

Governance, Market regulation, and Global crisis

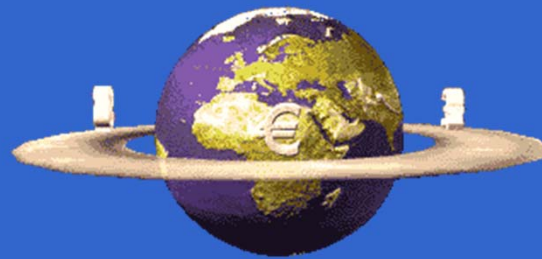
Michel Henry Bouchet
September 2013

skema
BUSINESS SCHOOL



BOUCHET SKEMA 2013 (c)

Governance, Market regulation and Global crisis



Sept-Dec 2013

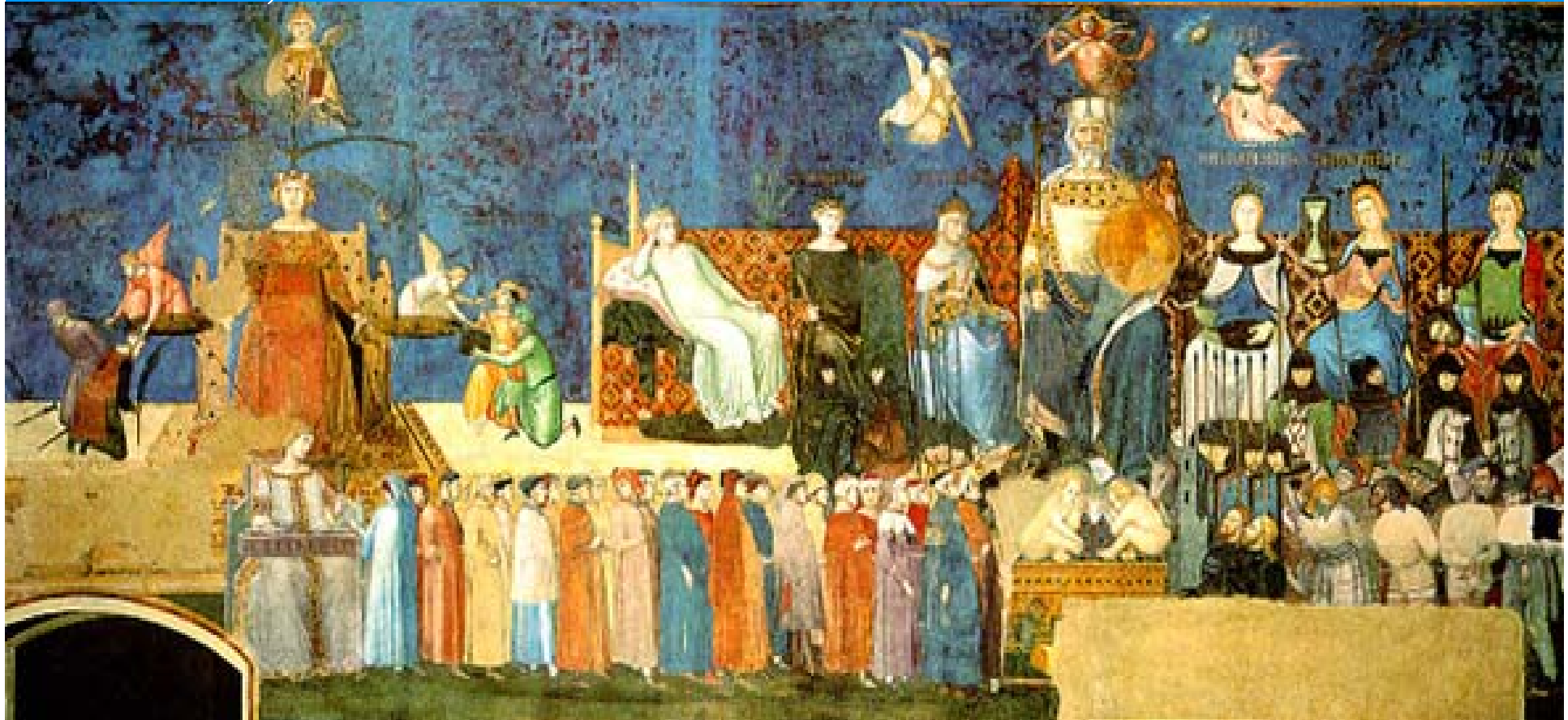
What is « good governance »?

- ☞ IV^o century BC - Aristotle: education, virtue, justice and ethics are crucial for reaching the Ultimate Human Good of Happiness
- ☞ Like Plato, he condemns the accumulation of wealth, usury and speculation: **chrematistic**



What is « good governance »?

XIV^o: Sienna: the allegory of **good government** = delicate balance between Wisdom, Justice, Strength, Prudence, and Peace



Defining Governance and Corruption

☞ What is governance?

- "Sound public administration and service quality"

Summer (2000) US Treasury Secretary

☞ What is corruption?

Corruption, (Latin *corruptio* = decay), is one of the key criteria to assess the quality of governance, along with transparency and the rule of law.

- "It is the abuse of public power for private benefit"

World Bank and Tanzi (1998) - IMF



The corruption equation

$$\begin{aligned}(x_1 - x_2)^2 &= (x_1 + x_2)^2 - 4 x_1 x_2 \\ &= \left(-\frac{b}{a}\right)^2 - 4 \frac{c}{a} \\ &= \frac{b^2 - 4ac}{a^2}\end{aligned}$$

☞ **C** (corruption) = **M** (monopoly) + **O** (Opacity)
+ **D** (discretion) – **A** (accountability)

☞ Fighting corruption, thus, requires eliminating monopoly, reducing discretion and promoting transparency and the rule of law while increasing accountability standards and practices (Robert Klitgaard)



The new focus toward corruption and governance

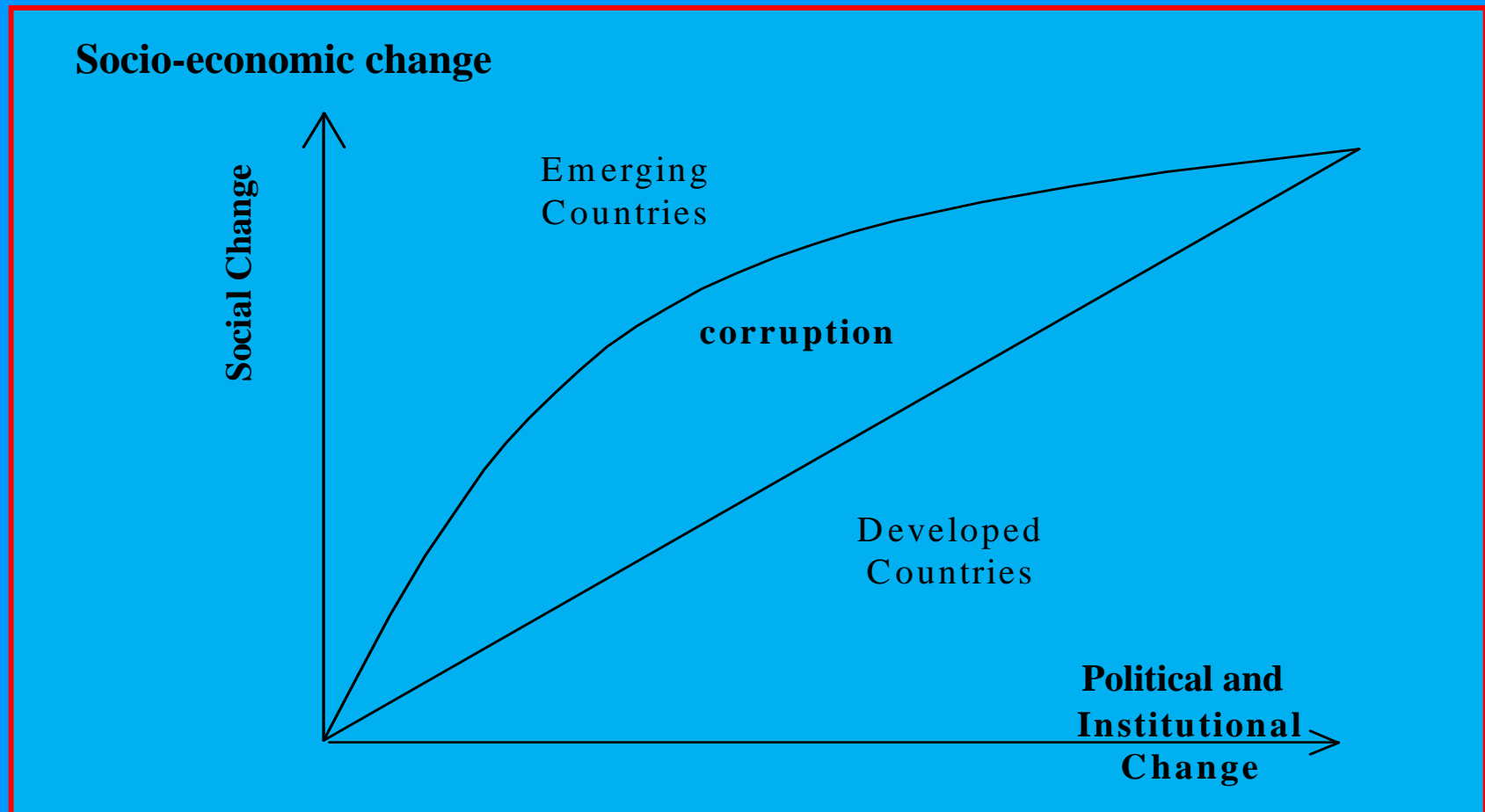
Two root causes of the global crisis:

1. Income inequality offset by cheap and abundant credit
2. Bad governance, corruption and poor regulation (Goldman Sachs Abascus deal, JP Morgan « London whale » trading scandal, Barclays Libor rate-rigging affair, shadow banking, money laundering....)



Where does bad governance come from?

High pace of socio-economic change combined with weak institutional development



S.Huntington (1968): modernization process leads to distorted socio-political behavior in fast changing societies

Why do corruption and bad governance matter in the first place?

- New « hot topic » on IFIs' agenda: « economic & social efficiency of aid flows? »
- Sovereign governance is a prerequisite for « sustainable development »
- NGOs: Focus on bad governance, capital flight and money laundering
- Global crisis and focus on tax evasion and shadow finance



Corruption & Development: the official consensus

- Until mid-1990s, « fatum approach »: corruption was regarded as too difficult and controversial to deal with
- Corruption seen as a sort of « social disaster » that, like soil erosion, cannot be prevented



Corruption & Development: the « new » official consensus

- Corruption increases transaction costs and uncertainty while lowering efficiency
- Corruption reduces the transparency of economic transactions while undercutting the State's ability to raise tax revenues and to fight poverty
- Corruption weakens the State and its ability to promote development and social justice; it is regressive
- Financial fraud and opacity contributes to systemic crisis (Asian crisis, global crisis)



Corruption & Development: the « new » official consensus

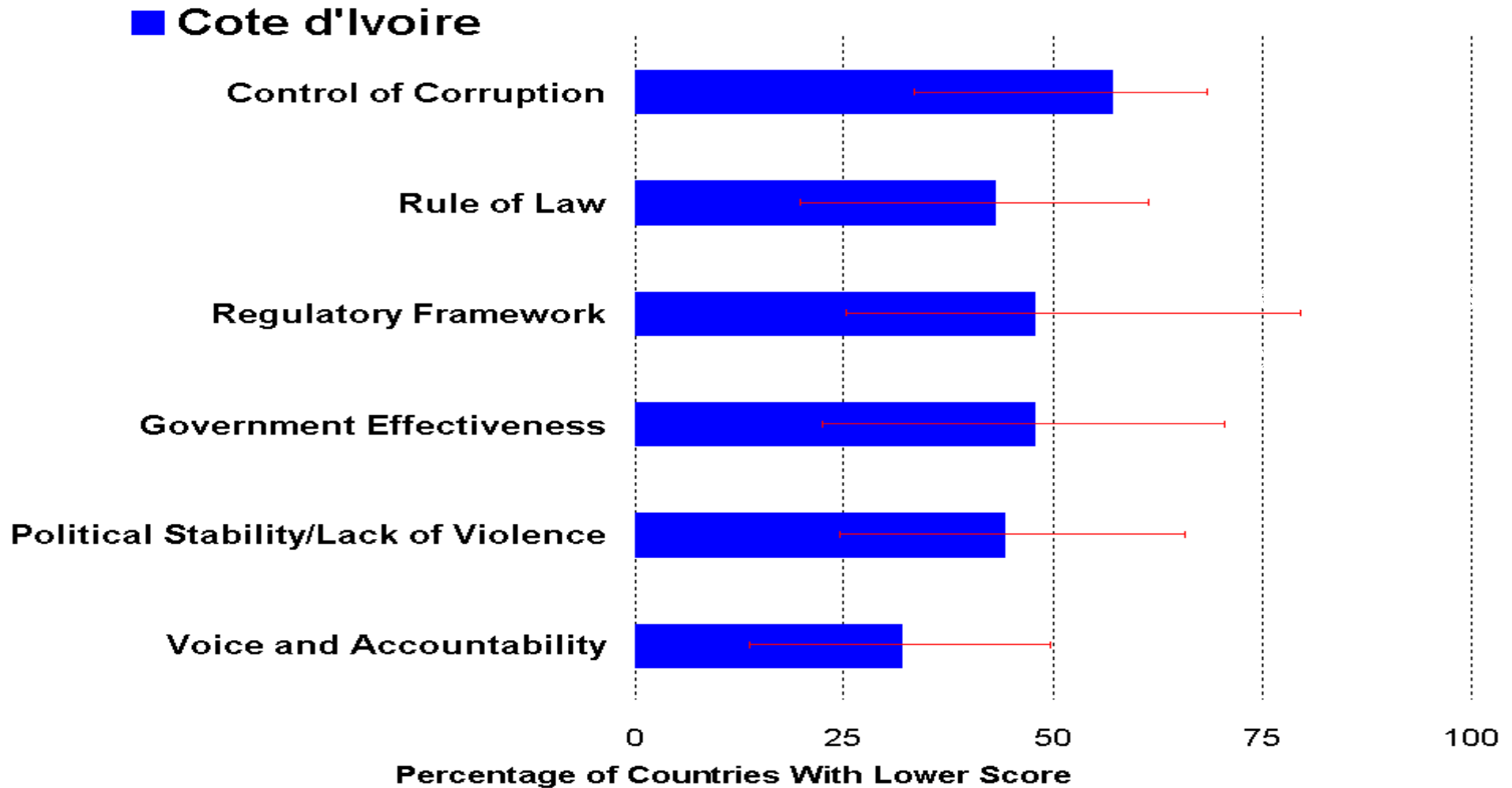
World Bank Report: « Aid and Reform in Africa »

- ☞ Conclusion: Out of 10 large recipients of development aid, 8 resisted reforms while local authorities propped up their favored client groups, thereby ensuring continued inefficiency.
- ☞ ODA did not promote sustainable development policies. *Aid money to countries with poor governance allows governments to avoid reform!*



Measuring corruption? WB's Governance center

(Higher values imply better governance ratings)



Measuring Corruption? Transparency International CPI

1	New Zealand
2	Denmark
3	Singapore
3	Sweden
5	Switzerland
6	Finland
6	Netherlands
8	Australia
8	Canada
8	Iceland
11	Norway
12	Hong Kong
12	Luxembourg
14	Germany
14	Ireland
16	Austria

France = 22
 China = 80
 Russia = 133



162	Guinea-Bissau
162	Kyrgyzstan
162	Venezuela
168	Burundi
168	Equatorial Guinea
168	Guinea
168	Haiti
168	Iran
168	Turkmenistan
174	Uzbekistan
175	Chad
176	Iraq
176	Sudan
178	Myanmar
179	Afghanistan
180	Somalia

Business Freedom Index 2013

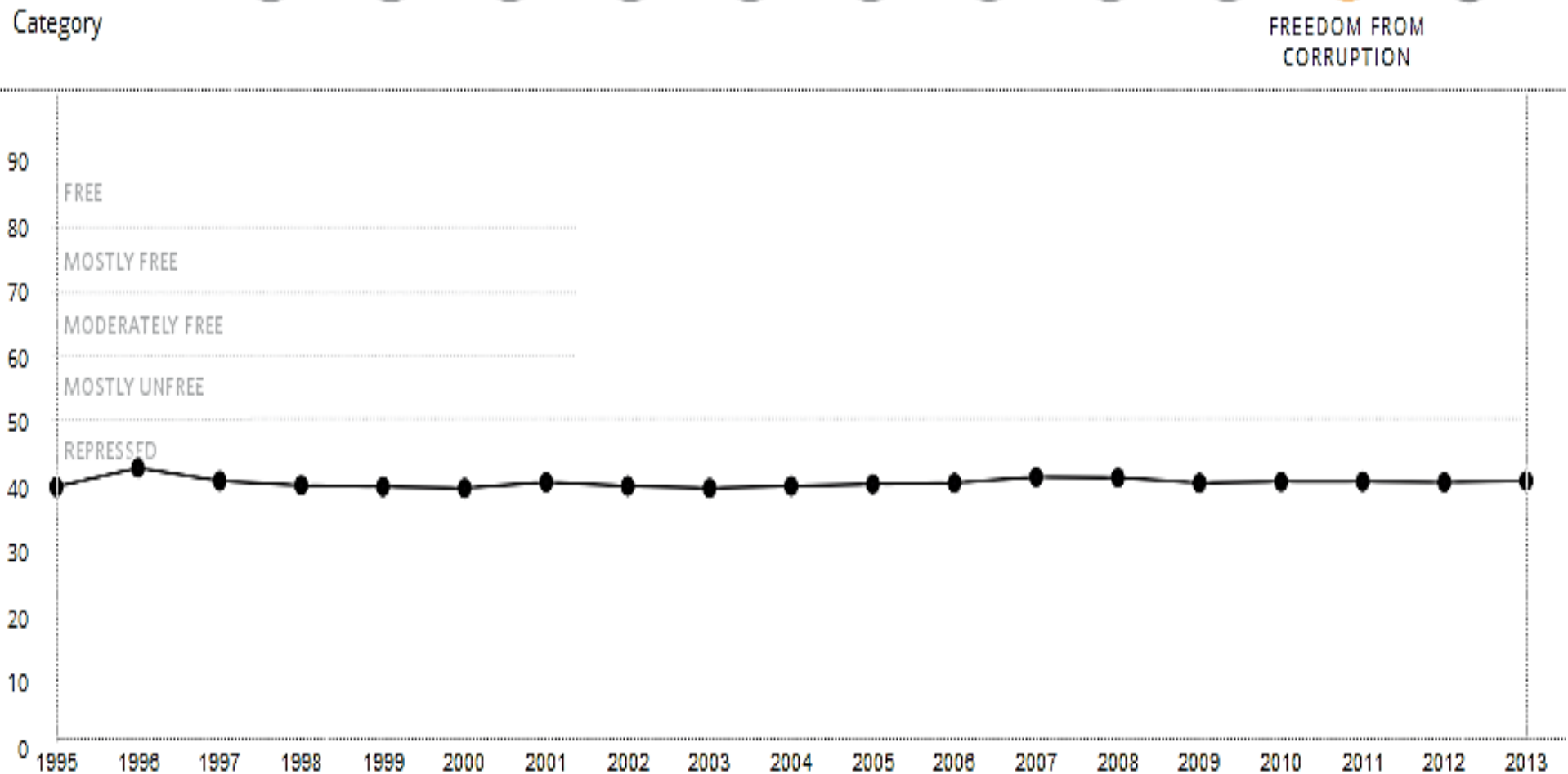
Heritage Foundation (10 indicators including corruption)

1. Hongkong
2. Singapore
3. Australia
4. New Zealand
5. Switzerland
6. Canada
7. Chile
8. Mauritius
9. Denmark
10. USA
14. UK
19. Germany

34. Korea
50. Mexico
62. France
74. South Africa
100. Brazil
119. India
136. China
139. Russia
175. Zimbabwe
176. Cuba
177. North Korea



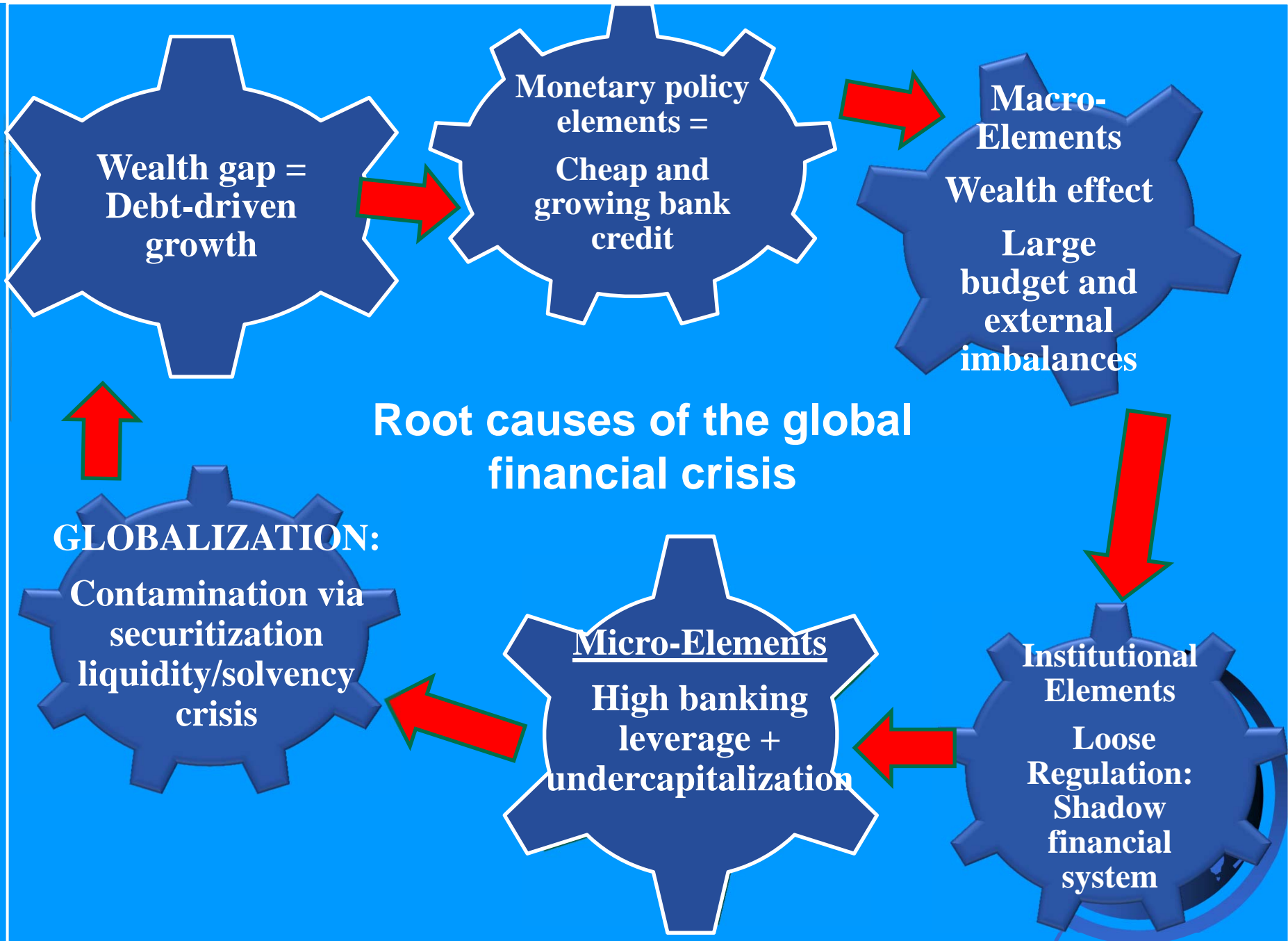
No major decline in global corruption since 1990s (according to the **Freedom from corruption index** of Heritage Foundation)



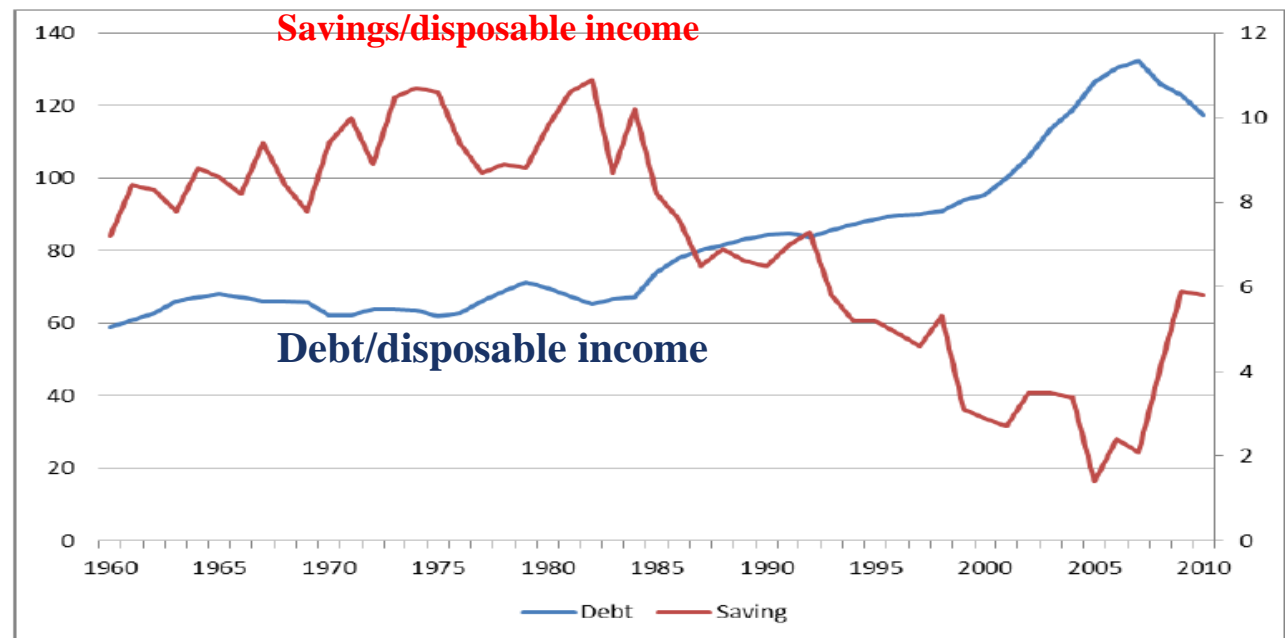
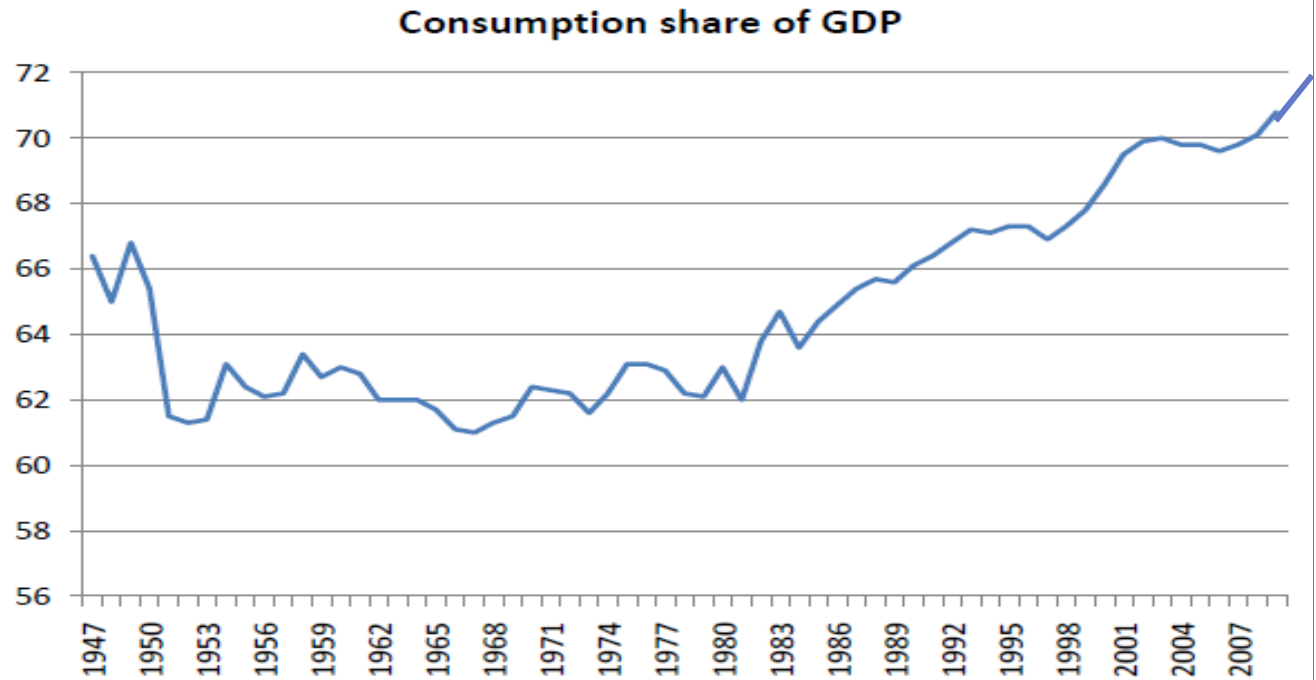
Challenge of Global governance: Decoupling between market forces and national regulation!

➤ How to promote regulation and governance when the global political system is still based on the « Nation State » system of Westphalia Treaty of 1648 and the UN of 1945?





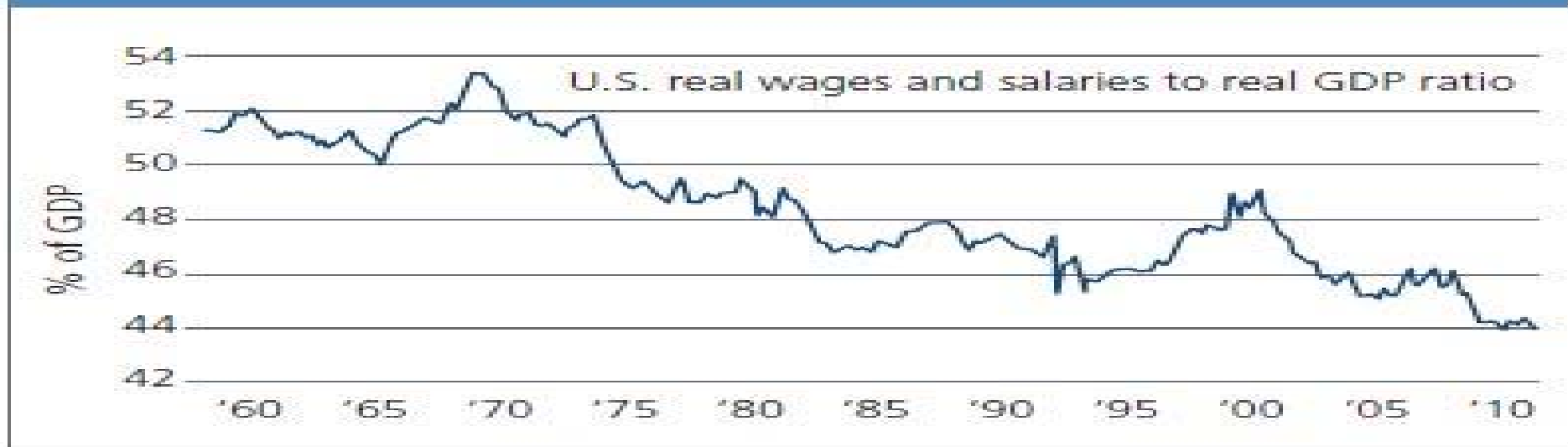
The global financial crisis is rooted in rising income inequality!



Wealth gap + Debt-driven growth = Financial crisis

CAPITAL TRUMPS LABOR

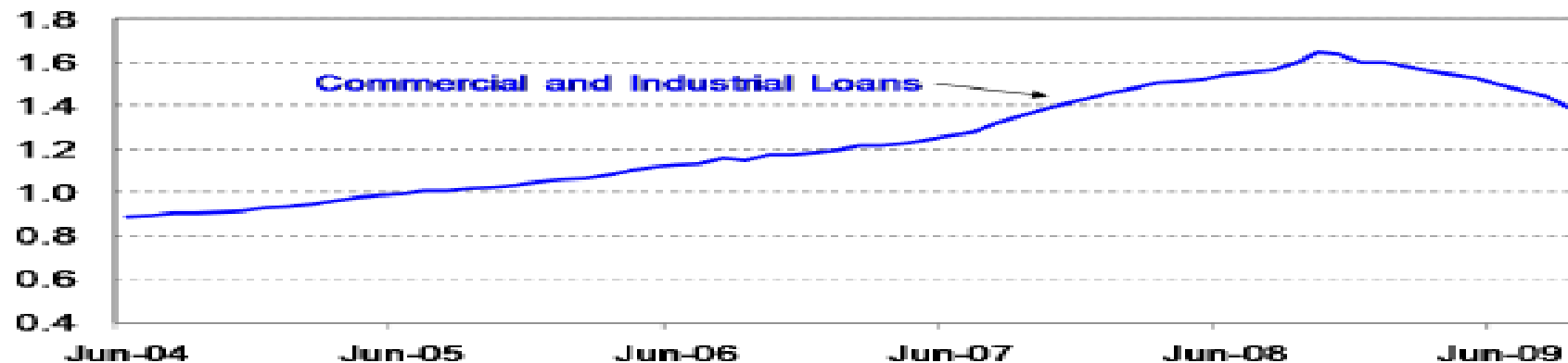
(PIMCO 2012)



Commercial and Industrial Loans Outstanding at US Commercial Banks

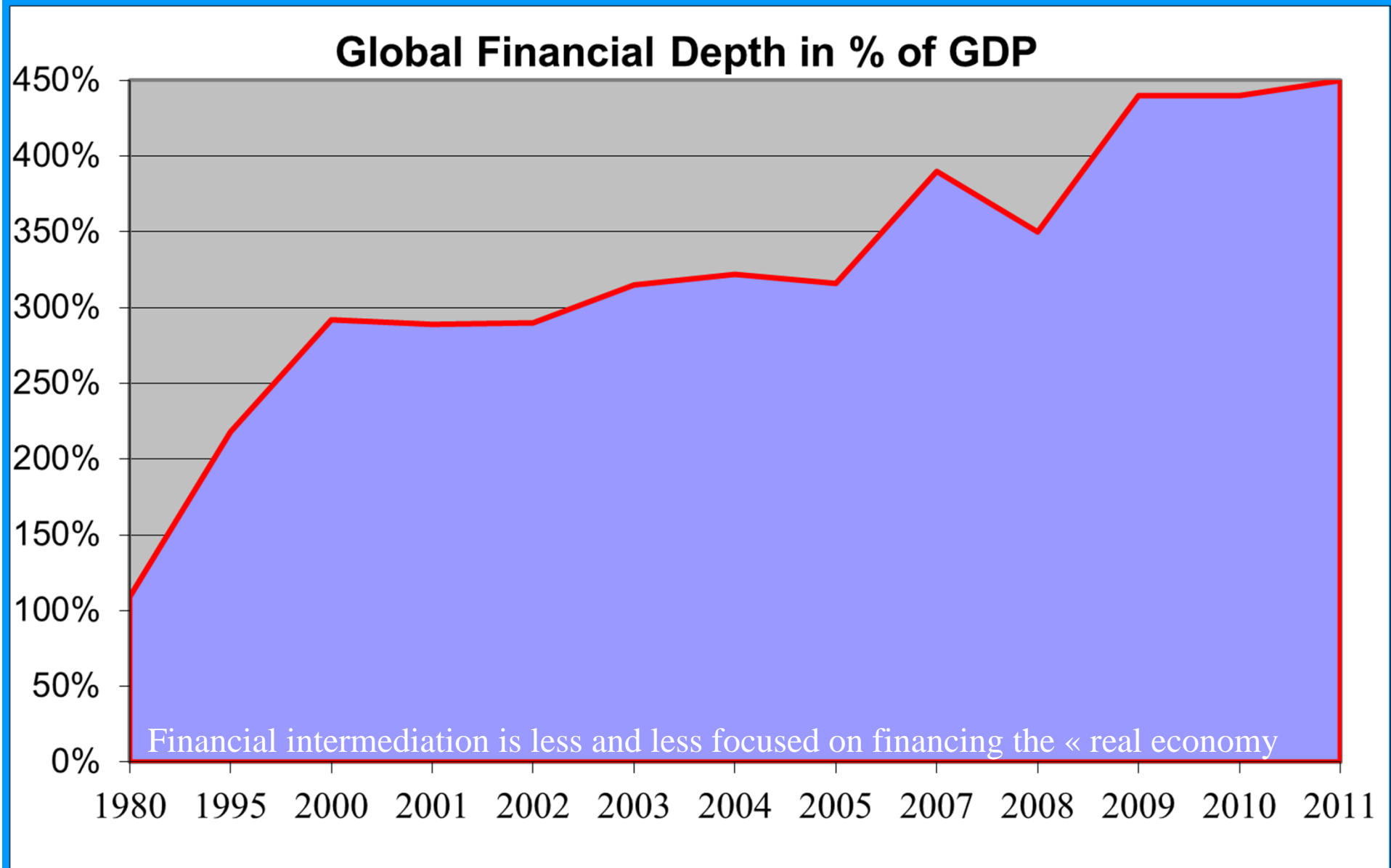
End of Month, June 2004 – September 2009

Trillions of Dollars



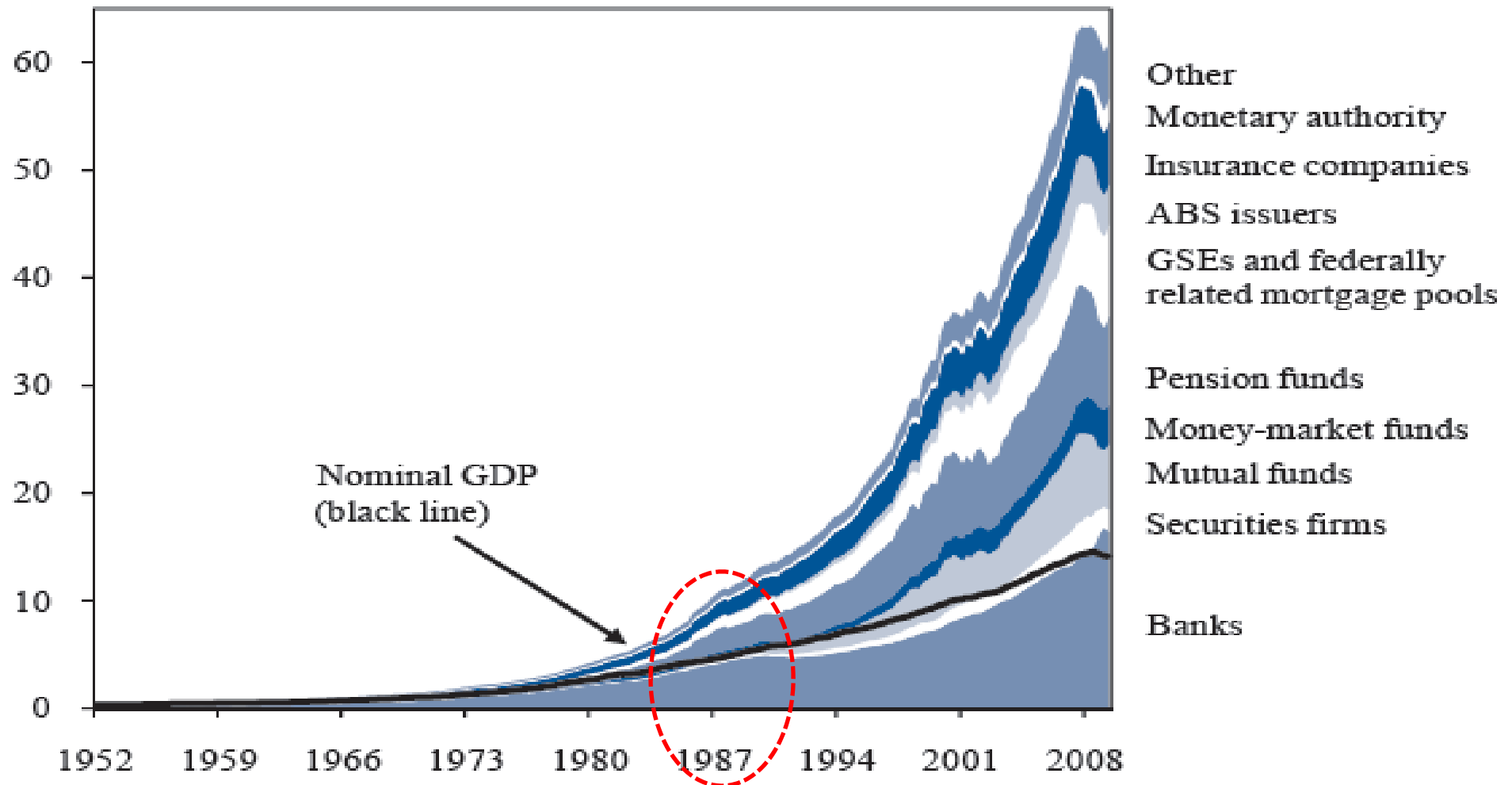
Note: Data as of the last week of each month.

1990s: The financial genie has escaped from the bottle!



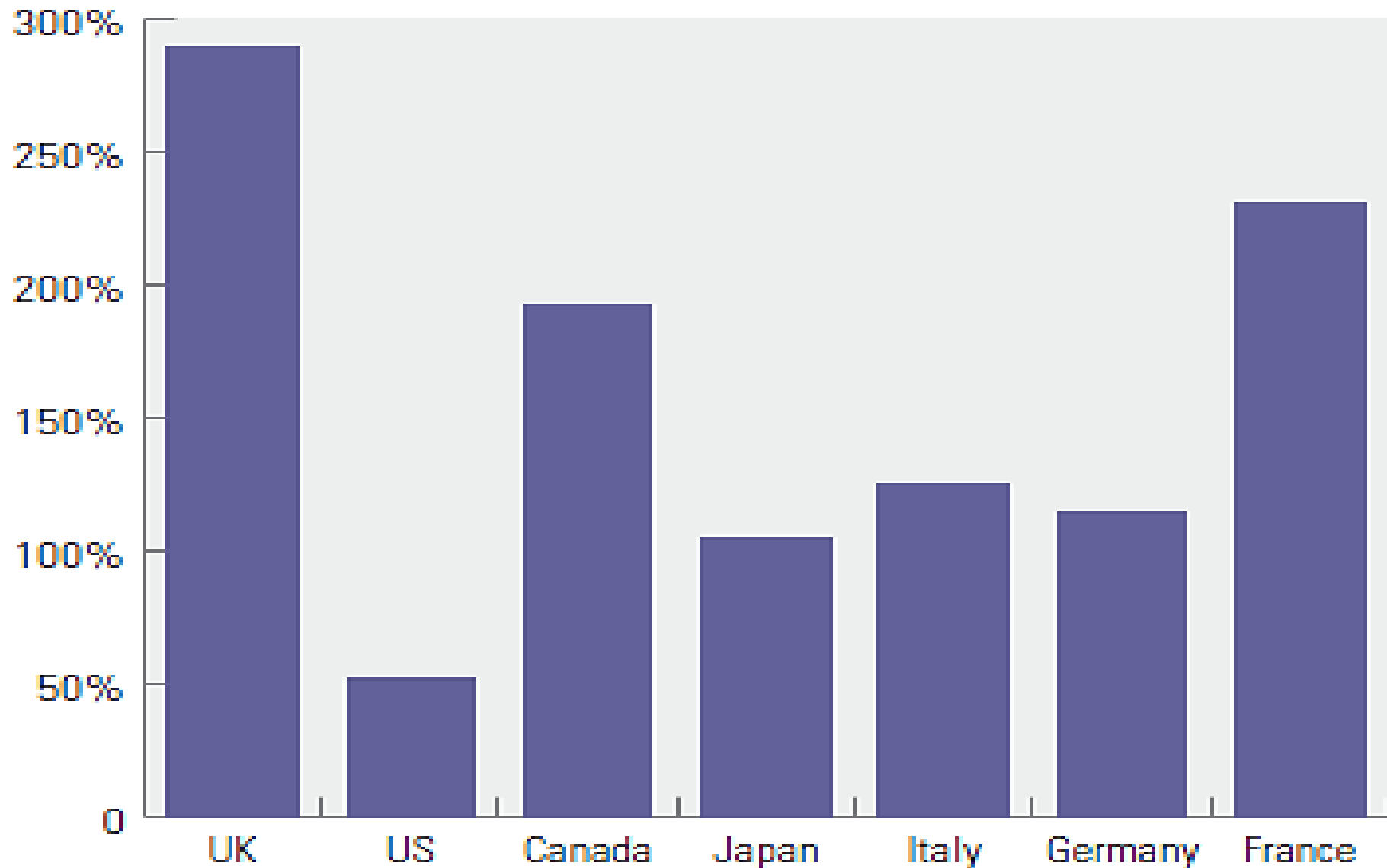
Basel 1 = Rising securitization and growing nonbank financial system

Trillions of dollars



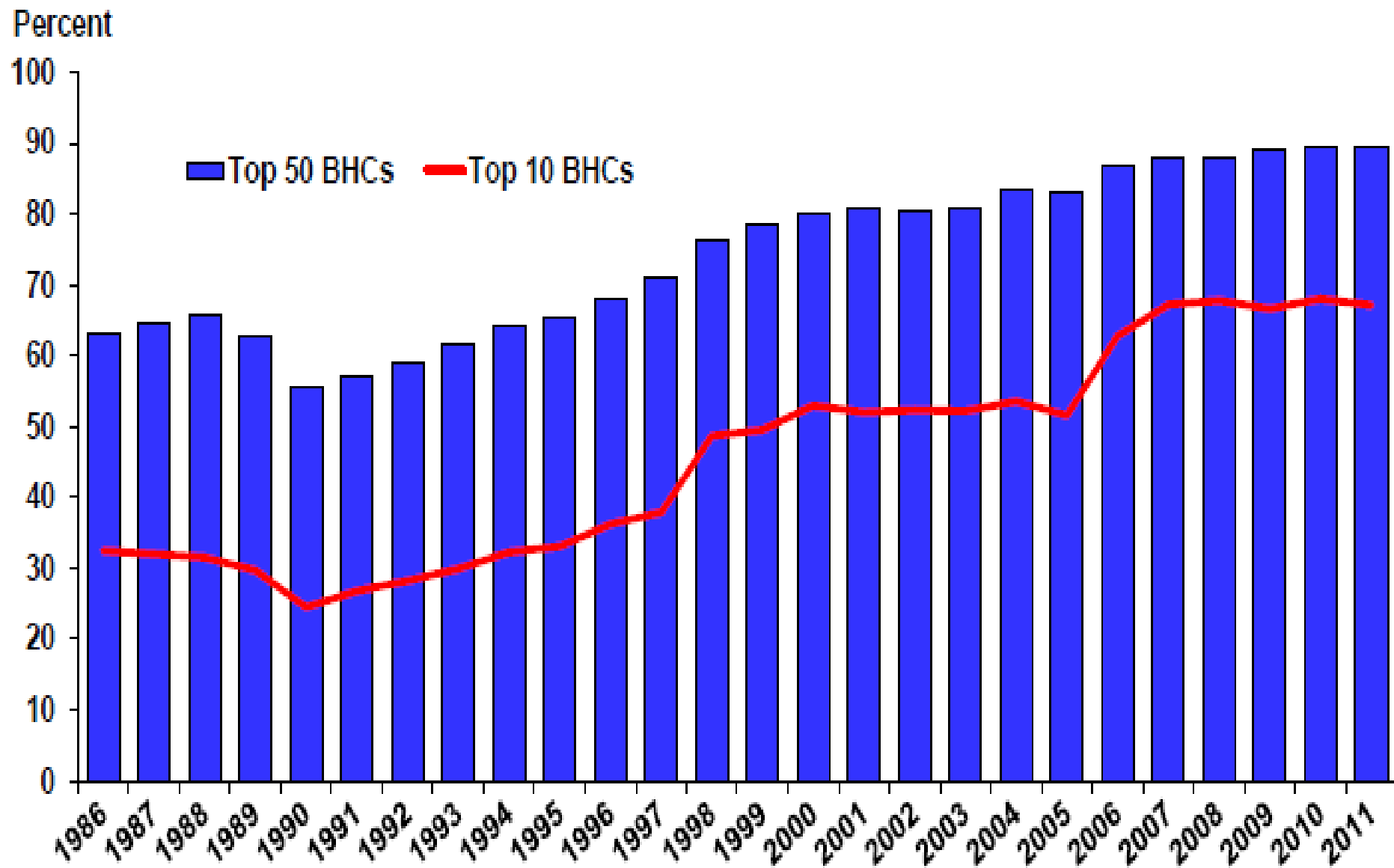
Sources: Federal Reserve Board, Flow of Funds; Department of Commerce (Bureau of Economic Analysis), National Income and Product Accounts Table 1.1.5.

Banks Assets /Country GDP

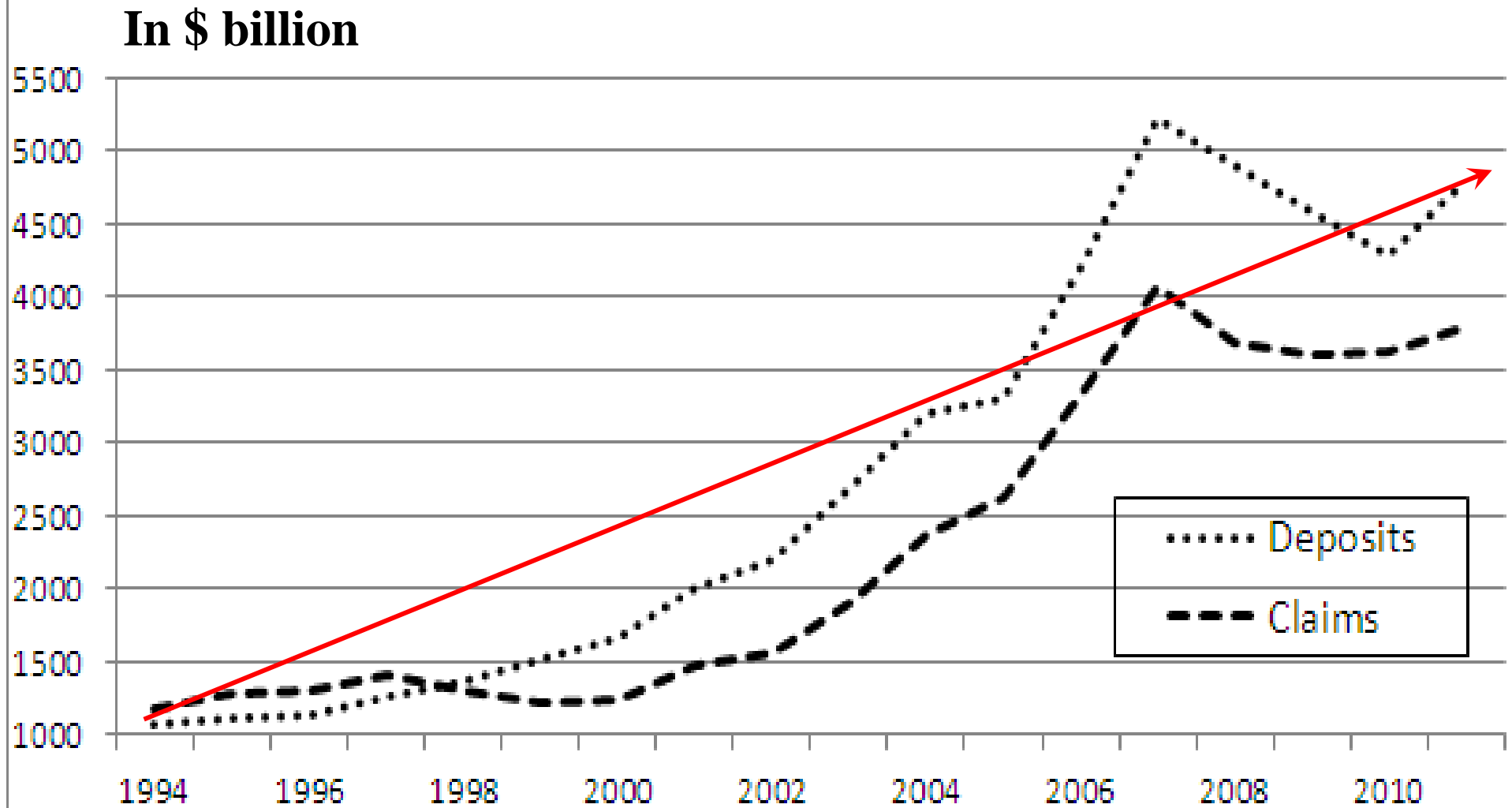


Toward an oligopolistic banking system?

US banking assets concentration 1986-2011



20% of all international banks' claims are held in offshore centers (BIS)



Globalization, money laundering and tax heavens?



- Overall private financial assets held in offshore tax heavens reach between \$17000 billion and closer to \$25500 billion (according to former chief economist of MacKinsey, James S. Henry, The Observer, 07-2012)
- Equivalent to Σ US + Japan GDP!





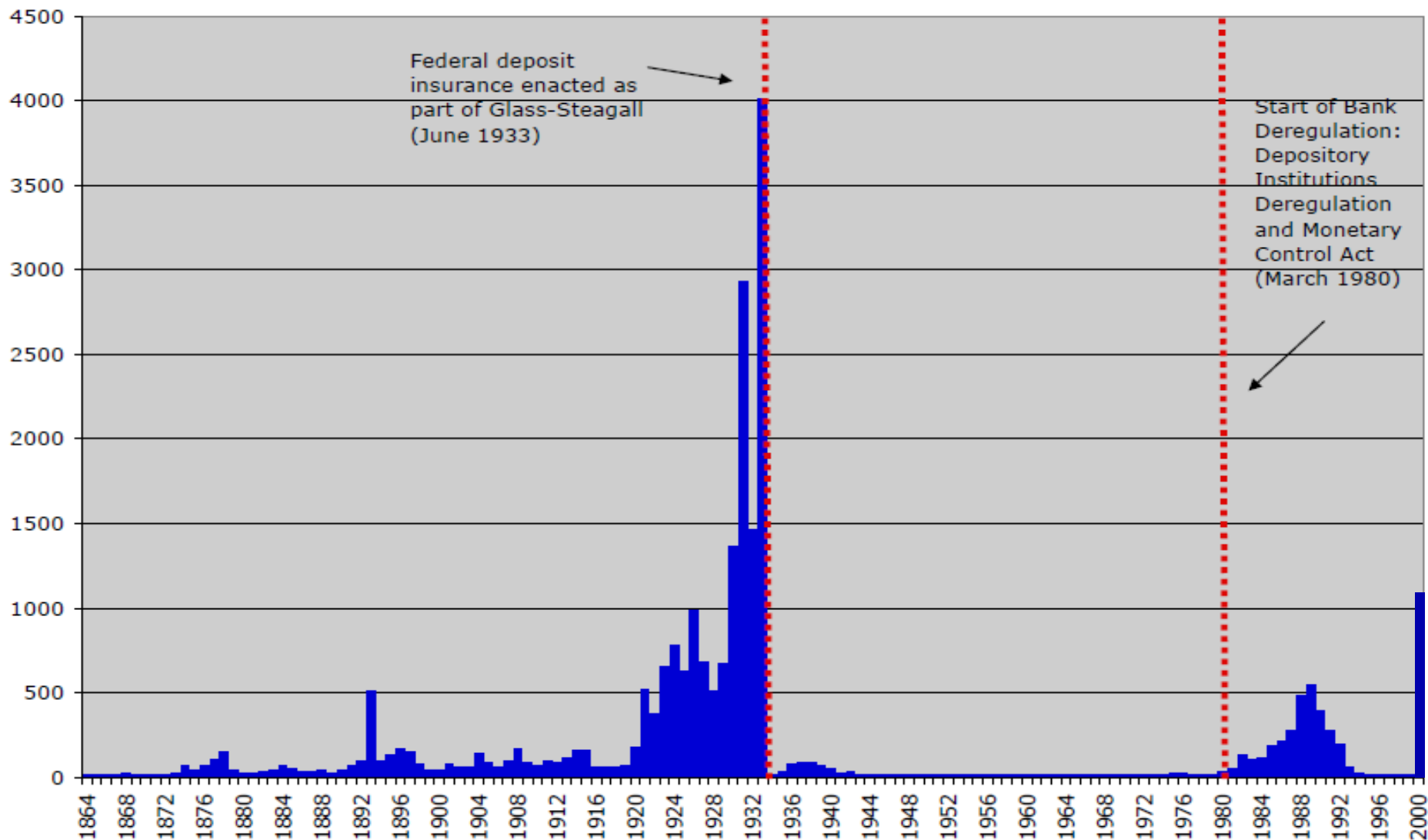
Regulation, de-regulation, and re-regulation?

- 1933: Glass-Steagall Act: FDIC + financial institutions separation according to functions: speculative investment banks are left to survive on their own
- 03/1980: Deregulation and Monetary Control Act
- 1999: Clinton's financial modernization Act:
- Senator Dorgan: « *We will look back in ten years time and say we should not have done this, but we did it because we forgot the lessons of the past, and that which is true in the 1930s is also true in 2012!* »



The cost of banking de-regulation

A Unique Period of Calm Amid the Storm: Bank Failures (Suspensions), 1864–2000



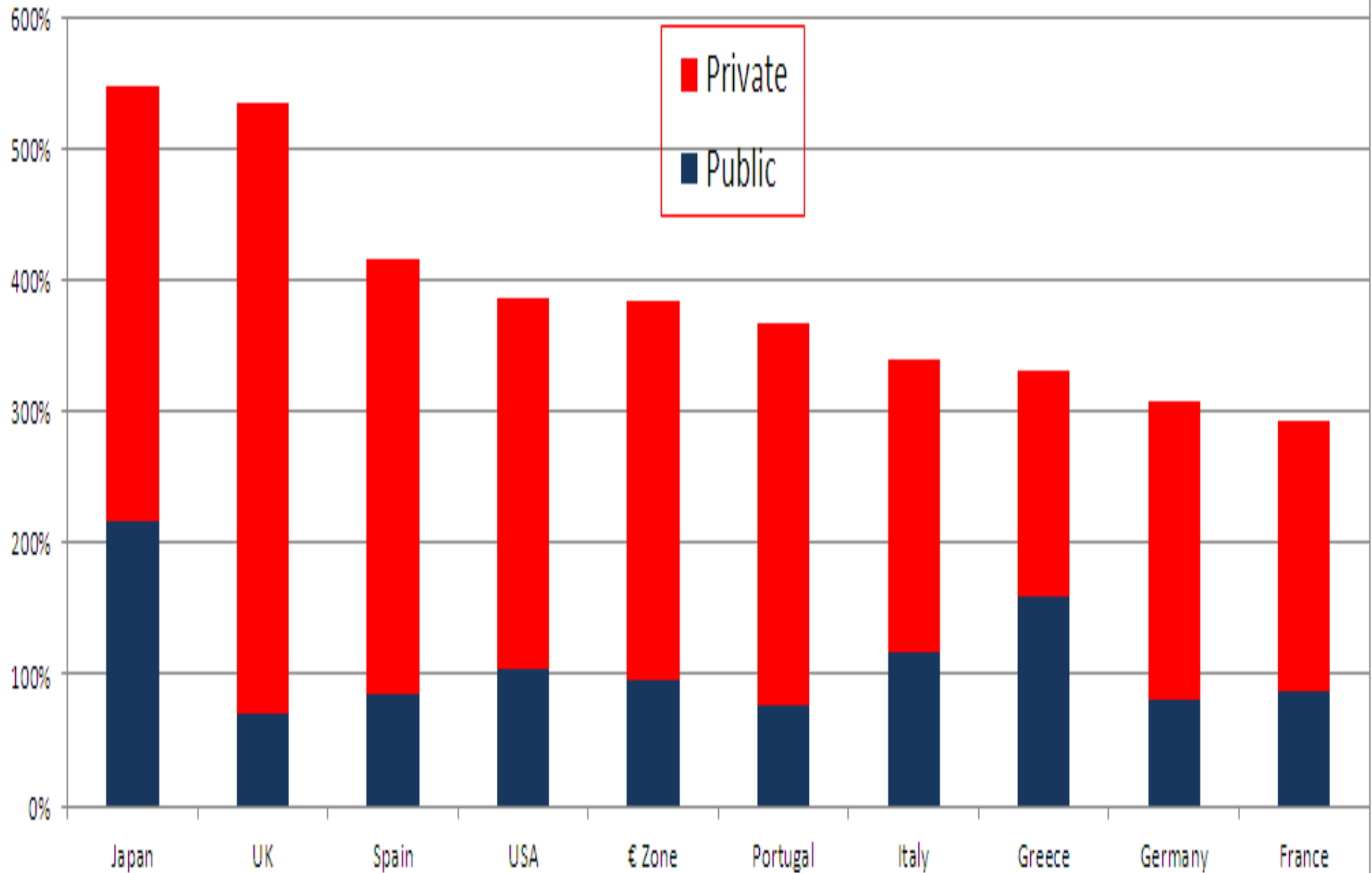
Negative externalities: Big banks = Nuclear power stations?

- ☞ Declining socio-economic services of financial intermediation, with systemic risks requiring expensive clean-up operations
- ☞ Solution: close supervision, stronger capital ratios, and « pollution taxes »
- ☞ Danger of excessive leverage : in March 2008, Bear Stearns had a leverage ratio of 36... and a return on equity of 20% (same for AIG, Lehman Brothers, Enron, Parmelat...)

“Today’s global megabanks are too big to manage. It is time to break up the largest banks. Make them small enough to manage and simple enough to fail.” S. Johnson August 2012 NY Times

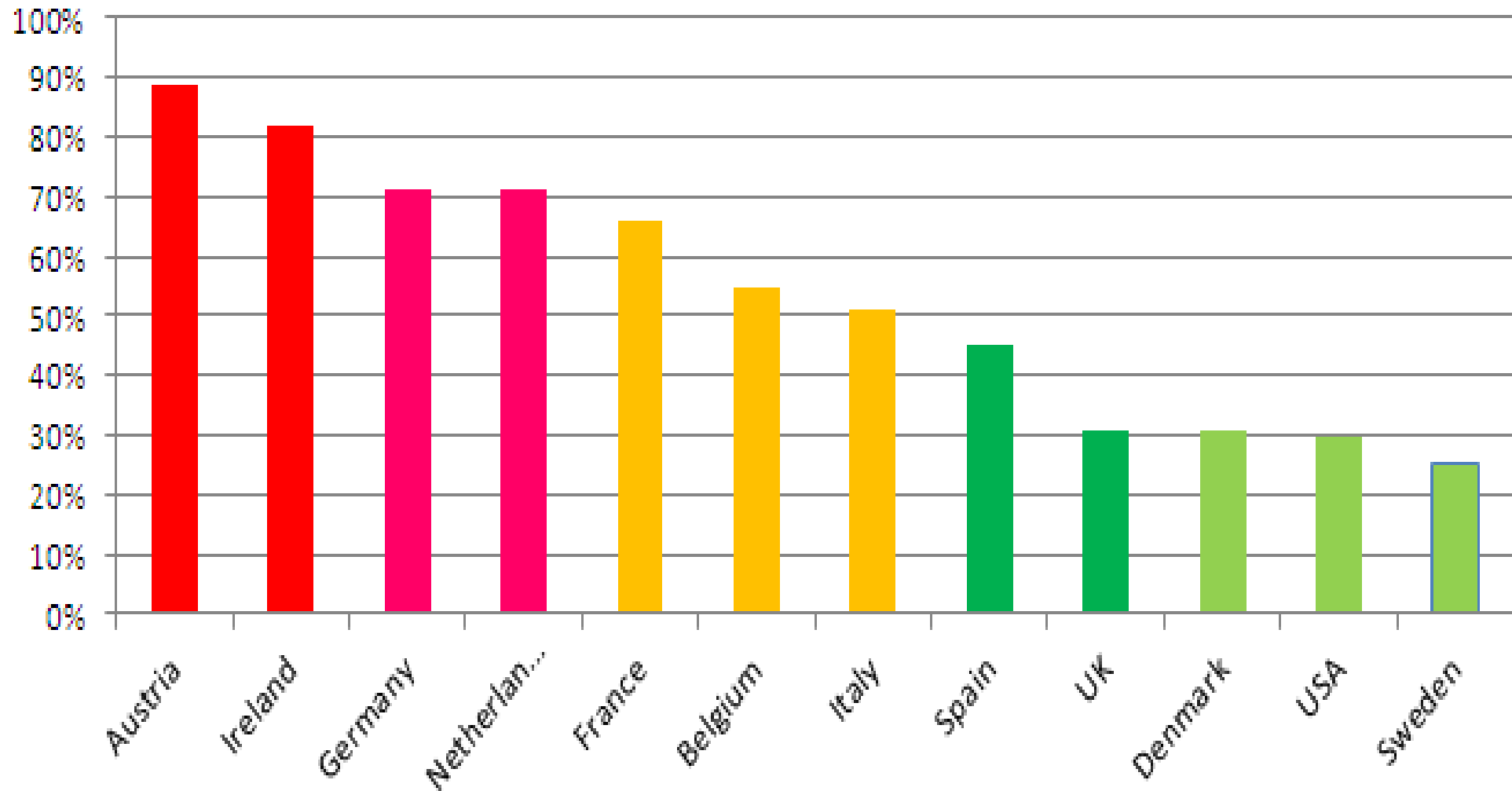


Overall national debt burdens % GDP



Capital market globalization = Investment funds and rating agencies in the driving seat

Share of Public Debt held by foreign investors in 2012 %



☞ Global crisis =
governance crisis + regulation crisis

Is there a pilot in the plane's
cockpick?

Who is in charge?

IMF, World Bank, UN, BIS, WTO...



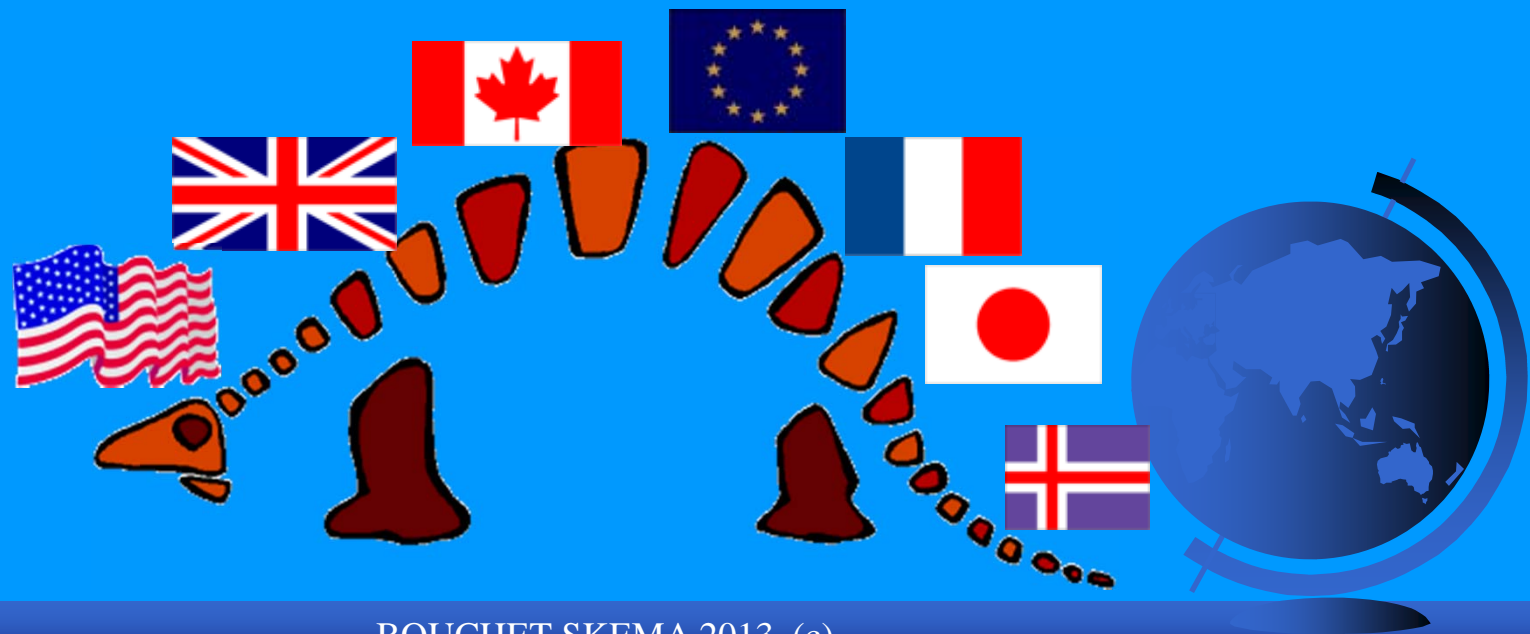
**The 2008-2015 global crisis will be
recognized as a crucial watershed
between market forces vs nation-states**



CONCLUSION

Globalization without Governance leads to economic growth without Sustainable development

What is at stake is to regulate global markets thanks to stronger regulatory power of nation states and to enhanced global governance



Sustainable growth requires social mobilization
and political stability
within a « nation » rather than in a « country »

☞ Development = social inclusiveness
 Σ (policy choice + political choice)



Globalization is not to be blamed for low human development

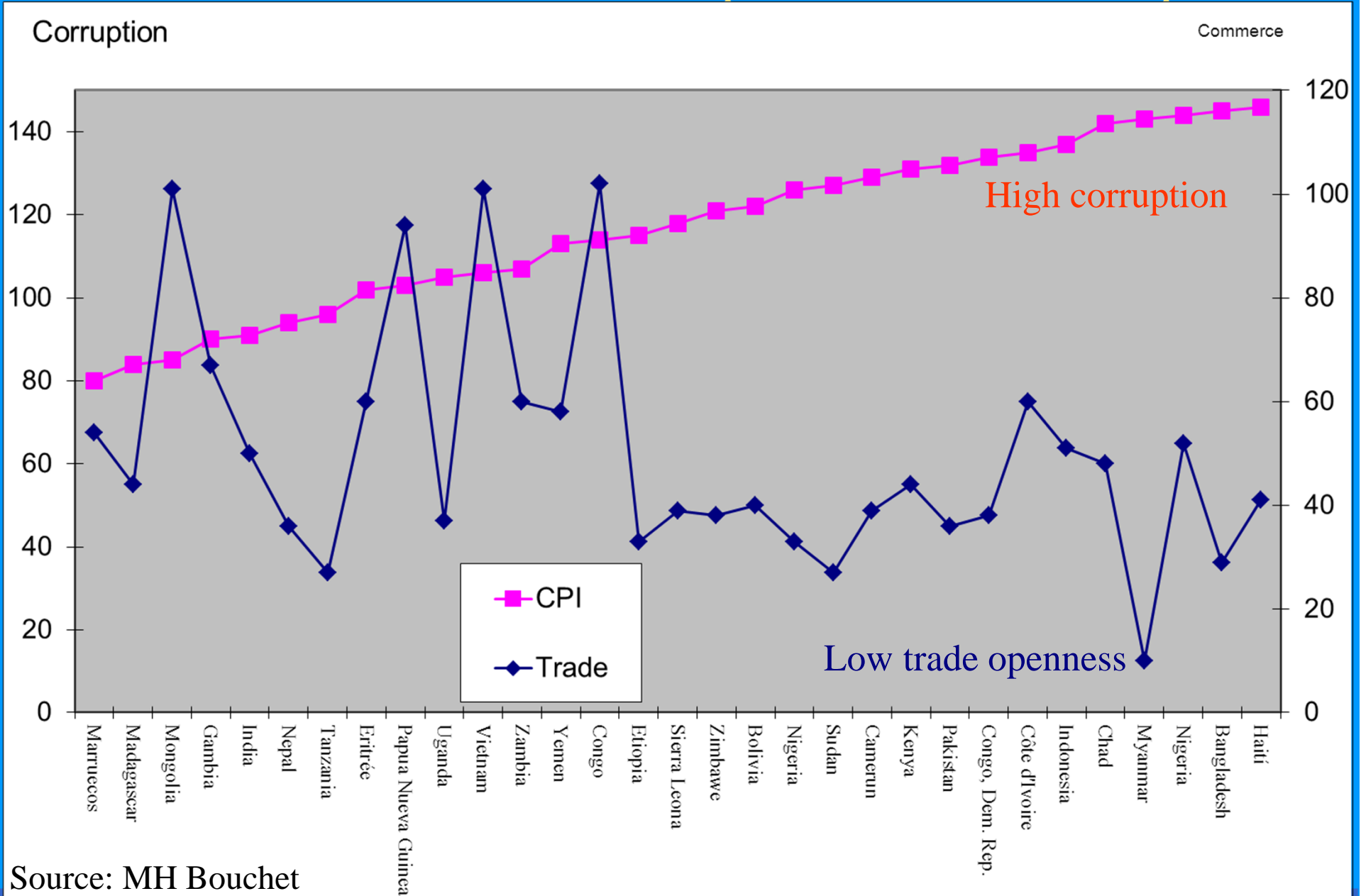
... **Bad governance** should be blamed

1	Norway
2	Australia
3	United States
4	Netherlands
5	Germany
6	New Zealand
7	Ireland
8	Sweden
9	Switzerland
10	Japan
11	Canada
12	Korea
13	Iceland
13	Hong Kong
15	Denmark

HDI-UNDP 2013

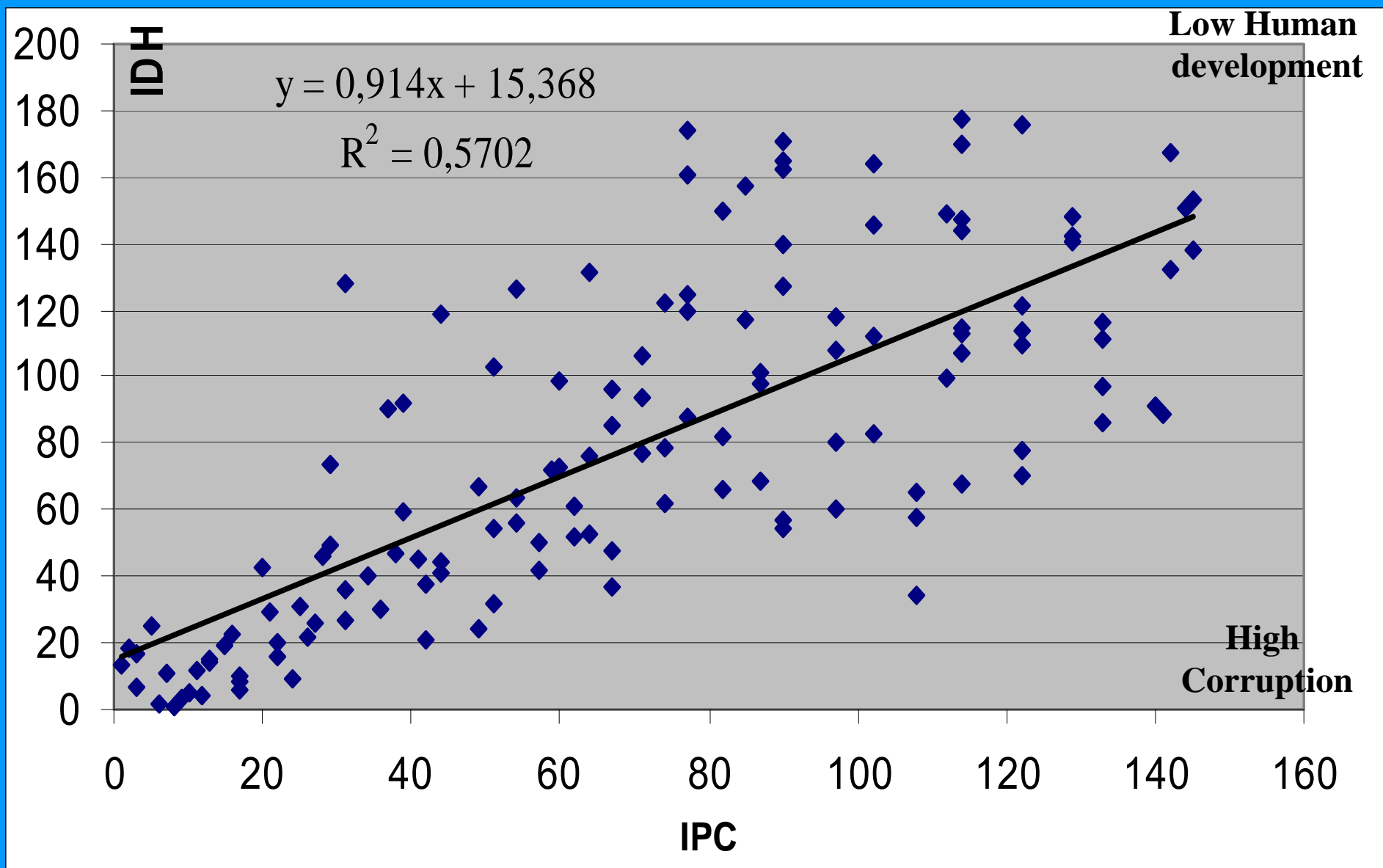
170	Malawi
171	Sudan
172	Zimbabwe
173	Ethiopia
174	Liberia
175	Afghanistan
176	Guinea-Bissau
177	Sierra Leone
178	Guinea
178	Burundi
180	Central African
181	Eritrea
182	Mali
183	Burkina Faso
184	Chad
185	Mozambique
186	Niger
186	Congo (DR)

Correlation between trade openness and corruption?

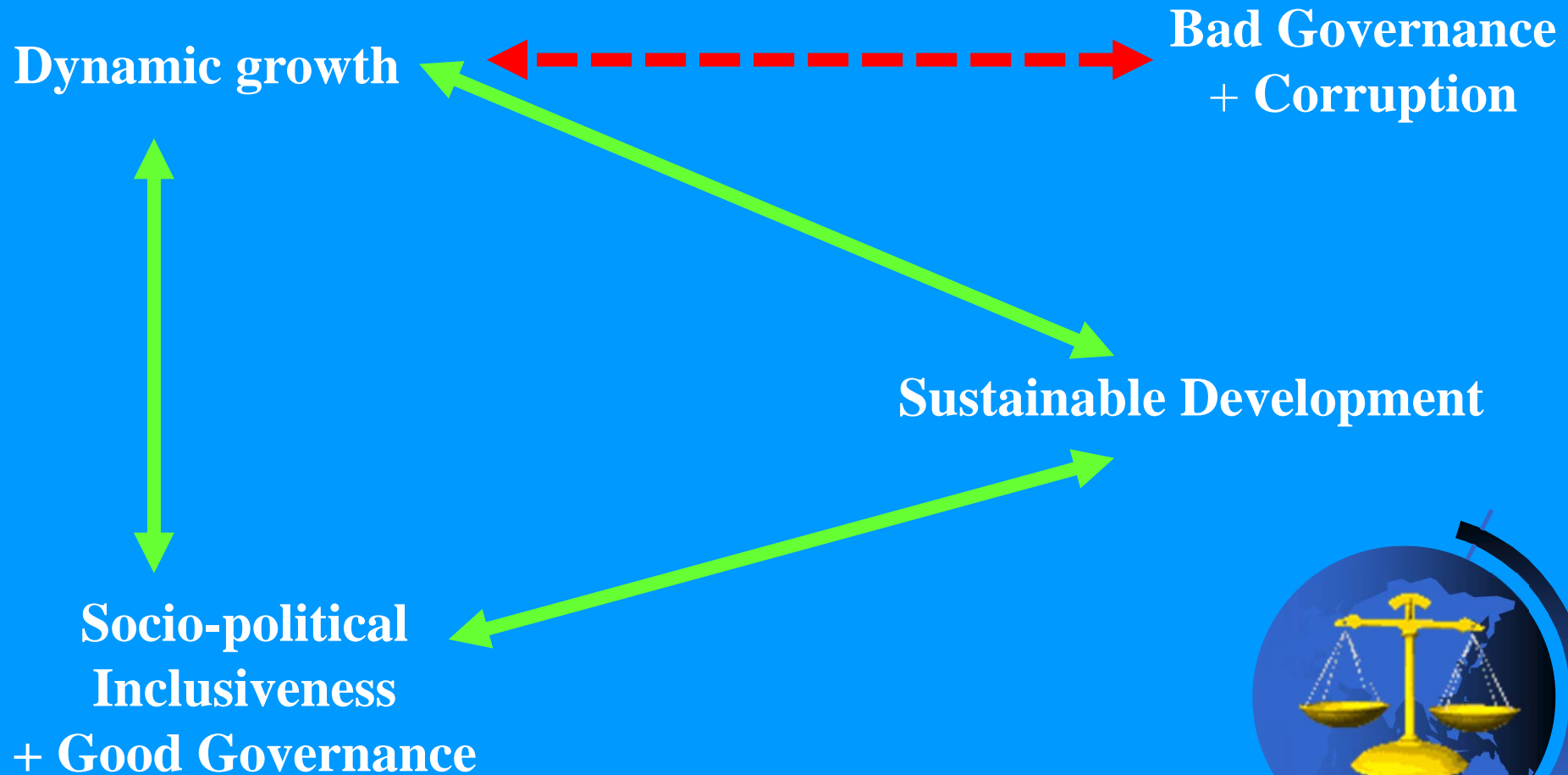


Source: MH Bouchet

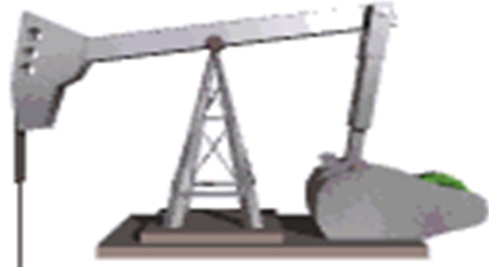
Correlation Human development /Corruption



Trilemma of growth and development?



Development = Economic Growth + key conditions that make it sustainable!

	CHILE	COSTA RICA	RUSSIA	GABON
GDP/per capita	\$15,000	\$11,000	\$15,000	\$14,000
Life Expectancy	79	80	67	61
HDI Rank	40	62	55	106
				
	ARMENIA	SRI LANKA	CONGO	ANGOLA
GDP per capita	\$5000	\$5000	\$5000	\$5000
Life expectancy	74	75	57	51
HDI Rank	87	97	142	148

Better off in Tunisia than in Algeria?

TUNISIA

- GDP Per capita = \$8500
- HDI= 94
- Life expectancy = 75
- Doing Business= 55
- Corruption = 59

ALGERIA

- GDP Per capita=8500
- HDI= 96
- Life expectancy= 73
- Doing Business= 136
- Corruption = 105



Conclusion:

Economic Growth + Good Governance + Democracy are key inputs of Development

- ☞ Modernization theory: Democracies are more likely to emerge as countries become economically developed at middle-income levels: The more well-to-do a nation, the greater the chances it will sustain democracy
- ☞ Democracy, in turn, will help transforming economic growth into development
- 1. **Per capita income grows faster under democracy** (population rises less fast than under dictatorships)
- 2. Good governance and democracy provide a **stable political environment**, hence a positive impact on sustainable growth!

