisis. As Beverly Keene, International Coordinator for Jubilee South, told a Round Table convened by the UN Conference on the financial crisis and development, "new lending to countries throughout the South ... in response to crises that are clearly not of their own making, can only be understood to be as illegitimate as the kind of lending that took place in earlier years to dictators. ... This is a time for new resources to be provided as a form of compensation by those who were responsible for the policies and decisions that brought about these crises."<sup>63</sup>

There is a huge gap between the modest efforts by the G20 to give the appearance that they are attempting to deal with illicit capital flight and the measures needed to actually address the problem. The communiqué from the April 2, 2009 G20 meeting in London announced that the Organization for Economic Cooperation and Development (OECD), another group controlled by the wealthiest industrial countries, would immediately publish a list of jurisdictions that were not in compliance with OECD standards on transparency and exchange of information on taxation.

But the OECD standards themselves are very weak. They only cover bilateral treaties when multilateral action is needed. Moreover, the burden of proof lies with the authority requesting an investigation into transactions, requiring them first to make a strong case, something that is beyond the capacity of most developing countries. Most problematic of all is that the OECD approach only deals with individuals who avoid taxes without touching the activities of transnational corporations.

When the OECD list appeared on the same day as the G20 communiqué it was divided into three sections. There was a "blacklist" of countries not cooperating with the OECD's rules on improving transparency that named only four developing countries - Costa Rica, Malaysia, Philippines and Uruguay, none of which are known as major tax havens. There was also a "grey" list of 38 jurisdictions that have committed to reach, but have not yet met, the OECD's standards. This category included mostly small developing countries designated as "tax havens" but also listed Switzerland, Luxembourg, Belgium and Austria as "other financial centres" not yet in compliance. Thirdly, there was a "white" list of 40 countries, including all G8 nations, deemed to be in compliance. One tax expert dismissed the black list as "a face-saving exercise, with mainly, inconsequential players."<sup>64</sup>

Peter Gillespie, an analyst with Ottawa-based Inter Pares recounts what happened next: "Astonishingly, within days of the close of G20 meeting, the OECD blacklist was empty. Intense diplomatic pressure had successfully [moved the four countries to the grey list.] ... Both the Swiss and Liechtenstein governments were outraged to be named on the grey list. Switzerland threatened to retaliate by not paying its annual dues to the OECD, an extraordinarily self-righteous response from a country that is the world leader in laundering thefts from poor countries."<sup>65</sup>

In contrast to the weakness of the G20 and OECD response to the issue of illicit tax avoidance, the Stiglitz

Commission names the fact that “the principal sources of tax evasion, tax secrecy, money laundering, and regulatory arbitrage [are] located in developed countries’ on-shore banking systems.... The biggest money laundering cases involved banks in London, New York and Zurich.” The Commission goes on to denounce the “discriminatory targeting of small international financial centres in developing countries while a blind eye is turned to lax rules in developed economies.” Instead of relying on the OECD it calls for multilateral cooperation to establish fair rules for all through “a new intergovernmental Commission to strengthen international tax cooperation ... under the auspices of the Economic and Social Council (ECOSOC) of the United Nations.”<sup>66</sup>

### ***Resistance by the North amidst a Changing Geopolitical Landscape***

When the proposals of the Stiglitz Commission were debated at the UN Conference on the World Financial and Economic Crisis and its Impact on Development in New York from June 24<sup>th</sup> to 26<sup>th</sup> 2009, Canada joined with the US in opposing a formal role for the UN in exercising oversight over the financial and economic system. The Canadian delegate explicitly denied that the UN should have a role in designing a global reserve system, reforming the Bretton Woods institutions, or establishing a framework for sovereign debt restructuring.<sup>67</sup> Yet Canada’s defence of the status quo cannot mask the fact that the geopolitical balance of power is changing as symbolized by the emergence of the G20 as a policy-making forum supplanting the G8. By admitting “emerging” nations such as China, India, Brazil and South Africa into the G20, the industrialized countries can, to some extent, fend off calls for more fundamental change through more democratic forums like the United Nations. As Philip Stephens writes “[T]he rich nations ... can imagine sharing power, but they assume the bargain will be struck on their terms: that the emerging nations will be absorbed – at a pace, mind you, of the west’s choosing – into familiar international forums and institutions.”<sup>68</sup>

Symbolic of this power-sharing bargain is the turn around by Brazil from being one of the harsher critics of the IMF to a *de facto* supporter through its decision to lend \$10 billion to the IMF for its new Flexible Credit Line.<sup>69</sup> The irony of this reversal has not been lost on President Lula da Silva who commented: “I spent 20 years of my life carrying a banner and shouting in the street, in the gates of factories, on platforms: ‘Get out IMF’ ... And these days, I called my finance minister and told him: ‘We are going to loan money to the IMF.’”<sup>70</sup> In an attempt to defend his decision Lula said

the Fund should not dictate economic policy in exchange for loans as it had in the past.

Counterbalancing to some extent its new support for the IMF Brazil has reluctantly agreed to join Argentina, Bolivia, Ecuador, Paraguay, Uruguay and Venezuela in establishing a new Bank of the South. With an initial authorized capital of US\$20 billion the Bank of the South will provide an alternative to the World Bank. Nevertheless, it remains to be seen whether the new bank will predominantly invest in large infrastructure projects that facilitate resource extraction for export or in locally controlled projects designed to enhance food and energy sovereignty.

China has also agreed to lend \$50 billion of its foreign exchange reserves to the IMF while at the same time insisting on a larger role for the UN. China is also cooperating with its neighbours in advancing regional Asian initiatives. On the last day of the UN conference when the US declared its reservations about even discussing reform of the global reserve system, China reiterated that the time has come to begin working on a new global reserve currency. China’s Minister of Foreign Affairs, Yang Jiechi, stated that China supports a bigger role for the UN in tackling the global crisis. He also pointed to China’s bilateral currency swap agreements with other Asian countries worth 650 billion renminbi (US\$95 billion) and its contribution of 32% of the \$120 billion regional reserve pooling arrangement known as the Chiang Mai Initiative.<sup>71</sup>

At a UN hearing on the crisis held in October of 2008, Ecuadorian Minister Pedro Páez Pérez presented a Proposal for a Crisis Response Agenda from the South.<sup>72</sup> That agenda begins with the launch of independent entities entirely controlled by Southern countries such as the Bank of the South. It also envisions the establishment of stabilization funds controlled by Southern countries and joint consultations on setting credible exchange rates through Regional Monetary Agreements.

Agreements among Southern countries to use their own currencies instead of dollars or euros or yen for intra-regional trade could lead to the establishment of regional central banks and Common Reserves Funds from which Southern countries could borrow instead of having to seek funds from the Bretton Woods Institutions. South American countries are also discussing eventually creating a common currency. While this vision of South-South cooperation might be implemented first among South American countries, Páez Pérez suggests that the same kind of cooperation could occur in other regions

eventually opening the way for a new global financial architecture.

Another sign of a shifting balance of power is the precedent set by Ecuador's official Commission for the Integral Audit of Public Credit. That commission conducted an exhaustive audit of the country's debts that uncovered numerous irregularities in past borrowing practices, dating back to the years when the country was under military dictatorships. The Commission's report led to a decision to suspend payments on illegally contracted debt nominally valued at \$3.95 billion.<sup>73</sup> Despite private financial institutions initial strong rejection of Ecuador's initiative, 81% of the bondholders holding the debt in question eventually voted to accept payments of 35 cents on each dollar of defaulted debt.

### ***Financial Institutions Resist Fundamental Reforms***

Not surprisingly private financial institutions are resisting fundamental reforms of the financial system despite the risk that it will go on lurching from one catastrophe to the next. The Stiglitz Commission warns that "there is substantial risk that unless work on more fundamental reforms is undertaken now, momentum for reform will be lost with the recovery. There are strong political forces at play and those who have benefited from existing arrangements will resist fundamental reforms. But allowing these interests to prevail would ensure the recurrence of crisis."<sup>74</sup>

As economies begin to recover from the current crisis private financial institutions are repaying some of the billions of dollars worth of bailout loans they received from public entities and returning to business as usual. By accepting some minor adjustments they are avoiding the kind of measures needed to prevent future crises. In April of 2009 the *Financial Time's* economics editor Martin Wolf wrote: "The world economy cannot go back to where it was before the crisis, because that was demonstrably unsustainable."<sup>75</sup>

By October Wolf conceded that while "regulation of the financial sector and reform of the international monetary system ... are now on the agenda ... **on both action is likely to fall far short of what is needed.**"<sup>76</sup> According to Wolf "reliance on the currency of one dominant country as the principal source of reserves creates vulnerability at the very heart of the global economy."<sup>77</sup> Yet the September, 2009 G20 Pittsburgh summit's communiqué does not even acknowledge calls by several G20 members - China, Russia, India and France - and the United Nations General Assembly for a new reserve system.

While the Pittsburgh communiqué does signal some movement towards reform of domestic financial systems, the proposed reforms are modest and decisions are mostly put off for future implementation or referred to the IMF for further study. Walter Mattli and Ngaire Woods, professors at Oxford University, have published research showing that "the longer politicians wait to implement reforms after a financial crisis, the greater the chance that financial industry lobbyists and other specialists take over the process and water down reforms."<sup>78</sup>

Prior to the Pittsburgh summit, Simon Johnson, a former chief economist at the IMF, accurately predicted how, despite the preparation of long documents on reform options, and agreement on statements of principle by G20 leaders and the melodrama of rival proposals on issues like curbing bankers' bonuses, in the end nothing meaningful would happen.<sup>79</sup> Johnson describes how those with a vested interest in the current system orchestrate sophisticated delaying actions. While they agree there is a problem, they send the job of formulating solutions to committees of experts who produce reports of mind-numbing detail, which few really understand. Then by the time the experts report back it is two years later and the public no longer remembers what caused the crisis in the first place.

One key issue under debate concerns whether private banks will be obliged to increase the amount of their own capital they hold in reserve in relation to their assets (that is their loan portfolios and other financial properties). One reason why Canadian banks weathered the crisis better than most is that their assets were less than 20 times greater than their capital. In the US asset to capital ratios were on the order of 30 to one and in some European Banks the ratios were as high as 50 to one.

Just as Simon Johnson predicted, at Pittsburgh the G20 leaders discussed revising the Basel rules on capital adequacy by the end of 2010 with effective implementation put off until the end of 2012. Similarly, they discussed higher capital requirements for non-standard products that are not traded on exchanges, but took no "concrete steps to bring hedge funds and private equity firms in line with minimum standards of transparency and accountability with respect to regulators."<sup>80</sup>

What is at work behind the scenes is the tremendous political power of private financial firms. Josef Ackermann, who chairs the Institute of International Finance, the industry's most powerful lobby group, has declared that efforts by the G20 to require financial institutions to hold more money in reserve risks choking off economic growth. He says: "The capital issue is important, but it is

**not as important as liquidity and profits,**<sup>81</sup> and furthermore, “official regulatory reforms must be balanced.”<sup>82</sup>

The Institute of International Finance chief does not acknowledge the billions of dollars in bailout funds that have rescued many of its members. As of April, 2009 governments had provided \$9 trillion worth of financing for banks through loans, asset purchases and guarantees since the beginning of the crisis. Yet these same banks are resisting real regulation in return for being bailed out. Martin Wolf wryly interprets the Institute of International Finance’s position as saying “Thanks for your money; now please go away.”<sup>83</sup>

### ***Financial Transaction Tax***

Prior to the Pittsburgh Summit German Finance Minister Peer Steinbrück wrote an op ed in the *Financial Times* describing how financial market participants gained “significant benefits from financial bailouts ... but are not pulling their weight” in accepting responsibility for finding solutions or paying for the costs of the crisis. Steinbrück says G20 nations “average support for the financial sector is more than 30 per cent of gross domestic product (including capital injections, guarantees, treasury lending and asset purchases, liquidity provision and other central bank support.)”<sup>84</sup>

Accordingly, he proposes a financial transactions tax (FTT), applied across all G20 countries, to ensure that all financial market participants contribute equally. He proposes a tax rate of 0.05% on all trades of financial products (including equities, bonds, derivatives, and foreign exchange) that could yield up to \$690 billion a year or about 1.4% of world GDP.

The proceeds, he says, would be used to finance the cost of the crisis. There is no hint in the Minister’s op ed as to whether any of these proceeds would be used to indemnify Southern countries who are not members of the G20 who have suffered massive losses from a crisis that was none of their making.

Steinbrück concludes by saying the idea of a FTT would be addressed at Pittsburgh by Chancellor Angela Merkel who has received initial support from British Prime Minister Gordon Brown and French President Nicholas Sarkozy. France has indicated that the purpose of the tax would be to relieve domestic taxpayers of the burden of paying for bailouts of financial institutions and not used to indemnify Southern countries.

While the Pittsburgh G20 Communiqué does not explicitly endorse a FTT it does include the following: “We

task the IMF to prepare a report for our next meeting with regard to the range of options countries have adopted or are considering as to how the financial sector could make a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system.”<sup>85</sup>

While this endorses the idea that the private financial sector should bear part of the costs of the crisis they provoked, giving the IMF responsibility for coming up with proposals could very well be a way of burying the idea in another round of “experts” reports that will delay or perhaps prevent any real action.

Shortly after the Pittsburgh summit IMF Managing Director Strauss-Kahn threw cold water on the idea of any kind of a FTT, by disingenuously comparing it to the Tobin tax on foreign exchange transactions alone. Strauss Khan said it was an “old idea” from the 1970s and would not work today without acknowledging how a broad FTT would be substantially different from James Tobin’s original proposal for a tax on currency trades only. He did agree that the financial sector should provide resources to mitigate the risk they are creating. But he gave the task of preparing the report to John Lipsky, a US citizen who was appointed as the IMF’s First Deputy Managing Director by the Bush administration.

### ***Wall Street Flexes Its Political Muscles***

The ability of Wall Street interests to derail meaningful reforms is amply evident in the resources they deploy in lobbying members of Congress and financing their election campaigns. Wall Street firms spent over \$5 billion on lobbying and federal campaign contributions between 1998 and 2008 and another \$200 million on lobbying in the first nine months of 2009 alone.<sup>86</sup> Financial firms employ five lobbyists for every member of Congress

Meanwhile as the global economy shows signs of slow recovery, Wall Street firms are busy creating new generations of tradable assets. Among the instruments they look forward to exploiting is an expanded market for trading in carbon emission permits. While a carbon market already exists under the European Union’s Emissions Trading System, financiers anticipate a much larger global market will emerge after the US passes an energy bill to establish a cap-and-trade system for dealing with CO<sub>2</sub> emissions.

There is serious potential for carbon markets to become another out-of-control, multi-trillion-dollar speculative bubble, similar to the subprime mortgage bubble that brought on the 2008 financial crisis. Already carbon trading involves transactions worth “over \$100 billion

yearly and [is] projected to rival the financial derivatives market, currently the world's largest, within a decade."<sup>87</sup> The international market for carbon trading is forecast to be worth an extraordinary \$3 trillion by 2020 if the US becomes a full participant.<sup>88</sup>

The newest example of a speculative financial asset designed by Wall Street traders is what they call "life settlements" also known as "death bonds." According to the *New York Times*:

"After the mortgage business imploded last year, Wall Street investment banks began searching for another big idea to make money. They think they have found one.

The banks plan to buy 'life settlements', life insurance policies that ill and elderly people can sell for cash. ... They then plan to 'securitize' these policies ... by packaging hundreds or thousands together into bonds. They will then resell those bonds to investors ... who will receive payouts when [the original policyholders] die. The earlier the policyholder dies, the bigger the return."<sup>89</sup>

This scheme resembles the market for Credit Default Swaps described in Part One where traders in CDSs speculate on homeowners inability to keep up with mortgage payments. Just as buyers of CDSs stand to gain if a homeowner defaults, purchasers of "life settlements" would profit from a rash of deaths due, for example, to a flu epidemic.

## Conclusion

The issue is not whether an unsustainable financial system will have to change. Rather the issue is how will change occur. Will it happen by disaster or by design, in a haphazard way or in a more careful and structured way?

Many civil society groups view the crisis as an historic turning point – the end to a fundamentalist belief in unfettered free markets and an opportunity for a new beginning. As World Council of Churches General Secretary, the Reverend Samuel Kobia, has written: "What we need are brave and new measures to correct this unjust and unethical system in order to prevent such a crisis from occurring once again."<sup>90</sup>

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KAIROS: Canadian Ecumenical Justice Initiatives unites eleven churches and religious institutions in work for social justice in Canada and around the globe.

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