

# **The Social Consequences of Contemporary Financial Markets and the Case for a Financial Transaction Tax**

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# Contents

Acknowledgements.....	5
Abstract .....	8
Chapter 1.....	9
Methods and Introduction .....	9
1.1 Aims.....	9
1.2 Methods .....	10
1.3 Structure of the Thesis .....	11
Chapter 2 The Financialisation of Global Markets .....	23
2.1 Introduction.....	23
2.2 Background to a Structural Crisis .....	24
2.3 An International Perspective .....	32
2.4 The History of Financialisation and Crises .....	42
2.5 The Global Financial Crisis .....	45
2.6 Credit Contagion.....	48
2.7 Real versus Shadow Economies.....	54
2.8 Synthetic CDOs and the Global Economy .....	56
2.9 Expansionary Economies .....	59
2.10 Financialisation and Concentration of Wealth.....	61
2.11 Conclusion .....	62
Chapter 3 The Social Consequences of Financial Markets.....	64
3.1 Introduction.....	64
3.2 Social Realities of Financialisation .....	67
3.3 Weakened Social and Political Structures .....	69
3.4 United States Health and Wealth in Decline .....	75
3.5 Nation States Finances .....	79
3.6 Changing Economic and Social Debate.....	80
3.7 The Rise of the Global Precariat .....	86
3.8 The Minsky Phases.....	91
3.9 Social Fallout and Incarceration .....	92
3.10 Housing Market Dysfunction.....	94
3.11 America's Rotting Foundations .....	99
3.12 Conclusion .....	100

Chapter 4 Financial Systems Analysis.....	103
4.1 Introduction.....	103
4.2 The Growth of Financial Systems .....	107
4.3 The US Economic Surge .....	114
4.4 Housing Markets Provide Collateralised Debt.....	116
4.5 Financial Innovation and Systems .....	120
4.6 Risk Modelling.....	126
4.7 Financial Reform to Counter Market Risk .....	135
4.8 High Frequency, Flash Trading and Dark Pools .....	137
4.9 Systemic Debt and Leverage.....	141
4.10 Systemic Meltdowns: Taxpayers to the Rescue.....	143
4.11 Lobbyists and Political Donations.....	144
4.12 Conclusion.....	149
Chapter 5 The Case for a Financial Transaction Tax.....	151
5.1 Introduction.....	151
5.2 Financial Transaction Tax – Rationale .....	153
5.3 Political support for FTTs.....	154
5.4 Objectives of an International Tax on Financial Transactions.....	159
5.5 Arguments to Promote a Tax on Financial Transactions.....	160
5.6 Targeting FTT Resources for Australian Housing and Homelessness Services.....	161
5.7 Global Revenues .....	162
5.8 A Brief History of the Financial Transaction Tax (FTT).....	164
5.9 Social Scope of a Financial Transaction Tax.....	169
5.10 Global Capacities .....	173
5.11 Financial Transaction Tax Proposals.....	177
5.12 Revenue and Stabilising Effects .....	181
5.13 Excessive Liquidity and Price Volatility in Financial Markets .....	189
5.14 An FTT Will Reduce High Frequency Trades.....	191
5.15 Conclusion .....	193
Chapter 6 Financial Transaction Taxes: Risks and Possibilities .....	195
6.1 Introduction.....	195
6.2 Black Ice Economics.....	197
6.3 Alternatives to the Efficient Market Hypothesis .....	212
6.4 Unorthodox or Heterodox? Perspectives on Market Dynamics.....	214

6.5	Lobbying and Revolving Doors .....	215
6.6	Collusion and Corruption.....	217
6.7	Global Hedge Funds and Dominant Centres .....	225
6.8	Financial Reform Gains Global Political Momentum.....	227
6.9	Proponents of FTTs Meet Strong Resistance.....	230
6.10	Summary.....	231
Chapter 7 Conclusion .....		234
References.....		239
Appendix 1: List of Figures .....		269
Appendix 2: List of Tables .....		270

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I was drawn to the world of Political Economy as an elected union representative in the Australian coal industry. I had worked as an underground miner in Australia and Canada.

A conversation at a Coal Industry Tribunal hearing in Sydney, gave rise to a regime of study and the completion of a Diploma in Labour Studies with the Adelaide University.

Some years later (1997), I was working with the late Jim Bacon, Premier of Tasmania, who had a strong knowledge of International Political Economy. He fostered, and strengthened, my knowledge in this vibrant field, through to the completion of a Bachelor of Arts (Hons) degree (University of Adelaide).

During the period 2001 to 2005, I developed an interest and understanding of the way international financial markets work and particularly how unregulated finance capital had a deepening influence on social circumstances globally. This led to the completion of a Master of Arts degree (Political Economy) (University of Tasmania) in 2007.

In 2007–08, I inquired about the possibility of developing the theme of instability in global financial markets and the social effects that were starting to consume and influence developed nation states. The collapse of Bear Stearns and Lehman Brothers during this period (2007–08) precipitated the Global Financial Crisis. The social fallout continues as a protracted international recession.

In June 2008, I applied to attend the London School of Economics (LSE) through placement in a course on Global Political Economy. Mercia Bresnehan, then Director of Housing Tasmania, encouraged my attendance and offered her support to attend the LSE. The introductory speech to visiting students was delivered by Professor David Held who urged students to examine the human side of the growing economic turmoil that was occurring globally. It was to change and fashion the argument of my chosen field of study. I owe so much gratitude to Mercia. The University of Tasmania contributed to my study at the LSE.

In 2009, I was honoured to be awarded the Australasian Housing Institute's 2009–2011 Outstanding Achievement Award for Professional Excellence in Social Housing, in part, for the study and research I undertook at the London School of Economics. I feel privileged to be contributing to social policy reform in this area of politics and economics. The field of heterodox political economy has strong social connections.

Constructing an argument, accessing high-level research information and guiding the flow of this thesis would not have been possible without the considerable expertise of Dr Anastasia Nesvetailova, Reader of Political Economy at the City University, London. Her influence through published material, suggestions, and a strong focus on detail has brought this work to another level. I cannot over estimate my gratitude to Anastasia and her guidance and influence on the way I now see this world.

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## DECLARATION of ORIGINALITY

This thesis contains no material which has been accepted for a degree or diploma by the University or any other institution, except by way of background information and duly acknowledged in the thesis, and to the best of my knowledge and belief no material previously published or written by another person except where due acknowledgement is made in the text of the thesis, nor does the thesis contain any material that infringes copyright.

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## **Abstract**

This thesis considers the social effects of unprecedented growth in financial trades and speculation. The key claim is that speculative finance capital markets have caused widespread economic and social pressures. An argument is advanced that socio-economic inequalities are resultant of overleveraged, unregulated finance, and market integration over the last three decades. Pressures on civil society have arisen through governments transferring state-based funds to bail out private institutions, and stimulate economies. Socialisation of debt is used to strengthen the private sector.

Central to this argument is the consideration that two economies have emerged in parallel throughout the developed world. The “real economy” of developed nation states has been depleted by protracted global economic crises. The second, “shadow economy”, has re-emerged as a concentrated economic force with speculative daily global financial trades of over US\$ 4 trillion, including AU\$41 billion in trades, every day, in Australia. The majority of trades are enabled by sophisticated high frequency trading corridors between Wall Street and the City of London. The consequences are felt worldwide.

Two key questions are addressed in this thesis. First, given the social consequences emanating from global financial markets, and the concomitant socialisation of debt in developed economies, is the introduction of a financial transaction tax a feasible, progressive economic and social reform to partially ameliorate the negative effects of speculative finance capital on nation states? Second, could a miniscule tax on trades, recalibrate the relationships between governments and markets and provide accountability, oversight and stability? This thesis concludes in the affirmative.

Additionally, this thesis posits an argument that transaction tax revenues in Australia, the eighth largest derivatives transaction-trading nation in the world, should be used specifically to strengthen national social policy commitments to homelessness, and provide a targeted resource for sustainable social housing provision.

# Chapter 1

## Methods and Introduction

### *1.1 Aims*

The social consequences of continuing financial crises on democracy are still in the early stages. Many established academics support the claim that democratic processes fail in this current phase. Austerity measures, limited resources for services, national reserves depleted by transfer of funds to bailouts and economic stimulus, have led to increasing collusion between finance capital players and politics, and have radically changed social and political economies.

The aim of this thesis is to address global debt crises and the enduring effects of the global financial crisis by providing evidence to support the introduction of a global financial transaction tax (FTT). It will be argued that this progressive economic reform will provide the audit mechanisms, accountability controls, and frameworks needed to ameliorate the deleterious effects of a dysfunctional market destabilising civil society.

A global FTT has the capacity to add US\$800 billion into economies around the world that participate in, or allow markets to operate from sovereign territories. An FTT is supported by progressive political players, but blocked by financial market lobbyists. This thesis examines global initiatives underway to support proposals.

In order to achieve this key aim, the thesis also considers the underlying economic implications directly related to modelling FTT architecture and how outcomes will be of benefit to the wider global civil society.

The rationale of this dissertation draws on previous works by the author, draws together, and examines the volume of recent work by scholars in the field of International Political Economy. This work is timely, as many politicians and academics have argued for an FTT.

Against this there has never been assembled such an intensive lobbying effort to deride and discredit the foresight and social morale galvanised by those who believe that the rights of secretive and greedy shadow economy players should be placed ahead of community and social goods, and that an equitable distribution of wealth is the sustainable way to support global goods, equality and fairness.

Gathering material to substantiate claims of market dysfunction and building evidence to support a financial transaction tax is to be carried out through three specific mechanisms. First, data from comparative sources of economic expertise (Keynes, Minsky, Krugman, Morris, et al.) is sourced and referenced against the abundance of articles, papers and data in reputable carriers such as the *Economist*, the *Guardian*, the *Financial Times*, the *New York Times* and academic papers whose commentary on changing financial market circumstances provide pieces to the puzzle as new developments overtake those that are known.

## **1.2 Methods**

Gathering material to support an argument for accountability in financial markets has been carried out through specific strategies. Because of the historical nature of financial crises and downturns, including sovereign debt, and austerity measures in Europe, there is a requirement to access accredited material available online. Research data has been sourced from many fields. In 2008-09, the University of Tasmania assisted with a research and study trip in the United Kingdom. I studied at the London School of Economics and interviewed political economists in London. This was a time of high volatility in global markets and the Global Financial Crisis was emerging.

To understand the political and economic context I have researched the works of Keynes, Minsky, contemporary economists, Krugman, Stiglitz, Simon Johnson and published works by Charles Morris, Satyajit Das, and, Nigel Dodd. I have sourced and referenced against the abundance of articles, papers and data in reputable carriers such as The *Economist*, The *Guardian*, The *Financial Times*, The *New York Times* and journals whose commentary on changing financial market circumstances provides linkages to the arguments and information.

Recent articles by political economists suggest that neoliberal ideologies have exerted an influence on capital players and helped accentuate social inequalities across the world. In this respect, I have drawn on material from contributors of all sides of the political spectrum. I have examined heterodox economic responses to these issues, including the works of Professor Dick Bryan of the University of Sydney, who has written extensively on the “money crisis” within the context of the global financial crisis and its current phases.

I have referred to Pakulski’s (2005) key text “Globalising Inequalities: New Patterns of Social Privilege and Disadvantage”. This work seems timely, as Pakulski has provided a framework to examine the different forms of inequality through this past decade. Whilst the global economy lifts millions out of poverty in India and China, socioeconomic events in

developed countries have resulted in widespread unemployment. Spain's youth unemployment attests to social problems as economies slow down, as is currently occurring.

Many books have been published on socio-economic and political issues related to the current global market conditions. Many have been referenced extensively in this thesis. Other material has been resourced from the London School of Economics Financial Markets Group Paper Series with contemporary discourse on social and financial issues. The City UK market Group provides market analysis through linkages to the Bank of England and the Bank for International Settlements providing credible evidence of changing market dynamics.

I have noted the research available and I am informed by my occupation within a government housing department of the linkages between financial markets, their effect on economies and the serious nature of social inequalities. Research has centred on developing an argument that supports policy reforms that lead to the strengthening of oversight and policy measures that afford citizens the opportunities to outcomes that are not limited to the ebbs and fluctuations that occur in social circumstances delivered by unregulated and unaccountable market players.

I am informed by research on concentration of wealth patterns, consolidation of financial market entities and new ways of sophisticated trading mechanisms. I am informed that these conditions will put further stress on citizens if not addressed in a responsible manner. My research addresses these issues and promotes options that are available at this point. Because of the changing nature of these social and economic problems, and the emotive nature of the subject, balanced new material has been difficult to access.

### ***1.3 Structure of the Thesis***

As stated earlier, this thesis examines the socialisation of debt and the rise of political, monetary, and fiscal policy that has supported the regime of financialisation. As part of this examination, Chapter 2 (The Financialisation of Global Markets) and Chapter 3 (The Social Consequences of Financial Markets) detail the rise of finance as the dominant politically endorsed structure over three decades. Both chapters provide an overview of expansionary economics and the rise and fall of the theory which encapsulated the social reform of high levels of home ownership as a vehicle from which capital markets engineered powerful forms of accumulated risk through financial engineering.

Chapter 4 (Global Financial Systems) consolidates the previous two chapters as it describes the systems of finance that influence both global and local economies. Chapter 4 describes systemic risks which arise from sophisticated trading networks of algorithm and “flash” trades, a trading system that becomes integrated both by scientific advancement and networks of ownership throughout the world. These financial market systems have been legitimised by neoliberal political economy regimes over the past four decades and provide high-net-worth individuals and elite corporations with exceptional political power. These are the systems that a global financial tax would oversee and provide oversight. These are systems that enable speculative trades of nearly US\$700 trillion a year.

Chapter 5 introduces the conceptual frameworks for a financial transaction tax, which could provide a minimal tax on each individual financial transaction. Cumulatively, significant resources would be made available to those countries enabling transactions to and from their sovereign space. Chapter 5 develops the central issue of accountability of finance and financial systems described in chapters 2–4. A financial transaction tax would be a legitimate tool specifically engineered for the process of providing a resource base to speculative unregulated capital trades. An FTT will not stop or lesson trades as has been touted by those lobbying against its introduction. It actually benefits traders by further legitimising their activities whilst holding them accountable for some of the negative aspects that trading produces. Chapter 5 scopes the framework and approaches to deliver equity.

Chapter 6 builds on chapters 4 and 5 by describing the nature of political instability sitting alongside economic instability as the frameworks that confront developing and developed nation states in 2012. The instability of the European economies threatens world growth and viability. Chapter 6 examines three critical intersections of global economic and political importance. The first is the balance of power between the developing Eastern economies and the developed nation states of the West, primarily the G20 counties. Chapter 6 looks at the rise of the Beijing Consensus as it overtakes the Washington Consensus in political economy and social terms. This chapter examines the socialisation of debt as developed, highly in-debt nation states provide public funds to bail out and rescue corporations. Chapter 6 presses the point that a global financial tax will provide a policy framework to dampen speculative trades, make market trades accountable, and concomitantly advantage nation state economies with a resource to reactivate public account systems. . It posits an argument that revenues in Australia, the eighth largest derivatives transaction trading nation in the world, should be used specifically to strengthen national social policy commitments to homelessness, and

provide a targeted resource for sustainable social housing provision. The consequences of the continuing financial crises on democratic systems are in its early stages. Many established academics support the claim that democracy fails in the current phase of financial crises.

Together this thesis poses the central question: given the structural shift in the balance of economic power from the West to the East and the socialisation of debt in neoliberal developed economies, is the introduction of a global financial transaction tax a progressive economic and social reform to ameliorate the effects of speculative finance capital on nation states? Could revenues help stabilise the economic and social effects?

#### ***1.4 Introduction***

The financial transaction tax is a socially progressive proposal supported by eminent economists and global leaders. Originally suggested by Nobel Laureate Economist James Tobin in 1961, the idea of the tax has been topical, and contested, for five decades. It is, by design, an instrument to deal with the pressures of transnational finance activities. On August 1 2012, France became the first major European country to introduce a Financial Transaction Tax into law, with a tax rate of 0.2 per cent on three types of transactions. Fifteen European countries are now supporting or closely examining proposals.

The last three decades has resulted in the globalisation and integration of financial markets. This has lead to unprecedented growth in global financial trade and speculation causing widespread economic and social pressures. Burgeoning derivatives markets are becoming concentrated. Market share<sup>1</sup> of the 10 largest firms in the United Kingdom has increased from 71 per cent in 2001 to 92 per cent in 2010. The largest 20 firms accounted for 99 per cent of turnover. In the United States, the largest 10 financial entities accounted for 95 per cent of turnover in 2010. Many entities operate from tax havens where \$US 21 trillion<sup>2</sup> is currently being held.

More recently, pressures on civil society have arisen through governments allocating taxpayer funds to bail out private institutions and to stimulate debt-ridden economies. Civil society and public sector resources have been drained in an attempt to strengthen private sector accounts. The socialisation of private sector debt<sup>3</sup> has been a feature of contemporary

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<sup>1</sup> “Derivatives 2010”. *TheCityUK*. December 2010. ([www.TheCityUK.com](http://www.TheCityUK.com))

<sup>2</sup> “US 21 Trillion hidden in tax havens” Tax Justice Network –McKinsey Consultants. *ABC News* 23 July 2012

<sup>3</sup> Public sector finance transferred to cover private sector debts during recent phases of financial crises.

macroeconomic policy settings across most developed states. Globalisation of finance has contributed to financial instability<sup>4</sup>.

Banking and financial system speculation and concomitant fragility has spread rapidly from the United States to Europe and, to a lesser extent, Australia. The International Monetary Fund estimates debt levels in the G20 countries to be \$US 30 trillion. Ratings agency Standard and Poor's forecasts a "global wall" of nonfinancial corporate debt maturities, due from 2012 to 2016, which will need to be refinanced over the next five years, at US\$ 43 to US\$ 46 trillion<sup>5</sup>. Standard and Poor's argues that this factor, amid the current Euro zone crisis, a soft US economic recovery following the Great Recession, and the prospect of slowing financial growth, raise the downside risk of a "perfect storm" for credit markets. There is a growing scenario of global recession that politicians fail to explain. Historian Antony Beevor<sup>6</sup> suggests, "the public have not been told about how desperate the situation is because no politician, then or now, dares to spell it out."

As a direct consequence of the global credit squeeze, unemployment, and increasing nation state debt levels have occurred across civil, industrial and resources sectors with millions of workers now facing unemployment, or underemployment. For global citizens, particularly those located in developed states, the horizontal linkages that often integrate social communities are being replaced by vertical ties binding the individual to the state. Global civil societies face considerable inequalities. There is a risk of a job-less generation, disconnected, and left behind.

Two economies have emerged, in parallel, throughout the developed world. The first, the "real economy" (of developed nation states) has been depleted of resources by the global crisis in finance. Second, the "shadow economy", has re-emerged (following the 2008 financial meltdown), as a dominant force with daily global currency trades of over US\$4 trillion, underpinned by burgeoning derivatives markets. Derivatives markets are recording record turnovers of nearly US\$700 trillion. Seventy seven per cent of these trades are speculative. A concentration of wealth and political power is evident in this shadow economy. It is within this context that social accountability of finance becomes the key

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<sup>4</sup> Hugo Banzinger. "Did the Globalisation of Finance Undermine Financial Stability? Lessons in Economic Stability." *London School of Economics Financial Markets Group Paper Series. Special Paper 211*. June 2012.

<sup>5</sup> *Standard and Poor's*. "The Credit Overhang: Is a \$46 Trillion Perfect Storm Brewing?" 10 May 2012. ([www.cpfinancial.net/.../the-credit-overhang-is-a-perfect-storm](http://www.cpfinancial.net/.../the-credit-overhang-is-a-perfect-storm))

<sup>6</sup> Antony Beevor. "Beevor's Europe crumbles." Quoted in Review. *Australian Financial Review*. 15 June 2012. ([review@fairfax.com.au](mailto:review@fairfax.com.au))

question of this thesis. Can finance capital be allowed an elite market space, and political protection?

Global political leaders, economists, and civil society groups have endorsed conceptual frameworks supporting a global or local financial transaction tax (FTT). European countries are examining its merits, and motives. In June 2012 the European Parliament<sup>7</sup> voted in favour of the European Commission's proposal for a financial transaction tax. Eleven European countries have now supported implementation of an FTT<sup>8</sup>.

An FTT on financial trades would ameliorate some of the detrimental social impacts from the present financial crisis and provide a framework, and rationale, to prevent further disruption. An FTT would provide oversight and accountability on speculative finance capital activities on a global and nation state level.

For promoters of rapid deregulation of the global economy attached to policy settings pursued under such labels as "Neoliberalism", "Anglo-Saxon", "Anglo-American Model", or "the Washington Consensus"<sup>9</sup>, persistent and rising inequality was until recently only a modestly embarrassing imperfection in an otherwise appealing picture of market prosperity. This prosperity appeared more tangible through booming housing markets and an increasing display of wealth in most developed countries around the globe.

However, this was a prosperity missed by those in civil society who were unable to access the wall of hedge fund enabled finance capital in the "carry trade" credit markets. These were markets where US dollar surpluses held in China and Asia coursed back through the United States and on to Australia for housing, motor vehicle, investment and personal debt. Ferguson<sup>10</sup> argues that over-leveraged personal and business finance is a contemporary feature of modern developed state economies.

Inequality among nations has been explained by the insistence that the leaders of poorer nations had not been pursuing the right policy mix of deregulated markets, privatised

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<sup>7</sup> "EU Parliament votes for financial transaction tax." KPMG. ([www.kpmg.com/.../taxandlegalnewsflashes/](http://www.kpmg.com/.../taxandlegalnewsflashes/))

<sup>8</sup> Spiegel Online International. Banking and Finance. "Eleven EU Countries Agree on Transaction Tax." 10 September 2012.

<sup>9</sup> John Williamson. "What Washington Means by Policy Reform". In "Latin American Readjustment: How Much has Happened" *Institute for International Economics* 1989. The concept and the name "Washington Consensus" originated in 1989 through John Williamson, an economist from the Institute for International Economics, an international economic think tank based in Washington D.C. Williamson used the term to shared economic policy themes amongst Washington based institutions at the time (including the International Monetary Fund, World Bank, and U.S. Treasury Department).

<sup>10</sup> Niall Ferguson. 2011. *Civilisation: The West and the Rest*. Amazon Press. 2011.

government services, weakened labour unions, and most importantly a readiness to accept carry-trade<sup>11</sup> investments from the growing number of hedge funds and sophisticated financially engineered products.

These global inequalities were identified and remedied by World Bank and International Monetary Fund operatives preaching “open market” doctrines to new funding recipients. Non-compliance was viewed as a perceived weakness demonstrated by hesitant governments resisting deregulation.

By the last years of the twentieth century, this rationalisation was undercut by a string of economic disasters that had befallen governments whose leaders and policies were considered exemplary of the new capitalist modelling. México, Thailand, Indonesia, Korea, Japan, Brazil, and Russia adorned the gallery of nations whose economies soured shortly after their leaders were lauded by the global policy elite for pursuing sound economic fundamentals.

Around the same time, the failure of Long Term Capital Management in the United States in 1998 exemplified the massive leverage risks in corporations and markets, increasingly decoupled from the real economy and historic financial models of trade and development. New sophisticated hi-tech transfers of capital through unregulated and largely unknown players were emerging within the shadow economy (and shadow banking systems<sup>12</sup>).

The first decade of the new century (2001–2012) has witnessed the most extraordinary political and socioeconomic events, startling in scale and veracity, yet not entirely unanticipated given the nature of speculative global capital trades and heavily debt laden economies.

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<sup>11</sup> Investors borrowing at low interest rates (in low rate states including Japan and the United States) and lending long to businesses and ultimately consumers in countries where interest rates are comparatively high (Australia and European countries). “Carry Trade” finance has been a dominant form of credit distribution in developed nation states.

<sup>12</sup> Bryan J. North and Rajdeep Sengupta. “Is Shadow Banking really Banking?” *The Regional Economist*. October 2011. (The term “shadow banking” has been attributed to remarks by economist and money manager Paul McCulley to describe a large segment of financial intermediation that is routed outside the balance sheets of regulated commercial banks and other depository institutions. Shadow banks are defined as financial intermediaries that conduct functions of banking “without access to central bank liquidity or public sector credit guarantees.” The size of the shadow banking sector was close to \$20 trillion at its peak and shrank to about \$15 trillion last year, making it at least as big as, if not bigger than, the traditional banking system).

When governments hand control of regulated capital markets to unregulated margin-seeking traders, this disconnect becomes palpable, and dangerous. Policymakers, influenced by lobbyists in the two largest financial trading nations, the United States and the United Kingdom have downgraded and off-shored industrial development, heartland manufacturing, and home-grown research and development, in favour of financial services headquarters in Wall Street and Canary Wharf. Between these two locales, 85 per cent of the total global currency speculative trades of US \$4 trillion are transacted every day of the year<sup>13</sup>.

Rhodes and Stelter<sup>14</sup> argue that the levels of debt in the global financial system are unsustainable and that the developed countries must immediately address the crisis of debt. Rhodes and Stelter contend:

Total debt-to-GDP levels in the 18 core countries of the Organisation of Economic Co-operation and Development (OECD) raised from 160 per cent in 1980 to 321 per cent in 2010. Disaggregated and adjusted for inflation, these numbers mean that the debt levels of non-financial corporation's increased by 300 per cent, the debt levels of governments increased by 425 per cent and the debt levels of private households increased by 600 per cent. But the costs of the West's aging populations are hidden in the official reporting. If we include the mounting costs of providing for the elderly, the debt levels would be significantly higher. Add to this sobering picture the fact that the financial system is running at unprecedented leverage levels, and we can draw only one conclusion: the 30-year-old credit boom has run its course. The debt problem simply has to be addressed.

Underpinning this considerable growth in capital markets, and overlaying socioeconomic civil society patterns, has been the continuance, over the past two decades, of a new phase of accumulation associated with the concentration of capital through centralised financial centres. Streithorst<sup>15</sup> argues that since the 1980s, debt has been the world economy's essential engine of growth.

Capital centres emerge alongside, support, and influence capital elite stakeholders over real economy socioeconomic outcomes and strategies in all forms of government policymaking. The new macroeconomic structures are underpinned by financialisation of global markets splitting traditional and historical global investment and development funds and trades (real economy); into highly complex linkages between agents and borrowers in finance capital markets (shadow economy). The 2008 financial crisis and the resultant stagnation of

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<sup>13</sup> Bank for International Settlements. 2011.

<sup>14</sup> David Rhodes and Daniel Stelter. "Collateral Damage: What Next? Where Next. What to expect and how to Prepare." *The Boston Consulting Group*. January 2012

<sup>15</sup> Tom Streithorst. "Debt is Good." *Prospect Magazine*. 3 February 2012.

economies is often attributed to the spread of shadow banking which accounts for a third of total banking assets globally<sup>16</sup>.

The impact of financialisation reinforces and enables capital accumulation amongst high net wealth individuals and corporations, influences political outcomes, turns politicians into servants, and, most grossly, develops a new phase of socioeconomic inequity. It has provided the structural vehicle for the socialisation of debt. In pursuit of the next sophisticated instrument to trade fast and with stealth, the recently crippled investment banks including Goldman Sachs have re-emerged with massive profits and rewarded, again, top traders with top packages.

A rising tide of angst and disbelief amongst civil society leaders and policymakers has forced an open enquiry into cash market accountability<sup>17</sup> following disclosure of the LIBOR rate fixing scandal. More incessantly, past and present operatives of Goldman Sachs now occupy top-level government offices in Italy and Greece as most European countries enter turbulence occasioned by a sovereign debt crisis.

Considerable energy has recently been shown by the leader of the United Kingdom based Financial Services Authority (Lord Adair Turner), German Chancellor Angela Merkel and newly elected French President Hollande to introduce a miniscule tax on speculative global financial transactions as a means to ameliorate the socialisation of debt. These proposals for a publicly accountable global financial transaction tax have been mooted since the idea was first put forward by Nobel Laureate Economist James Tobin in the 1960s. The case for broader tax imposts on speculative capital had been promoted by John Maynard Keynes decades earlier.

Despite the “unfashionable” nature of the tax and attempts by financial institutions and hedge funds to dismiss this progressive idea, the recent greed by financial players and capital elites has seen a new investigation of the merits of the tax as a means of countering the deleterious effects of the global recession on society.

The proposal for financial transaction taxes (FTTs) has seen renewed urgency (late 2011–12) that has brought French President Hollande, German Chancellor Merkel and European leaders together to discuss and recommend the proposals put forward.

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<sup>16</sup> “Shadow Banking: A European Perspective.” Conference Description narrative. City University. London.

<sup>17</sup> British Bankers Association “Calculating Interest” 17 July 2012.  
([http://www.bbalibor.com/technical\\_aspects/calculating\\_interest](http://www.bbalibor.com/technical_aspects/calculating_interest) )

Anni Podimata, the Member of the European Parliament spearheading Parliament's position on establishing a financial transaction tax, issued a statement about the intention of 11 European countries to press ahead with the FTT. The newly formed Dutch Government formed on 31 October 2012 became the 11th out of 27 European Union countries to support and adopt an FTT. Podimata stated:

I welcome the decision of 11 Member States to introduce a Financial Transaction Tax under enhanced cooperation on the basis of the Commission proposal of September 2011. It is a socially fair tax, an indispensable part of a complete and coherent solution to exit the crisis. This is a reward for Parliament, which has been calling for an FTT for over two years. It will contribute to shifting the burden from the citizens to the financial industry - which has not yet contributed its fair share to the cost of the crisis. It will target the most speculative activities and at the same time provide finances equal to more than half of the EU's annual budget at a time of intense fiscal consolidation. We will continue to bring on board the greatest possible number of member states.<sup>18</sup>

Many versions have been promoted by politicians and researchers and have included a tax localised to financial areas such as Europe and Asia. A global financial transaction tax is the most ambitious and encompassing model, as it is fair and equitable, and imposes most effect on speculative capital market players; those that increasingly monopolise the markets in the United States and United Kingdom. A global financial transaction tax on capital inflows and outflows from Australia, the sixth largest global trader, could bring AU\$6 billion in revenues<sup>19</sup>.

Recently the former chief of the International Monetary Fund and now Professor of the Sloan School of Management at the Massachusetts Institute of Technology, Professor Simon Johnson, likened the hold of the "financial oligarchy", over US policy, with that of business elites in developing countries including Russia. Other commentators agree. Certainly, the mix of capital elites and policymakers is starkly evident in Washington, and in Europe where high profile entities with links to high finance have been chosen, not elected, to power. Professor Johnson argues that the weight of the US financial sector, on government, is preventing a resolution of the current crisis saying<sup>20</sup>:

In its depth and suddenness, the US economic and financial crisis is shockingly reminiscent of moments we have recently seen in emerging markets. The similarity is evident: large inflows of foreign capital; torrid credit growth; excessive leverage; bubbles in asset prices, particularly property;

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<sup>18</sup> European Parliament Press Release. *Financial Transaction Tax: Anni Podimata welcomes plan to press ahead*. 26 October 2012.

<sup>19</sup> For background access (<http://eprints.utas.edu.au/1034/>

<sup>20</sup> Martin Wolf. "Is America the new Russia?" *Financial Times*. 14 April 2009

and, finally, asset-price collapses and financial catastrophe. But there's a deeper and more disturbing similarity: elite business interests – financiers, in the case of the US – played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of the government, until the inevitable collapse. Moreover, the great wealth that the financial sector created and concentrated gave bankers enormous political weight.

Johnson suggests that the GFC has unearthed many unpleasant truths about the United States and foremost amongst these is that the financial industry has effectively “captured the government”, a state of affairs that more typically describes emerging markets and is at the centre of many emerging market crises and, further, that “recovery will fail unless we break the financial oligarchy that is blocking essential reform. And if we are to prevent a true recession we are running out of time.”<sup>21</sup>

Governments in the United States, United Kingdom, Greece, Italy, Ireland, Spain and Australia, have all been a part of the momentous cycle of financial infusion and cross-border flows of capital over this decade. Each country (apart from the resources-driven and China-focused Australian economy) is suffering a severe downturn that is savagely effecting employment, exports, consumer, and housing markets. Most nation states, developed and developing are undergoing considerable realignment in the face of the crises that have swept aside modern convention and changed global outlooks substantially, perhaps forever.

The realignment is integrated further in the dynamic of developing nations versus the failure of developed nations to absorb the mismanagement of mountains of debt accumulation, particularly over the past decade (2001–2011).

Economist Simon Johnson provides a summary in this end game scenario in *The Atlantic*:

The conventional wisdom among the elite is still that the current slump “cannot be as bad as the Great Depression.” This view is wrong. What we face now could, in fact, be worse than the Great Depression—because the world is now so much more interconnected and because the banking sector is now so big. We face a synchronized downturn in almost all countries, a weakening of confidence among individuals and firms, and major problems for government finances. If our leadership wakes up to the potential consequences, we may yet see dramatic action on the banking system and a breaking of the old elite. Let us hope it is not then too late.

There has recently been a social resurgence and urgency of world leaders seeking global economic and social reform. A global hedge fund research organisation issued results of a

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<sup>21</sup> Simon Johnson. “The Quiet Coup.” *The Atlantic Online*. May 2009.  
( <http://www.theatlantic.com> )

survey of member funds that predicted another severe financial meltdown would occur within five years if financial market players continue efforts to avoid any form of regulation.

Further financial dysfunction and social disruption has emerged in Greece, which has implications for the European Union (EU) and particularly debt-laden Spain, Ireland, Italy, and the United Kingdom. The tenuous nature of slow recovery from the GFC has been further heightened by the nature of dealings between European states and Wall Street over the past decade. Revelations of how Wall Street entity Goldman Sachs helped to mask problems with the debt-fuelled Greek and Italian economies has led economists and commentators to forecast a decade of further economic and social unrest caused by the seemingly terminal nature of debt suffocation across European economies.

An example of close political and corporate dealings is the relationship of ex-Goldman Sachs operative, now Italian Prime Minister Mario Monti, who is now overseeing Italian reform. Monti recently supported<sup>22</sup> the growing push for a European FTT being championed by French President Hollande and Germany's Chancellor Angela Merkel.

The newly instated Greek and Italian leaders are also past Goldman Sachs insiders. The new European Central Bank President, Mario Draghi<sup>23</sup>, was Goldman Sachs International's vice-chairman for Europe between 2002 and 2005, a position that put him in charge of the "companies and sovereign" department which, shortly before his arrival, helped Greece to disguise the real nature of its books with a swap on its sovereign debt.

Mario Monti was an international adviser to Goldman Sachs from 2005 until his nomination to lead the Italian government. According to the bank, his mission was to provide "advice on European business and major public policy initiatives worldwide". As such, he was a "door opener" with a brief to defend Goldman's interest in the corridors of power in Europe<sup>24</sup>.

Lucas Papademos was the governor of the Greek central bank from 1994 to 2002. In this capacity, he played a role that has yet to be elucidated in the operation to mask debt on his country's books, perpetrated with assistance from Goldman Sachs. In addition, perhaps more importantly, the current chair of Greece's Public Debt Management Agency, Petros Christodoulou, also worked as a trader for the bank in London.

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<sup>22</sup> Colleen Barry. "Monti backs French and German push for FTT." *Associated Press*. 11 January 2012.

<sup>23</sup> "Our Friends from Goldman Sachs." *Le Monde Diplomatique, Paris*. 16 November 2011.

<sup>24</sup> "Our Friends from Goldman Sachs." *Le Monde Diplomatique (ibid)*

Effectively, the rescue efforts of governments in the immediate past (2008–2011) have been to transfer private corporate debt to the government balance sheet, thus adding additional burdens on the states' social and economic responsibilities. Taxpayers and citizens who rely on state support systems will see social supports and services wound back, in austerity measures that will not hurt elites with capital secreted in tax havens which add US\$ 1.2 trillion each year to the existing accumulated US\$ 21 trillion that is stored in global tax havens and shelters<sup>25</sup>. Australia loses over AU\$ 20 billion to offshore tax shelters each year.

The International Monetary fund (IMF) reports<sup>26</sup> that G7 nations now owed a combined debt of \$US 30 trillion. Economic commentator Associate Professor Steve Keen of the University of Western Sydney forecasts at least a decade of economic and social turmoil caused by an emerging contagion of debt problems across Europe and the possibility that Greece's problems will spread to the wider global economy. In shades of the sub-prime deals and sophisticated economic architecture to conceal bad debts inherent in collateral debt obligations, financial derivatives are playing a strong role in the Greek issues. In dozens of deals across the Continent over the past decade, US banks have provided "off-the-balance sheet cash to countries in return for payments in the future. In the case of Greece, that cash return comes from traded away rights to the banks to accept airport fees and returns from the Greek national lottery<sup>27</sup>.

True reform for real balance to ameliorate the deep-set social losses from financial market players will be hard won, against a very highly resourced opposition, and it will take time. A financial transaction tax is the first step in making markets accountable and resourcing public accounts.

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<sup>25</sup> John Christensen. The Tax Justice Network. "The fight against tax havens, avoidance and evasion". *Australian Broadcasting Commission*. 23 November 2011.

<sup>26</sup> Rick Wallace. International Monetary Fund Report. "Economists Differ on effect of Greek Troubles: Recovery to survive debt crisis." *The Australian Newspaper*. 13-14 February 2010.

<sup>27</sup> "Wall Street Helped to mask Debt Fuelling Europe's Crisis." *The New York Times*. 14 February 2010.

## Chapter 2

### The Financialisation of Global Markets

#### 2.1 Introduction

This chapter provides evidence of the “financialisation<sup>28</sup>” of global financial markets in the context that increased speculative finance activity, within the shadow economy, creates tensions for nation states, whose control of the real economy becomes increasingly more difficult. The proliferation of speculative transactions has created a shadow economy, essentially reconfiguring capitalism in modern times. This chapter describes the growth of shadow economies and particularly the rise of the financial architecture that enables the markets.

The primary cause of the current crisis<sup>29</sup> in capitalism has been the global dysfunction of financial markets, unaccountable and opaque, discretely distant from the control of nation-states. Whilst these shadow systems of corporate trading take place parallel but removed from real economy business systems, which are subject to the tax rules and regulations of nation states. Bryan argues that the ongoing financial crisis first manifested “as a crisis in stores of value, and in that sense it has not been a ‘financial crisis’ pertaining to financial institutions and their solvency, but also a ‘money crisis’ pertaining to what is used in financial markets as money.” Further Bryan<sup>30</sup> suggests, in respect to transfer to public money to the private sector:

But in this crisis, the value of these assets crashed and their moneyness disappeared –that’s what is meant by a liquidity crisis. It seems to me very significant that the first intervention of the governments and central banks was not about shoring up financial institutions directly, it was to say to financiers: bring in your mortgage-backed securities and we will convert them into state money. ... In the sense that when their moneyness suddenly disappeared the state sought to convert them into another form of money.

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<sup>28</sup> Randall Wray. “The rise and fall of money manager capitalism: a Minskyan approach.” *Cambridge Journal of Economics*. (2009) 33(4):807–28, Stephanie Blankenburg and Palma, Jose- Gabriel. “The revenge of the market on the rentiers: why neo-liberal reports of the end of history turned out to be premature.” *Cambridge Journal of Economics* (2009) 33(4):829–66 in “Introduction: the global financial crisis.” Blankenburg and Palma (2009) focused on the causes and nature of the current financial crisis, Wray and Palma (2009) attempt a more wide-ranging historical analysis of what went wrong and why. Wray takes a Minskyan stance from which he provides a detailed account of the gradual transformation of finance capitalism throughout the twentieth century. Intentionally taking a step back from the detailed analyses of unfolding events and the debate surrounding policy responses to these, Wray examines the historical antecedents of today’s ‘money manager capitalism’ through the lens of the works of Veblen, Hilferding, Keynes, Schumpeter and, Minsky. He proceeds to analyse the rise and fall of contemporary ‘money manager capitalism’ from the 1970s through to the current crisis. Successfully managing to bring together economic history, the history of economic thought and detailed technical knowledge of financial structures in one overarching account of why we are where we are now,

<sup>29</sup> Serge Halimi “Undo the Maths” *Le Monde Diplomatique*. 2 August 2012. (Halimi suggests that the current crisis is one of the worst in history)

<sup>30</sup> Dick Bryan. “The underlying contradictions of capitalist finance.” *Workers Liberty*. 30 June 2009.

This chapter distinguishes the growth and sophistication of speculative systems of financial trade and concludes that it is ethical, equitable and responsible for global nation states to impose a financial transaction tax to in effectively replenish depleted public accounts.

The design of the FTT is to raise revenue and modify the behaviour of financial institutions and markets in order to minimise excessive risk-taking and speculation. Opaque speculative activities are widely seen as detrimental to the healthy functioning of financial markets. Financial transaction taxes have a very long history, but have gained much more interest and appeal in the wake of the global financial crisis of 2008. Their appeal has elevated since the European debt crises of 2010–2011. Regulation through FTT approaches will make market players accountable.

## **2.2 *Background to a Structural Crisis***

Martin Wolf (2011) argues that because of the Global Financial Crisis there has been a limited but cautious recovery in many countries including the United States and the United Kingdom. There is, however, a major sovereign debt crisis in Europe and very high levels of unemployment in most developed countries. As such, the capacity of nation states to defend claims on welfare budgets is severely depleted. Many counties in Europe teeter on the verge of bankruptcy. Wolf argues that:

The immediate aftermath of the financial crisis that reached a crescendo in the autumn of 2008 was an economic collapse. This was accompanied by heroic action and followed by a welcome recovery. Now we are beginning to see a new shape to the world economy. This is a divided world. It is divided partly because the illness – asset price bubbles, excessive leverage and financial sector irresponsibility – directly affected a number of high-income countries, including the biggest of them all, the US. It is also divided because some of the medicine the high-income countries are taking is having harmful side-effects on the rest of the world.<sup>31</sup>

Upheavals in global financial markets have occurred with increasing intensity. Financial market volatility in Europe, Russia, the United States of America, Mexico, Southeast Asia and Argentina, have caused considerable anxiety to policymakers and created both social and financial disruption on a global scale.

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<sup>31</sup> .” Martin Wolf. “A World Divided by a Common Economy.” *The Financial Times*. 25 January 2011

The 2008 Global Financial Crisis (GFC), and the ensuing credit squeeze contagion, is the worst financial crisis since the Great Depression and have redrawn the boundaries between governments and markets. The GFC has reconfigured the role of capitalism in modern times. It has drawn analysis to the developing societies in Southeast Asia and India as dynamic consumer producers to Western countries as direct consumers, with the concomitant transfers of capital from the West to the East. It has drawn analysis to the growing disconnect of developed consumer economies principally represented by but not limited to the group of twenty nations (G20), and developing economies India and China, which by contrast have a focus on trade and manufacture of consumables. This tension between developed and developing states is a critical feature in this debate. These are crises emanating from the rise in the dynamic of financialisation.

Goldstein<sup>32</sup> argues that much of the literature on the specific subject of financialisation is less than a decade old. Epstein (2005:3)<sup>33</sup> quotes some earlier references to financialisation from papers presented to a political economy conference in 2001 arguing that whilst a common definition had not emerged in existing literature, clear tendencies had emerged. In this regard Goldstein follows the dominant trend offered in early subject literature by Hilferding (1981)<sup>34</sup> in his concept that financialisation is a process that alters the fundamental aspects of capitalist micro and macroeconomics. Hilferding argued that the fusion of banking finance and industry led to forms of financialisation.

Further, Goldstein suggests that Hilferding's study of a new phase of capital accumulation associated with the concentration and specialisation of speculative financial instruments of trade, associated with a rise in power of financial players, provides a framework to analyse the resurgence of influence that financial markets have over economic and social policies in the neoliberal era. Financialisation affects real<sup>35</sup> economy accumulation, rising macro-instability, inequity, economic crises amongst most global states, and the subsequent formation of policy settings<sup>36</sup>.

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<sup>32</sup> Jonathon P Goodstein. "The Political Economy of Financialisation." *The Review of Radical Political Economics*, Volume No.4. Fall. 2009. Page 453.

<sup>33</sup> Gene Epstein. "*Financialisation and the World Economy*." Edward Elgar. Cheltenham. UK .2005

<sup>34</sup> Jonathon P Goldstein. "*Heterodox macroeconomics: Keynes, Marx and Globalisation*." J.P. Goldstein and M.G. Hilliard.. Routledge. London and New York 2009

<sup>35</sup> Real economy refers to nation state controlled domestic resources. Shadow economy refers to speculative largely unregulated inter-nation capital movements such as futures and open leverage from derivatives markets.

<sup>36</sup> Also, see Demir (2007), Crotty (2003, 2005), Orhanganzi (2008), and Krippner (2005).

The financialisation of integrated global markets is both an economic and political construct. The closer global financial markets come to genuine integration, the more centrally they act in absorbing and challenging the political authority of states. For over three decades, the political paradigm has been to “open up” and deregulate financial markets to absorb global influence in competitive trading paradigms, earlier related to goods and services, and more recently to financial speculation.

The strongest political systems have engineered a shadow economy, initially through the United States and United Kingdom axis; the so-called Anglo-Saxon financial market system of financial trading identifiable by the Washington Consensus model of economic and social design. A design built around low tax, low regulation, and minimal government interference.

Alliances between political elites and finance capital market players over the past three decades of financialisation have contributed to the sell-out of nation state wealth.

Leyshon and French<sup>37</sup> argue that in the wake of the 2007-2009 financial crisis there appeared to be an opportunity to change the dominant role of financial capital in the process of financialisation. They argued that in the post crisis period political opportunities existed to intervene and reign in the role of investment banks and financial institutions. This rationale had been a result of government’s actions to bailout and nationalise private sector entities. Leyshon and French suggested:

For a brief moment, such intervention appeared to have dealt a significant blow to the ideological confidence of neoliberalism and its faith in the supremacy and infallibility of markets as a mechanism for allocating resources. Things were going to be different in the wake of the largest financial crisis for seventy years.

Further Leyshon and French state that intervention and reform of financial capital markets could have been achieved by “a revival of ideas displaced and disparaged during the thirty or so years of neoliberal dominance. Leyshon and French draw on the works of political economists Nesvetailova and Palan<sup>38</sup> who argued:

At the level of theory in the midst of the imploding financial markets and banking systems in 2008, there was a seemingly serious debate about the return to Keynesian norms of financial regulation and a Minskyian framework for understanding finance”

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<sup>37</sup> Andrew Leyshon and Shaun French. “These f@#king guys; the terrible waste of a good financial crisis” *Environment and Planning A* 2010. Volume 42, pages 2549-2559.

<sup>38</sup> Anastasia Nesvetailova and Ronan Palan “The end of liberal finance? The changing paradigm of global financial governance” *Millennium: Journal of International Studies* 38. 2010

Contrary to the opportunities that were available to moderate the effects of financialisation, excessive speculation in markets, and concomitant social consequences, a series of events has developed subsequently to give rise to a new form of market liberalisation enabled by a new form of political and financial collusion described by Leyshon and French as “distributive coalition” and further that:

The financial crisis was indeed a catalyst for change, but rather than developing a form of capitalism wherein the state exerted more control over the economy it seems conversely to have heralded an age of austerity and an emboldened form of hyper-neoliberalisation which, as it takes form, has resulted in families ... paying bankers bills through rising taxes, shabbier public services and higher unemployment<sup>39</sup>.

Moreover, Leyshon and French suggest that:

according to the Institute of Fiscal Studies (IFS, 2010)<sup>40</sup>, in the UK at least it is the poorest families that will be expected to pay the highest price. At the same time, as financial markets have rebounded, so the high salaries and bonuses of the New York and London financial districts have returned, to ensure that “talent” is rewarded and retained, and top-end property prices are on the rise again.

In contrast Agrawal (2001)<sup>41</sup>, and Blankenburg and Palma (2009:10)<sup>42</sup> argue, that in the United States, financialisation was an indirect (and, at the time, misunderstood) result of opening global capital markets – a development that allowed the Reagan Administration to sidestep the hard budget constraints that had confronted previous administrations. They (Blankenburg and Palma) argue that an analysis of the financialisation of the United States economy offers an important corrective to the view commonly associated with the globalisation literature that capital markets have escaped the control of the state.

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<sup>39</sup> Stephens, P, “Three years on, the markets are masters again” *The Financial Times*. 29 July 2010, (<http://www.ft.com/cms/s/0/c0074548-9b47-11df-baaf-00144feab49a.html>), and, Hendrinske R P, Sidaway J, 2010, “Neoliberalism 3.0” *Environment and Planning A* 42 2037-2042, also Mykhnenko V, Birch K, 2010, “Conclusion: at the end of an economic order?” in *The Rise and Fall of Neo-liberalism: The collapse of an economic order?* Eds K Birch, V Mykhnenko. Zed Books, London. Pp 255-268.

<sup>40</sup> *Institute of Fiscal Studies (IFS)* 2010. “The distributional effect of tax and benefit reforms to be introduced between June 2010 and April 2014: a revised assessment.’ BN108. IFS London.

<sup>41</sup> Charles Goodhart. “Anglo-Saxon versus Asian Model of Financial Market Relationship with Government.” *Mostly Economics Magazine*. March 2007.

<sup>42</sup> Stephanie Blankenburg, and Jose Gabriel Palma “Introduction: The Global Financial Crisis” *Working Paper*. 2009.

This theme is explained in the financialisation debate as a contest between the Anglo-Saxon versus Asian models of financial market modelling.<sup>43</sup> This Anglo-Saxon versus Asian Model of financial market relationship with government is further described as follows:

- One is the Anglo Saxon (AS) Model in which government designs the basic macroeconomic and regulatory policy and financial firms decide on their own how to act, or do not act within the policy framework.
- Second is the Asian model in which the government not just sets the policies but also has a larger say in the working of the financial system, including accountability and regulation.

These factors provide a framework to the tensions that now occur between financialisation of the global and regional market place. These are tensions which dominate all levels of financialisation and have primarily been responsible for the accumulation models of debt in the Anglo-Saxon (developed economies) and vast surplus capital (for lending) in developing Asian economies.

Whilst this view of the earlier model locates a United States centric view, it is clear that the Reagan Administration introduced the concept of financialisation as “free-market models” that were adapted quickly across continents, particularly as Wall Street was given tax-exempt status, as was Canary Wharf in the City of London, by then Prime Minister Thatcher. The United States as the leading state in the world economy had been able to harness developments in global capital markets to domestic political objectives, which proved expansive in political, economic, and social terms. Financialisation solved a number of intractable problems for the Reagan Administration, as it sought to extricate itself from the dilemmas that marked the crisis of the 1970s (Bretton Woods transfer from the gold standards). A bear market in the United States lasted between January 1973 and December 1974, and then faltered. The severe downturn affected all the major financial markets in the world, particularly the United Kingdom, and was one of the worst stock market downturns in modern history. The crash came after the collapse of the Bretton Woods monetary system over the previous two years. It was compounded by the outbreak of the 1973 oil crisis in October of that year. This was a major event in the serious recession that hit most developed countries through the 1970s.

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<sup>43</sup> Amol Agrawal, quoting Charles Goodhart in “Anglo-Saxon versus s Asian Model of Financial Market Relationship with Government”. *Mostly Economics Magazine*. March 2007

Wallenstein (2010:133)<sup>44</sup> refers to the crises of the 1970s, which played a central role in the national and global political debates, and argues that the term crisis was replaced by the more general term globalisation to describe the prescriptive nature of the political economy of the period. Wallenstein writes that globalisation provided a more “optimistic terminology to crises”. This period followed the post war era of 1945–1970 a period he argues is “aptly referred to” in French as *les trente glorieuses*.

This period marked the height of United States hegemony and also coincided with the most expansive Kondratieff A-upturn that the capitalist world economy had witnessed, in respect to the enveloping cycle of crises that was to mark the future of world system economic paradigms, Wallenstein asserts that downturns, and presumably systemic dysfunction, are “absolutely normal” in cyclical rhythms, saying “it is how they live, the way they deal with the inevitable fluctuations of their operations”. For Wallenstein the two key issues are how producers make profits, and how states guarantee the world order. In the shadow economy and the real economy, both these issues are challenged now, on many fronts.

Robert Reich<sup>45</sup> (2008:50) suggests that a number of key issues changed the nature of capitalism and the rise of financialisation. Amongst these were Ronald Reagan’s tax cuts in 1981, and the waves of deregulation starting in the early 1970s post-Bretton Woods period. The growing movement toward financial deregulation introduced the growth in politically elected officials lobbying for changes in laws that would give corporations competitive advantage, and, seeking far greater influence over decision making. In Washington there are now over 10,000 lobbyists, (see Figure 4.9) many ex-politicians with considerable influence in capital markets.

Reich (2008:50) argues that none of these theories looks at global systems of political economy as a whole: a period where politics and economics combined. Reich argues further that:

Since the late 1970s a fundamental change has occurred in democratic capitalism in America, and that change has rippled outward to the rest of the world. Capitalism has triumphed and not simply as an ideology. The structure of the American – and much of the worlds – economy has shifted toward far more competitive markets. Power has shifted to consumers and investors. Meanwhile the *democratic* aspects of capitalism have declined. The institutions that undertook formal and informal

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<sup>44</sup> Emmanuel Wallenstein. “Structural Crisis.” *New Left Review*. March-April 2010

<sup>45</sup> Robert Reich, 2008. “The Road to Supercapitalism.” Chapter 2. In “Supercapitalism: the transformation of business, democracy and everyday life”. *Scribe Publications*, Carlton, Australia.

negotiations to spread wealth stabilise jobs and communities, to establish equitable rules of the game, – giant oligopolies, large labour unions, regulatory agencies, and legislatures responsive to local main street communities – have been eclipsed.

Gourinchas and Rey (2005)<sup>46</sup> suggest that financial globalisation accelerated as the United States economically transformed, and its relationship to other international nation states changed, from a World Banker, into a World Venture Capitalist. This thesis argues that in the era of current global financial dysfunction, the most pertinent of issues is how nation states manage control of their economies from the voracious effects of burgeoning capital markets that are unregulated and largely uncontrolled by traditional state mechanisms. This new shadow economy management is within the authority of nation states, though the execution of financial market management is problematic as there are no definitive accountability processes within states or global financial systems. There is also no recognisable grouping of financial sector players who would volunteer to scrutiny. The political will to challenge markets that use commonalities in the legal systems appears to out of political scope. Paul Volker the US economist who is credited as the chief architect of the current global financial system, once stated that the automatic teller machine, popularised in the 1970s, was the last truly beneficial financial innovation whose benefits are connected to society<sup>47</sup>. As state based economists struggle to manage the devastating effects that have been placed on real economies by new architectural instruments like Special Purpose Vehicles, Collateral Debt Obligations (CDOs) synthetic CDOs, CDO squared and cubed, and Credit Default Swaps (CDS) the fallout inevitably is picked up by citizens of states, with increasingly diminished capacity to supply services. These are services usually supplied by states and known as “common goods<sup>48</sup>”. Sometimes, the only relationship that financial players have with real or shadow economies is within their nano-second trading window.

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<sup>46</sup> Pierre-Olivier Gourinchas and Helene Rey. “From World Banker to World Venture Capitalist: US External Adjustment and the Exorbitant Privilege”. *National Bureau of Economic Research*. Cambridge MA 0213. Working Paper 11563. August 2005. (<http://www.nber.org/papers/w11563>).

<sup>47</sup> Reference to Paul Volker. “The Cult of Smart Money.” *Prospect Magazine*. 1 June 2010. (<http://www.prospectmagazine.co.uk/2010/06/the-cult-of-smart-money/>)

<sup>48</sup> Guido Montani, “*Money and Finance as Global Public Goods: Contribution to Supranational Macroeconomic Theory*” 23 January 2012 (<http://sgo.sagepub.com/content/1/3/2158244011424175>). Guido Montani is professor of international political economy at the University of Pavia (I). His recent publications in English include the following: “The European Union, global public goods and post-hegemonic world order” in *European Union Review*, “The neo-Ricardian theory of economic integration” in *Bulletin of Political Economy*, “Global imbalances and the transition to a symmetric world monetary system” (with Ricardo Fiorentini) in *Perspectives on Federalism*, and “World trade and world money: A neo-Ricardian outlook on global economy” in *Bulletin of Political Economy*.

The current decade from 2001 to 2012 has been defined as the neoliberalist period of low, or no, regulation policy influence by states, and strong political support for financial players in a crossover of political interests, lobbyist influence, and lax regulation laws.

This period has witnessed considerable changes in international financial regulation geared implicitly toward capital interests. Tacit policy levers provide governments with the ability to provide oversight through offshore tax systems but these measures are not used. The 2001–2011 decade has witnessed an unparalleled growth and financialisation diversity in derivatives and cross-border financial trades in sophisticated exotic financial products boosted through high technology algorithm “flash-trade” corridors, in milliseconds. Quantum global over-the-counter derivatives open positions are over US\$600 trillion alone. Currency trades are over US\$3 trillion a day, every day of the year.

This decade has also been marked by corporate excess, and resurgence (post GFC) in the shadow economy related volumes of inter-nation trade during and parallel to a tightening of credit in the real economy. Consequently, the volatility of financial trading, through hedge funds, fund of funds, and derivatives markets, many originating from offshore tax havens, has emerged as a considerable risk to orderly global financial market function. States are less able to guarantee stable economies than they have ever been. The distribution of inherent and real risk in markets has become borderless. Elected governments are fragile.

Concomitantly, persistent problems related to market dysfunction have occurred for global nation states, many of which had passed through previous disruptive crises (Southeast Asia, Japan, Russia, the United States, and the United Kingdom) which had direct linkages with speculative capital inflows and outflows and interest rate speculation on currencies. Many had been economically disrupted during speculative short selling trades, such as the short selling run on the British Pound by Quantum Fund manager George Soros.

Many states had been caught unaware that an imminent challenge was being directed at their currencies (Southeast Asia, Russia and the United Kingdom). But for hedge fund managers the rewards have been breathtaking. Soros earned US\$840 million in 2005; a year when the average take-home pay for the top 20 US hedge fund managers was US\$565 million, a 45 per cent increase on the previous year.<sup>49</sup>

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<sup>49</sup> “The very richest hedge fund managers.” *New York Times*. 26 May 2006.

Political economists and social scientists have used the description “revolution” to compare past financial paradigms to market integration models that have developed over the past three decades. Market integration has, in many cases, become ultra-destructive in social terms, particularly over the past decades which have seen massive movements of credit from investment banks to business and private consumers for real estate and speculative purchases, many of which built the major credit bubbles across developed states economies. Integration of global financial markets has also played out in the past decades as a transfer from state funds to corporate players, then as markets collapsed a further transfer of taxpayer funds to bailout corporations. Significant debt problems now plague European and United States economies. The socialisation of debt is seemingly a part of developed countries macro-economic tools which are used freely and with little debate. This is a new socioeconomic phenomenon.

### ***2.3 An International Perspective***

A financial transaction tax has been promoted over many decades to counter the speculative tremors falling from the growth and sophistication of market regimes. Nobel Laureate Economist Joseph Stiglitz argued in 2009 that the benefits of a regulatory approach provided by an FTT are twofold. He equates that a tax philosophy should be to tax bad things rather than good in the same way that pollution should be taxed more than work and savings, saying that “what bankers get up to is pollution” Further that:

Very little social returns come from short term trading. It results in extremely volatile and excessive trading. So anything that discourages short-termism is to be encouraged. At the same time, the money collected can be used to perform a socially useful function. Does anybody seriously believe that anything happens because of the sort of micro-second trading we’re now seeing? It’s a function of speed. No investments are being made as a result of it, no jobs are being created. Finance has a vital socially important role to fulfil, which is to raise capital, to run payment systems, to oil the wheels of everything society does. But bankers fail to perform that socially useful function- and because of that the world’s economy has suffered.

Major tensions exist between nation states and international financial markets. The central issue is that financial transaction trading plays an ever increasing role in the global economies, local and global (real and shadow). Neoliberalist free trade has opened vast trading cyber-corridors within the shadow economy, an economy increasingly disconnected from the control of states. An economy that has effectively been “rescued” by the application of real economy (taxpayer) funds from the public sector to bailout ailing institutions.

Although the International Monetary Fund (IMF) indicates that only one third of toxic sub-prime debts in financial markets have been ameliorated by bailout efforts (bought with taxpayer funds), currency and derivatives markets are growing rapidly in volume and participants. The IMF found that global banking institutions still had US\$3.4 trillion in bad debts to write off on top of the US\$1.7 trillion paid in bailouts to date.

Bill Gross, senior executive of the United States' largest mutual fund, PIMCO, commented on the current critically high levels of state and federal debt in the United States in an article headlined "No Way Out of Debt Trap, Gross Says: US Living Standards Doomed to Fall"<sup>50</sup>. Gross argues that "In the US, states across the country face a collective \$125 billion shortfall for fiscal 2012, while Congress is facing a budget gap nearly 10 times that size," adding:

PIMCO founder Bill Gross – one of the world's largest mutual funds managers, who focuses mostly on bonds – has previously said that if the United States were a corporation, no one in their right mind would lend us money. For the last decade, we've been 'relying on the kindness of strangers' to help cover our debts... After years of reckless spending, America's debt level is nearing a breaking point and can no longer rely on foreign capital as a last resort. When a country reaches a certain debt level, confidence in that country's ability to repay that debt becomes jeopardized, there is really no way out of this trap and this conundrum at this point.

Meanwhile, the debt trap hole gets deeper and deeper. "The federal government posted its largest monthly deficit in history in February 2011, a \$223 billion shortfall," *The Washington Times* reports<sup>51</sup>. "That one-month figure, which came in a preliminary report from the Congressional Budget Office, dwarfs even the most robust cuts being talked about on Washington's Capitol Hill, and underscores just how much work lawmakers have to do to get the government's finances in balance again". The United States debt at the end of 2011 stands at US\$15 trillion and is growing.

By "strangers," Gross is referring to foreign counterparts, (China and Japan for example). Basically, for years, Americans have spent their dollars on less expensive Japanese and Chinese made goods and Indian services. Japan and China turned around and used those dollars to buy up United States Treasuries Debt Bonds and other dollar-denominated assets. Now after years of reckless spending, America's debt level is nearing a breaking point and can no longer rely on foreign capital as a last resort. "When a country reaches a certain debt

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<sup>40</sup> "No Way Out of Debt Trap, Gross Says: U.S. Living Standards Doomed to Fall." *Bloomberg*. 8 March 2011.

<sup>51</sup>. "US Sets \$223 billion deficit record: Dwarfs Hills cutting goals." *The Washington Times*. 7 March 2011.

level, confidence in that country's ability to repay that debt becomes jeopardized," says Gross, citing the work of Ken Rogoff and Carmen Reinhart in "This Time Is Different"<sup>52</sup>.

United States Federal Reserve Minutes released in February 2011 indicated that Chairman Bernanke has no intention of halting his US\$600 billion debt monetisation program in 2011, which continues to build the regime of financialisation both in the United States and globally. The United States Government deficit for the year to September 2011 will hit a massive US\$1.6 trillion, which is a US\$500 billion increase on last year, despite extensive quantitative easing (QE) funds flowing through the system. Political economists and social commentators believe that the United States economy and money market positions are artificially higher entirely because of monetary and government stimulus rather than gains in real economy spending and real economy recovery.

Despite political statements of an overall broad-based recovery, the current deficit statistics reveal considerable cause for alarm, including real and projected deficit accumulation figures including:

- 2008 deficit \$455 billion
- 2009 deficit \$1.42 trillion (stimulus increase of \$965 billion)
- 2010 deficit \$1.17 trillion (stimulus decrease of \$250 billion)
- 2011 deficit \$1.6 trillion (stimulus increase of \$430 billion)
- 2012 projected deficit \$1.1 trillion (stimulus decrease of \$500 billion).

QEI, which ran from around March 2009 to March 2010, saw the monetisation of \$1.75 trillion in mortgage and treasury debt. QEII, currently underway, involves the purchase of a further \$600 billion in government debt. The program started formally in November 2010, and ran until June 2011. By March 2009, as QEI provided \$965 billion in addition fiscal stimulus began to move through the system, the market took off. It kept going right through to April 2010. By this time QEI was over and the net contraction in deficit spending (\$250 billion in 2010) was having an effect. Then the market fell and the lack of federal- and deficit-induced liquidity saw the market shrink from April to August 2010.

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<sup>52</sup> Kenneth S. Rogoff and Carmen M. Reinhart. "This Time it is Different: A Panoramic View of Eight Centuries of Financial Crisis." *NBER Working Paper No. 13882*. University of Maryland. 2008.

Then in late August 2010, amidst increasing talk of the United States economy entering a double-dip recession, Federal Reserve Chairman Bernanke spoke about reviving quantitative easing (QE). The market showed some positive reaction but has continued (late 2011) on a stalled recessionary pace. QEII ended in June 2011. The United States Government's 2012 fiscal year will see a strategic \$500 billion stimulus reduction. When Congress spends more than it collects, which is something it does with regular monotony, it issues pieces of paper (debt bonds) into global capital markets in exchange for cash for spending on unproductive, pet projects. The Federal Reserve could be heading toward a US\$2 trillion annual budget deficit, compounded by the uprising against Middle East despotic regimes, and with a prospect of oil price hikes. The latest round of QE 3 is now placing US\$40 billion into the US economy as mortgage-backed securities.

The social consequences of these statistics emerging from the United States are distressing in terms of quantitative and qualitative reporting. For the greater American populace the level of distress is measured in those forced to seek government assistance. Food stamps are, across the United States, now being sent to more than 44 million people. Another 15 million qualify – one out of every five Americans.

Debt, defaults and more mounting global state debt is plaguing countries around the globe. The Organisation for Economic Development (OECD) issued a paper in February 2010, which researched the value of an FTT, following an examination in November 2009 that predicted an unprecedented post-war level of member government's budget deficits and debt for the decade 2011 to 2020. OECD government deficits and public debt are forecast to exceed 7.6 per cent and 103 per cent respectively by the end of 2011, compared to 73 per cent in 2007. The OECD's Advisory Committee<sup>53</sup> argued:

As a result of the global crisis, including the bailing out of the banking sector, OECD government deficits have reached unprecedented levels. For the OECD, the size of fiscal consolidation projected at \$300–370bn per year over the coming years will place severe budget constraints on governments. Working families risk paying twice for the crisis: first through rising unemployment and falling incomes and then, as a result of cuts in public expenditure, through reduced access to social services and the corresponding rise in inequality. The OECD fiscal consolidation programme would put post-war welfare systems and social cohesion at risk. And yet these same governments have still to deliver on their commitments to finance global public goods, including raising Official Development

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<sup>53</sup> "The Parameters of a Financial Transaction Tax and the OECD Global Public Good Resource Gap." *Organisation for Economic Cooperation and Developments Trade Union Advisory Committee Paper*, 2010-2020.

Assistance to 0.7% of Gross National Income and climate change adaptation and mitigation measures for developing countries. The global public good resource gap that would emerge would be in the range of \$324-336bn per year between 2012 and 2017 (\$156bn for climate change, \$168-180bn for ODA). These figures could change should the global economy move to self-sustaining recovery and growth rates and hence tax receipts rise. Nonetheless, at least part of the new public policy coming out of the crisis should be grounded on a revision of tax policy. The criteria for tax policy must be social justice, economic value and political acceptability. On all these grounds an FTT would make sense.

Foreign exchange traders buy volumes of United States Government Treasury debt. The US Federal Reserve does too. Buying by foreigners and the Federal Reserve represents additional cash or net new stimulus going into the United States economy (because the funds are not taken from elsewhere). Both the Federal Reserve and foreign governments buy United States Government debt with money that did not previously exist. The Federal Reserve simply creates additional bank reserves to fund its purchases. In addition, in a slightly more complex way, so do foreign central banks.

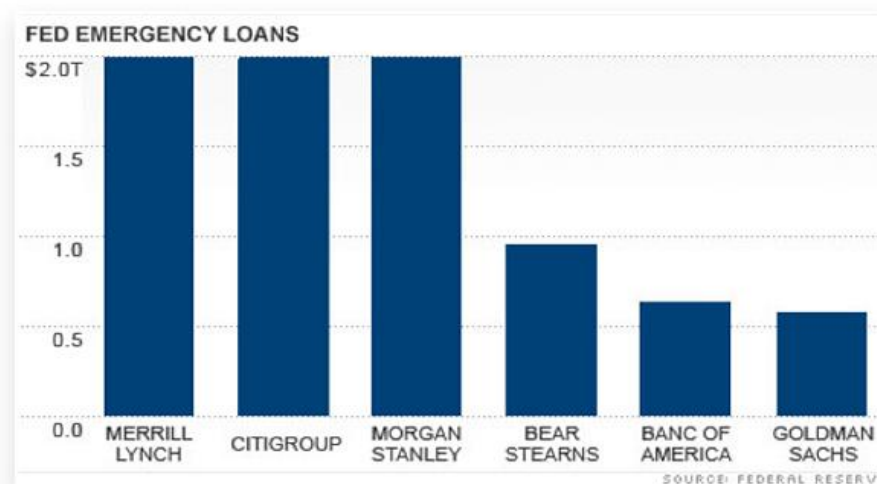
The big buyers of US Treasury debt – the Asian central banks – do so purely to keep their currencies competitive. If they were simply major buyers of US treasury bonds, because they wanted to invest in them, they would need to sell their domestic currencies to buy US dollars in the Foreign Exchange market. This would push up the relative value of their currencies – and detrimentally affect their export markets. Instead of selling *existing* domestic currency and buying US dollars, these countries *print additional domestic currency* and use that as the source of their buying. This is how they keep their currencies ‘competitive’. This is very inflationary. Thus the source of inflation is the United States Treasury debt bond market. This debt is monetised (internalised) by the Federal Reserve and foreign central banks to keep their export dependent economies afloat.

This high-risk financialisation, in the US and Europe, ultimately results in asset price inflation. Likewise, in Asia, it is consumer price inflation that is the driver of tighter monetary policies. Inflation pressure is growing in China and India.

Markets around the world are fuelled by artificial stimuli, the end result of a decade of financialisation of money markets globally. Jeffrey Sachs, Professor of Economics at Columbia University argues that in this time of political upheaval Wall Street is so politically powerful that it has written its “own ticket” for the past 25 years and “in a way, that’s shocking”.

Sachs reports<sup>54</sup> that Wall Street has had its most profitable year (2010) in its history and “made profits of US\$55 billion in the midst of the biggest global downturn since the depression” – profits (that have) only been possible because of taxpayers’ bailouts and a zero interest rate policy by the Federal Reserve. Sachs argues strongly for a financial transaction tax, which he says, should be harmonised across countries, emphasising that it is a progressive and non-distortionary tax. It is a means of adding equality to very unequal market outcomes.

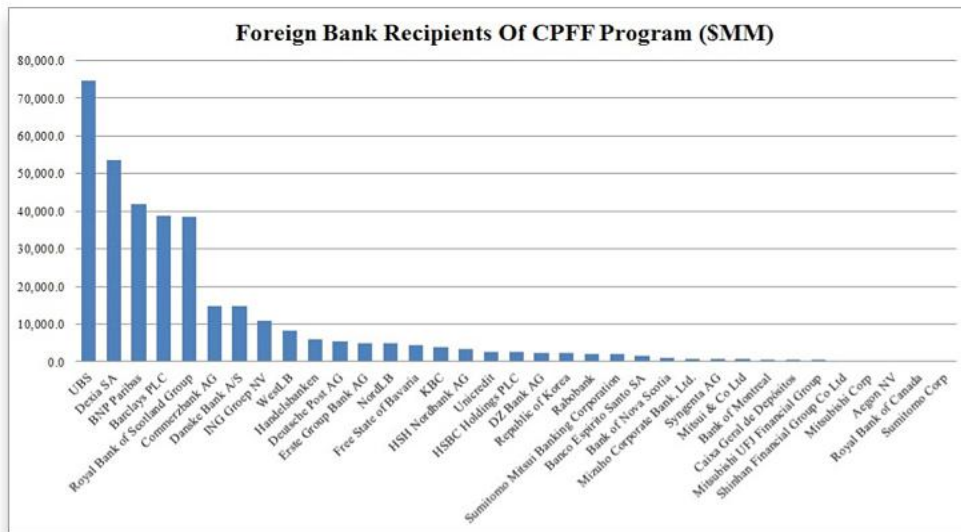
In 2010, markets were reflat by a massive influx of public account bailout and stimulus funds. The table below was compiled from statistics that the United States Federal Reserve was forced to release under a Freedom of Information request made by *Bloomberg* in December of 2010. The Federal Reserve fought to keep the details of their back-room dealings private, but it has come to light that at the peak of the Global Financial Crisis in 2008, the Federal Reserve made more than \$9 trillion loans to both United States and international banks including a cartel of 14 United States banks and 35 international banks who “quietly queued up for a financial lifeline”.



Source: U.S Federal Reserve

**Figure 2.1: United States Federal Reserve – Emergency Loans Quantum.**

<sup>54</sup> Jeffrey Sachs. *The Guardian*. 23 March 2010.



Source: U.S Federal Reserve

**Figure 2.2: Foreign Bank Recipients of CPFF Program<sup>55</sup>.**

This \$9 trillion figure was much higher than expected. The big “money centre” banks and investment banks of Wall Street – not to mention at least 35 other non-United States banks, needed many trillions of dollars just to survive the upheavals of 2008. Since then, banks have received more bailout funds from the Federal Reserve. Banks have been buying stocks, just as the Federal Reserve had planned. Starting in March 2009 the Federal Reserve began deliberately targeting higher stock prices. This targeting led to stocks falling in March of that year. Every gain in the stock market since is what is called a “reflation rally”; this in effect means the rise in stock prices is induced, and has been driven by central banks printing new money in the form of quantitative easing or (printing money), a process likely to lead to hyperinflation in the long run. The US debt rises by as much as US\$40 billion a month.

Burgeoning hedge funds, once the exclusive tool of the rich and well placed, now attract the investment capital of global state pension funds at significant levels. Hedge fund managers are amongst the highest earners in the world. Against this, failing states with massive sovereign debt overlays are being forced to adopt draconian austerity measures designed to cut states’ debt. State services and support to citizens is being slashed.

<sup>55</sup> U.S Federal Reserve. “Foreign Bank Recipients of CPFF Program Funds (SMM)”. *Bloomberg*. December 2010.

James Galbraith called for regulations that would prohibit credit default swaps transactions by any European financial entity which has flow-on effects on European citizens. Galbraith<sup>56</sup> also called for an immediate tax on financial transactions, arguing that in the current market context, dysfunction must be addressed immediately to arrest a contagion, suggesting: “If capital controls must be reimposed to arrest financial contagion then so be it. In a contest between the state and the financial markets, with the survival of stable forms of government, and civil society, in question, the state cannot be allowed to lose out”.

These new dynamics are attracting attention from a wide range of policy makers and commentators, as speculative unregulated finance is causing major dislocations on a global scale. Clearly evidenced, post-Global Financial Crisis is that unregulated capital has the capacity to create global economic change that is severely disrupting civil society. A précis of recent turmoil in the aftermath of the global credit crisis and capital flight demonstrates how the rapid withdrawal of capital in a protracted credit squeeze affects not only business and government financial structures but disenfranchises millions of inhabitants in countries all over the globe.

These new financial dynamics are a demonstration of the changing axis of dominant financial nation states, stating that China and the rapidly growing eastern and Indian economies are overtaking a stalled United States economy stimulated, falsely, by quantitative easing.

Deregulation of markets has provided new and volatile trading grounds, which provide investors with avenues for financial speculative trading, which can be withdrawn from host economies in a matter of seconds. The volatile and unstable nature of business conducted by these new elite financial players creates ongoing problems for nation states. OECD figures indicate that exchange rate volatility between member states has raised threefold since the early 1970s and that after reaching high levels of volatility the rate reached a plateau in the 1990s, before taking off in a sensational increase trend from 2001 to 2011. Markets rely on volatility for wider trade margins.

By far the most volume of foreign exchange transactions begins with speculative originators in the United States, the United Kingdom, and then within OECD member states and the flourishing unregulated offshore tax haven bases<sup>57</sup>. The largest trade market is within the City

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<sup>56</sup> James K Galbraith. “The wolf pack stalks Europe”. *Le Monde Diplomatique* (<http://mondediplo.com/2010/06/06/crisis-eur>)

<sup>57</sup> Bank for International Settlements. September 2011.

of London, with its complementary offshore centres of The Isle of Man, Jersey and Guernsey, and Cayman Islands. Capital held within offshore centres grows by US\$1.2 trillion each year, even as the real global economies trend toward protracted recession

In the 1970s, as a result of moves toward financial deregulation and liberalisation, the Thatcher Government in the United Kingdom enacted the 1979 UK Banking Act that removed discrimination between offshore and onshore financial markets. The City of London was afforded offshore status<sup>58</sup> in an expanding and ultra- competitive, global, financial market network. These markets provide a clear distinction between investment and structural nation state development in traditional (Foreign Direct Investment) markets and the dynamic new investment regimes in speculative currency activities. The City of London was soon to become the leading centre in these transactions and, has held and increased this leading edge for three decades. The City of London has emerged as the central element in the British competitive strategy.

Commenting on the growing push to bring the United Kingdom<sup>59</sup> into line with other European states on a European financial transaction tax, United Kingdom Prime Minister David Cameron told German Chancellor Angela Merkel he will not agree to a financial transaction tax that will affect hundreds of thousands of jobs. The financial transaction tax initiative had been proposed to pay for another increase in the Eurozone budget. However, because London is the financial capital of the continent, Britain would have to pay up to 80 per cent – or £37billion – of the costs. Financial services account for 30 per cent of the country's GDP and city experts predict that if the tax is imposed, 500,000 jobs would be lost. The dilemma for Cameron is that over the last three decades of financialisation regimes there has been a hollowing out of UK based manufacturing and industries. There is literally no other employment or economic “engine room” to replicate the financial services industry.

Concomitantly, global financial markets have been predictably growing in parallel with the spread of financial innovations, which in turn can be associated with new forms of neoliberalism paradigms, adopted by most western, developed states. Internal capital and banking crises, for instance, have developed through events associated with deregulated

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<sup>58</sup> Nicholas Shaxson “An Offshore Island in the Thames”. *The New Statesman*. 10 November 2011 (<http://www.newstatesman.com/economy/2011/11/london-corporation-cityles>)

<sup>59</sup> “David Cameron says No to tax that will cost Britain £37bn and 500,000 jobs: Britain is set to make a stand over an EU tax that could cost the country billions of pounds”. *The Financial Times*. 19 November 2011.

institutions (traders, banks, funds, and entrepreneurs such as Soros), which have been described as the vehicle from which the Asian, Russian and South American and other financial crises have formed.

Charles Goodhart, Emeritus Professor in Banking and Finance with the London School of Economics spoke (March 2010) at the University of Tasmania on the subject of Financial Regulation and the Global Financial Crisis. Professor Goodhart commenced his address by stating that issues of financial markets and outcomes used to be the province of students of the subject of Political Economy. It used to be a study of practical issues with a view to understanding practical economic outcomes.

Goodhart suggested that in today's markets there is a belief that the Federal Reserve would be able to restore stability in times of crisis and that that would prolong real economy asset growth patterns, which have trended through from early 1990s through to the present. All faith was placed in the past Federal Reserve Chairman Alan Greenspan to maintain the period of growth irrespective of crises occurring in other countries. The period was known as "The Great Moderation"<sup>60</sup> distinguished by steady interest rates, contained inflation, and a growth rate lower than those in the emerging states of China and India.

Quiggin argues that "a variety of explanations have been put forward for the 'Great Moderation'". To the extent that the Moderation has been seen as more than a run of good luck, it has typically been explained either by a combination of improvements in macroeconomic management associated with central bank independence and reliance on monetary rather than fiscal policy and the benefits of economic liberalism, as argued by Gerard Baker<sup>61</sup> who states:

Economists are debating the causes of the Great Moderation enthusiastically and, unusually, they are in broad agreement. Good policy has played a part: central banks have got much better at timing interest rate moves to smooth out the curves of economic progress. But the really important reason tells us much more about the best way to manage economies. It is the liberation of markets and the opening-up of choice that lie at the root of the transformation. The deregulation of financial markets over the Anglo-Saxon world in the 1980s had a damping effect on the fluctuations of the business

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<sup>60</sup> John Guiggin. "Refuted Economic Doctrines #3." 2011.  
(<http://www.johnquiggin.com/index.php/archives/2009/01/05/refuted-economic-doctrines-3-the-great-moderation>)

<sup>61</sup> Gerard Baker. "Welcome to the Great Moderation" *The Times*. London. 19 January 2010.  
(<http://www.timesonline.co.uk/tol/comment/columnists/article1294376.ece> )

cycle. These changes gave consumers a vast range of financial instruments (credit cards, home equity loans) that enabled them to match their spending with changes in their incomes over long periods.

When the Global Financial Crisis hit in 2007, there was an expectation that the Federal Reserve would restore the system, reduce risk, and prices would continue a steady rise. The advent of the crisis forced a completely new analysis of what under-layers of new market financial instruments looked like and how they acted in market settings in times of crisis. The current enduring global financial crisis is the culmination of series events, which include the balance of financial and economic power between the East and the West, loose lending on a global scale and political misjudgement in developed Western nation states. There is a clear historical aspect to this crisis.

#### **2.4 The History of Financialisation and Crises**

Eric Hobsbawm<sup>62</sup> called the 30 year period following the end of World War II as capitalism's golden years, a period of remarkable economic growth with a stable financial system based on a "pegged" currency system (until 1973), without the boom and bust cycles which have been the main feature of the preceding neoliberal era. Also featured in the growth years of capitalism were stable employment, little or no inflation and the building of social support networks in the form of housing, health and the welfare state.

United Kingdom economist John Maynard Keynes influenced policy settings designed to allow participating states a mechanism to control inflation whilst producing growth in employment and stability within manufacturing sectors. For over three decades, Keynes delivered the fiscal mechanism to tighten public spending in order to reduce overheating economies and increase public spending to stimulate public spending and thus create employment opportunities through the production of goods and services. The Keynesian social democratic consensus continued through to the early seventies providing economists with the economic levers to stabilise the state in a period of high growth and predictable social stability and civilised capital growth.<sup>63</sup>

The first major financial crisis (following the deregulation of major global markets) occurred in Latin America in the early 1970s because of rampant inflation in South American countries, Argentina and Brazil. By 1974, all major Western economies suffered high levels

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<sup>62</sup> Eric Hobsbawm. "The Age of Revolution, The Age of Capital, The Age of Empire and The Age of Extremes" as quoted in *The Monthly No 45*. May 2009.

<sup>63</sup> Robert Manne. "*Goodbye to All That?: on the Failure of Neo-Liberalism and the Urgency of Change*" edited by Robert Manne and David McKnight. Black Inc Group April 2010.

of inflation and unemployment following the 1973 Oil Crisis in which oil prices soared, precipitating the 1973–74 stock market crash in the United States. A prolonged secondary banking crisis followed in the United Kingdom. The Keynesian economic model was expected to stabilise leading global economies but failed the test and was partially discredited by economists unable to wrestle back global macro and state economic stability. The next major upheaval on the international stage occurred in Mexico with the “Mexican Weekend”<sup>64</sup> bank stock crisis which spread across the continent to become the Latin America debt crisis.

The Wall Street “Black Monday” crisis closed the New York Stock Exchange in October 1987. Europe witnessed a succession of crises during the early 1990s, quickly followed by Mexico in 1994 and 1995. The Asian crises started in 1997 and spread through the continent to Russia in August 1998. Each of these crises was triggered by a run on the currency of nation states and was highlighted by the inability of those states to defend their currencies. These are also political issues. There are no current global political or economic strategies in place to prevent any reoccurrences of “runs” on currencies.

Currency markets remain unregulated and attract a wide range of private and corporate players betting in a virtual casino type of trading with daily quantum’s upwards of US\$4.5 trillion. Capital runs and flight also provide shorting opportunities to market elites.

These are only the more prominent examples of the 70 banking and 90 currency crises recorded since the 1970s. It would appear there are no systems presently in place to arrest the exponential global financial trading problems, which are becoming ever more severe in nature and repercussive in economic dysfunction. The global nature of trading makes all countries vulnerable. The possibility of major dysfunction is only a transaction away.

In late 1998, a corporate investment system underwent a crisis of its own. The United States Government was forced to bail out the beleaguered Long Term Capital Management Fund (LTCM) whose corporate failure, in mid-November 1998 reportedly came within a whisker of causing massive disruption to the United States and global economies. Global economic analysts were amazed at the rapidity of the ensuing crisis and the potential for severe financial dysfunction that emerged from the LTCM corporate collapse. Essentially, the success of LTCM was built through highly leveraged investment partnerships and on the personal reputations of two Nobel prize-winning economists on the executive board.

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<sup>64</sup> The 1994 Economic Crisis in Mexico was also known as the Mexican Peso Crisis or the Tequila Crisis and was caused by the sudden rapid devaluation of the Mexican Peso in December 1994.

LTCM raised its leverage position up to 140 times its original capital equity and placed positions on the relative prices of bonds in the US and overseas markets. Following the Russian devaluation, debt moratorium and the flight of capital to safer options, LTCM was left with excessive open option positions that it could not sustain (Edwards 1999).

Within weeks (17–31 August 1998) LTCM was forced to send its investors advice that it had lost 52 per cent of its capital value. It had lost all of its original value and was looking at a systemic risk to other financial actors. The United States Federal Reserve Bank was forced to orchestrate a rescue operation by private banks and financial firms. Commentators and reporters in the United States who had labelled the financial disasters in the Southeast Asian and Russian areas (and the Japanese slowdown), as being the result of result of “crony capitalism” were forced to apply the same label to LTCM, whose small circle of “name officials” were bailed out of a potentially far reaching disaster. Long Term Capital Management single-handedly created chaos in global markets that potentially (had the United States Government not acted swiftly) could have been catastrophic. The world economy was within a glance of a meltdown<sup>65</sup>.

The major growth being experienced in China has gone some way to reviving the Japanese economy, although most of the structural problems are still unresolved. Successive ministers and prime ministers have been unable or unwilling to deal with the legacy of effectively bankrupt banks and the Japanese economy has remained increasingly isolated as a result. Adam Posen<sup>66</sup> who sits on the Bank of England’s Monetary Policy Committee recently commented on the current state of the Japanese economy and its inability to shrug off its continuing recessionary spiral suggesting:

The Japanese economy has entered a recession and it seems it is never coming out of it. It means year after year of huge governments deficits and a world of zombie banks that are being kept alive only by taxpayer’s money. It means year after year of false dawns, high unemployment and lapses back into recession. It’s an acute form of economic purgatory and one which Britain is facing. This follows a debt fuelled boom that politicians saw as prosperity. The UK has an uncomfortable parallel to the Japanese financial system.

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<sup>65</sup> Nigel F.B. Allington, John S.L. McCrombie and Maureen Pike “Lessons Not Learnt: From the Collapse of Long Term Capital Management to the Subprime Crisis”. *Cambridge Centre for Economic and Public Policy*. CCEPP WP03. Department of Land Economy, University of Cambridge. March 2012.

<sup>66</sup> Adam Posen. Bank of England publication 26 October 2009 as quoted in *The Spectator Magazine* 14 December 2009.

Whilst the United States growth has fallen, China has continued to build internally with one recent report estimating that 64 million units of housing stock remain uninhabited across the major cities in China. Japan's exports to Greater China (including Hong Kong and Taiwan) are now bigger than Japanese exports to the United States. Concomitantly in the United States there has been a significant slide in the stock market and a continuing slide in the value of the dollar<sup>67</sup>. Events in the developed and developing world have been substantially altered by the major event of our time: the Global Financial Crisis. It has accelerated the significant interface that exists between developed and developing nation states.

## **2.5 The Global Financial Crisis**

Financial Times commentator Martin Wolf<sup>68</sup> stated, shortly after both the United States and the United Kingdom dipped into recession in the wake of the Global Financial Crisis:

Just as Keynes's ideas were tested to destruction in the 1950s, 1960s, and 1970s, Milton Friedman's (Monetarism) ideas might suffer a similar fate in the 1980s, 1990s, and 2000s. All gods fail if one believes too much.

The worst financial crisis since the Great Depression has again redrawn the boundaries between governments and markets as a crisis originating in the United States has spread across Europe engulfing most North Atlantic states. Following the stock market crash of 1929 it took three years before the United States Government was able to launch a series of rescue efforts to end the Depression that had gripped the country and had dramatically slowed growth in other states. Thousands of banks had failed and deflation had set in, national output fell by a third and unemployment peaked at 25 per cent. In the aftermath the boundaries between the government and markets were tested<sup>69</sup>.

By comparison, a year after the collapse of the United States investment bank Bear Stearns, the government was forced to take the most dramatic economic intervention since the 1930s. This time the United States unemployment rate was 6.2 per cent and the country was not technically in recession but a series of financial indicators provided enough warning for the Federal Reserve to act decisively to avoid a looming financial catastrophe as American Insurance Group (AIG), the world's largest insurer, teetered on the edge of default, a situation that would have spread panic immediately to other nation states and would have in a

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<sup>67</sup> "Foreigners Snap up Properties in the US". *The Wall Street Journal* 12 June 2012.

<sup>68</sup> Martin Wolf, quoted in Edmund Conway "50 Economic Ideas." *Section 10. Monetarism*. Quercus, London.

<sup>69</sup> Zanny Minton Beddoes, Doug Elmendorf, Thomas Helbing, Subir Lall, Adam Posen, Eswar Prasad, Kenneth Rogoff, and Arvind Subramanian quoted in *The Economist* "When Fortune Frowned." 11 October 2008,

practical sense prohibited the flight of most global aircraft insured with the AIG. In two tumultuous weeks in September and October 2008 the United States Federal Reserve and Treasury nationalised the countries two mortgage giants Freddie Mac and Fannie Mae, took over AIG (the world's largest insurance corporation) and extended government deposit insurance to US\$3.4 trillion in money market funds.

Effectively AIG is now a publicly owned entity, although executives continued to be reward with private sector type bonuses. AIG received US\$170 billion in taxpayer bailouts and in the fourth quarter of 2008, posting a loss of US\$61.7 billion, the greatest ever for any United States corporation. Beyond the US \$165 million in bonus payments, total bonuses for the AIG financial unit reached US\$450 million and bonuses for the entire company reached US \$1.2 billion. This quickly led to public outrage. United States President Obama is reported<sup>70</sup> to have said, "[I]t's hard to understand how derivative traders at AIG warranted any bonuses, much less \$165 million in extra pay. How do they justify this outrage to the taxpayers who are keeping the company afloat?" and "In the last six months, AIG has received substantial sums from the US Treasury. I've asked Treasury Secretary Geithner to use that leverage and pursue every legal avenue to block these bonuses and make the American taxpayers whole."

In 2008, a temporary short selling ban was placed over nearly a thousand stocks. The United States Government pledged to take over US\$700 billion in sub-prime related toxic debt into its public accounts, a move which was replicated in a series of emergency rescue bailouts around the world. The bailouts effectively transferred private sector debt to the public account under the government's premise that some private sector corporations were "too big to fail"<sup>71</sup>, thus testing the free market philosophy of allowing non-competitive entities to fail as a "natural market correction". The landscape of global economic paradigms had suddenly and dramatically changed as investment banks that relied on high leverage wholesale funding became insolvent.

Many United State national investment banking icons defaulted including Lehman Brothers, whilst Bear Stearns, Morgan Stanley, and Merrill Lynch were taken over by commercial banks. The much vaunted "shadow banking system" (the engine room of inter-nation trades of a secret nature) and hedge funds, money market funds, securities dealers and an array of

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<sup>70</sup> "Obama's Statement on A.I.G." *The New York Times*. 16 March, 2009.

(<http://thecaucus.blogs.nytimes.com/2009/03/16/obamas-statement-on-aig>), and "Obama Orders Treasury Chief to Try to Block A.I.G Bonuses," *The New York Times*. 16, March 2009

<sup>71</sup> Andrew Ross Sorkin "Too Big to Fail" Open Library 2009

non-bank financial institutions that define the deregulated capital market players in American, European (and Australian) banking systems were revealed to be inextricably entangled in the start of the second largest economic crisis in history.

The United States alone expanded its liabilities by more than a trillion dollars in three weeks. At the start of the crisis the IMF estimated that global losses related to sub-prime mortgage originated debt was at least US\$1.5 trillion; however, this amount was a low estimate. It is now known to be over US\$4.5 trillion, with US\$1.5 trillion in toxic debt having been eradicated by nation states use of public funds. Nearly US\$3 trillion, much of it toxic debt structures, remains in the financial system as portions of CDOs and other “sophisticated” leveraged investment vehicles. The social implications of this transfer of public funds are discussed in Chapter 3.

By the fall of Lehman Brothers and the collapse of other investment banks in September 2008, many of the developed states’ economies were already in recession partly because of tightened credit facilities (post Bear Stearns) (September 2007) and oil price spikes in early 2008. Most “real” economies had already been retracting before the September 2008 meltdown and the first calls to re-regulate the financial markets were heard from virtually all developed states caught up in the contagion emanating from the United States. Meanwhile, “shadow” economy financial players are engaged in daily trades far eclipsing those of pre-Lehman Brothers meltdown. In fact many institutions such as Goldman Sachs have repaid the debt to government and are again paying staff in trading rooms and trading platforms record bonuses on unregulated speculative trades, despite growing disquiet across government and community sectors.

Essentially the contest between the state economy and its relationship with unregulated markets is at the core of global political economy debate. Whilst states have ceded (since the collapse of the gold standard in 1971) considerable ground to the neoliberalist free market philosophy, a clear distinction is yet to be put forward in respect to financial transaction tax regulatory frameworks on a global scale. Nation states and their local state governments still accept professional advice from ratings agencies who determine credit ratings for states’ borrowing and debt structures. Ratings agencies such as Standard and Poors, Moody’s and Fitch assessed mortgage packages in the United States that were bundled into exotic Collateral Debt Obligations based securitised knowing that the risk associated with these transaction was extremely high. AAA rated debt from the sub-prime borrowers triggered the

massive contagion that is currently enmeshed in the global financial system and creating social and economic distress worldwide. Rating agencies were integral in the sub-prime meltdown.

Post-Lehman (2008) the then President of the United States<sup>72</sup>, George W Bush, stated to a group of Republicans that Wall Street “needed to sober up a bit and wean itself off all these fancy financial instruments” and prior to September 2008 events (Lehman collapse) the former Chairman of the Federal Reserve Paul Volker gave financiers a “D grade” with a critique, saying, “for all its talented participants, for all its rich rewards, (the) bright new financial system has failed the test of the market place.” In the short timeframes after Lehman, the government took over some of world’s biggest financial institutions in “serial weekend rescues” which required US\$700 billion of public resources. Commentators suggested that the transformation of all five big American banks investment banks – either by bankruptcy or rebirth as commercial banks – is powerful evidence that Wall Street had, indeed, failed the test of the marketplace.

## **2.6 Credit Contagion**

Parallel to the global credit squeeze (resultant of the Global Financial Crisis) the re-emergence of transnational shadow economy capital, awash with speculative financial instruments (still significantly buoyed by political lobbying influence) dominate the next progressive phase of the continuing crisis as it takes hold across Europe. Waves of credit (pre-crisis) have now become waves of debt (post-crisis), as governments across the developed world grapple with budget cuts and defaults in Ireland, United Kingdom, Iceland, Italy, Spain, Portugal and Greek economies. A sovereign debt crisis with underlying structural indices post 2007 appears to be deeply entrenched in economic and social interplays across North Atlantic continents<sup>73</sup>. Many European countries are now either technically insolvent or facing insolvency. Most are producing budgetary cuts at levels not seen in recent times. With growing seriousness, European Union nation states are cutting services and programs that target those least able to care for the following table (2.1) evidences the entrenched stratum of government debt being held by European states, showing budget deficits and debt as a percentage of gross domestic product. Further information on the composition of broad debt levels (household, non-financial sector, and government debt is located in Figure 6:1 and 6:2 in Chapter Six of this thesis.

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<sup>72</sup> “Taming the Beast: how far should finance be re-regulated?” *The Economist*. 11 October 2008.

<sup>73</sup> Anastasia Nesvetailova and Ronen Palan. “A Very North Atlantic Financial Crisis” *Working Paper* 2010.

**Table 2.1: European Debt as Percentage of GDP, 2010<sup>74</sup>.**

Nation State	United Kingdom	Greece	Spain	Ireland	Italy	Germany
Debt % to GDP	68.6%	112.6%	54.3%	65.8%	114.6%	73.1%

Addressing the growing sense of frustration at debt levels across Europe, Credit Agricole CIB analyst Daragh Maher suggested that:

The preoccupation remains the ongoing fiscal stress in the euro zone and the contagion thereof, which is no longer confined to considerations regarding the likes of Portugal, Italy and Spain. Instead, it has spread across continents and asset markets, much in the same way as the ripples of the (US) subprime crisis extended far beyond initial expectations<sup>75</sup>.

For five months prior to the Greek bailout, the market stayed afloat because various unnamed Greek “officials” claimed that a bailout was coming. The fact that “rumours” of a bailout propped the market up indicates that market participants were delusional, inferring that lending more money to a bankrupt country would “solve” its debt problem. Greece’s fiscal situation is not all that worse than several other European countries. Ireland, Spain, and the UK, all are running comparable deficits. Italy actually has a higher debt-to-GDP ratio, and Germany and the United Kingdom are only a matter of years off from having Greek-type debt-to-GDP ratios themselves. (See Table 2.1 above.)

The current crisis was pre-determined by low interest rate policies in Europe and the United States in early to mid-2000 to 2003 as the United States Federal Reserve effectively created cheap credit to enable a housing market bubble to replace the NASDAQ stock market collapse, and the recessionary mood following the September 11, 2001 terrorist attacks.

Morris<sup>76</sup> argues that the relentless deregulation drive that started during the Reagan Administration steadily shifted lending activities to the purview of non-regulated entities, until by 2006 only about a quarter of all lending occurred in regulated sectors, down from about 60 per cent 20 years before. Dogmatic market capitalists hailed the deregulation, free

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<sup>74</sup> European Commission Economic Forecast. Autumn 2010.

<sup>75</sup> Daragh Maher, *Credit Agricole CIB Analyst*. May 2010

<sup>76</sup> Charles R. Morris. *The Trillion Dollar Meltdown: Easy Money, High Rollers, and the Great Credit Crash*. Published by the Public Affairs. 2008

market ideological trend, none more enthusiastically than Alan Greenspan. In the week before LTCM imploded (August 1998) Alan Greenspan<sup>77</sup> told Congress “market pricing and counter-party surveillance can be expected to do most of the job of sustaining safety and soundness” further in 2003 stating:

Crisis of derivatives often raises the spectre of the failure of one dealer imposing debilitating losses on its counterparties, including other dealers, yielding a chain of defaults. However, derivative market participants seem keenly aware of the counterparty credit risks associated with derivatives and take various measures to mitigate those risks.

Having previously pleaded the case for the US Federal Reserve to intervene in the LTCM crisis, Greenspan had changed his market non-interventionist philosophy full turn, insisting the Federal Reserve had to intervene because:

Had the failure of LTCM triggered seizing up of the markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own. (Morris 2008:58)

This is evidence of the major lines of disconnection in political and economic policy at the highest level. Developed nation states have endorsed free market models of neoliberalism for three decades, knowing that the festive intermix of players in capital markets; political identities and lobbyists, had the last say in the bigger question of political economy. This is the Achilles heel of modern economic management. In ever growing numbers, civil society has been asked to accept the views of their elected members that money, and the wider regime of financialisation, is being managed effectively, when clearly there are major market disruptions, requiring public bailouts.

The underlying trigger of the ongoing credit contagion is that market elites and politicians failed to understand and assess risks and warn their constituents about high-level risks of aggressive lending. Home mortgages became the grist for elite quantitative portfolio management after they had been re-engineered into securitised instruments that looked much like tradable bonds. This re-engineering greatly improved market efficiencies and reduced funding costs but also created the illusion that the underlying risks were well under control and understood. The regime was securitisation – packing up loans in the form of collateralised mortgage obligations (CMOs) and selling them off to pension funds and other

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<sup>77</sup> Edward Chilcote. *Credit Derivatives and Financial Fragility*. Policy Note. The Levy Economics Institute of Bard College. 2006/1.

investors. Instead of holding loans on the banks books, banks began to package specific tranches of debt as CMOs collateralised loan obligations (CLOs) and collateralised debt obligations (CDOs), and sold sell them to outside investors. That way banks would still collect hefty start-up fees whilst encumbering very little of their capital. For bankers, lending (through securitisation) had become costless and riskless.

All three of the trends – the shift of a significant portion of financial transactions to unregulated markets, the steady worsening of agency problems, and the pretence that all mortgages can be successfully securitised together – created the great credit bubble of the 2000s. Morris<sup>78</sup> further argues that:

To be a banker in these times (2001 up until the mid-2007 era was very heaven. When the dot-com boom imploded in late 2000, the Fed responded by cutting the federal funds rate from 6.5% to 3-5% within the space of a few months. In the aftermath of the tragic events of September 11, 2001 the Fed continued to lower rates – all the way down to 1% by 2003, the lowest rate in half a century. The Fed (through advice from Greenspan) did not start lifting rates again until mid-2004, and for thirty –one consecutive months the base inflation adjusted short term interest rate was negative. For bankers, in other words, money was free.

Money was free, bankers' lending (securitisation and collateral debt obligations) had become costless, and mathematicians had banished risk through credit insurance (credit default swaps).

The United States' fiscal condition is potentially worse than Greece's. The US is expected to run a \$1.7 trillion deficit this year. The United States' deficit is currently US\$15 trillion, 12.3 per cent of GDP, next to Greece in risk and severity. Then, there is debt-to-GDP ratio. If you ignore unfunded liabilities like Social Security and Medicare, the US already has a debt-to-GDP ratio of 98.1 per cent. That is only slightly off Greece's debt-to-GDP of 112 per cent. Adding the debt of the Government Business Entity, (GBE) Fannie Mae and Freddie Mac mortgage debts (US \$5 trillion), and debt is well over a debt-to-GDP of 112 per cent (actually it's 130 per cent or so). When you include Social Security and Medicare (\$45 trillion), this puts total US debt-to-GDP at 421 per cent (\$59 trillion of debt on a GDP of \$14 trillion). The true figures make the United States technically insolvent.

Recently economists have noted that a dangerous gap of mutual distrust and incomprehension had opened between the world of Eurozone politics and financial markets and that the gap is

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<sup>78</sup> Charles R Morris. 2008 "The Trillion Dollar Meltdown: Easy Money (ibid)

wide enough for countries like Greece to fall through. The Greek crisis has again brought to focus the tenuous situation of European Union partnerships and the enormous attacks by financial speculators on the “PIIGS” (Portugal, Italy, Ireland, Greece and Spain). Add to that the tenuous nature of the United Kingdom economy and it is clear that the wave of sovereign debt being absorbed into economies of these nation states is going to be a problem that even the “shock and awe” application of massive taxpayer-funded bailouts is not going to readily solve, despite short-term “confidence” boosts in markets.

Johan Norberg<sup>79</sup> suggests that the difficulties confronting most Anglo-Saxon developed states economies in 2011- 2012 are that the global financial crisis, starting in September 2007 was “at least part a result of record low interest rates, huge deficits and large scale credit consumption”. Norberg (2011) argues that the current crisis is likely to deepen as governments across the world are trying to solve serious sovereign debt problems by maintaining fiscal policy settings of record-low interest rates, huge deficits, and large scale credit-financed consumption. This time they are also using more novel means of creating easy money: bank bailouts, stimulus packages and quantitative easing. Creating economic growth through quantitative easing is unsustainable, inflationary, and ultimately leads to a worsening of social circumstances for citizens. The IMF states that the world’s rich developed countries have in fact increased their debt levels by 50 per cent over the past three years. British Prime Minister David Cameron unveiled a poster during the British election campaign saying that a baby born in 2010 would owe the equivalent of 17,000 British pounds. This would grow to £21,000 in four years.

As European leaders approved the massive bailout/rescue package for Greece, European central banks began buying Eurozone bonds on May 10, 2010 in an unprecedented injection of cash into the beleaguered European financial system. Despite a temporary bounce in confidence levels as measured by positive market reaction, the euro currency sank again and has continued without sustained support. By early June 2010, the euro sank to a four-year low against the US dollar after Spain’s credit rating was downgraded and the European central bank warned of the possibility of bank write-downs. Unemployment across the 16 countries that share the euro hit a record of 10.1 per cent with almost 16 million citizens looking for work in a rapidly eroding economic and social landscape.

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<sup>79</sup> Johan Norberg, (January 2011) “The Great Debt Bubble of 2011: have our governments averted a financial disaster – or paved the way for a new one”. *The Spectator* ([www.spectator.co.uk](http://www.spectator.co.uk))

Not unexpectedly, governments have been forced to use public funds to bail out the dysfunctional international financial system in the same way that the United States Government transferred billions of dollars of public funds towards its own financial institutions in 2008. Parallel to the use of public funds to replace corporate debt is a swathe of austerity programs for the populace. Whilst the reaction in the streets of Europe against tough social based austerity measures is continuing, Europe's political leaders have launched attacks against the veracity of financial markets and particularly international short sellers who have targeted faltering economies in their market strategies to exact profits. Dysfunction in global financial markets is causing considerable social unrest.

Angela Merkel, the German Chancellor, threw her government's support behind a renewed drive to introduce a global tax on financial transactions, insisting that "ordinary citizens" were demanding that financial institutions share more of the cost of the global crisis<sup>80</sup>. She said that a tax on stock exchange transactions, or a tax on all financial activity, including the profits and bonuses paid by banks, was needed, and she was determined to push for a decision at the G20 summit in November 2011. If the G20 could not agree on such a measure, she said, and then the European Union should act alone. Merkel, British Prime Minister David Cameron, and newly elected French President have each expressed support for a financial transaction tax (FTT). Cameron, though, only supports a global model. Merkel has been the most consistent supporter of an FTT.

Cameron's support for the FTT is a sign that conservative politicians are being forced to look at all available resources to balance the undesirable economic effects on public funds. In a formal statement of policy to the German Bundestag, Merkel also announced that the ban on short selling in Germany would last indefinitely, or until the European Union agreed on a common regulation. Ms Merkel toughened the government stance on financial regulation in the face of a growing popular backlash against the cost to Germany of providing credit guarantees to the weaker economies in the euro zone. She said that the currency crisis in the euro zone was the greatest test of the European Union since the signing of the Treaty of Rome in 1957. Strong measures are needed. German Chancellor Angela Merkel has spoken at length about the possibility that Greece may have to voluntarily leave the euro configuration (albeit temporarily) if it fails to meet the strict austerity conditions that are held

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<sup>80</sup> "Merkel toughens stance on financial regulation" Quentin Peel, Berlin. *The Financial Times*. 19 May 2010.

against loans. The head of the OECD Angel Gurría said that contagion in the Eurozone called for swift action by Greece saying, “(the contagion) is like Ebola”. “When you realise you have it you have to cut off your leg in order to survive<sup>81</sup>”.

## **2.7 *Real versus Shadow Economies***

So totally disengaged have “real” state-based economies become from the macro shadow financial markets that their presence is only noted during times of dysfunction. The plight of local-based nation state economies is severely altered in times of global economy dysfunction. The reality for citizens based within market systems aligned to “real” economies is that the decade of global macro overlay of credit has created high levels of risk through industries, and households. Nation states grappling with sovereign debt have no choice but to instigate austerity measures including massive cuts in public service budgets, which will be, of necessity, an anathema to its citizens, such is the gargantuan nature of debt reduction required to balance national accounts. These measures reduce social opportunity. They create precarious housing, employment and living conditions to millions of citizens around the globe as I discuss in Chapter 3.

Three distinct phases map disconnect between real and shadow economies. First, the regime of free markets and the concomitant neoliberal paradigm of concentrated wealth and consolidating corporate power, thus formulating a vast and highly specialised lobbyist machine to sell the strategies for financial engineering. Second, the winding down of the industrial and manufacturing sector in favour of unregulated global market players, enabled by sophisticated “state of the art” flash and algorithm trading mechanisms to capture the trading edge in markets. Third, is a disenfranchised social aftermath resulting from the boom and bust cyclical nature of global finance? The necessary de-leveraging of credit markets, and with it unemployment, inability of citizens to maintain employment, and business stress, has been the politically and social undesirable consequence facing many developed states. Whatever gloss is layered across the capacity of current governments to trade out of insolvency, and protect their citizens in hard times, there is no escaping the veracity, secrecy and political engineering and influence of lobbyists in this contemporary political economy phase.

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<sup>81</sup> Jeremy Walker. “Europe’s dithering on debt threatens to power up the financial doomsday machine again.” *The Telegraph (UK)*. 28 April 2010.

The financialisation of global markets was driven by excessive lending on a massive scale because all three inhibitors had been taken out of the equation. Global capital supplies to an awaiting array of speculative investors were available in large volume. Bank lending (through the agency of securitisation) had become common practice, and mathematicians appeared to have banished risk through credit insurance (credit default swaps/synthetic CDOs) (see the following section). Engel and McCoy<sup>82</sup> suggest that:

Subprime securitisation is a relatively new phenomenon, followed on the heels of securitisation in the prime residential loan market, first pioneered in the late 1970s. By the early 1990s, technological advances made it possible to estimate and price the risk of sub-prime loan pools, paving the way for sub-prime securitisations. In 2005, total securitisations of subprime and home equity loans ballooned to an estimated US\$525.7 billion. Today lenders securitise almost eighty per cent of subprime mortgages<sup>83</sup>.

When money is free and lending is costless and riskless, the rational lender will keep on lending until there is no one else to lend too. Alan Greenspan foresaw a glorious new era of finance adding to his string of memorable “bubble” endorsements he announced a “new paradigm of active credit management”.

Fleckenstein<sup>84</sup> suggested:

Even the most unglamorous drudge shops in the gleaming towers of finance chunked out unending streams of gold. Home equity loans to risky and strapped homeowners, high-rate credit cards to insolvent consumers, and a vast strategy involving banks, accountants, credit agencies and all under the policy structures known to the Fed.

All bubbles burst and by the end of 2007 indications that the finance capital driven housing bubble was about to end. . By 2007 (after Greenspan against all odds had held interest rates low for a protracted period of massive credit expansion), the *Economist* magazine wrote that “the global financial system ... has become a giant money press as Americans’ easy money policy spilled beyond its borders... This gush of global liquidity has not pushed up inflation. Instead it has flowed into share prices and houses around the world inflation a series of asset price bubbles”. Stephen Roach, chair of Morgan Stanley Asia has the called the US Federal

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<sup>82</sup> Kathleen C. Engel and Patricia A. McCoy “Turning a Blind Eye: Wall Street Finance of Predatory Lending” *Fordham Law Review*. Volume 75.

<sup>83</sup> “U.S. RMBS Volume and Rating Activity Continue to Set Records.” *Standard and Poor’s (S&P) Rating Transitions 2005*. 24 January 2006.

<sup>84</sup> William A. Fleckenstein, with Frederick Sheehan. “*Greenspan’s Bubbles: The Age of Ignorance at the Federal Reserve*.” McGraw Hill, New York. 2008

Reserves' performance during this period as "unconscionable". At this period, strong political leadership was urgently needed, but not forthcoming.

A survey "Asset Price Bubbles and Monetary Policy" released by the European Central Bank<sup>85</sup> in 2005, was scathing of the fast easy money policies in the US and stated in part:

{A}s households are typically encouraged to spend out of their capital gains when asset prices advance, durable and sizable bubbles can boost consumer expenditure. ... In this respect, empirical evidence tends to suggest that a deflating bubble in the housing market is more costly than an equally sized crash in the in the stock market, as housing equity is more widespread and more intensely used as collateral for securing credit.

## **2.8 *Synthetic CDOs and the Global Economy***

Sophisticated financial instruments called collateralised debt obligations (CDOs) became the new phenomena signalling the rapid specialisation of money market expertise, using globally integrated technology, in the contemporary phase of financialisation. The CDOs spliced tranches of debt categorised into risk-rated components by ratings agencies, which investors around the world demanded to pass onto the new-age cyber investment markets controlled by hedge funds and a growing band of single investors who believed that risk could be measured by rating agency assessment.

Another form of investment vehicle that has played a leading role in the financialisation of global markets is the synthetic CDO, which has taken the sophisticated nature of specialist innovative architecture to a new level. The synthetic CDO<sup>86</sup> was also instrumental in the matrix of circumstantial events during the sub-prime crisis involving investors, speculators and mortgage holders. These mortgage-related securities were seen as the dominant reason for the diminution of lending standards that enabled high-risk clients into mortgage loan markets. High risk clients who in any other setting would not be granted loans became acceptable to loan originators because their sign up contribution (debt) was immediately accepted into the portfolio structures being marketed to wider global investors. The portfolio

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<sup>85</sup> "Asset Price Bubbles and Monetary Policy" released by the European Central Bank. 2005

<sup>86</sup> Collateralised debt obligations (CDOs) are a type of structured asset-backed security (ABS) with multiple "tranches" that are issued by special purpose entities and collateralized by debt obligations including bonds and loans. Each tranche offers a varying degree of risk and return so as to meet investor demand. CDOs' value and payments are derived from a portfolio of fixed-income underlying assets. CDO securities are split into different risk classes, or tranches, whereby "senior" tranches are considered the safest securities. Interest and principal payments are made in order of seniority, so that junior tranches offer higher coupon payments (and interest rates) or lower prices to compensate for additional default risk.

structures accept tranches of high, medium, and low risk debt into securitised CDOs, thus layering risk within the investment unit.

The lowering of lending standards created a higher a volume of speculative debt to be incorporated in the financial modelling that inherently differentiated between the desires to accommodate low income borrowers and the demand of institutional investors who viewed CDOs as safe, positively rated, high yield financial market instruments. Financiers then sell these specialist investment vehicles globally.

A synthetic CDO<sup>87</sup> is primarily a complex financial security, a speculative investment instrument, which manages the risk that an obligation will not be repaid. It is a derivative whose value is originated from a predetermined and predefined set of reference securities that may or may not be owned by parties (counterparties) that contract over different viewpoints and outcomes. Both parties effectively bet on perceptions. Investment banks and hedge funds are typical counterparties, and are involved in selecting the reference securities to be wagered upon and the counterparties to buying the relative risk. These market players are critical to the financialisation of global financial markets. Moreover, each depends on the other.

Complex legal entities known as structured investment vehicles (SIVs) facilitate contracts. One counterparty pays a premium to the other in exchange for a payment if a certain event occurs. These premiums are highly leveraged over-the-counter transactions, which are unregulated, off the record, and mostly transacted from offshore tax havens. They are, nevertheless, highly speculative and use credit default swaps as the medium to transact. Their spread can be over a hundred consenting companies, across the globe. It is a form of insurance against bonds (securitised debts such as CDOs). The controversial nature of these international trades is located in the associated inter-related nature of relationship with ratings agencies, who receive payment by the mortgage originator to grade investment risk<sup>88</sup> inherent in the procedures. Payments to ratings agencies were seen as a major contributing factor to market dysfunction.

Residential mortgages became the grist for quantitative portfolio management after they had been re-engineered into instruments that looked much like tradable bonds. This re-

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<sup>87</sup> A Synthetic CDO is a form of CDO in which the underlying credit exposures are taken on using a Credit Default Swap (CDS) rather than having a specialised “vehicle” to buy assets such as bonds and securities. Synthetic CDO’s can either be single tranche CDO’s or fully distributed CDO’s. CDS’s generate income selling insurance against bond defaults.

<sup>88</sup> “Goldman Responds to SEC Complaint” April 16, 2010. “Bank Bundled Bad Debt, Bet against It, and Won” *The Wall Street Journal*. April 2010.

engineering greatly improved shadow economy market efficiencies through reduced funding costs, but also created the illusion that the underlying risks were well under control and understood. This illusion was aided by the proprietary compliance of ratings agencies Standard and Poors, Fitch and Moody's, all of whom allocated AAA first grade assessment of mortgages sold to high risk citizens without reasonable ability to complete repayment agreements. Rating agency compliance thus triggered the economic dysfunction as investments collapsed. All three of the trends – the shift of financial transactions to unregulated markets, the steady worsening of agency problems, and the pretence that all finance can be mathematised – flowed together to create the great credit bubbles of the 2000s, and the post Global Financial Crisis sovereign debt now carried by developed states.

Many economic analysts were raising concerns that the sub-prime debt levels were posing excessive risks to markets. Little political response was forthcoming. Yves Smith<sup>89</sup> argued that:

Every mortgage industry conference discussed it, every credit committee considered it. The bad debts were packaged up in collateralised debt obligations or CDOs – bundles of debt divided into tranches from very high-risk “equity” to safe-bet “AAA”. In such an environment demand for subprime backed CDOs should have fallen off a cliff and thus shut down the boom. But it didn't. Demand for sub-prime backed debt packages continued to rise and their yields continued to fall. The bubble continued on Wall Street even as house prices stabilised and then began to fall. How could that be? As more investors realised the precariousness of the bubble demand for subprime debt should have disappeared choking off the cash that enabled the boom. Most mortgage industry participants assumed that there was a degree of rationality that would constrain reckless behaviour.

Streithorst<sup>90</sup> suggests that the difference laid with the availability of the credit default swaps (CDSs) and synthetic CDOs which used us CDSs to “mimic the behaviour of underlying debt, thus allowing short sellers a profitable “if vicious” vehicle to lay their bets. This market engineering supported the buoyancy of the market, regardless of the nature of the pre-existing model which related to houses and mortgages in the “real economy”. Fundamental differences in the market structures thus demonstrate the growing disconnect between the shadow economy (speculative non-transparent financial innovations) and the real economy. In 2002, well before the current credit crisis, Warren Buffett, who is one of the most successful investors in history and in 2008 was ranked by Forbes Business Magazine as the

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<sup>89</sup> Yves Smith as quoted in Tom Striethorst “The Cult of Smart Money” *Prospect Magazine*. 1<sup>st</sup> June 2010

<sup>90</sup> Tom Streithorst “The Cult of Money” *ibid*

richest person in the world, raised serious concerns<sup>91</sup> about the incentives of market participants working with derivatives and specifically warned about the explosion in derivatives:

The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts. In my view, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.

Lessons to be learnt from the financialisation of markets have been short lived as Republican members of the Financial Crisis Inquiry Commission in December 2010 voted to remove the terms “Wall Street”, “Shadow Banking System” and “Deregulation” from the bipartisan report on the causes of the most significant global economic crisis of our times. The Republican Party report said the crisis was the United States Government’s fault and that it had nothing to do with hedge funds or creating mortgage-backed securities such as CDOs and CDSs. The Republicans stated in the report that the crisis had nothing to do with big bonuses or skewed incentive structures and laid the fault directly on the government forcing banks “to make bad loans to poor people”. The Republican Chairman of the House Financial Services Committee<sup>92</sup> told a reporter the purpose of the regulators (during the prelude to the crisis) is “to serve the banks”. These responses to a financial catastrophe (ongoing) indicate the high level of political deficit of global leaders who have aligned themselves intricately with money market elites.

## **2.9 Expansionary Economies**

Darvas and von Weizsacker<sup>93</sup> argue that short-term speculation and the parallel increase in liquidity made markets more efficient than before and that a larger share of additional trading is the consequence of anomalies in financial markets. They argue that it linked to the excessively low interest-rate policy of major developed countries since the early 2000s, which has fuelled the dual expansion of money and credit with subsequent asset-price booms

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<sup>91</sup> Warren Buffett 2008. Quoted in European Parliament Report. “The Financial Transaction Tax: Small is Beautiful” *European Parliament Publications* June 2011.(also see references 67 and 68) ([www.europarl.europa.eu/document/.../20110607ATT20919EN.pdf](http://www.europarl.europa.eu/document/.../20110607ATT20919EN.pdf))

<sup>92</sup> Tom Streithorst “Financial crisis: Republicans re-write history”. *Prospect Magazine* available at ([www.prospectmagazine.co.uk/2010/12/financial-crisis-republicans-re-write](http://www.prospectmagazine.co.uk/2010/12/financial-crisis-republicans-re-write))

<sup>93</sup> Zsolt, Darvas, and Jacob Von Weizsacker February 2010 “Financial Transaction Tax: Small is Beautiful” *Bruegel Policy Contribution*. ([www.bruegel.org](http://www.bruegel.org)). Briefing paper prepared for the European Parliament Economic and Monetary Affairs Committee’s public hearing “Financial transaction taxes: making them work” 2 December 2009.

that further fuelled trading activity, with this activity grossly outpacing expansion of nation state economic activity registered as gross domestic product (GDP). For example, the annual turnover in global financial markets was 20+ per cent of global GDP in 1995 and 70 per cent in 2007, with 64 per cent of this market being derivatives related to fixed income products (including CDOs and CDS). Gross open positions on over-the-counter derivatives were US\$80 trillion in 1998 and by late 2007 and the Lehman's precipitated meltdown, the figure was US\$680 trillion, more than 40 times the size of the annual GDP of the United States. The gross open position post crisis is US\$583 trillion.

Hedging and distribution of interest-rate risk may not be related solely to fixed-income securities, but also to credit. There are no readily available statistics on all-inclusive world credit, but its stock may be between 100 per cent and 200 per cent of world GDP, which was US\$55 trillion in 2007. Adding the stock of credit to the stock of fixed-income securities, the resulting sum is still a tiny fraction of the US\$ 2,403 trillion fixed income related annual derivatives trading<sup>94</sup>.

The past decade (2001–2012) has been a financial speculators' utopia. Offshore financial centres including known tax havens as well as designated low tax zones of Canary Wharf in London and Wall Street hit optimum trade levels. More than half of all global financial transactions were siphoned through offshore financial centres and the lack of transparency, lax regulatory approaches by governments, and sophisticated financial modelling, has prevented external scrutiny. The paradigm of shadow economies is built on secrecy and lobbying at the highest political levels.

Very little is known about who owes, and who is obligated, but it is obvious that the process of securitisation has made asset classes highly tradable and the consolidation processes therein makes the task of evaluation and nature of risk analysis and identity virtually impossible. United States economic commentator Robert Reich<sup>95</sup> argued:

What is desperately needed is a clear delineation of the boundary between global capitalism and democracy – between the economic games, on the one hand, and how its rules are set on the other. If the purpose of capitalism is to allow corporations to play the markets as aggressively as possible, the challenge for citizens is to stop these economic entities from being authors of the game.

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<sup>94</sup> "Financial Transaction Tax: Small is Beautiful" *Bruegel Policy Contribution Issue 2010/ibid*

<sup>95</sup> Robert Reich. (2007) writing in the August 2007 edition of *Foreign Policy*. Quoted in "The end of the end: the rise of the Beijing consensus will have shocking implications for Australia." *Spectator Australia*. 25 February 2012.

The systemic risk associated with offshore markets, the essential “engine room” for speculative transactions is described in detail in Chapter 5.

## ***2.10 Financialisation and Concentration of Wealth***

From 1980 to 2006 the wealthiest 10 per cent of Americans increased their share of national income from 35 per cent to 49 per cent. In the 1970s, the richest one per cent of Americans owned 20 per cent of America. On the eve of the Global Financial Crisis they owned 40 per cent of the nation’s wealth. During the Keynesian era of the 1970s and early 1980s, American CEOs earned 25 to 30 times the salaries of median workers’ wages, but by 2007 it had reached 500 times<sup>96</sup>. In Australia, a recent survey<sup>97</sup> estimated that the wealthiest 20 per cent of society own 61 per cent of the nation’s wealth whilst the poorest 21 per cent own one per cent.

The financialisation of global economies has been examined by political economists, concerned that the rise in the neoliberalist models have placed democracy and the capitalist economy at risk, further, suggesting that governments were “structurally dependent” on corporations in the closed economies of the post war world. Lysandrou (2011) argues that the driving force behind the structured credit products that triggered the financial crisis was a global excess demand for securities, and that key to the build-up of this demand was the huge accumulation of private wealth<sup>98</sup>.

This perceived inter-dependence has become much stronger with the increasing models of international financial liberalisation and has deepened the dependence of global states to both the real and shadow financial markets. A number of scholars<sup>99</sup> have concluded that international financial deregulation is associated with regressive taxation and income dynamics, as well as decreasing government expenditures, which is concomitantly explained by the continuing neoliberalist economic modelling, which prefers the sale of state-owned services to the private sector. This is contradicted by the willingness, during this phase of the sovereign debt crisis, of the state to accept corporate debt into public accounts.

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<sup>96</sup> Robert Manne and David McKnight. “Death throes of the neo-liberal delusion” based on the chapter “Goodbye to All That? On the Failure of Neo-Liberalism and the Urgency of Change” *The Monthly* April 2010

<sup>97</sup> Melissa Fyle. “Rich and Poor divide underestimated”. Australian Bureau of Statistics and research paper “Australian attitudes Towards Wealth Inequality and the Minimum Wage” by David Neal and Cassandra Gavan of Empirica Research, Michael Norton of Harvard University and Dan Ariely of Duke University. 15 May 2011

<sup>98</sup> Photis Lysandrou. “Global Inequality, Wealth Concentration and the Subprime Crisis: A Marxian Commodity Theory Analysis” *Development and Change, Volume 42, Number 1*, January 2011. pp. 183-208.

<sup>99</sup> Dennis Quinn “The Correlates of Change in International Financial Regulation” *Georgetown University*, September 1997. See also Kurzer (1993), Steimo (1994), Cohen (1996 p288).

The position argued in this thesis is that the financialisation of western Anglo-Saxon economies is placing an ever-increasing burden on the standard of living, employment expectations, and provision of services, for citizens of those states. In terms of the post-Lehman Brothers crisis, it is estimated that the cost to governments globally will be in excess of US\$7trillion. That is, US\$4 trillion in transfers of government money to bail out corporations, effect broad stimulus packages, and realign commitments to the provision of government education, health services and environment protection already depleted by the neoliberalist modelling and the erosion of the corporate tax base over three decades. The socioeconomic costs of the current crisis are high. In Spain alone, the unemployment rate is estimated to be 21 per cent, adding to likelihood of social turmoil across this and other countries<sup>100</sup>. Eurostat, economic forecasters, estimates that 25.1 million men and women were unemployed in the European Union in June 2012, of whom 17.8 million are from the Eurozone<sup>101</sup>. A financial transaction tax would provide an ethical response to making the financial sector more accountable.

## **2.11 Conclusion**

The recent phase of sovereign debt crises across Europe and the United States has arisen because of the continuing imbalance between economies running large current account surpluses and economies running large current account deficits. This imbalance of trade in finance (and consumables) is between three of the world's largest economies (Japan, Germany and China), and the heavily indebted nation states in Europe and North America. This imbalance has underpinned the transfer of China's excessive savings to the United States, which has engineered a financial system based on high volume, low interest finance. This series of circumstances may not be unique but the social consequences are now being felt across the globe as the participants in the (almost) free market in finance are called to account. For the lenders and on-sellers in shadow economies, their accumulated concentration of wealth has been mesmerising. For members of real economies, the time of reckoning is at hand. Banks are debt laden, civil society is under great pressure and the immediate prospect of debt reduction will be painful.

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<sup>100</sup> Maley, Karen "Europe feels the cold hand of debt", *Business Spectator*. 29 April 2010.

<sup>101</sup> Stephen Castle "Unemployment rate in Eurozone is at a record high". *New York Times News Service* 31 July 2012.

This chapter has examined the implicit policy mechanisms that have underpinned the rapid growth in transaction volumes, and the disconnect between the “real” and the “shadow”<sup>102</sup> economies, as the key measure of financialisation in the decade 2000–2011. This chapter looked specifically at financialisation as a framework which introduces Chapter 3: The Social Consequences of Financial Markets. Chapter 3 examines the social costs directly emanating from unwise lending and borrowing on a global scale and liberalisation of markets.

Macro level interplays directly influence social consequences. Significant political economy directions include, primarily, the balance of power between the emerging BRIC economies of Brazil, Russian Federation, India, and China and the developed Western economies of the United States, Europe, and Australia. . Related directly to this is the reliance of Western economies upon China. Policymakers in Western countries struggle to find political relevance in nation state communities facing high debt repayment and high unemployment in stagnant economies. Chapter 3 examines the social consequences emanating from fragile market economies now dominated by buoyant shadow economies increasingly disconnected with the real economies of developed Western nation states that after thirty years of growth now face retracting economies with declining wealth. Declining stock rates of 9.6 per cent over the past five years<sup>103</sup> have occurred in Australia. Democratising fragile finance is a social imperative.

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<sup>102</sup> The real economy defined as internal state economies that are known and taxed but not always regulated and the shadow economy as unregulated with borderless impact (i.e. over-the-counter derivatives markets). See also reference 115.

<sup>103</sup> Alan Kohler. Australian Broadcasting Commission. Inside Business Program. 5 August 2012

## Chapter 3

### The Social Consequences of Financial Markets

#### 3.1 Introduction

Wilhelm Reich (1933) suggested that governments and elected leaders should consider the social implications of economic policy outcomes when he asked: “What do we owe one-another as members of the same society when we no longer inhabit the same economy?”<sup>104</sup>

Chapter 3 seeks to explain the effects that current political settings, which enable unregulated capital markets, have on society, locally and across borders. The aim of this chapter is to develop an argument that evidences the urgent need to provide stability in global markets through the introduction of a regulatory taxation mechanism.

Severe social consequences have been a feature of the Global Financial Crisis and its second phase of credit contraction, and financial deleveraging<sup>105</sup>. Austerity measures across Europe and North Atlantic countries restrict welfare states’ service provision capacities and turn this crisis into the most socially destructive in modern times.

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<sup>104</sup> Reich, Wilhelm, “*The Mass .Psychology of Fascism.*” Farrar, Straus and Giroux. Berlin. 1933 (Published in English 1980).

<sup>105</sup> A *short-term cycle*, (which is commonly called the business cycle), arises from a) the rate of growth in spending (i.e. total \$ funded by the rates of growth in money and credit) being faster than the rate of growth in the capacity to produce. A *recession* is an *economic contraction* that is due to a contraction in private sector debt growth. *Recessions* end when central banks lower interest rates to stimulate demand for goods and services and the credit growth that finances these purchases, because lower interest rates 1) reduce debt service costs; 2) lower monthly payments (de facto, the costs) of items bought on credit, which stimulates the demand for them; and 3) raise the prices of income-producing assets like stocks, bonds and real estate.

A *long-term debt cycle* arises from debts rising faster than both incomes and money until this can’t continue because debt service costs become excessive, typically because interest rates can’t be reduced any more. A deleveraging is the process of reducing debt burdens (e.g. debt/income ratios). *Deleveraging* typically end via a mix of 1) debt reduction, 2) austerity, 3) redistributions of wealth, and 4) debt monetisation.

A *depression* is the economic contraction phase of a deleveraging. It occurs because the contraction in private sector debt cannot be rectified by the central bank lowering the cost of money.

In *depressions*, a) a large number of debtors have obligations to deliver more money than they have to meet their obligations, and b) monetary policy is ineffective in reducing debt service costs and stimulating credit growth. Depressions are typically ended by central banks printing money to monetize debt in amounts that offset the deflationary depression effects of debt reductions and austerity. Dalio, Ray. March 2012 “How the Economic Machine Works and how it is reflected now” Bridgewater Associates LP. United States. (See also) “The Great Escape: Delivering in a Delevering World” PIMCO Investment Outlook. April 2012. PIMCO.

Bresser-Periera<sup>106</sup> (May 2010:2) argues that the major change to world financial markets that occurred after the end of the Bretton Woods system in 1971, is now entrenched and associated within the regime of financialisation and hegemony through neoliberalism.

Further, Bresser-Pereira suggests that:

*financialisation* will be understood here as a distorted financial arrangement based on the creation of artificial financial wealth, that is financial wealth disconnected from real wealth or from the production of goods and services. Neoliberalism, in its turn, should not be understood merely as radical economic liberalism but also as an ideology that is hostile to the poor, to workers and to the welfare state. Second, I will argue that these perverse developments, and the deregulation of the financial system combined with the refusal to regulate subsequent financial innovations, were the historical new facts that caused the crisis.

As set out in Chapter 2, following the Global Financial Crisis there has been a re-emergence of transnational capital, awash with speculative instruments, and political influence. This denotes the next regressive phase of the Global Financial Crisis, a crisis increasingly integrated with North Atlantic economies and a crisis that continues to place risks on Australian civil society. Whilst the real economies of many global states are faltering in their recoveries, shadow economies are buoyant, protected and dangerous in that they will always place stress on states which appear to be cautious or unwilling participants, and inflict financial harm even on unwilling participants

This chapter describes the breakdown of the neoliberalist economic regime as the crisis essentially becomes a battle between states and the unregulated shadow economy financial markets with civil society the unprotected and often disenfranchised interface between the key determinates.

As nation states in East Asia, China, and Vietnam join the industrial democracies of India and Japan to provide finance and goods to the integrated global economy, many citizens have become alarmed at the ever-widening effects of financialisation of globalised markets, and the variety of social issues that manifest in the form of

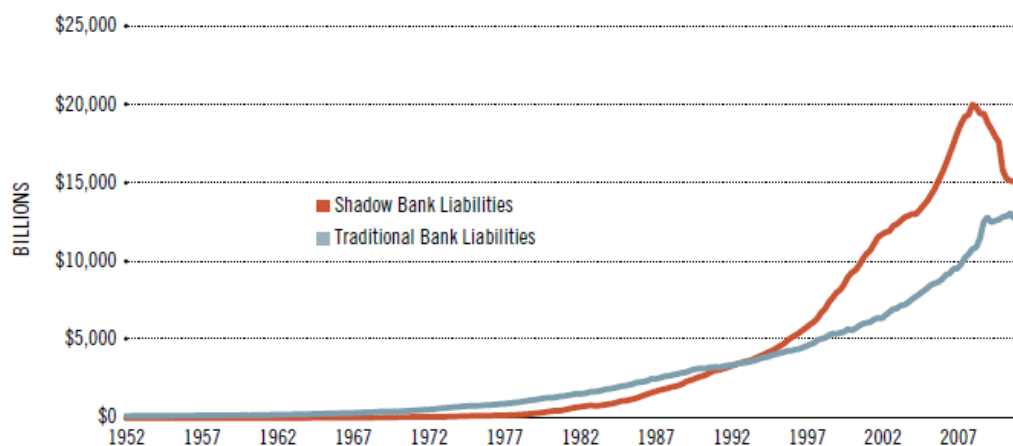
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<sup>106</sup> Luiz Carlos Bresser-Pereira. "The Global Financial Crisis and a New Capitalism?" *Levy Economics Institute Working Paper No. 592*. May 2010. The Getúlio Vargas. Foundation

economic and political instability, unemployment, under-employment in times of downturns, destabilisation of states' internal financial systems, and environmental degradation.

Many economists have been calling for a moderation in the free market approach enthusiastically adopted by politicians over the past three decades and freely adapted by capital markets particularly over the past decade (2001–2012). Multi-layered shadow economy structures are increasingly disassociated from state-based real economy regulatory systems, but at the same time create key changing forces in the economic and social life of nations<sup>107</sup>. Dysfunction in fast growing global shadow economies triggers interest rate rises in state-based economies with the instant result that homeowners are disadvantaged, capital value evaporates, and investments are downgraded. This also has an effect of competition in currency valuations between countries. Shadow economy players win, or lose, on sophisticated fraction-of-a-second bets on interest rate and currency value fluctuations in a vast trading theatre that affects economic and social choice.

Four trillion dollars is traded every day in the currency trade markets alone. Most trades are within shadow economies.



**Figure 3.1: Shadow Bank vs. Traditional Bank Liabilities, 1952–2007.<sup>108</sup>**

<sup>107</sup> Joaquin Pires O'Brien "Towards a fair capitalism." *Contemporary Review*. December 2001

<sup>108</sup> Shadow Bank vs. Traditional bank Liabilities 1952-2007.: *Federal Reserve Board/Haver Analytics* and calculations from Adrian, Ashcraft, Boesky, and Pozar.

### 3.2 *Social Realities of Financialisation*

The emergent regime of financialisation has been “sold” to global citizens following the dot.com bubble and bust in the United States and the terrorist attacks in New York. With public confidence at low levels the Bush Administration, Alan Greenspan engineered a financial revival through the introduction of almost free money, with hedge funds and investment banks, channelling carry trade finance originating from China and Japan. This combined with a growing sophistication in financial architecture created the “perfect storm” of cheap money to translate into new debt passed onto consumers through all western nation states in a Wall of Money. From 2003 to 2005, outstanding mortgage debt grew by US\$3.7 trillion (an amount almost equal to the US\$3.8 trillion of total outstanding debt). Fleckenstein argued that in three years (2003–2005) the United States had accumulated in debt what had previously taken 200 years to “rack up”<sup>109</sup>, adding that “one might wonder how Chairman (Greenspan) felt with the ‘*mortgage-for-anyone-with-a pulse*’ was concerned when, on April 8 2005 Greenspan “let the country know where he stood” in respect to the flood of credit through to consumers saying:

(T)he technological advances have resulted in increased efficiency and scale within the financial services industry. Innovation has brought about a multitude of new products, such as subprime loans, and niche credit programs for immigrants...With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumer's, leading to a rapid growth in sub-prime lending.

Peter Boone and Simon Johnson (July 2010)<sup>110</sup> argue that:

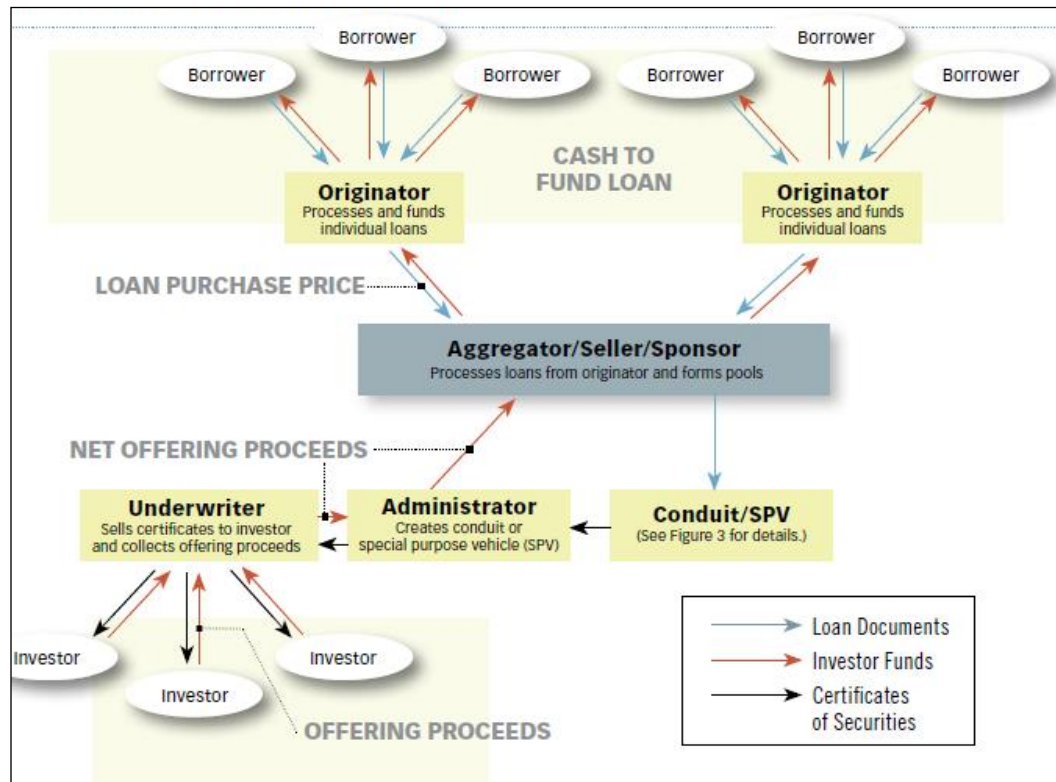
During the last four decades governments in wealthy countries have built up large contingent liabilities due to the implicit guarantees they have provided to their financial sectors. Politicians are motivated to create near term growth and always reluctant to permit hardships that would otherwise arise from defaults and greater austerity. As a result, the industrialised world has experienced excessive and dangerous financial sector development.

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<sup>109</sup> William A. with Frederick Sheehan Fleckenstein, “Greenspan’s Bubbles: The Age of Ignorance at the Federal Reserve.” *McGraw Hill*. New York. 2008

<sup>110</sup> Peter Boone and Simon Johnson. Chapter 10. “Will the politics of global moral hazard sink us again?” in “*The Future of Finance and the theory that underpins it*” Adair Turner and others (2010) *The Future of Finance: The LSE Report and Conference*. July 2010. London. United Kingdom. See also reference in *The London Evening Standard* “Anthony Hilton: Too much banking can be a bad thing.” 31 October 2012.

Including all promises, U.S. and European taxpayers back over 250% of their GDP in implicit obligations, all of which contribute to the development of moral hazard in lending around the world. If this incentive system remains in place and these liabilities continue to grow unchecked, the eventual end of this “Doomsday Cycle” – with repeated bailouts for distressed lenders – will be large sovereign defaults and economic collapse. The current round of regulatory reform is not sufficient to stop this trend.



**Figure 3.2: The Creation of Securities from Loans<sup>111</sup>.**

This chart describes the complexities of loan originators in the comparatively new financial market led securitisation of loans. Securitisation of loans figured prominently in the “subprime meltdown” as finance capital engineered a product to channel finance to lenders and then home buyers in the United States. The process of securitisation allowed underwriters to package loans (high and low risk) to on-sell through global investment banks. Special Purpose Vehicles enabled the packages to be wrapped and on-sold).

This chapter explains sovereign debt and the concomitant phenomenon of the socialisation of debt. The two decades from 1980 to 2000 have delivered extraordinary economic growth to most developed countries through the liberalisation

<sup>111</sup> Christopher Holt. “Is Securities Lending starting to dry up a little”. *MarketSkeptics*. June 2009

of finance. This continued through the next decade (2001–2007). In the United States alone, increases in housing wealth reached US\$8 trillion; peaking in 2007 and then dropping by over 25 per cent in the third quarter of 2008 (post Lehman). Housing wealth has now turned to housing debt of unprecedented levels with 4.1 million mortgages across the United States either foreclosed (2.1 million) or at serious risk of foreclosure (over 2 million mortgages with no repayments for longer than 90 days).

For the troubled government-guaranteed mortgage agencies Freddie Mac and Fannie Mae, their ongoing solvency is threatened by mortgages originated during the “free lending period” of 2006 and 2007 which account for 24 per cent of the total portfolio valued at US\$5 trillion.

Against this, credit losses for these mortgages total 67 per cent of the securitised portfolio values and still threaten the entire system<sup>112</sup>. In what follows, this chapter seeks to explain the current dynamics of financial markets from a social and stakeholder perspective. The wider social implications are drawn against a background of developments in the shadow and real economies. Consistent with the central views and arguments in this thesis, a position is put that posits moderate regulatory reform through the introduction of a financial transaction tax on a global unilateral scale. This thesis argues that speculative capital trades are injurious to global civil societies.

### **3.3 Weakened Social and Political Structures**

Wallenstein<sup>113</sup> argues that the term *globalisation* became the more optimistic euphemism to describe the economic and concomitant social crises that played through successive cycles from 1970 to the present time. He (Wallenstein) suggests that the period 1945 to 1970 marked the height, and supremacy, of the United States’ hegemonic period referred to as *les trente glorieuses*: the most expansive Kondratieff A<sup>114</sup>-upturn that the world had ever known. Against this the cyclical rhythms of downturns were a natural market circumstance of world capitalist system functionality, with the two key interfaces being how states guarantee the world order

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<sup>112</sup>. “Fannie Mae and Freddy Mac: Unfinished Business” *The Economist Finance and Economics Section*. The Economist 14 July 2010

<sup>113</sup> Emmanuel Wallenstein. “Structural Crisis.” *New Left Review*. March April 2010

<sup>114</sup> The Kondratieff Wave is the economic theory that there is a long economic cycle model lasting approximately fifty years. The Kondratieff Wave overlays the ordinary business cycle which is shorter in scope. Thus the present downswing could mark the start of a cycle that could last for decades.

of social norms of welfare and common goods, and producers make profits within the processes of supply and demand. These are the necessary function of expansion at state and global levels.

The United States' *real* economy could well have been delivered a death blow by the after effects of the financial crisis. The *real* economy<sup>115</sup> has been effective in shifting corporate debt to the public sector in order to prop up ailing financial interests (post Lehman Brothers and Bear Stearns) but the net effect of high level government debt is significant government cutbacks and program tightening in the form of austerity in the public service account.

Transnational capital players on the other hand have been successful in providing unprecedented lobbying techniques to stall and discredit government approaches to regulate capital markets. Unregulated markets have recovered from a relatively modest post Global Financial Crisis slump to record daily international turnover both in numbers of trades and quantum<sup>116</sup>. Notional amounts outstanding of over-the-counter derivatives climbed 18 per cent to \$707.6<sup>117</sup> trillion by the end of June 2011, compared with the six months ended December 2010, when they increased three per cent, the Bank for International Settlement said in their report. Interest-rate swaps jumped 21 per cent to \$441.6 trillion in the first half, accounting for 62 per cent of the total amount, the report showed. Credit-default swaps rose eight per cent to \$32.4 trillion.

Critiques of free market capitalism locate their focus on the structure of markets and their relationship to social institutions. The instability and volatility of active markets can devalue the economic base of real lives, or in more macro-scenarios can lead to the collapse of national and regional economies. Susan Strange<sup>118</sup> (1986:9-10) called this instability "casino capitalism", a phenomenon she links to five trends: innovations

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<sup>115</sup> The *real* economy is distinctly different to the shadow economy. The *real* economy encapsulated the state based incoming and distribution of revenue to the services deemed by the state to be those that guarantee the social goods of a society: that is environmental management, water, communications, electricity, waste disposal, education, and welfare. The *shadow* economy relates primarily to finance without borders, unregulated capital flows, tax haven based micro-economies, lobbyists to sell their cause within state based governments in order keep their issues protected.

<sup>116</sup> "Derivatives Market Growth Accelerates to 18% BIS." *Bank for International Settlements (BIS)* September 2011 as reported in Bloomberg November 2011

<sup>117</sup> Bank for International Settlements (BIS). *Quarterly Survey of Over the Counter (OTC) Derivatives International Notional Amounts Outstanding*. March 2012.

<sup>118</sup> Susan Strange "Casino Capitalism" Pluto Press. 1986

in the way in which financial markets work; the sheer size of markets; commercial banks turned into investment banks; the emergence of Asian nations as players; and the shift to self-regulation by banks.

The speed at which markets work combined with their now, near-universal pervasiveness, results in a volatility that extends globally. Approximately US\$7 trillion dollars are invested daily as speculative foreign currency transaction trading convoys<sup>119</sup>. The quarterly turnover in global exchange-traded interest rate derivatives hit US\$600 trillion (gross outstanding contracts) in 2007 (pre-crisis), US\$80 trillion in equity-related trades, and US\$8 trillion in currency-related derivatives<sup>120</sup>.

Market analysts argue that there are two views that explain the explosion of global financial transactions from 2000 to 2010. The first suggests markets are more efficient due to increasing technology specifically related to lower transaction costs through higher volume, sophisticated mechanisms, and efficiencies. The second argument posits a regime of flawed incentives, within markets protected by governments that have held fiscal policy settings of low interest rates. This has fuelled speculative expansion of money and credit into asset price booms, resulting in trade activity outpacing the expansion of economic activity at state levels.

The voracious nature of free market expansionary support by governments has been the key feature of the political economy over the past two decades. Key developed nation states engage in the voluminous financial trade convoys through specifically and strategically placed trading centres (Wall Street and Canary Wharf), as designated financial centres. Governments are seduced by the flow-on effects of cheap money and high volume trades, huge profits and the concomitant employment related tax of highly paid traders and executives operating in specific geographical locations. With the onset of the Global Financial Crisis and the employment and trade volume downturns, governments in the United States and Great Britain are bending under the social distrust and dis-ease that were unimaginable even five years ago. The integrity of states has been questioned and alarmingly, found wanting. In the United States, and Great Britain, property speculators have unfinished asset developments around the

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<sup>119</sup> Denoting the cross border capital flows from trading centres (Wall Street, Canary Wharf, London)

<sup>120</sup> Darvas, Zsolt and Jakob von Weisacker. February 2010 "Financial Transaction Tax: Small is Beautiful". Bruegel Policy Contribution. Briefing paper prepared for the European Parliament Economic and Monetary Affairs Committee's public hearing "Financial Transaction Taxes: Making them work." December 2009

cities and countryside. In these countries and in Australia building and property industry sector workers, architects, and families have been displaced.

In “The Crisis of Global Capitalism<sup>121</sup>”, investment guru George Soros also highlights the potential for disequilibrium in the financial system, and the inability of non-market sectors (state-based governments) to regulate markets. In “False Dawn”, John Gray (1998:76)<sup>122</sup> echoes, “national governments find themselves in environments not merely of risk but of radical uncertainty”. Gray attacks the paradigm of neoliberalism for weakening social and political institutions in both first and third world nations. “In the late twentieth century there is no shelter – for corporations or for governments – from the global gale of creative destruction.

Rapidly shifting economies driven by unregulated markets have real consequences on the lives of individuals. The velocity of social, economic, and technological change as well as the shifting of ownership in the forms of mergers and takeovers results in an unpredictable relationship with work. In “Corrosion of Character”, Richard Sennett<sup>123</sup> (1998) captures this impact of the flexible capitalism across two generations of workers. From service workers in a bakery, to capital traders in Canary Wharf, to IBM software engineers, work has become increasingly illegible and job security increasingly tenuous. Financial and technological innovation drives organisational instability. Shifts in the tenuous relationships between the real and shadow economies can destabilise whole sectors of the economy, both eliminating and creating jobs. Social risk and uncertainty lurk on the edges of both state and global employment. Adapting to the volatility and unpredictability of the economy is difficult and anxiety-ridden. Increasingly states are left to manage the fallout from market ebb and flow. This theme was enunciated by Pierre Bourdieu (2005:1)<sup>124</sup> who described neoliberalism and free market systems:

... as the dominant discourse would have it, the economic world is a pure and perfect order, implacably rolling the logic of its predictable consequences, and prompt to repress all violations by the sanctions that it inflicts, either automatically or – more unusually –through the intermediary of its armed extensions, the International Monetary Fund (IMF) and the

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<sup>121</sup> George Soros “*The Crisis of Global Capitalism*” Public Affairs 1998.

<sup>122</sup> Gray, John “*False Dawn*” Amazon Press 1998

<sup>123</sup> Sennett, Richard “*The Corrosion of Character: The personal consequences of work in the new capitalism*” W.W.Norton. 2000

<sup>124</sup> Pierre Bourdieu, “Utopia of Endless Exploitation: the essence of neoliberalism ” *Le Monde Diplomatique*. France. Translated into English by Wendy Kristianasen. 2005

Organisation for Economic Development (OECD) and the policies they impose: reducing labour costs, reducing public expenditures and making work more flexible. Is the dominant discourse right? What if, in reality, this economic order was no more than the implementation of a utopia – the utopia of neoliberalism – thus converted into a political *problem*? One that, with the aid of the economic theory that it proclaims, succeeds in conveying of itself as the scientific description of reality.

Bourdieu argues that the theory of neoliberalism is, akin to pure mathematical fiction and that from this sort of Walrasian<sup>125</sup> “pure theory” flow all the deficiencies and faults of the discipline of economics and the fatal obstinacy “with which it attaches itself to the arbitrary opposition which it induces, through its mere existence between a properly economic logic based on competition and efficiency, and social logic, which is subject to the rule of fairness”.

Further, Bourdieu suggests the theory of neoliberalism is de-socialised and de-historicised at its roots and has sought to “make itself true” and empirically verifiable. “In effect, neoliberal discourse is just one amongst many. Rather it is a strong discourse, the way psychiatric discourse is in an asylum”. “It is so strong and so hard to combat only because it has on its side “all of the forces of a world of relations of forces, a world that it contributes to making what it is”.

This theme is extended by Selbourne<sup>126</sup> who states:

Britain’s way of life, like the way of life of all nations was an organic and particular creation. It had its own ecology, as does the natural world. But in the last few decades, and at accelerating pace, a great unravelling has taken place in Britain, a free country degraded of its freedoms, And “business as usual” will serve the British interest no more than Goldman Sachs and Lehman Brothers have served the world economy. The difference between freedom and licence has been unlearned. The country’s broadly shared values rested, among other things, on convention, on common law and custom, on a sense of community and despite social inequality, on respect for public service and on a belief in the work ethic. They have not survived the self-degrading moral and market free-for-all which has been unleashed upon the land. It has reduced the citizen to a mere customer and consumer, and has invited so many free-loaders- from duck house parliamentary cheats to fiddlers of the welfare system, indigenous and incomers alike – to take liberties with this battered country rather than to fulfil their obligations to it. Moreover the truth about these matters is not the

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<sup>125</sup> Auguste, Walrus (1800-1866) French economist and author of “*De la nature de la richesse et de l’origine de la valeur* (*On the Nature of Wealth and the Origin of Value*) (1848) Walras was one of the first economists to apply mathematics to economic inquiry.

<sup>126</sup> David Selbourne “Too late to save Britain – it’s time to emigrate”, *The Spectator* 17 July 2010

exclusive possession of either left or right, but lies between them: you cannot strengthen “social cohesion” while privatising public institutions which hold civil society together, or by slashing public provision in order to pay for the harms caused to the polity and economy by unbridled private interest.

The macro economic and political issues are further developed by introducing the processes inherent in the transfer of power from the West to East: the force *majeure*, which is further discussed in the following chapter on systems analysis. The Global Financial Crisis, and ensuing sovereign debt contagion, has raised serious questions about the future of the European Union and the capacity of developed nation states as the axiom of power shifts to state capitalist models of China and eastern economic zones. This crisis is forcing politicians to bend to pressure from conservative political persuasions, desperate to protect the privileges won over decades of neoliberalism.

This argument has a logical extension in the current world of political economy where politicians in the United States have been forced to water down significant financial regulation reforms<sup>127</sup> within structures of the Dodd-Frank Wall Street Reform and *Consumer Protection Act 2010*, because opponents engaged an “army” of lobbyists with over US\$600 million in “incentives” to argue against the reform by pressing to maintain the status quo in the neoliberalist financial trading and banking system.

Chapter 5 describes the growing nature of forensic lobbyists whose persuasion has no borders, other than self-interest. Whilst those corporate players and high net wealth individuals (HNWI) engage in the territory which defines both the *shadow* and *real* financial systems, a new corporate welfare assistance program is being supported by the Obama Administration in a matrix so dysfunctional and unconscionable that it could only come from a government system tied implacably to a financial and political system dominated by neoliberals. This has been evidenced in mid-2012 by the seeming reluctance of politicians to bring finance capital speculators into account over the LIBOR scandal. Understated borrowing costs on international markets had been known for years<sup>128</sup>.

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<sup>127</sup> “Financial regulation bill nears finish line with support from Snowe –Brown.” *The Washington Post* 13 July 2010.

<sup>128</sup> Mollenkamp, Carrick and Mark Whitehouse. “Study Casts Doubt on Key Rate.” *The Wall Street Journal*. 30 May 2008.

Similarly, corporate subsidies and tax breaks take money from middle income wage earners and then the state transfers these funds to speculators to subsidise industry. “The Washington Examiners” columnist Tim Carney<sup>129</sup> calls this new subsidy as the purest form of corporate welfare saying, “we are lending money to foreign governments or companies so that they will buy from Boeing or Pfizer and Archer Daniels Midlands but the money to pay for it comes from middle class pocket books”.

This argument is placed firmly at the hands of government leaders in the Obama Administration by Douthat<sup>130</sup> who argues that the transfer of funds from the middle class to the corporate sector in the United States is not the “most pernicious sort of redistribution from the successful to the poor; rather it’s from the savers to the speculators, from outsiders to insiders, and from the industrious middle class to the reckless unproductive rich. The types of rich he identifies as hedge fund players whose incomes are often in excess of US\$500 million a year. This redistribution is clearly a phase of the shift in the geopolitical balance of power, manifest in all structures of the economic system. Ironically, the economic powerhouses of the United States and the United Kingdom are at the forefront of major change.

### **3.4 United States Health and Wealth in Decline**

A United States Federal Reserve report<sup>131</sup> suggested that with the decoupling of unprecedented numbers from the workforce and housing sectors across the United States, most Americans felt poorer. The report indicated that households had lost US\$5.1 trillion (9 per cent) of their wealth in the last three months of 2008 and that this amount was the highest ever recorded for any period during the 57-year history of the central banks records. For the full year, taking in the period spanning the Bear Stearns (September 2007) and Lehman Brothers (September 2008) implosions, household wealth across the United States dropped by US\$11 trillion or 18 per cent. The report says that stock market declines will add trillions to the quantum of losses occurred. Most of the wealth lost was related directly to stock market losses, which fell heavily post Bear Stearns, with the Standard and Poors 500 Index market indicator falling a 23 per cent in the fourth quarter of 2007 alone. Comparatively, the value of residential real estate fell less (US\$870 billion or four per cent overall).

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<sup>129</sup> Tim Carney. *Washington Examiner*. ([www.highbeam.com/publications/examiner-washington-dc](http://www.highbeam.com/publications/examiner-washington-dc)) 16 February 2012.

<sup>130</sup> Ross Douthat, “The Class War we need”. *New York Times* July 2010.

<sup>131</sup> Vikas Bajaj. “Household Wealth Falls by Trillions.” *The New York Times*. 13 March 2009

Krugman (2010:1)<sup>132</sup> likens the current state of economic and social malaise in the United States to the “US being crippled by a financial crisis – a crisis parallel in depth and social severity to that of the Great depression of 1938–1940”. Krugman says that one key difference this time is the lack of capacity for the country to pull its self out of a dire situation as it did under President Roosevelt in 1938 via a massive public financed stimulus in the form of warfare reparations. Equivalent in today’s terms to the equivalent of US\$30 trillion, the economy in the United States under Roosevelt lifted from dire consequences, in 1938, to become an economic powerhouse transforming a welfare economy in deep depression to a warfare economy destined to consolidate the hegemonic power structures of the United States for decades.

Krugman argues that when an economy is deeply distressed with high levels of unemployment, a Keynesian approach to stimulus is maintaining spending and relative employment rather than an austerity approach during which spending is constrained, jobs lost as the state falls into recession. The current Obama Administration is acting on this advice knowing there are only further pledges of public debt to stimulate an economy almost devoid of a panacea for long-term recovery.

Whilst for middle to low median income Americans the losses in real estate and retirement funds has been substantial absolute losses sustained by the most affluent in the society was greatest because they owned a higher proportion of stocks and bonds which were first hit as markets severely retracted post Bear Stearns and through the ensuing period to Lehman Brothers collapse. The *New York Times* reports that the top 20 per cent of income earners are known to spend more than the bottom 60 per cent. This has a significant effect on post-crisis spending in economic recovery models. This reduced the overall borrowing of the population, but the federal government borrowed significant amounts to service bailouts.

Recently (2011–2012), United States Government borrowing has increased at an annual rate of 37 per cent. The systemic nature of structural problems (unemployment, housing defaults, lack of manufacturing opportunities, and urban decay), and commitments to universal health care pose unprecedented constraints to

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<sup>132</sup> ” Paul Krugman “1938 in 2010”. *The New York Times*. 5 September 2010 ([www.nytimes.com/2010/09/06/opinion/krugman.html](http://www.nytimes.com/2010/09/06/opinion/krugman.html))

broad economic rebuilding across the United States and Europe; two North Atlantic continents subjected to the proliferation of vast quantities of cheap money throughout the 2001–2011 decade. These are two continents now struggling for a formula to repay debt and provide services to an ever-increasing number of citizens dependent on government assistance to sustain their lives.

Within Europe, nation state governments have rescued the banks in country after country, neither asking nor getting anything in return. Public funds have bailed out corporate entities faltering on bankruptcy. Rather than accept the neoliberalist free market edict that had allowed the market to dispatch those who failed, successive governments readily transferred the debt to the public account, thereby significantly altering the capacity of the state to fund its services and maintain orderly supply of public goods. Halimi argued that the secrecy code of the state (Greece) and the corporation (Goldman Sachs) is not new, is not unnoticed, but at a time of considerable social focus on the default and issues surrounding an economy, it cannot be dismissed. He (Halimi 2010) <sup>133</sup> states:

So Goldman Sachs first helped Greece to borrow billions of Euros in secret, and then told it how to get round the European restrictions on public debt<sup>134</sup>. The bill for this ground-breaking financial advice was subsequently added to the huge Greek deficit. And the winners and losers? Lloyd Craig Blankfein, CEO and chairman of Goldman Sachs, received a \$9m bonus; Greek civil servants will lose the equivalent of a month's salary each year. A country, like a bank, is "too big to fail". So Greece will be rescued – at a price. The European Central Bank claims to know all about Wall Street's game, and ECB president Jean-Claude Trichet is taking a very hard line with the Greek government, warning that Greece will have to take "vigorous steps" to mend its ways, "under close and constant EU supervision". In other words, hand over control of its economic affairs and reduce its 2009 deficit – 12.7% of GDP – to 3% by 2012. To cut the deficit by almost 10%, particularly in an area of weak growth, is an almost impossible task, requiring major surgery rather than "discipline". Oddly enough, the aim of the exercise is to strengthen the euro at the very time

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<sup>133</sup> Serge Halimi. "Too Big to Fail." *Le Monde Diplomatique*. 14 August 2010.

<sup>134</sup> The *New York Times*. 13 February 2010 quoted a figure of \$300 million for the fees paid to Goldman Sachs for finding a way for Greece to borrow billions of dollars secretly, to enable the country – already deep in debt – to join the European Monetary Union.

when the US and China are devaluing their currencies in order to consolidate the process of recovery<sup>135</sup>.

Angela Merkel considered that “it would be a disgrace if it turned out to be true that banks (referring in this case to Goldman Sachs) that already pushed us to the edge of the abyss were also party to falsifying Greek statistics”. Goldman Sachs is unlikely to be moved by this tirade. Barack Obama’s comment on Blankfein’s US\$9 million bonus was anodyne: “I, like most of the American people, don’t begrudge people success or wealth. That is part of the free-market system.”

Arguments from free market enthusiasts posit that wealth serves the whole community. Goldman Sachs paid 0.6 per cent tax<sup>136</sup> on its profits in 2009; these positions in favour of community benefits from free markets are questionable against the extraordinary levels of taxpayer funds transferred over continents to bail out corporate entities. This is socialisation of the private sector<sup>137</sup> and the socialisation of debt. Lysandrou<sup>138</sup> argues that:

The richest one per cent of Americans earns nearly a quarter of the country’s income and controls an astonishing 40 per cent of its wealth. Inequality in the US is more extreme than it has been in almost a century – and the gap between the super-rich and the poor and middle class people has widened drastically over the last 30 years. In the United States, a partisan debate over how to cut deficit spending and reduce the US’ \$14.3 trillion debt is underway. As low and middle class wages stagnate and unemployment remains above nine per cent, Republicans and Democrats are arguing over whether to slash funding for the medical and retirement programs that are the backbone of the United States social safety net, and whether to raise taxes – or to cut them further.

These are the end points of the decades of neoliberal financial regime based on the abandonment of the gold standard of the early 1970s as a leveraging landmark followed by the Glass-Steagall era of deregulation by the Clinton Administration, and the concomitant private sector expansion of new forms of credit and derivatives.

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<sup>135</sup> Yves de Kerdrel “Le problème ce n’est pas la Grèce, c’est l’euro” *Le Figaro*, Paris 16 February 2010.

<sup>136</sup> Quoted in *Harper’s*, New York, February 2010

<sup>137</sup> “Inequality as one of the root causes of the financial crisis: a suggested interpretation” *Economy and Society*, August 2011, Vol.40, No 3;

<sup>138</sup> Lysandrou, Photis. “Global Inequality, Wealth Concentration and the Subprime Crisis: A Marxian Commodity Theory Analysis”. *Development and Change*, Volume 42, Number 1, January 2011. pp. 183-208. 2011.

### 3.5 *Nation States Finances*

So totally disengaged have “real” state-based economies become from the macro shadow financial markets that their presence is only noted during times of dysfunction. The reality for citizens based within the market systems aligned to “real” economies is that the massive overlay of lax credit has created high levels of risk through industries, households, and government balance sheets. Nation states grappling with sovereign debt have no choice but to instigate massive cuts in public service budgets which will be, of necessity, an anathema to its citizens, and more importantly most detrimental to those citizens who rely on government services.

This new tension runs through from real economy stakeholders (federal, local and state government service providers and the not-for-profit organisations) in much the same way as it does between governments and financial market players globally. This new dynamic is profound in terms of inter-relations between stakeholders and those political parties who provide responses. It is certainly new political territory where governments are actively socialising corporations such as the AIG.

The same disengagement between largely unregulated and self-regulated financial players and nation states elected bodies was recently highlighted in a bond equity loss by the State of California when financial market heavyweight Goldman Sachs, allegedly, placed shorting positions against bond defaults. California, already struggling against its own crippling state debt, accused Goldman of gross impropriety in its dealing with government, arguing that further losses reduce California’s capacity to fund services and pension agreements. Recently the State of California came under “friendly fire” when Goldman Sachs made a \$35 million bet in the credit derivatives market against California, the biggest such trade in the past few years by Wall Street banks that underwrite the state’s bond sales, according to information that the banks provided to the state.

The *Financial Times* (June 2010) reported<sup>139</sup> that California, the biggest issuer of United States’ state debt, this year began an inquiry into the trading of credit default

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<sup>139</sup> Nicole Bullock “Goldman bet \$35m against California” *The Financial Times*. June 5 2010

swaps (CDS)<sup>140</sup> by its six major underwriters, which have earned \$215 million of commissions on bond sales since 2007, reporting:

Bill Lockyer, California's Treasurer, wanted to determine if banks selling its bonds were simultaneously booking profits by betting or facilitating bets against the debt. Mr Lockyer also wanted to work out the effect that trading in credit derivatives could have on the perceived risk of default of California, and borrowing costs. This is particularly important when US state and local governments have suffered several years of budget deficits and face long-term concern about pension obligations.

Such is the draconian nature of debt reduction required to balance national accounts that citizens already marginalised by the macro financial market dysfunction will be dealt the double blow of less money to balance the family and personal budget whilst living in debt riddled countries with little scope to maintain safety net support for a wider audience of its citizens in need of basic services supplied by the state.

### **3.6 *Changing Economic and Social Debate***

Peter Bohmer and Robin Handel argue that centre left political parties are embracing the same economic policies and consorting with anti-Keynesian macroeconomists, leaving the likes of Paul Krugman and Joseph Stiglitz<sup>141</sup> to argue their case on the sidelines. They ask whether this is an intellectual mistake on their part arguing:

What if we drop the assumption that the purpose of today's economic policies is to rescue us from the Great Recession, and put in its place the hypotheses that centre left political parties are now aimed at benefitting higher income groups rather than promoting the interests of their former political constituencies?

For decades prior to the financial crisis of 2008 and the onset of the Great Recession, neoliberal economic policies were championed by centre left as well as right wing governments. Not only Margaret Thatcher and Ronald Reagan, but Tony Blair and Bill Clinton also claimed that neoliberal policies would improve economic performance by removing unnecessary and counterproductive shackles on regulated financial trading, global capital trades and corporate creativity. But while privatisation, deregulation, tax cuts for corporations and the wealthy, capital

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<sup>140</sup> CDS's are privately traded derivatives that pay out when a bond issuer defaults.

<sup>141</sup> Peter Bohmer and Robin Hahnel "Why Are Centre Left Political Parties Supporting Global Fiscal Austerity?" *Le Monde Diplomatique*. 25 July 2010

liberalisation, and capital trade liberalisation did not increase global growth rates or reduce poverty as advertised, these policies did greatly enhance corporate power, disempowered workers, consumers, and citizens, and have produced a substantial and entrenched redistribution of income and wealth. Fiscal austerity, social stigmatism, and stalling financial reform in response to the worst financial crisis and deepest recession in 80 years is not about improving economic performance as its proponents claim. These policies are more concisely about continuing to shift income and wealth from the poor to the rich, and from the industrial and manufacturing sectors to the rapidly growing (and lobbyist influenced) domains of neoliberalist finance, insurance, and real estate (known as FIRE) which have become increasingly ascendant in the United States and Europe, despite the fact that these policies will worsen the economic slump and make another financial crisis likely. This new positioning by right and centrist politicians has fundamentally altered state-based relationships and placed social charter theories in disarray. At no other time of financial market breakdown and dysfunction has there been a tectonic shift to the right. Centre right and right ideologists now have a charter to consolidate wealth. Consolidating wealth is also related to growth in poverty quantitatively across developed states. United States economist Paul Krugman<sup>142</sup> suggests that:

I'm starting to have a sick feeling about prospects for American workers – but not, or not entirely, for the reasons you might think. Yes, growth is slowing, and the odds are that unemployment will rise, not fall, in the months ahead. That's bad. But what's worse is the growing evidence that our governing elite just doesn't care – that a once-unthinkable level of economic distress is in the process of becoming the new normal. And I worry that those in power, rather than taking responsibility for job creation, will soon declare that high unemployment is “structural,” a permanent part of the economic landscape – and that by condemning large numbers of Americans to long-term joblessness, they'll turn that excuse into dismal reality. Not long ago, anyone predicting that one in six American workers would soon be unemployed or underemployed, and that the average unemployed worker would have been jobless for 35 weeks, would have been dismissed as outlandishly pessimistic – in part because if anything like that happened, policy makers would surely be pulling out all the stops on behalf of job creation.

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<sup>142</sup> Paul Krugman. “Defining Prosperity Down.” *New York Times* 2 July 2010.

Krugman argues that the United States Congress is “sitting on its hands”, with Republicans and conservative Democrats refusing to spend anything to create jobs, and unwilling even to mitigate the suffering of the jobless. Krugman further argues that “Congress can’t afford to help the unemployed – that we must get budget deficits down immediately or the ‘bond vigilantes’ will send U.S. borrowing costs sky-high”. The economy versus civil society, deficits versus employment settings, must be seen against the dire structural public debt that pervades the country. The United States Government has accepted the social cost of further financial disruption. The nation’s public debt including municipal bonds and the US\$7 trillion new deficits amounts to US\$18 trillion, equivalent to the Greek scale of 120 per cent of gross domestic product.

America is continuing lack of response to intractable and crippling unemployment levels is described by Stockman (2010)<sup>143</sup> as “the pretence that its new monetarist and supply side doctrines are rooted in its traditional financial philosophy”. Stockman argues that in the past, Republicans depended on the regular balancing of accounts, “in government, in international trade, on ledgers of central banks and in financial affairs of private households and business” but that new regimes amount “to little more than money printing and deficit finance – vulgar Keynesianism robed in the ideological vestments of the prosperous classes”. More consequently, he purports that these approaches mock political party ideals and feed “serial financial bubbles and Wall Street depredations that have crippled our economy”.

Citing a growth in the shadow banking systems (investment banks, and finance companies and special conduits that lie outside the regulated banking system), from US\$500 billion in 1970 to US\$30 trillion, by September 2008, Stockman argues that the hollowing out of wider American economy is a “destructive” social change as high value quality jobs in services and technology professions shrunk 12 per cent to 68 million, from 77 million. These jobs have been replaced by part-time low paid positions. Stockman<sup>144</sup> says that it is not surprising that during the last “bubble” (2002 to 2007) the top one per cent of Americans – “paid mainly from the Wall Street

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<sup>143</sup> David Stockman “Four Deformations of the Apocalypse” *The New York Times* July 31 2010.

<sup>144</sup> Stockman (ibid) was a Director of the Office of Management and Budget in the Reagan Administration and is authoring a book on the financial crisis to be released soon.

casino” – received two thirds of the gain in national income, whilst the bottom 90 per cent got only 12 per cent.

On this point Krugman concurs and adds:

Some of us have tried to point out that those bond vigilantes are, as far as anyone can tell, figments of the deficit hawks’ imagination — far from fleeing U.S. debt, investors have been buying it eagerly, driving interest rates to historic lows. But the fear mongers are unmoved: fighting deficits, they insist, must take priority over everything else — everything else, that is, except tax cuts for the rich, which must be extended, no matter how much red ink they create. The point is that a large part of Congress — large enough to block any action on jobs — cares a lot about taxes on the richest 1 per cent of the population, but very little about the plight of Americans who can’t find work.

In the United States, wealth is highly concentrated in a relatively few hands. As of 2007, the top one per cent of households owned 34.6 per cent of all privately held wealth, and the next 19 per cent (the managerial, professional, and small business stratum) had 50.5 per cent, which means that just 20 per cent of the people owned a remarkable 85 per cent, of the state’s assets, leaving only 15 per cent of the wealth for the bottom 80 per cent (wage and salary workers). In terms of financial wealth (total net worth minus the value of one’s home), the top one per cent of households had an even greater share: 42.7 per cent. Table 3.1 and Figure 3.3 present further details drawn from the careful work of economist Edward N. Wolff at New York University (2010).

**Table 3.1<sup>145</sup>: Distribution of Net Worth and Financial Wealth in the United States, 1983–2007.**

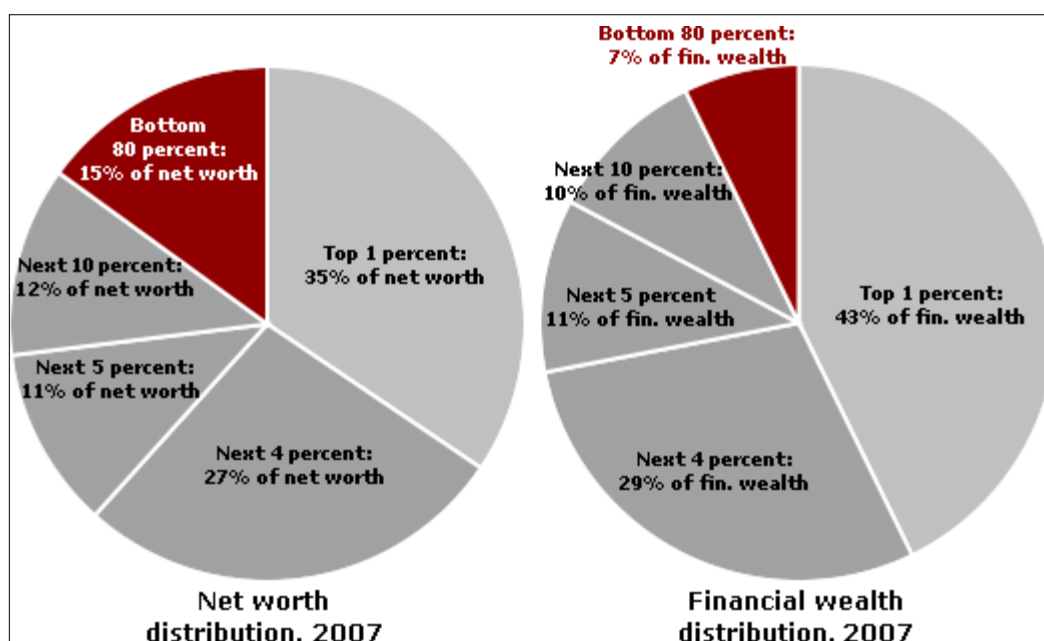
	<b>Total Net Worth</b>			<b>Financial Wealth</b>		
<b>Year</b>	<b>Top 1%</b>	<b>Next 19%</b>	<b>Bottom 80%</b>	<b>Top 1%</b>	<b>Next 19%</b>	<b>Bottom 80%</b>
1983	33.8%	47.5%	18.7%	42.9%	48.4%	8.7%
1989	37.4%	46.2%	16.5%	46.9%	46.5%	6.6%
1992	37.2%	46.6%	16.2%	45.6%	46.7%	7.7%
1995	38.5%	45.4%	16.1%	47.2%	45.9%	7.0%
1998	38.1%	45.3%	16.6%	47.3%	43.6%	9.1%
2001	33.4%	51.0%	15.6%	39.7%	51.5%	8.7%
2004	34.3%	50.3%	15.3%	42.2%	50.3%	7.5%
2007	34.6%	50.5%	15.0%	42.7%	50.3%	7.0%

Notes:

Total assets are defined as the sum of: (1) the gross value of owner-occupied housing; (2) other real estate owned by the household; (3) cash and demand deposits; (4) time and savings deposits, certificates of deposit, and money market accounts; (5) government bonds, corporate bonds, foreign bonds, and other financial securities; (6) the cash surrender value of life insurance plans; (7) the cash surrender value of pension plans, including, 401(k) plans; (8) corporate stock and mutual funds; (9) net equity in unincorporated businesses; and (10) equity in trust funds.

Total liabilities are the sum of: (1) mortgage debt; (2) consumer debt, including auto loans; and (3) other debt.

<sup>145</sup> Edward N. Wolff. *Wealth, Income and Power* New York University 2010. ([www2.ucsc.edu/whorulesamerica/power/wealth.htm](http://www2.ucsc.edu/whorulesamerica/power/wealth.htm) l)



**Figure 3.3<sup>146</sup>: Net Worth and Financial Wealth in the United States, 2007.**

In terms of types of financial wealth, the top one per cent of households has 38.3 per cent of all privately held stock, 60.6 per cent of financial securities, and 62.4 per cent of business equity. The top 10 per cent has 80–90 per cent of stocks, bonds, trust funds, and business equity, and over 75 per cent of non-home real estate. Since financial wealth is what counts as far as the control of income-producing assets, it has been said that just 10 per cent of the people own the United States of America.

In 2009 the United States Department of Agriculture<sup>147</sup> released a report that counted the number of hungry families. Some 16 per cent of all families in the United States were food insecure (up from 12 per cent in 2007). That amounted to 49 million people, including more than 16 million children. That is over a quarter of all the children in the United States. In 2009, the number is higher but it is not known how much. About one-third of those families went hungry. The other two-thirds survived because they had access to federal food programs, or got food at a local food pantry or soup kitchen. That means they were hungry too, but not quite as much. Hunger is not spread evenly.

More than one-quarter of all black and Latino households were food insecure, compared to 16 per cent in general and more than 13 per cent of all families made up

<sup>146</sup> Edward N. Wolff. “Wealth, Income and Power” *ibid*-

<sup>147</sup> David Bacon and Betsy Edwards “Hungry By Numbers.” *Z Magazine* July 2010

of single mothers and their children. Some 42.2 per cent of food-insecure households had incomes below the official poverty line of US\$21 834 for a family of four, in 2008. So more than half of all hungry families had incomes above the national poverty line, a line so low that millions of families not officially “in poverty” do not have enough money to buy the food they need. In 2009–2010, with unemployment in California reaching more than 12 per cent, these numbers were on the increase.

Families who formerly had no trouble feeding themselves, who went out to eat in restaurants, cannot now put enough food on the table to keep everyone from going hungry. There has been a massive increase in the number of people who went to food banks, food pantries, and soup kitchens to try to make up for what they could no longer buy. In 2010, almost five million people went to food pantries last year, up from four million the year before. By the end of 2010 government affiliated food banks and community food kitchens served more than 37 million Americans, up from 2006 by 46 per cent<sup>148</sup>.

Asked to consider the future of social organisation in the United States, Krugman stated:

What lies down this path? Here’s what I consider all too likely: Two years from now unemployment will still be extremely high, quite possibly higher than it is now. But instead of taking responsibility for fixing the situation, politicians and Fed officials alike will declare that high unemployment is structural, beyond their control. And as I said, over time these excuses may turn into a self-fulfilling prophecy, as the long-term unemployed lose their skills and their connections with the work force, and become unemployable. I’d like to imagine that public outrage will prevent this outcome. But while Americans are indeed angry, their anger is unfocused. And so I worry that our governing elite, which just isn’t all that into the unemployed, will allow the jobs slump to go on and on and on.

### **3.7 *The Rise of the Global Precariat***<sup>149</sup>

Across most North Atlantic countries, the political actions transferring corporate debt to the public account could not have come at a worse time. Those most vulnerable, living in otherwise developed European nation states layered in debt, will fall through the social safety nets, victims of one of the most insidious economic escapades of our time. An economic and social framework supported by most Western governments

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<sup>148</sup> Christie Garton, “New Breed of Americans going hungry”. *USA Today* 19 May 2011.

<sup>149</sup> Mike Davis, *Planet of Slums*. Verso 2006.

through three decades of neoliberalist regimes of high level greed and corruption, of massive personal and corporate profits, but now witness to the social class of citizen known as the precariat.

Pakulski<sup>150</sup> argued that global social inequalities are taking different forms than those of earlier periods, and that globalised inequalities are less structured than national class hierarchies are. Pakulski suggests that issues of democracy and elite power have shaped the inequalities that have come to prominence during the past decade of neoliberalism. Transformations of manufacturing and information technology to China and India have displaced millions of citizens in developed economies and “hollowed out” manufacturing “heartlands of the United States, Europe and particularly the United Kingdom where the finance sector has been given full government support. Inequalities, high youth unemployment and social decline now feature as key negative transformations in many societies.

If one accepts that the financial system has a political as well as economic dimension, then it follows that the political and economic effects have a social benefit and dis-benefit. This altered state suggests a vast number of people who are suddenly disconnected from mainstream societal structures and become dislocated from systems. Guy Standing<sup>151</sup> suggests that:

Forty years ago, it was widely predicted that by now everybody would be working for income for about 20 hours a week, living in security and in professional positions of some kind. Instead, we have experienced the growth of a new and dangerously angry class, the precariat.

The “precariat” is a term now applied to millions of citizens living under precarious conditions of informal part-time employment, unaffordable private sector, or unavailable social housing systems, illegitimacy and illegality in state frameworks, and living out a threatened and precarious personhood, disengaged from the mainstream societal norms. New global precariat city dwellers are hireable on demand, available at call, exploitable at will, and fireable at whim. These vast “surplus new suburban populations” were previously driven into cities by the relative

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<sup>150</sup> Pakulski, Jan. *Globalising Inequalities: New Patterns of Social Privileges and Disadvantage*. Allen and Unwin. 2004.

<sup>151</sup> . Guy Standing. “Who will be a voice for the emerging precariat.” *The Guardian*. 21 March 2012. (<http://www.guardian.co.uk/commentisfree/2011/jun/01/voice-for-emerging-precariat/>)

urgency of the politically favoured neoliberal regimes, by the reorganisation of the countryside, by agribusiness, and as escapees from war ravaged or brutalising dictatorships, or by climate change. A precariat concentrated into segmented and unsupported spaces, as incubators of organised crime and disease<sup>152</sup>.

These are the new city dwellers eking out a subsistence survival when promises of employment fail to eventuate and housing is unavailable. The precariat are the disadvantaged surplus populations, already displaced, even before the latest shock wave of dysfunction in global markets. Groupings described as the precariat exist and manifest in countries like the United Kingdom and the United States, as manufacturing and industrialisation gave way to the chorus of political leaders who put their countries' growth into a macro-economic matrix of private financiers who themselves remain permanently shielded by tax havens and the extensive web of corporate and family trusts.

Austerity measures across Europe will affect severely on the already disadvantaged in communities. In Australia, recent announcements of services reductions have seen many not for profit organisations saying they are simply unable to cope with the growing number of disenfranchised and homeless people presenting at their services. An ACOSS Australian Community Sector Survey<sup>153</sup> revealed that there was a 12 per cent increase in assistance provided by agencies with 745 respondent agencies reporting provision of services on 6.180 million occasions in 2010 compared with 5.513 million occasions in the year before.

The International Labour Organisation estimates that worldwide unemployment could rise by at least 30 million people, and possibly as much as 50 million people, from 2007 to 2009, if conditions continue to deteriorate. It also expects that more than 200 million people, mostly in developing economies, will be pushed into poverty (Recommendations of the UN Commission of Experts on Reforms of the International Monetary and Financial System, 19 March 2009<sup>154</sup>, p. 2). According to Greenspan, if one adds to the losses of the financial and listed corporate sector "the thousands of

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<sup>152</sup> "The Case of the Missing Precariat". *American Exceptionalism, Part 42 All Academic*. 2010 ([http://www.allacademic.com/meta/p\\_mla\\_apa\\_research\\_citation/2/0/8/7/2/](http://www.allacademic.com/meta/p_mla_apa_research_citation/2/0/8/7/2/))

<sup>153</sup> "One in Twenty Australians Seeking Help Turned Away." *Pro Bono Australia News* 15 August 2011.

<sup>154</sup> "Responding to the Financial Crisis and Measuring Systemic Risk" *IMF. Global Financial Stability Report*. Washington, DC: IMF. April (2009a)

billions of dollars of losses of equity in homes and losses of non-listed corporate and unincorporated businesses that could easily bring the aggregate equity loss to well over US\$40 trillion, a staggering two-thirds of last year's global gross domestic product"<sup>155</sup> (Greenspan 2009).

These vast "surplus new suburban populations" (often citizens dislocated from subsistence farming) are relocated into cities by the relative urgency of the politically favoured neoliberal regimes, by the reorganisation of the countryside to agribusiness, and as escapees from war-ravaged areas. A precariat concentrated into segmented and unsupported spaces, as incubators of social unrest, organised crime, and disease. More recently, the precariat have been manipulated and exploited by political regimes of all persuasions from variously nefarious geographies to major cities in Europe, China to the United States.

In China the precariat are persuaded to leave subsistence farming and become working consumers, amongst millions of like citizens providing growth in the economy of a strong communist social system. In the United States, the same type of authoritarian system tacitly supported lower income persons through mortgage originators into their own homes in a disaster that is yet to be concluded, let alone mitigated, by the four million plus mortgage holders who have walked away from or at risk of walking away from their now unaffordable home. As China continues its economic transformation from industrialisation to consumer-based growth, the apparent difference between state capitalism and welfare capitalist models in the West will become deeper.

This is where, in the West, an effective interface between capital and social systems would be greatly enhanced by a financial transaction tax regime. This interface would link the disparate nature of political forces tending to now polarise between rentier capitalism in the West and state sanctioned capitalism in the East.

Three distinct phases map the structure and polarisation of political forces of both left and right persuasion. First is the regime of unregulated markets and the neoliberalist paradigm of concentrating wealth and corporate power, consolidated by formulating a highly specialised lobbyist machine to support new regime strategies for financial

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<sup>155</sup> Alan Greenspan. "We need a better cushion against risk." *The Financial Times*. 26 March. 2009.

engineering. Second is the winding down of the industrial and manufacturing bases in favour of global financial markets. Third is the establishment of high-level financial engineering enabled sophisticated “state of the art” flash and algorithm trading mechanisms to capture the “edge” in market technology. This leads to the dichotomy of social voids as a result of the boom and bust cyclical nature of finance and the de-leveraging of unsustainable credit markets. This creates a social scenario of reduced services, high levels of unemployment, inability of citizens to maintain part-time employment, and the fractures that this causes across communities.

Whatever political “spin” is layered across the capacity of current governments to trade out of insolvency, and protect their citizens in hard times, there is no escaping the veracity, secrecy and political influence of lobbyists in the contemporary political economy phase. This existing phase is marked by excessive profits and the concentration of wealth, and is now marred by savage cuts in social services provision. Another unaddressed issue (as states battle to control sovereign debt) is the number of citizens looking to retire (particularly in the United States where the veracity of the public account to fund retirees is soon to be tested) and the states’ reduced ability to fund the retirement programs in many European countries. As surely as neoliberalism has been a growing and dominant paradigm across developed and developing countries, the next phase of prolonged slow growth and recession will take place in economies tainted by high debt. This is a very political problem.

The banking crisis that began in 2007 and became a global crisis in 2008 will probably represent a turning point in the history of capitalism. Besides being the most serious economic crisis that market-oriented, capitalist economies have faced since 1929, it is also a social crisis. The International Labour Organization predicts that unemployment will have grown from around 20 million to 50 million by the end of 2009. According to the Food and Agriculture Organization, as the incomes of the poor are falling due to the crisis but the international prices of food commodities remain high, the number of undernourished people in the world will increase by 11 per cent in 2009, and, for the first time, exceed one billion. The questions that this major and seemingly intractable social crisis raises are many. Why did it happen? Why did the theories, organisations and institutions that emerged from previous crises fail to prevent this present global sovereign debt crisis in Europe and the United States? Some economists and global leaders sought solutions.

### 3.8 *The Minsky Phases*

Twenty-five years ago, when most economists were extolling the virtues of financial deregulation and innovation, a maverick economist named Hyman P. Minsky maintained a more negative view of Wall Street. Minsky noted that bankers, traders, and other financiers periodically played the role of arsonists, setting the entire economy ablaze. Minsky argued that the very logic of “Wall Street capitalism” encouraged businesses and individuals to take on too much risk, he believed, generating ruinous boom-and-bust cycles. The only way to break this pattern was for the government to step in and regulate the money men.

Many of Minsky’s colleagues regarded his “financial-instability hypothesis,” which he first developed in the 1960s, as radical. In the political climate of the United States economy in the 1970s and 1980s, Minsky was a pessimist: his vision of financial capitalism emphasised inherent capital market instability, and unpredictability of financial flows, rather than the optimality of free market specificity<sup>156</sup>. Today, with the European crisis seemingly on the verge of metamorphosing into a recession enveloping continents, references to the Minsky theory have become commonplace. Minsky’s hypothesis is well worth revisiting. The first stage is recognising the market policy and making a correct diagnosis.

There are five stages in Minsky’s model of the credit cycle: displacement, boom, euphoria, profit taking, and panic. Kindleberger<sup>157</sup> analysed hundreds of financial crises dating back centuries and found them to share a common sequence of events, one that followed monetary theorist Hyman Minsky’s model of the instability of a credit system. Fundamentally, the more stable and prosperous an economic structure appears, the more leverage and speculative financing will build within the system, eventually making it highly vulnerable to a surprising, extreme collapse.

A displacement occurs when investors get excited about something – an invention, such as the Internet, or a war, or an abrupt change of economic policy. The current cycle began in 2001, with the United States Federal Reserve chief Alan Greenspan’s decision to reduce short-term interest rates to one per cent post September 11, 2001,

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<sup>156</sup> Anastasia Nesvetailova “Ponzi Finance and Global Liquidity Meltdown: Lessons from Minsky” *Working Paper CUT/002 City University London*. Centre for International Politics

<sup>157</sup> Kindleberger was quoted in *Where are we in the boom and bust liquidity cycle?* Thomas Sayles, March 2012. Thomas Sayles is Associate Director of Macro Strategies, One Financial Centre, Boston, Maryland, MA 02111. ([www.loomissayles.com](http://www.loomissayles.com))

and an unexpected influx of foreign money, particularly Chinese money, into United States Treasury bonds. With the cost of borrowing – mortgage rates, in particular – at historic lows, a speculative real-estate boom quickly developed that was much bigger, in terms of over-all valuation, than the previous bubble in technology stocks.

As a boom leads to euphoria, Minsky argued, banks and other commercial lenders extend credit to ever more dubious borrowers, often creating new financial instruments to do the job. During the 1980s, junk bonds played that role. More recently, it was the securitisation of mortgages, which enabled banks to provide home loans against the risk they would ever be repaid. Investors who bought the securities would be left to deal with any defaults in the real economy. In the shadow economy a vast array of exotic financial instruments were engineered to provide trade instruments for corporate and institutional market players. These instruments included collateralised mortgage obligations (CMOs), collateralised debt obligations (CDOs), and synthetic CDOs, to package up and structure securitised debt, and credit default swaps (CDS) to insure against insolvency. Structured investment vehicles (SIVs) provided the unregulated instruments (derivatives) for over-the-counter (OTC) trades. According to data available from the Bank for Financial Settlements (June 2007) 84 per cent of all trades in derivatives is OTC<sup>158</sup>. Ninety-five per cent of all financial trades are speculative in nature and bare no relative good to the public. Unlike regulated exchanges in the real economy, the OTC market trading takes place on a one-to-one basis between the buyer and the seller and prices and volumes are not disclosed<sup>159</sup>. The Minsky model seems to chart a course for highly leveraged financial systems heading toward a collapse. Without state intervention and the transfer of public funds to the private sector, this system breakdown would be upon us. The following provides evidence of social decay falling into steep decline.

### **3.9 Social Fallout and Incarceration**

In the United States, protracted unemployment is causing considerable concern both in terms of numbers and social issues related to support services. The worsening economic situation reduces state aid to services for the poor and unemployed. If job seekers were to find work at any sort of sustained rate it would take at least five years

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<sup>158</sup> BIS Derivatives Statistics: Quarterly, Basle: *Bank for International Settlements*. 2010.

<sup>159</sup> Randall Dodd. "Subprime: tentacles of a crisis" *Finance and Development*, December 2007.

for unemployment to reach an “acceptable “ level of five per cent. Incarceration levels in the United States are at all-time high<sup>160</sup>. One in 200 Americans is incarcerated.

A report in the United States<sup>161</sup> analysed the recession-driven drop in wealth. As of December 2009, median white wealth had dipped 34 per cent to \$94,600 and median black wealth had dropped an incredible 77 per cent to \$2,100, leading Memphis mayor A.C. Wharton to say “This cancer is metastasising into an economic crisis for the city, it’s done more to set us back than anything since the beginning of the civil rights movement”. The Bureau of Labour Statistics<sup>162</sup> reported no change in the current record numbers of unemployed stating:

Both the number of unemployed persons, at 14.6 million, and the unemployment rate, at 9.5 per cent, were unchanged in July 2010. In July, the number of long-term unemployed (those jobless for 27 weeks and over) was little changed at 6.6 million. These individuals made up 44.9 per cent of unemployed persons. The number of persons employed part time for economic reasons (sometimes referred to as involuntary part-time workers) was essentially unchanged over the month at 8.5 million but has declined by 623,000 since April. These individuals were working part time because their hours had been cut back or because they were unable to find a full-time job. About 2.6 million persons were “marginally” attached to the labour force in July, an increase of 340,000 from a year earlier. These individuals were not in the labour force, wanted and were available for work, and had looked for a job sometime in the prior 12 months. They were not counted as unemployed because they had not searched for work in the 4 weeks preceding the survey.

Whilst the shadow financial trades and interests remain as the political arm of the global neoliberal regime in most western and many non-western countries, its influence is felt most strongly in the English speaking world, especially in the United States and like all ideologies the regimes are evaluated by their consequences. Neoliberalism has brought to the United States a high level of inequality and an unparalleled level of wealth concentration to the masters of the capitalist paradigm.

Between the mid-1970s and 2007, the gross domestic product of the United States trebled whilst during the same period the median income of Americans remained stagnant. During the Keynesian era 1970s and early 1980s, American CEOs earned

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<sup>160</sup> US Incarceration and Correctional Population Levels: *US Justice Department quoting Correctional Population in the United States, 2010*. December 2011.

<sup>161</sup> The Economic Policy Institutes “The State of Working America” as quoted in the *New York Times* 31 May 2010.

<sup>162</sup> United States Department of Labor – Bureau of Labor Statistics August 2010.

25–30 times the salaries of median workers' wages, but by 2007 it had reached 500 times<sup>163</sup>. The top 10 hedge fund managers alone in the United States had average take home pays in excess of US\$500 million in 2006. The financialisation of the United States and Western economies has been created by a coalition of the financially wealthy against a degradation of services and conditions for the vast majority of citizens now embracing record debt levels.

Despite well scripted political statements that sub-prime borrowers were at fault for optimistic loan expectations that could not be met, the underlying cause of the so-called sub-prime meltdown was the voracious appetite of the booming derivatives markets to engineer securitised investment vehicles calibrated to accept tranches of high risk housing mortgages to roll into collateralised debt obligations, and insured through credit default swaps to sell off around the world as the new sophisticated way to invest. The social fallout from this three-year financial dysfunction is still to be played out. Government bailouts for sovereign debt-affected states are now really continuums of loans as financial integration through neighbour nation states is complex. All nation states are affected. Only one third of the terminal international financial market toxic debt has been located and ameliorated by the use of taxpayer funds. The remaining debt is virtually unpayable by states already laden with public account debt. The outlook for social services for those already affected is bleak. The inevitable intersection will be played out between strongly lobbied politicians protecting the spaces between sovereignty of states and shadow economy operatives. The consequences will inevitably fall to disadvantaged civil society already weakened through absorption of debt and a growing precariat whose mass will rise substantially.

### ***3.10 Housing Market Dysfunction***

The immediate effects of rapid escalation of financial liquidity was extremely fast growth in United States private housing sector. Between the 1980s and the late 1990s, homeownership was around 64 per cent of all dwellings. By mid-2005, the American dream of home ownership (and its concomitant associated benefits of stable communities, schools, and a solid base for developing family finances), realised homeownership rates of 69 per cent. The new entrants to homeownership were

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<sup>163</sup> Robert Manne and David McKnight. "Death throes of the neo-liberal delusion" based on the chapter "Goodbye to All That? On the Failure of Neo-Liberalism and the Urgency of Change." *The Monthly* March 2011.

disproportionately African American and Latino families (through the agency of sub-prime, Alt-A, and ARM mortgage facilitators), becoming homeowners in the burgeoning wastelands across the country that were rapidly transposed as developing subdivisions and streets with no names.

Mortgage lenders by 2003 were having difficulty finding enough people to sign up to housing loans so they settled on signing NINJA (No Income/No Jobs/No Assets) clients to “honeymoon loan” mortgages, with low initial rates, then rates getting higher and unaffordable as the cycle progressed. Sub-prime loans jumped from an annual volume of US\$145 billion in 2001 to \$625 billion in 2005. More than a third of all loans represented more than the value of the property<sup>164</sup>. This large-scale liquidity directed at home buyers lasted through to early 2007 when the market, saturated with new debt levels, started to see a wave of mortgage defaults as rates climbed out of the early “honeymoon” rate periods.

The nation was witnessing the greatest sale of home mortgage products in United States history. Purchasing turned to a default epidemic in 2007–2008, deteriorating into a housing and social nightmare of proportions unseen in any other time. It was driven by corporate madness, excessive, non-sustainable and irrational, but with no political resistance. During this period the Bush Administration (United States), Blair Government (United Kingdom), and the Howard Government (Australia) did not attempt to curb the tide. The most irrational events were the things that *did not* happen during the escalation of money coming into countries as credit for consumers. Politicians failed to warn consumers that markets were actually working against each other; that the behaviour of market players was schizophrenic, without rules, and investments were inherently risky. As social risk became a political risk, politicians orchestrated their responses in favour of the capital market players.

In 2007, a paper appeared in the, *Environment and Planning A*, charting how American mortgage markets (well known for discrimination by exclusion) had come to “operate as venues of segmentation and discrimination by inclusion: credit is

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<sup>164</sup> Charles R. Morris. “A Wall of Money.” Chapter 4. “*The Trillion Dollar Meltdown*.” Public Affairs. 2008

widely available, but its terms vary enormously”<sup>165</sup>. Wyly et al in their paper describing the “sub-prime phenomenon note:

Discriminatory exclusion persists in some submarkets, but is now accompanied by discriminatory inclusion and segmentation: a specialized breed of financial institutions working with real-estate industry actors and secondary-market investors has propelled dramatic growth in ‘subprime’ lending. As used in the industry, subprime refers not to below prime interest rate, but rather to lenders’ judgments of less-than-perfect borrowers ... the rapidly growing subprime market provides fertile ground for abuse, fraud, and exploitation in a syndrome known as predatory lending ... .Activists and advocates who have fought for years against practices that unfairly excluded qualified minorities are now faced with aggressive predators who have found ways to extract profits even when high-risk loans force borrowers into delinquency, default and foreclosure.

Hedge funds and institutional lenders supported booming real estate businesses securitising and rolling up mortgages into collateralised debt obligations and hundreds of billions of US dollars began rolling into markets as “carry trade” finance (borrowing low and lending long) money came through the United States from host nations Japan, China, Korea, and other East Asian countries.

This was the start of the “buying back our money” fiscal policy enacted by the United States Administration of President George W. Bush. Enablers were a fiscal policy of low interest rates, collusive politics between financial interests and policymakers, sophisticated IT systems, and the process of creating free trade agreements to governments in order to create a wider consumer audience. Free trade in finance agreements proved particularly useful for Australia. Australia’s agreement was finalised shortly after the Howard Government’s commitment to the “Coalition of the Willing” agreement for engagement in the Iraq War. Australia was courted by the United States to sign the agreement. Prior to this, the United States and Australia had limited commitments to free trade to selected geographically aligned countries.

Two decades of growth in the neoliberalist “free” market economy in the United States delivered US\$8 trillion in housing wealth alone. The agreement with the United States delivered the finance to drive the housing “bubble” in Australia from 2001.

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<sup>165</sup> Elvin Wyly, Mona Atia, Elizabeth Lee, and Pablo Mendez. 2007 p 2017 in *Environment and Planning D: Society and Space* 2008, volume 26, pages 195 ^ 198

In the past decade, it is estimated that up to eight million American families lost their homes due the twin socioeconomic events of automatically resetting mortgages engulfing the sub-prime borrowers along with huge rises in unemployment rates. Almost 11 million homeowners in the United States owe more on their mortgage contracts than their homes are worth<sup>166</sup>. This is a major social catastrophe. It is a catastrophe that London School of Economics Professor Willem Buiter cited in an article entitled “Home Loans in the US: the biggest racket since Al Capone”<sup>167</sup>. Interestingly, Buiter is critical of a plan put forward by President Obama to allow distressed borrowers to try to renegotiate mortgage repayments, calling it (the plan) “a tax on the prudent to subsidise the imprudent that is both inefficient and unfair”, echoing growing sentiment in the United States that there is a limit on the taxpayer support that should be offered to corporations or citizens who have willingly undertaken risk.

In contrast to Buiter, the former Chief Economist with the International Monetary Fund, Simon Johnson, argues strongly that the social cost to nations represents immense hardship in respect to personal, community and government outcomes. In addition, those governments have a high level of responsibility to lessen the damage from wholesale foreclosures. Writing in the *New Republic*<sup>168</sup> Johnson suggests:

It’s important to know that there is a clear case to be made for using taxpayer money to reduce the number of foreclosures and help homeowners refinance their mortgages. On the negative side, foreclosures destroy economic value in several ways: transaction costs push foreclosure itself; reduced value of foreclosed houses, and impact on houses in the neighbourhood; reduced property taxes for local governments; and increased crime due to vacant houses. The death spiral of foreclosure-forced sales, falling house prices, and further foreclosures needs to be broken.

During the past decade (2002–2012), policy settings enabled loose credit to most developed countries, especially those with special status through the “Coalition of the Willing”. Carry trade finance<sup>169</sup> at very low rates (ex Japan at 0.5 per cent) was

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<sup>166</sup> “Signs of Life in United States Housing as bargains lure buyers” *Wall Street Journal*. 23 March 2012.

<sup>167</sup> Willem Buiter. “Home Loans in the US: The biggest racket since Al Capone.” *Financial Times*. 18 February 2009.

<sup>168</sup> Simon Johnson. *The New Republic*. 21 February 2009.

<sup>169</sup> The term carry trade refers to currency markets where investors borrow low-yielding currencies to invest in high yielding currencies. It involves trading through sophisticated methods of high frequency

introduced by hedge funds into countries like Australia to finance a housing blitz, with mortgages at rates of six per cent or lower. Unregulated lenders proliferated in Australia with easy money outlets opening in cities and country towns offering as much money as consumers requested. This scene was replicated across the United Kingdom, Ireland, Spain, Greece, and Iceland where a burgeoning financial services industry started to make a mark on lending and corporate services.

To accompany the almost free money, a new asset class of credit derivative, credit default swaps (CDSs) were devised that insured banks issuing collateralised debt obligations (CDOs), against loan defaults. Brokers took their profits (commissions) up front, packaged the risk as securitised parcels of CDOs, thus ensuring that the risk was passed off to investors, both local and global.

An independent survey “Asset Price Bubbles and Monetary Policy” released by the European Central Bank in 2005<sup>170</sup> was scathing of the “fast easy money policies” in the United States and stated, in part, “As households are typically encouraged to spend out of their capital gains when asset prices advance, durable and sizable bubbles can boost consumer expenditure... In this respect, empirical evidence tends to suggest that a deflating bubble in the housing market is more costly than an equally sized crash in the stock market, as housing equity is more widespread and more intensely used as collateral for securing credit”. This housing market failure and the subsequent systemic toxic debt endemic in financial instruments have caused a protracted global downturn, Home buyers and credit users with loans on cars, consumer goods, and plasma televisions are now wondering who to blame for the predicaments that threaten to place them in a financial bind for a generation. The contagion becomes a double bind for those now losing employment whilst at the same time watching the equity dissipate from housing and superannuation investments. It is socially unacceptable. Peter Costello and former Prime Minister John Howard encouraged the free market paradigm, signed a free trade agreement enabling excessive carriage of cheap finance into Australia, oversaw the massive housing bubble and were clearly at the wheel as Australians became the largest borrowers per head of population in the world. They should be made accountable.

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technology and is an intricate part of opening up finance capital markets during the past decade in particular.

<sup>170</sup> European Central Bank. “*Asset Price Bubbles and Monetary Policy*.” 2005.

The story is similar across most developed countries suffering from the intractable pain of a sovereign debt crisis as the aftermath of the Global Financial Crisis. Across Europe and particularly in the United Kingdom where banks, homes, businesses, and the once mighty investment houses which effectively delivered strong gross domestic product growth to the United Kingdom's economy via the City and Canary Wharf investment centres in London, have hit the wall. It is estimated that the net loss to each taxpayer in the United Kingdom, from combined stock market downturns, loss of equity in houses and property, and decline in savings, is in the vicinity of £40,000. The downturn has obliterated 1.2 trillion pounds from Britain's national wealth<sup>171</sup>. Analyst Dharval Joshi of RAB Capita<sup>172</sup> suggests the combined impact of the share market and property downturn has been equivalent to the loss of a full years economic output in the United Kingdom.

### ***3.11 America's Rotting Foundations***

These figures could be far worse. Economics analyst David Rosenberg of the firm Gluskin Sheff has reported that two thirds of American homeowners have a mortgage (approximately 56 million in total). Half of these mortgages are guaranteed by Fannie Mae and Freddie Mac, the government-sponsored enterprises, themselves so heavily financed with taxpayer funds during the Global Financial Crisis. The two government-funded entities are extremely fragile and will be even more so if the current rate of mortgage default continues. Another 35 per cent of the portfolios are with banks of various types across the nation.

Prolonging the social dilemma for governments is the dynamic that money supply to the public account in states around the world is shrinking. Ratings agency Standard and Poor's<sup>173</sup> recently released a report estimating an amount of up to US\$46 trillion would be needed to bailout the non-bank financial sector by 2015. In addition, the regime of taxpayer bailouts of the private sector has substantially drained the public

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<sup>171</sup> "Official: 40,000 Pound loss for every taxpayer" *The Observer*. 25 January 2009.

<sup>172</sup> Dharval, Joshi in Barry Riholtz. "The \$4 trillion dollar question." *The Big Picture*. 15 July 2020.

<sup>173</sup> Gareth Vaughan. Interest.Co.Nz. May 11 2015. "*Standard and Poor's warns of potential US\$46 trillion 'perfect storm' in global credit markets*. Credit rating agency Standard & Poor's says a global "wall" of non-bank debt needed to meet companies' funding requirements over the next five years is increasing the risk of a perfect storm developing in global corporate credit markets. .Standard and Poors says non-financial corporations in the Eurozone, Britain, United States, China, and Japan need between US\$43 trillion and US\$46 trillion over the next five years. This includes US\$30 trillion of debt to be refinanced (with three-quarters of this between 2012 and 2016), and US\$13 trillion to US\$16 trillion of new money (for capital expenditure and working capital) that S&P estimates is required to spur economic growth".

account. This may well be the prime determinant of continued economic slowdown. The supply measurement known as M3 or “broad money” – all the money there is on loan or in circulation – has been contracting at a rate of almost 10 per cent annually in the United States.

Since the beginning of the global credit crunch following the Global Financial Crisis, central banks have been printing new stimulus money at an unprecedented rate, desperately adding liquidity to a financial system in danger of freezing up. M0, the narrowest measure (piquantly called “high powered money”) is the only part of the money supply controlled by central banks and it has dissipated considerably since September 2008 with the collapse of Lehman Brothers. Investment bank funds dried up in the scramble to deleverage toxic and real debt. It is this discrepancy between the narrow and broad money supply that bodes very badly for the future. China now holds US\$1.170 trillion in United States Treasury debt bonds (almost as much as the annual produced wealth of Russia). Bulard<sup>174</sup> argues, “China’s leaders even in their wildest nationalist dreams could not have imagined a more spectacular reversal of history than that the United States should be chastened and no longer top of the (capitalist) class, appealing to China to bail it out and boost world growth.”

United States Chairman of the Federal Reserve Ben Bernanke was a respected scholar of the Great Depression. Bernanke’s explanation is that the spread of that calamity centred on the abject failure of bank intermediation. In the early 1930s, as more and more banks failed, they took with them their particularised knowledge of their customers’ credit risk, which made lending riskier and thus less likely. It is again the unwillingness of banks to lend that may deepen the current downturn<sup>175</sup>. The rise of M0 and the fall of M3 suggest that from both a Monetarist and a Keynesian perspective, deflation is becoming likely.

### **3.12 Conclusion**

This chapter has described the social consequences that occur when financial systems become unstable. The chapter describes the rise of wealth through three decades of neoliberalist free market regimes where household and corporate wealth were realised through deliberate policy settings which encouraged specific economic policy

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<sup>174</sup> Martine Bulard. “Hooked on Debt.” *Le Monde Diplomatique* . 1 September 2011. (<http://mondsdiplo.com/2001/09/01debt>)

<sup>175</sup> “Shrinking Money Supply.” *Prospect Magazine*. 16 July 2010.

prescriptions to “reform” financial markets and create free trade amongst states and financial interests. Broadly termed “the Washington Consensus”<sup>176</sup> the policy advice had been the formative structure through which the United States provided funding and aid responses in the dynamic growth periods through to the Global Financial Crisis (GFC). High-level wealth creation was also enabled through the post GFC period by the expansion of international finance trade by hedge funds and sophisticated information technology expansion.

Some sections of the global economy were affected by the GFC but have remained buoyant and sustainable (international, unregulated over-the-counter banking and financial markets/shadow economy), whilst real economies burdened with debt are facing considerable periods of adjustment and social pain. These issues have arisen during earlier episodes of financial and concomitant regional destabilisation; it is only recently that the economic dysfunction that displaced millions in other countries, Southeast Asia, South America and Russia is producing similar challenges to western societies. Arguments brought forward in past decades remain the same.

Thompson<sup>177</sup> observed that the challenge to the nation state’s ability to regulate national economic conditions is illustrated by the Asian financial crisis of 1997. The severe depreciation of several Southeast Asian currencies was initially triggered by predatory offshore currency speculation. While the currency markets may not appear to have much direct connection with the lives of most people not involved in financial investing, the social repercussions of the crisis were considerable. World Bank statistics for Thailand (1999) reveal that between 1996 and 1998, the suicide rate increased by 40 per cent, the rate of abandoned newborns and orphanage admissions increased by 20 per cent, and the number of children being treated for drug abuse rose by 200 per cent. While this reflects no simple cause and effect relationship, the point is that the political and economic conditions under which the majority of the world’s population exists are subject to the influence of the global financial markets. Yet the market actors responsible for these increasingly unpredictable capital flows work for

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<sup>176</sup> John Williamson. First presented in 1989, Williamson, an economist with Institute for International Economics used the term to summarise conditions and policy advice by Washington based institutions such as the World Bank and International Monetary Fund, and the United States Treasury Department.

<sup>177</sup> Peter Thompson. “The Political Economy of Information in the Global Financial Markets and their Insulation from Democratic Accountability.” *Paper presented to the Political Economy International Association for Media and Communication Research for the IAMCR Conference 2004, Porto Alegre, Brazil, July 25- 30, 2004.*

institutions which eschew any democratic accountability and which operate in virtual economic spaces that are becoming increasingly insulated from state intervention/regulation.

Increasingly developed and developing nation states around the world continue to be dominated by the new controlling political economy powers of unregulated capital players in the form of central banks, hedge funds or high-net-worth individuals. The crisis in global social poverty has increased.

Three macroeconomic and political circumstances are influencing the future. The first relates to the changing balance of power between the West and the developing nation states in the East. This chapter has described the influence of the East upon the West financially. Second, the weakened economic conditions in the developed nation states of the West have their own fracture lines as the state has transferred vast amounts from the national public account to bailout banks, stimulate economies and rescue the private sector, thus substantially weakening the ability of the state services. The third and most important point is that regime change to debate and promote more equitable distribution systems, including a global financial tax, have been suffocated by the political influence of high-net-worth individuals who have the financial and lobbyist collusion with politicians to protect their selfish interests. This last point overrides the first issue, which could be managed by diplomacy. The second and third issues are possibly insurmountable given the massive concentration of wealth and influence derided by the capital elites over several decades. Even though a financial transaction tax would impact very slightly on the speculative trading market, it is disproportionately refuted at high political levels. The speculative transaction sector is miniscule in the scheme of the global society but holds an excessive control over political mechanisms and influence. It is the end of an era of excess at the top global political and corporate levels. It is the end of a growth period in the world that has produced high levels of wealth. An excess that has flowed through to citizens of countries around the world with the assistance of governments, ratings agencies, institutional players, hedge funds and anonymous capital tycoons secreted in tax havens.

Chapter 4 argues a case for systemic change and proposes a framework to implement a socially progressive policy instrument in the form of a Financial Transaction Tax.

## **Chapter 4**

### **Financial Systems Analysis**

#### **4.1 Introduction**

The aim of Chapter 4 is to provide an analysis of political, economic and social linkages that are embedded in global political economy systems. These linkages provide an explanation of theories underpinning the current global financial and sovereign debt crises. Chapter 4 builds on the arguments set out in Chapters 2 (Financialisation of Global Markets) and Chapter Three (The Social Consequences of Financial Markets).

Chapter 2 formulated and explained the processes of financialisation of markets and the regime of socialisation of credit as the underpinning cause of the global financial and sovereign debt crisis. Chapter 3 proposed an explanation of how speculative markets have delivered extreme negative social consequences within developed nation states. Chapter 4 posits the view that tensions between global “shadow” economies and “real” economies of developed nation states have had serious effects on most state capacities to provide civil society services, stable national accounts, and social programs.

Current systems of global political economy suggest a strong shadow finance system influence which contrasts radically to outcomes in real economies of most developed and developing countries. Shadow finance systems have, in recent times, heavily deleveraged from investments in stocks and shares (in regulated economies) to concentrate on derivatives in a new financial architecture that avoids “the concept of conservative banking<sup>178</sup> altogether”. This dynamic is quantified by the unprecedented growth in over-the-counter (OTC) derivatives markets, which expanded<sup>179</sup> by US\$106 trillion, to US\$707 trillion, between December 2010 and June 2011.<sup>180</sup> Real “domestic” economies remain disconnected, deflated, and detached in terms of debt

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<sup>178</sup> “The Great Escape: Delivering in a Delevering World.” *PIMCO Investment Outlook*. April 2012.

<sup>179</sup> Masaki Kondo. “Derivatives market Growth Accelerates to 18 % BIS Says.” *Bloomberg*. 16 November 2011.

<sup>180</sup> Bank for International Settlements. Quarterly Review. *Amounts outstanding of Over-the-Counter (OTC) Derivatives*. March 2012.

ratios to gross domestic product (GDP), as evidenced within European Union economies struggling with default and an inability to sustain growth<sup>181</sup>.

In Australia these altered economic circumstances are defined, and referred to as a “two-speed economy”. The Australian two-speed economy is essentially a manifestation of the global contest of faltering and failing financial systems competing against the emergence of rapidly expanding economies in Southeast Asia, South America and Indian sub-continent. It is essentially an economic contest between savings-oriented Eastern economies, led by China, and consumer-based Western nation states. Optimism about economies in Asia and pessimism about economies in the West is likely to be the prevailing mood of the current decade (2012–2022).

Australia has emerged as one of the strongest and most resilient economies in the developed world due in large part to unique geographical and natural minerals abundance. Australia has received exponential returns on resource wealth and is in close proximity to emerging economies India and China. Australia has also expanded its international standing in the shadow economy sector as quantified in terms of OTC derivative trades, which had grown to US\$3 trillion (notional amounts outstanding) by December 2010<sup>182</sup>. Politically Australia is positioning its economic growth as a centre of financial trade in the East Asia area. It is allied to the United States by a formal trade agreement.

Even though the United States’ economy is now recovering marginally (early 2012), an apparent inability to control the federal budget deficit and a rising national debt present a picture of both economic and political malaise. Similarly, the threat of sovereign-debt crises continues to hover over the European Union – and the European Union’s response has so far been anything but convincing (see Chapter 3). The conventional wisdom is that a profound shift of economic and structural political power from West to East is indeed underway. The question is whether the transition will be smooth or turbulent. Social indices would suggest that most developed states

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<sup>181</sup> “*Sovereign Market and Vulnerability Indicators*” International Monetary Fund April 2011. Sources quoted in this analysis: Bank for International Settlements (BIS) Bloomberg LP; IMF International Financial Statistics and World Economic Outlook databases. BIS,-IMF,-OECD,-World Bank Joint External Debt Hub.

<sup>182</sup> Bank for International Settlements. *Quarterly Review*. June 2011.

are locked in a protracted political and economic crisis. Their relativity focus has become more regional.

Within political economy systems debate, there is evidence of a new phase of globalisation. The United States alleges Chinese currency manipulation, as China allows its currency to appreciate as the Chinese consumer market begins to fulfil its potential. The relationship between China and the United States is seen as a microcosm of the new relationship between emerging and developed nation states. The largest player in global systems architecture is China. This economy is transforming. It is transitioning from its industrial production stage, which has maintained high GDP growth for two decades. The changes have been deliberate in terms of risk avoidance as China's main consumer systems markets of Europe and the United States have been challenged and are in economic decline since the Global Financial Crisis of 2008. The transition in China from an industrial export and investment-led economy, to a consumption economy marks a major strategic change, which will affect China, and possibly global momentum.

According to the optimistic scenario, the Western world will abandon any flirtation with protectionism, as it increasingly realises that the growth markets for the West's large company's lies with the emergent states of China, India and Brazil, and East Asia.

For neoliberal economies, this global and local crisis reveals fault lines in lax global regulation and supervision, misplaced political support of tax havens, tax free zones, and liberalised economic spaces to privileged players. This raises fundamental issues about future approaches for a system that has a political capacity to reform burgeoning speculative financial trading regimes to the benefit of global citizens through appropriate tax mechanisms. An ethical global tax system would provide an economic return to ameliorate some of the negative consequences delivered by shadow banking and dysfunction in financial markets. Neoliberal economies cannot support both ailing corporate structures and lose billions to tax havens.

The essence of the problem – as the Governor of the Bank of England, Mervyn King (May 2012)<sup>183</sup> has stated – *is that global banking institutions are global in life, but*

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<sup>183</sup> Mervyn King. “*Global Banks pulling back from overseas business.*” May 2012. China. Org.cn. (<http://www.china.org.cn/opinion/2012-05/25/content2>)

*national in death*. Dysfunction in banking and investment systems fall through to local markets. This occurs frequently when international financial systems falter, and citizens of states are penalised. King describes this new dynamic as a “crisis in capitalism.”

Before describing the emerging movement toward a financial transaction tax and presenting the models that have been brought forward, it is important to describe the international political and economic relationships that are prominent and emerging as system-based factors that differentiate shadow economies from local based nation states’ real economies.

Brock<sup>184</sup> (2011) argues that increasingly we are “living in the age of economists, the Age of Larry Summers, as it were, but economists have less and less say about the important issues of our time”. Further, Brock suggests that:

the term *economic imperialism* has been circulated for three decades. It refers to the reality that, of all social sciences, economics has emerged as the most relevant, most useful, and most rigorous discipline. Its perspective on social behaviour and its analytical methods have invaded every facet of sociology, political science, and social psychology.

Three main themes will be drawn in this chapter. First, the global regimes of unregulated, and politically sanctioned trades through offshore financial centres, is explained in terms of the changing nature and consolidation of trades from a wide range of offshore entities to the modern politically sanctioned centres of Cayman Islands, Wall Street and the City of London. Second, this increased offshore activity promotes the concentration of wealth, exorbitant privilege, and a political dilemma for governments supporting capital players whilst grappling with high levels of sovereign debt in real economies, and negative circumstances for civil society. Third, structural financial systems have created considerable tensions for elected governments; on the one hand pressing for fiscal growth in a time of high crisis, and on the other proposing radical services cuts to electorates already under intense socioeconomic constraints.

Against these changes, the central question of this thesis is reinforced. Is the introduction of a global financial transaction tax a plausible and sustainable economic

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<sup>184</sup> Horace W. Brock. PhD. President Strategic Economic Divisions Inc. “Why Economics Must Yield to Politics as the Paradigm of Tomorrow.” *Res Politica versus Res Economica*: (<http://www.SEDinc.com>)

and social policy mechanism to stabilise financial fragility and contribute resources in order to ameliorate the damage dysfunctional shadow finance has on nation states?

#### **4.2 The Growth of Financial Systems**

Montani (2011) argues that the 2007–2000 financial crises caused a dramatic fall in global output and employment and a serious deterioration of public indebtedness for many governments forced to rescue the banking system from failure. The crisis showed that national governments are not able to regulate the global market by means of the traditional instruments<sup>185</sup> of political economy. Speculative trading technology mechanisms have increased whilst macro wealth in real economies has decreased.

Specific national banking crises in the past have been more severe – for instance, the collapse of the United States banking system between 1929 and 1933 and the resultant depression. What is unique about this crisis is that severe financial problems have emerged simultaneously in many different countries, and that its economic impact is being felt throughout the world as a result of the increased interconnectedness of economic and political systems within the global political economy.

Pierre-Olivier Gourinchas and Helene Rey argue that the leading global economy, and the central country in the International Monetary System, the United States of America (US), has enjoyed an “exorbitant privilege” in global financial circles<sup>186</sup>.

They (Gourinchas and Rey) contend that the last two decades have been characterised by a sharp increase in international systems’ capital flows and in particular by the rising dynamic of globalisation of equity markets<sup>187</sup>, especially derivatives trading designed specifically as speculative trades inherent in the types of network sophistication that avoid regulation, governance and oversight. These are networks harboured in tax havens and tax free zones.

This does not mean, at this point, that economic recession, which many countries in the world now face, will be as severe as that of 1929–33. The crisis of the early 1930s

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<sup>185</sup> Guido Montani. 2011. *Money and Finance as Global Public Goods: Contribution to a Supranational Macroeconomic Theory*. University of Pavia, Via San Felice 5, Pavia.

<sup>186</sup> Pierre-Olivier and Helene Rey Gourinchas, (August 2005) “From World banker to World Venture Capitalist: US External Adjustment and the Exorbitant Privilege” *National Bureau of Economic Research. Working Paper 11563*. Cambridge, Massachusetts.

<sup>187</sup> Phillip R Lane, and Gian Maria Milesi-Ferretti (2001) “The External Wealth of Nations: Measures of Foreign Assets and Liabilities for Industrial and Developing Countries” *Journal of International Economics*. December 2001, and Lane and Milesi-Ferretti “A Global Perspective on External Positions” *International Monetary Fund*. June 2005

was made worse by policy responses, which can be – and are being – avoided today. However, it is clear that however effective the policy response, the ongoing economic and social cost of the financial crisis will be very large and will engulf countries with little or no connection to speculative trades. Social consequences from this crisis are extremely disruptive and far-reaching, and regionally systematic in nature. Europe's chronic sovereign debt positions affect consumer purchases originating in East Asia. An East Asian consequential downturn flows to Australia, which supplies commodities to China and India. Slowing economies in East Asia dampen capacities to continually purchase debt bonds to service United States debt level in this system.

We therefore need to ask profound questions about what went wrong, whether past intellectual assumptions about the nature of financial risk were seriously mistaken, or deliberately ignored, and what needs to be done to reduce the probability and the severity of future financial crises. An examination of regulatory approaches indicates systemic failure at both global and nation state levels. It indicates close collusion between economic and political elites. The secret and sophisticated technological approach of automated high-speed algorithm traders has enabled large quantum capital convoys across most developed countries. High-speed traders have the capacity to bet up (or short trade) national currencies. Hedge funds and their high-net-worth individuals' interests utilise legal tax free zone status in dispersed offshore havens.

At the same time, the United States has become a net borrower. Economist Ben Bernanke<sup>188</sup> (2005) explained the huge increase in the United States' current account deficit as “a remarkable reversal in the flows of credit to developing and emerging-market economies, a shift that has transformed those economies from borrowers on the international capital markets to large net lenders”.. These systems' growth regimes have been politically supported.

In essence, the new global financial system, combined with global (East versus West) macroeconomic imbalances, helped create unsustainable credit boom and asset price inflation. Those features then played a crucial role in reinforcing the severity of the financial crisis and in transmitting financial system problems into real economy

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<sup>188</sup> Ben Bernanke (2005). “*The Global Savings Glut and the Current Account Deficit*” Remarks at the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, 10 March 2005.

downturns. The shock to the banking system has been so great that it has impaired the financial system's ability to extend credit to the real economy. This dynamic continues to play a major role in exacerbating economic downturn. This, in turn, undermines banking system strength in a self-reinforcing feedback loop. The current level of public debt as a percentage of gross domestic product in Europe is an example of the deeply embedded underlying structures that are likely to restrain growth for a long period of time. Belgium (100.2 per cent), Italy (118.4 per cent) and Greece (130 per cent) are all higher in percentage terms than Ireland<sup>189</sup>.

Any agenda for regulatory reform therefore needs to address both the systemic factors which drove the initial over-extension of credit, and the factors which have played a crucial role by deepening the crisis and increasing the length and severity of the aftermath. Reforms should include responses to:

- The massive growth and increasing complexity of the securitised credit model, underpinned by inadequate capital requirements against trading books, which facilitated unsustainable growth in credit extension to households and to some parts of the corporate sector.
- An ethical approach to regulating and taxing cross-border capital flows through the introduction of a global financial tax across all trade corridors.
- Extensive commercial bank involvement in trading activities, which meant that falling asset prices have had a large and rapid effect on bank profitability, and in turn on perceptions of their credit worthiness, creating a collapse in bank funding liquidity.
- High leverage in multiple forms, which helped drive the rapid growth in credit extension and asset prices, and which increased the vulnerability of the system, since asset price falls had an amplified impact on system capital adequacy.
- The complexity and opacity of the structured credit and derivatives system, built upon a misplaced reliance on sophisticated mathematics, which, once irrational exuberance disappeared, contributed to a collapse in confidence

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<sup>189</sup> International Monetary Fund "Ireland caves in and asks for aid" *The Wall Street Journal*. 25 November 2010.

in credit ratings, huge uncertainty about appropriate prices, and a lack of trust that published accounting figures captured the reality of emerging problems.

- Lack of adequate capital buffers, as a result of which commercial banks' losses have driven falling confidence in the banking system, impairing the ability of the banking system to extend credit, and creating a powerful feedback loop between banking system stress and downturn in the real economy.

Macro-imbalances in the finances of the United States, the world's biggest economy are showing considerable signs of distress. By the end of June 2011, US borrowings were at a record US\$15 trillion, more than the total for the Eurozone as a whole. Many political economists and political science students are asking, "is America bust?"<sup>190</sup>

President Obama is promising to halve the budget deficit by 2013 and stabilise the debt at just over 70 per cent of GDP by 2015, but bipartisan political support for reform has not been reached. The first target date is just two years away and no one knows quite how that will be achieved. Politicians cannot agree on a compromise.

While countries across Europe are announcing austerity packages, Spain is cutting €15 billion, Germany €80 billion – the United States administration's instinct is to spend its way out of recession. US President Obama failed to persuade the rest of the G20 about the benefits of increasing spending in the face of the global crisis, yet he is also having little success in persuading people at home of the need for austerity. As one of the few western countries that still has the wherewithal to keep spending through printing currency in quantitative easing tranches of stimulus funding, the United States has been a big component of the negative global economic outlook as it increases indebtedness.

Kenneth Rogoff, Harvard Professor, whose book *This Time it Is Different*<sup>191</sup> is the definitive analysis of the history of financial crises, accuses the United States of storing up trouble for itself by using a trick called "playing the yield curve": taking

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<sup>190</sup> Heather Connon. "Is America going Bust?" *Prospect Magazine* 19 August 2011.

<sup>191</sup> Kenneth S. Rogoff and Carmen M. Reinhart "This Time it is Different: Eight Centuries of Financial Folly." Amazon Press, New York. 2011.

advantage of the fact that the rates for short-term borrowing are lower than for longer-term debt. About half of United States debt matures in the next three years (2012–2014), a far higher proportion of short-term debt than it has had at any time in the past, and a far shorter maturity profile than other economies: the average for United Kingdom, for example, is 14 years. It is worth remembering that the Greek crisis was triggered by the need to refinance short-term borrowings, forcing the country into its crisis €110 billion bailout and €35 billion cuts package.

No one expects the United States to need such a bailout, but the huge amount of debt which will need to be refinanced in the next three years means it is vulnerable to a “buyers’ strike”, should investors decide there are better opportunities elsewhere, or to demand higher yields for the increased risks of the rising deficit. Much depends on the attitude of the Chinese Government, which currently holds around half of all US debt. So far, China has shown no inclination to stop buying it, but the risks that the appetite could wane are already evident. China is moving gradually to a free float of its currency, ending the dollar peg, which could eventually cut the supply of dollars to its export earners.

It also means the United States is missing the opportunity to lock into long-term rates, which, while higher than short-term ones, are still very low by historical standards. As this stands, a small rise in interest rates could have a big impact. Jim Leaviss, head of retail fixed interest at fund managers M&G, points out that a two per cent rise in interest rates across all maturity levels could push the United States’ interest bill from the current “troubling” 17 per cent of revenues” to around 33 per cent. That, says Leaviss “could put economic recovery at risk.”<sup>192</sup>

Such a rise in rates looks unlikely in the near future. Even the most hawkish of economists thinks that interest rates will stay low for at least another year to keep the recovery going. That recovery, and the tax revenues it will generate, is vital to keep the faith that the United States will be able to deal with its deficit. But Rogoff points out that judging by historical standards, the higher the budget deficit, the lower economic growth tends to be: his (Rogoff’s) rule of thumb is that, at a deficit of 30 per cent of GDP, growth will average 3.7 per cent; at more than 90 per cent – which

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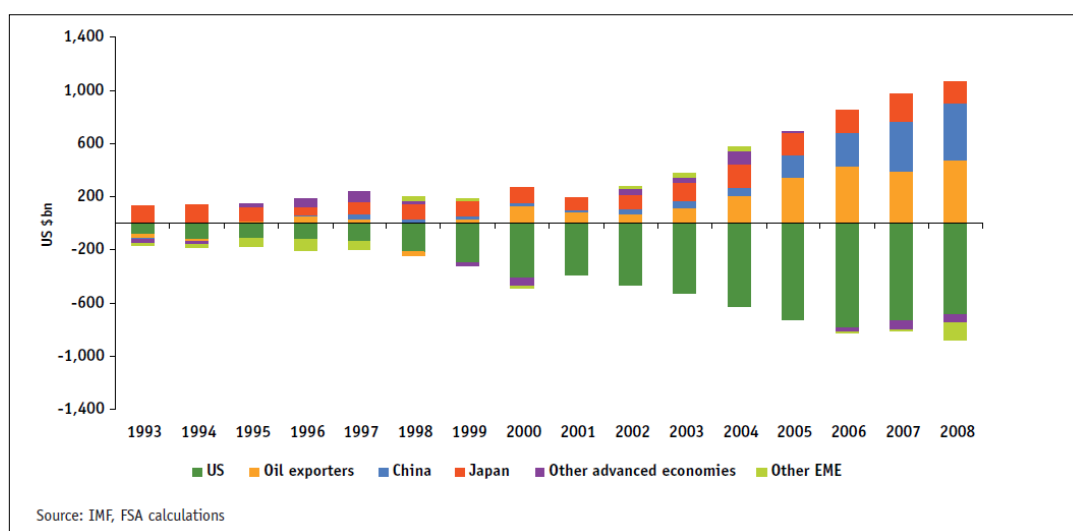
<sup>192</sup> Jim Leaviss. “100-year gilts given short shrift.” *The Financial Times*. 25 February 2012.

the US will reach this year – it falls to 1.7 per cent. Through 2012, this level has just been achieved.

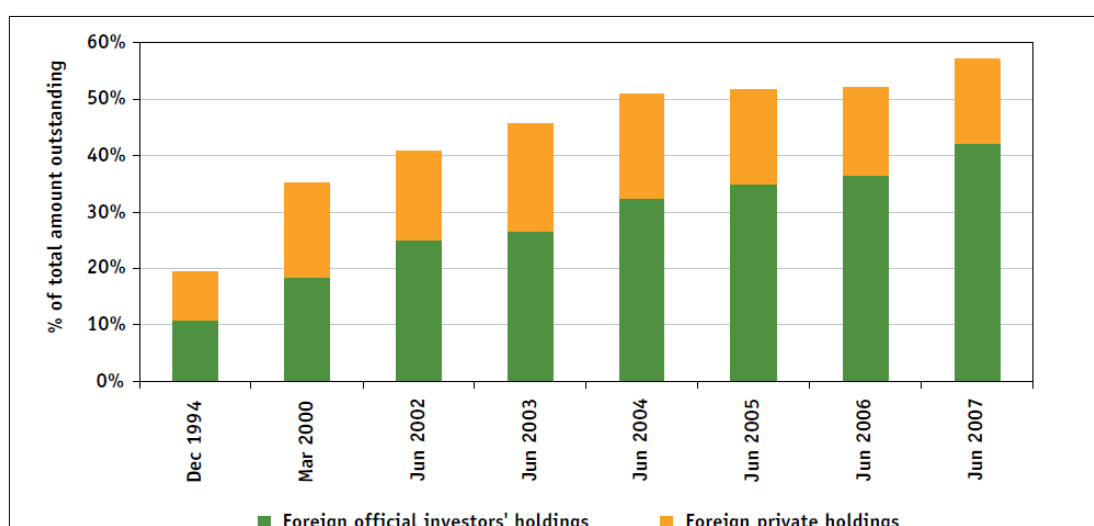
With a worsening European sovereign debt crisis, debt maintenance, austerity cuts and public anger, America's status as a safe haven may not change in the near future. Analysts at Barclays Capital argue that the dollar's status as a reserve currency means it can run far bigger deficits than other countries. Without that status, the United States' credit rating would already been downgraded from AAA to AA, the same as Spain. However, as long as its currency remains more than half the world's reserves – currently it is 60 per cent – a downgrade looks unlikely. The consequences of system breakdowns remain at high risk in a rapidly changing world.

The last decade has seen an explosion of world financial system macro-imbalances. China, and some other East Asian emerging developing nations have accumulated very large current account surpluses, while large current account deficits have emerged in North Atlantic developed economies of the USA, UK, Ireland, Spain, Germany, Greece and Italy amongst other countries. Many economies carry substantial outstanding national debt without the ability to reduce debt other than by reduction in public account expenditure in the form of the much-vaunted austerity.

A key driver of those imbalances has been very high savings rates in countries like China; since these high savings exceed domestic investment, China and other countries must accumulate claims on the rest of the world. China's savings philosophy mirrors that of other East Asian countries which have accumulated very high current account surpluses on the back of consumer spending and debt acquisition in the United States, Australia, United Kingdom and most developed countries that operate under neoliberal philosophies. However, since, in addition, China and several other surplus countries are committed to fixed, or significantly managed exchange rates, these rising claims take the form of central bank reserves. These are typically invested not in a wide array of equity, property or fixed income assets, but almost exclusively in apparently risk-free or close to risk-free government bonds or government guaranteed bonds (see Figure 4.1).



**Figure 4.1<sup>193</sup>: Global Current Account Balances 1993 - 2008.**

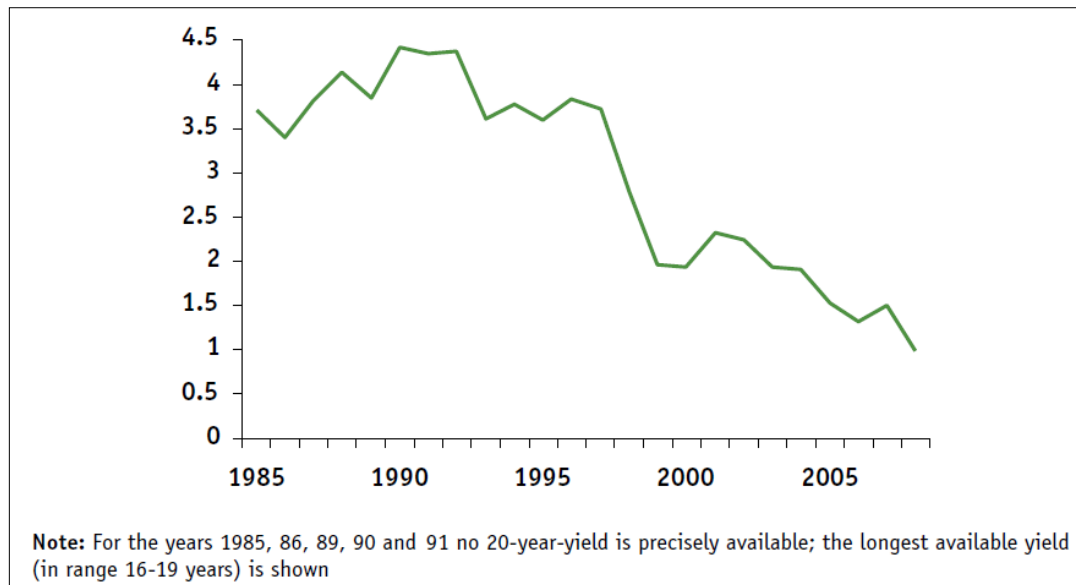


**Figure 4.2<sup>194</sup>: Foreign Ownership of Marketable Bonds as percentage of Amounts Outstanding, Dec 1994 - Jun 2007.**

This in turn has driven a reduction in real risk-free rates of interest to historically low levels (Figure 4.3).

<sup>193</sup> IMF, *US Treasury* "World Economic Outlook." Chapter 6: Divergence of Investment, October 2008. ([www.imf.org/external/pubs/ft/weo/2008/02/pdf/c6.pdf](http://www.imf.org/external/pubs/ft/weo/2008/02/pdf/c6.pdf))

<sup>194</sup> World Economic Outlook- Chapter 6: Divergence of Investment, October 2008.



**Figure 4.3: UK Real Interest Rates (20 Year Bonds Yield at May 25 or Nearest Week Day), 1985 - 2005. (See Reference 161)**

In 1990 an investor could invest in the United Kingdom or the United States in risk-free index-linked government bonds at a yield to maturity of over three per cent real; for the last five years the yield has been less than two per cent and at times as low as one per cent. Now in the United States the index-linked government loans are between zero and 0.5 per cent. These low rates were designed to stimulate a faltering economy post September 11. These very low medium- and long-term real interest rates have in turn driven two effects: first, they have helped drive rapid growth of credit extension surges to many developed countries, particularly in the United States, Europe, and Australia, but not exclusively for residential mortgages – with this growth accompanied by a degradation of credit standards, and fuelling property price booms which for a time made those lower credit standards appear costless. In Australia, this cheap credit has resulted in the highest per capita debt of any developed country. The second effect is a global deleveraging of unprecedented proportion.

### ***4.3 The US Economic Surge***

Global systemic market change was substantially enabled when the United States economic surge began in 1995 and continued unabated through to late 1999 when the Federal Reserve cut central fund rates from 6.5 to 3.5 per cent (in two months) as a fiscal policy response to stimulate the economy after the dot.com crash in 2000–01. The dot.com stock market bubble, fuelled by technology and internet stocks, fed the

United States economy into a frenzy from 1995 through to 1999<sup>195</sup> (under then President Clinton), despite the public utterances of Federal Reserve Chairman Alan Greenspan, who worried about the “irrational exuberance” of his Treasurer Robert Rubin’s economic strategy to cut deficits and lower interest rates. A year later Greenspan reversed his philosophical approaches with the comment that he accepted the “possibility of a new paradigm”<sup>196</sup>. This defined the start of a new era of low interest rates, a new era of credit assertion, and, by design, developing freedom for global financial markets. Morris (2008:67) suggests that:

the 2000s real estate bubble may be one of those rare beasts conjured into the world solely by financiers, which is confirmed by the fact that housing bubbles also occurred in the United Kingdom, Australia, Spain and other countries where residential lending became universally loose.

The dot.com bubble burst and had a major effect on stock and share prices, causing alarm with the speed and ferocity that overcame markets. The new Greenspan strategy proceeded to stimulate the economy by immediately lowering interest rates: a personal strategy by the Federal Reserve Chairman that was to set the course for recurring boom and bust cycles, not confined to the United States, but globally in nature and local in effect. In the aftermath of September 11, 2001, United States federal rates were again lowered to one per cent or below, the lowest rate in the United States for over half a century. This provided the launch pad for high leverage, hedge fund exuberance, and the engine room for global credit expansion.

For 31 consecutive months, the base inflation-adjusted rate was negative. Money was virtually free. The doors opened for financial engineers to rapidly design new instruments to take advantage of spreading risks through securitisation, IT-assisted instantaneous transfers, over-the-counter and off-balance-sheet banking arrangements, and money laundering and “fund parking” through hedge funds operating from tax havens. An intersection between regulated and unregulated markets grew rapidly under Chairman Alan Greenspan<sup>197</sup> and the George W. Bush Administration. Unregulated markets operated largely offshore (shadow banking and finance), whilst

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<sup>195</sup> William A. Fleckenstein. *Bubbleonians Running the Asylum: The Bubble Blow-off 1999-2000*. Chapter 4. *Greenspan’s Bubbles*. McGraw Hill. New York. 2010.

<sup>196</sup> Charles R. Morris. “*The Trillion Dollar Meltdown*.” Chapter 5. “*Wall Street finds Religion*.” Amazon Press. 2010.

<sup>197</sup> William A Fleckenstein. “*Greenspan’s Bubbles: The Age of Ignorance at the Federal Reserve*”. McGraw Hill. New York. 2008

regulated markets came within onshore governance structures within the real economy. This disconnect is still observed and radically favours investors.

Hedge funds, carry trade finance providers, and institutional lenders supported global booming real estate<sup>198</sup> businesses securitising and rolling up mortgages into Collateralised Debt Obligations with hundreds of billions of US dollars beginning to roll into markets as “carry trade” finance (borrowing low and lending long) money came through the United States courtesy of IT-enabled instant transactions from host nations Japan, China, Korea, and other East Asian countries. This was the start of the “buying back our money” fiscal policy enacted by the government of George W. Bush. Developed countries were awash with cash, or so it seemed. Global financial systems provided the next stage of integrated capital growth. To find borrowers was the next priority for geared-up, moneylenders. This system growth provided a bonanza for new financial products.

#### ***4.4 Housing Markets Provide Collateralised Debt***

The United States was witnessing the greatest sale of home mortgage products in its history and this purchasing turned to a default epidemic in 2007–2008, ultimately deteriorating into a housing and social nightmare of proportions unseen in any other time. It was driven by political settings designed to stimulate the economy, and enabled by corporate greed, excessive, non-sustainable and irrational, but no one in the Bush Administration or Blair Government (or the then Australian Howard Government in Australia) tried to curb the tide, or warn borrowers of the risks.

The resultant economic collapse produced consequences that were not scoped into political governance models that supported this type of irrational growth, either before or during the unprecedented escalation of money coming into countries as credit for consumers. This is a political phase where economics, specifically highly technical economic sophistication became dominant in financial systems.

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<sup>198</sup> On April 8, 2005 concluded in Greenspan’s “Consumer Finance” speech “Technological advances have resulted in increased efficiency and scale within the financial services industry. Innovation has brought about a multitude of new products, such as subprime loans and niche credit programs for immigrants with these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers these improvements have led to rapid growth in sub-prime mortgage lending; indeed, today’s subprime mortgages account for roughly 10 per cent of the number of all mortgages outstanding, up from just 1 or 2 per cent in the early 1990s”.

The process of delivering vast amounts of credit was a political construct across developed nations<sup>199</sup>. As social and financial risk became political risk, politicians orchestrated their responses in favour of the capital market players. This process intrinsically linked to a proliferation of lobbyists mostly based in Washington. Politicians in this era either lacked accountability or were so tied to capital and corporate elites that their positions were already compromised. Politicians were highly influenced by market-driven political ideologies linked to neoliberalism and supported by well-funded lobbyists. Kaiser (2009) argues<sup>200</sup> that

Over the past four decades Washington became a dysfunctional capital. ...money made by special interests using campaign contributions and lobbyists to influence government decisions, and money demanded by congressional candidates to pay for their increasingly expensive campaigns, which can cost a staggering sum. Politicians need for money and the willingness, even eagerness, of special interests and lobbyists to provide it explain much of what has gone wrong in Washington. They have created a mutually beneficial mutually reinforcing relationship between special interests and elected representatives, and they have created a new class in Washington.

High-risk housing markets are not confined to the United States; rather, they are a feature of most neoliberal developed nation states, including Australia where mortgage holders look to social services to assist with payments. It is a catastrophe that London School of Economics Professor Willem Buiter cited in a recent article entitled “Home Loans in the US: the biggest racket since Al Capone”. In contrast to Buiter, the former Chief Economist with the International Monetary Fund, Simon Johnson argues strongly that the social cost to nations represents immense hardship in respect to personal, community and government outcomes. In addition, that those governments have a high level of responsibility to lessen the damage from wholesale foreclosures. Writing in the *New Republic*<sup>201</sup> Johnson suggests:

It is important to know that there is a clear case to be made for using taxpayer money to reduce the number of foreclosures and help homeowners refinance their mortgages. On the negative side, foreclosures destroy economic value in several ways: transaction costs push foreclosure itself; reduced value of foreclosed houses, and impact on houses in the

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<sup>199</sup> Daniel Beland. “The Political Construction of Collective Insecurity: From Moral Panic to Blame Avoidance and Organised Irresponsibility.” *Centre for European Studies Working Paper Series 126*. October 2005.

<sup>200</sup>. Robert Kaiser. “*So Damn Much Money: The triumph of Lobbying and Corrosion of American Government*”. Alfred A. Knopf. New York. 2009

<sup>201</sup> Simon Johnson. *The New Republic*. 21 February 2009.

neighbourhood; reduced property taxes for local governments; and increased crime due to vacant houses. The death spiral of foreclosure-forced sales, falling house prices, and further foreclosures needs to be broken.

A survey “Asset Price Bubbles and Monetary Policy” released by the European Central Bank in 2005<sup>202</sup> was scathing of the “fast easy money policies” in the United States and stated in part:

As households are typically encouraged to spend out of their capital gains when asset prices advance, durable and sizable bubbles can boost consumer expenditure. ...In this respect, empirical evidence tends to suggest that a deflating bubble in the housing market is more costly than an equally sized crash in the in the stock market, as housing equity is more widespread and more intensely used as collateral for securing credit.

Ben Bernanke of the United States Federal Reserve has effectively named the current crisis as “market failure”. This economic market failure is entering a new social phase as millions of jobs are lost around the globe, first from the resources and mining sectors which had fed industrial growth in Asia, then from the manufacturing and building sectors, then from the public sector as governments rapidly lose income and resources (often relocated to financial market trading rooms).

Writing in the *Washington Independent* correspondent Mike Willis<sup>203</sup> pointed to the major social issues behind defaults saying:

Foreclosures nationwide topped 2.3 million last year, up 81 per cent from 2007 and 225 per cent from 2006, according to RealtyTrac, an online foreclosure database. In December, Credit Suisse estimated that, without government intervention, more than eight million families could lose their homes to foreclosure by the end of 2012.

The story is as bleak in the United Kingdom where the downturn has obliterated 1.2 trillion pounds from Britain’s national wealth<sup>204</sup>. Analyst Dharval Joshi of RAB Capital says the combined impact of the share market and property downturn has been equivalent to the loss of a full year’s economic output in the United Kingdom.

The boom and bust cyclical rotation is considerably more destructive in housing markets throughout European countries than in Australia where a combination of

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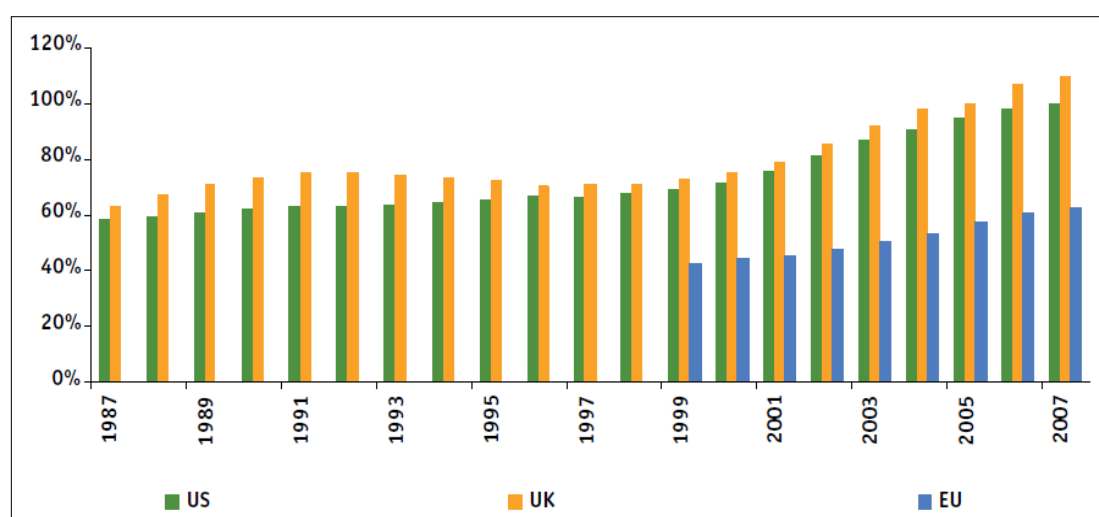
<sup>202</sup> European Central Bank. *Asset Price Bubbles and Monetary Policy*. 2005.

<sup>203</sup> “Foreclosure fury” as reported in the *Business Spectator* 20 September 2011 ([http://www.businessspectator.com.au/bs.nsf/Article/Foreclosure-fury-\\$pd20090220](http://www.businessspectator.com.au/bs.nsf/Article/Foreclosure-fury-$pd20090220))

<sup>204</sup> ‘Official: 40,000 pound loss for every taxpayer.’ *The Observer*. 25 January 2009.

resource-based export material demand, a growing population and high private property demand is driving the real estate market to ever higher territory and has given Australian consumers in all asset classes the dubious distinction of being the highest debt per capita nation in the world, a position that is unsustainable.

Debt levels in developed states have been accommodated by China and East Asia's capacity to accumulate and lend. It is accompanied by sophisticated trading mechanisms and innovation through capital convoys, algorithm and flash trading carrying huge volumes of finance. New sophisticated types of financial carriage from savings nations (China, Korea, Southeast Asia) to consumer nations (Europe, United States) have created radical systemic change in global political economy. The following chart (Figure 4.4) looks at the rising levels of debt in the United States, the United Kingdom and the European Union.



**Figure 4.4<sup>205</sup>: Household Debt as Proportion of Gross Domestic Product, 1987–2007.**

Cheap credit, lending, willingness by accumulators, and new powers vested in the those undertaking models of concentration of wealth have driven, among investors, a ferocious search for yield – a desire among speculators who wish to invest in bond-like instruments to gain as much as possible in spreads above the risk-free rate, to offset at least partially the declining risk-free rate. Twenty years ago a pension fund or insurance company selling annuities could invest at 3.5 per cent real yield to maturity on an entirely risk-free basis; now it would be only 1.5 per cent. Many new

<sup>205</sup> IMF, US Treasury. “World Economic Outlook- Chapter 6: *Divergence of Investment*, October 2008

sophisticated financial products, which appear to add 10, 20 or 30 basis points to that yield, without adding too much risk, have looked very attractive to macro investors.

Investment banks (looking like Ponzi scheme hedge fund arms), hedge funds and unregulated high-net-worth individuals have, this decade, driven massive growth in speculative betting across borderless trade zones. Convoys of finance, some distinguishable, others invisible, dominate the tax-free air zones from Wall Street to Canary Wharf, to Hong Kong and Sydney. Developments are rapid in financial trading and players continually look for an edge. This has come in the form of technology where high frequency trading specialists are usurping the agency of hedge funds that have lost the edge in efficiency and charges. Trading systems, concentrated in ever decreasing but powerful clusters bypass political attempts to negotiate progressive reform through proposed positions on financial transaction taxes.

Whilst significant losses have occurred in the real economy operated by nation states, primarily in the developed world, there has been an excess of capital flowing through corporations and high-net-worth individuals located in countries around the world with the assistance of governments, ratings agencies, institutional players, hedge funds and anonymous capital elites secreted in tax havens. This is the new post-2008 phase of a global system, which features a new sophisticated mode of capital accumulation, and a concomitant concentration of wealth. It comes with increased systemic risk. The challenge for global governments is clearly to rigorously develop options for a more equitable global system that includes a tax on traders' transactions. After all, they use the same legal system in both the origination of a trade and the receipt thereof. These trading systems are discussed in the following section.

#### ***4.5 Financial Innovation and Systems***

Systemic risk is principally located in international markets increasingly removed from nation state interference. This risk is immediately inherent in the collusion of politicians and financial interests. Most important in the systemic risk evaluation arguments has been the growth in centres designed to accommodate high levels of finance and effectively shield these areas from tax regulation or political influence. The vast wealth (estimated at US\$12.6 trillion) of tax haven entities has been politically supported for decades as the political and economic elite flaunt wealth and luxury items in the Cayman Islands and largely British Government protectorates,

including the City of London<sup>206</sup>, around the world. The protection of tax-free zones is highly political as noted by Shaxson who suggests:

The term “tax haven” is a bit of a misnomer; because such places aren’t just about tax. What they sell is escape: from the laws, rules and taxes of jurisdictions elsewhere, usually with secrecy as their prime offering. The notion that elsewhere (hence the term “offshore” is central. The Cayman Islands tax and secret laws are not designed for the benefit of the 50 000 odd Caymanians, but help wealthy people and corporations, mostly in the US and Europe, get around the rules of their own democratic societies. The outcome is one set of rules for a rich elite and another for the rest of us.

Further, Shaxson describes the City<sup>207</sup> as a “highly resourced lobbying organisation”.

These interconnected entities are in themselves both bastions of wealth, and risk, as the concentrations of wealth and influence ebb and flow from a large number of critical bases in the 1990s to a very small number of high volume protectorates in 2011. The Australian economy loses AU\$20 billion each year to havens, including Vanuatu<sup>208</sup>. They enable large trade volumes.

One of the most efficient instruments in contemporary financial systems is the special purpose vehicles (SPVs)<sup>209</sup> amongst other scientific and sophisticated speculative financial trading instruments. On this point, Nesvetailova<sup>210</sup> (2010:48) argues that:

The function of both SPVs and SPEs raises severe prudential problems. Tax havens have made it exceedingly easy to set up offshore SPVs yet crucially they do not have the resources, especially in terms of people, to perform appropriate due diligence on what are very sophisticated financial vehicles. For example, the Cayman Islands banking system holds assets of over 500 times its GDP and Jersey holds resources of over 80 times its GDP. It seems pertinent to ask whether such small jurisdictions can allocate sufficient resources to

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<sup>206</sup> Nicholas Shaxson. “The tax haven in the heart of Britain.” *The New Statesman*. 24 February 2011. (<http://www.newstatesman.com/print/201102240018>)

<sup>207</sup> Nicholas Shaxson. “An offshore island in the Thames.” *The New Statesman*. 10 November 2011 (<http://www.newstatesman.com/print/201111100030>)

<sup>208</sup> “Tax Office reveals extent of tax Avoidance to Vanuatu.” *Australian Financial Review* September 2011.

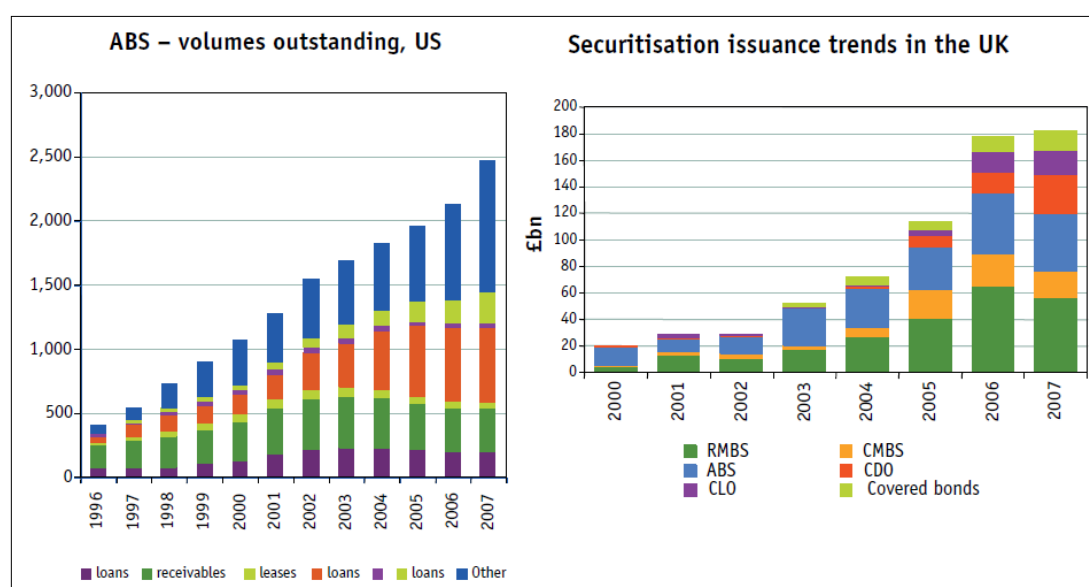
<sup>209</sup> Special Purpose Vehicles (SPV’s), entities (SPE’s) and investment vehicles (SIV’s) cover a broad range of investment products designed to operate as opaque, sophisticated ghost corporate structures with no people, or tangible identities to parent companies.

<sup>210</sup> Anastasia Nesvetailova. *Financial Alchemy in Crisis: The Great Liquidity Illusion*. Pluto Press. London. 2010

monitor and regulate such colossal sums of money. A report by the UK's National Audit Office<sup>211</sup> clearly suggests they do not.

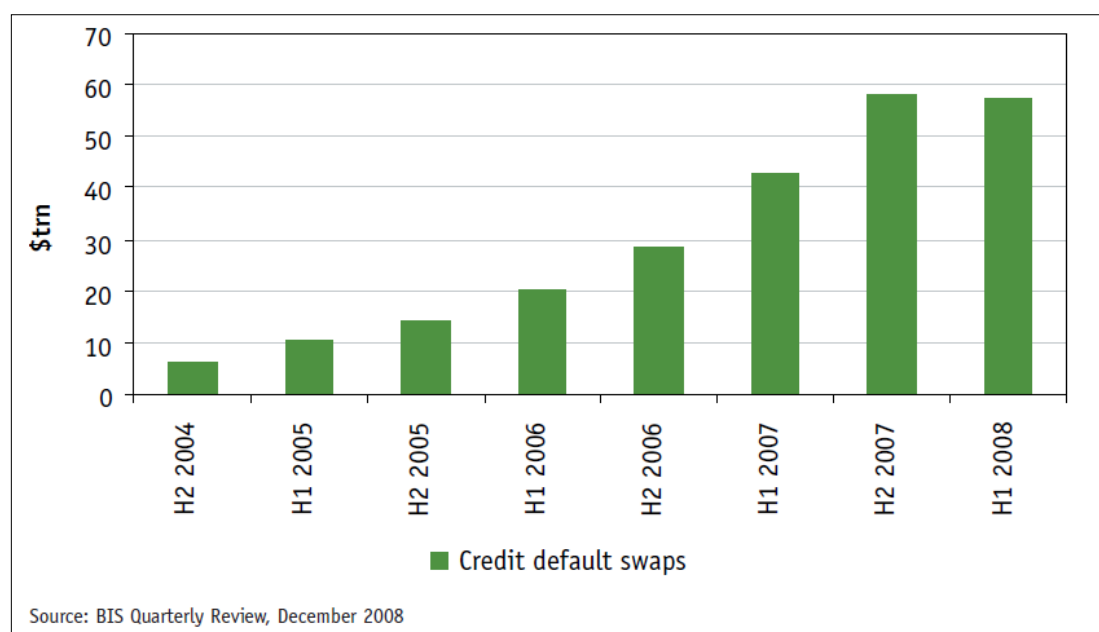
The demand for yield uplift, stimulated by macro-imbalances, has been met by a wave of financial innovation, focused on the origination, packaging, trading and distribution of securitised credit instruments. Increasingly the sophistication of new instruments becomes the domain of corporate elites with the resources to fund and develop market edge products. Simple forms of securitised credit – corporate bonds – have existed for almost as long as modern banking. In the United States, securitised credit has played a major role in enabling mortgage lending.

From the mid-1990s, financial system development entered explosive growth in both scale and complexity, with huge growth in the value of the total stock of credit securities (see Figure 4.5); an explosion in the complexity of the securities sold, with the growth of structured credit products; and with the related explosion of the volume of credit derivatives, enabling investors and traders to hedge underlying credit exposures, or to create synthetic credit exposures (synthetic collateral debt obligations and credit default swaps) (Figure 4.6). Proliferation of these market-betting instruments concomitantly lifted the need for secrecy of trades (and profits).



**Figure 4.5<sup>212</sup>: The Growth of Securitised Credit: Securitisation Issuance Trends in United Kingdom, 1996–2007.**

<sup>211</sup> National Audit Office 2007. “*Managing Risk in the Overseas Territories*” Report by the Comptroller and Auditor General, HC 4 Session 2007-2008. Foreign and Commonwealth Office, London: The Stationery Office 16 November 2007.



**Figure 4.6: Growth in Outstanding Credit Default Swaps, 2004–2008.** (See footnote 178)

This lethal dose of financial innovation most notably came into play in the “Too Big to Fail” dynamics surrounding the AIG insurance corporation in the United States. AIG took part in credit default swaps on collateralised debt obligations, the securitised investment pools of sub-prime mortgages whose dramatic collapse in value in 2008 was the proximate cause of the Global Financial Crisis<sup>213</sup> (Lanchester 2010:60).

These financial innovations sought to satisfy the demand for yield uplift. It was predicated on the belief that by slicing, structuring and hedging, it was possible to “create value”, offering investors combinations of risk, return, and liquidity which were more attractive than those available from the direct purchase of the underlying credit exposures. It resulted not only in massive growth in the importance of securitised credit, but also in a profound change in the nature of the securitised credit model<sup>214</sup>. It also resulted in the carriage by hedge funds of enormous amounts of global capital.

Nesvetailova<sup>215</sup> suggests that the Cayman Islands, Ireland, Luxembourg and Jersey are attracting a high proportion of sophisticated investment from opaque and

<sup>212</sup> IMF, *US Treasury* “World Economic Outlook- Chapter 6: Divergence of Investment”, October 2008.

<sup>213</sup> John Lanchester. *Whoops, why everyone owes everyone and no one can pay*. Penguin Books. 2010.

<sup>214</sup> Bryan Lowell *Breaking up the Bank*. (1988) which describes how securitised credit technology will deliver better economics, better credit underwriting, and better credit risk diversification’

<sup>215</sup> Anastasia Nesvetailova. *Financial Alchemy in Crisis*. Pluto Press. New York. 2010

concealed hedge funds and high-net-worth individuals from around the world, many based in these tax havens. The Bank for International Settlements<sup>216</sup> suggests that about 28 per cent of all cross-border transactions are carried out through offshore clusters. Of this 28 per cent (US\$ 29.164 trillion), the Cayman Islands (US\$1.7 trillion), Switzerland (US\$1.4 trillion), Ireland (US\$1.2 trillion) were the most prominent along with Bahamas (US\$436 billion), Jersey (US\$326 billion), Bahrain (US\$205 billion) and Singapore (US\$773 billion). This investment is related to the shadow economy.

The current financial and economic systems crisis, which has forced the past United States Federal Reserve Chairman Alan Greenspan to question the coherence of dominant conceptual financial and macroeconomic frameworks, is unprecedented in global reach and systemic gravity. Some basic figures speak for themselves. According to Blankenburg and Palma<sup>217</sup> global financial assets rose from US\$12 trillion in 1980 to US\$196 trillion in 2007. The International Monetary Fund's *Global Financial Stability Report* (2009) figures are considerably higher, at US\$241 trillion.<sup>218</sup> Global cross-border capital flows more than doubled between 2002 and 2008, with foreign investors holding one in four debt securities and one in five equities. While in 2000 only 11 countries had financial assets of more than 350 per cent of gross domestic product (GDP), 25 countries had deepened their financial markets to the same extent by 2007. As early as 1990, money managers had increased their control of United States corporate equities from eight per cent in 1950 to 60 per cent. Similarly, pension funds had extended their share of total business equities from less than one per cent to just short of 39 per cent, and their fraction of corporate debt from 13 per cent to 50 per cent.

In the period from 1986 to 2006, the United States' financial sector as a whole increased its share of corporate profits from 10–30 per cent, while its outstanding debts grew from 20 per cent of GDP in 1980 to 116 per cent in 2007. According to Tett<sup>219</sup> outstanding positions on credit defaults swaps today amount to no less than

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<sup>217</sup> Stephanie Blankenburg, and Jose Gabriel Palma. "Introduction: the Global Financial Crisis." *Cambridge Journal of Economics*. Volume 33, Issue 4.

<sup>218</sup> "Responding to the Financial Crisis and Measuring Systemic Risk": IMF. *International Monetary Fund (IMF). Global Financial Stability Report*. April (2009a) Washington, DC

<sup>219</sup> Gillian Tett. *How the Bold Dream of a Small Tribe at J.P. Morgan was Corrupted by Wall Street and Unleashed a Catastrophe*. Amazon Press. 2009

US\$600 trillion, with the risk embodied after discounting mutually offsetting contracts still as high as US\$14 trillion. As noted in the introduction notional outstanding amounts on over-the-counter derivatives are in excess of US\$700 trillion.

With the 2007–2008 collapse of the Bear Stearns and Lehman Brothers investment banks, the “curtains have now come down on this ‘dance of the trillions’” (Palma, 2009<sup>220</sup>), and toxic debt becomes a tangible feature of the terrain. The immediate “hangover” in the form of high levels of toxic debt is surreal not only in its sheer quantitative dimensions, but also because it is riddled with uncertainty. The socialisation of this debt is also a systems feature. As Tett remarked:

in the end the chain that linked a synthetic CDO of ABS [a collateralised debt obligation of asset-backed securities], say, with a “real” person, was so convoluted it was almost impossible for anybody to fit that into a single cognitive map—be they anthropologist, economist or credit whizz<sup>221</sup>.

Clyde Prestowitz<sup>222</sup> predicted in 2005 that the United States’ deficit figures were unsustainable saying that:

The US right now is absorbing 80 per cent of global savings. Well when you hit 100 per cent, the music stops and leading figures, people like Paul Volker, the former Chairman of the US Federal Reserve, people like George Soros, the great speculator, have all made statements that they fear a major financial crisis within the next five years because the system is unsustainable.

Prestowitz would possibly be surprised by global debt contagion that is now the next phase of the global financial crisis. The financial crisis in Europe outweighs that of the United States in sheer intensity, but in the context of financial systems, the European debt crisis could become global. A recent article stated, “The financial crisis in Europe, seemingly never-ending, has now hit a potentially disastrous phase. With interest rates on Italian and Spanish debt soaring, France looking shaky and even

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<sup>220</sup> José Gabriel Palma. *The revenge of the market on the rentiers. Why neo-liberal reports of the end of history turned out to be premature*. The Cambridge Journal of Economics. 2010.

<sup>221</sup> Gillian Tett *How the Bold Dream of a Small Tribe at J.P. Morgan was Corrupted by Wall Street and Unleashed a Catastrophe*. Amazon Press. 2009.

<sup>222</sup> Clyde Prestowitz former head of the Economic Strategy Institute in Washington and author of “Three billion capitalists: the Great Shift of Wealth and Power to the East” (2005) as quoted in ABC Online “*World Financial System heading for collapse, author says*”. (<http://www.abc.net.au/worldtoday/content/2005/s1446716.htm>)

Germany having trouble in the debt market there's a real possibility that the euro zone might just break apart"<sup>223</sup>.

#### **4.6 Risk Modelling**

Whilst the growth of offshore entities is a prominent systemic feature, over the past two decades, studies specifically related to the subjective nature of systemic risk have been missing in contemporary literature. In March 2011, the Bank of England (BoE) informed this enquiry through Working Paper 413<sup>224</sup> which provides an analysis of the systemic risk present in global financial markets, and presents a case that the rapid development of financialisation of global money markets is prone to substantial risk. The BoE Paper suggests:

An astonishing feature of the 2008 financial crisis was how quickly and extensively the relatively small write-downs in US sub-prime mortgages spread to a situation where only two years later governments worldwide had to provide massive support to their banking systems. International banks played a key role in transmitting contagion through their claims on each other. The paper examines how the interconnectedness of the international banking system impacts the threat of systemic risk in the international banking network.

The BoE Working Paper explains that cross-sectional systemic risk is defined as the potential for shocks that hit one part of the shadow financial system and is rapidly transmitted to the rest of the system. This potential can be analysed in a variety of ways. The BoE approach abstracts from specific details about shocks and looks more at the contagious capacity of the network, whilst examining the extent to which the international banking network became more broadly contagious over time.

To do this the Bank of England chose a benchmark modular structure to examine changes in the extent to which contagion spreads out of the fixed offshore tax haven clustering. The benchmark used is the clustering for 1989 quarter three (Q3) when the United Kingdom, Japan, the United States, and the Cayman Islands were combined into one tax haven module. This allows the examination of how systemic risk associated with financial problems that originate within these major offshore financial centres increased over time.

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<sup>223</sup> James Surowiecki. "An Avoidable Crisis." *The New Yorker*. 5 December, 2011. ([http://www.newyorker.com/talk/financial/2011/12/05/tatalk\\_surowiecki?](http://www.newyorker.com/talk/financial/2011/12/05/tatalk_surowiecki?))

<sup>224</sup> Rodney R. Garratt, Lavan Mahadeva, and Katsiaryna Svirydzenka. "Mapping systemic risk in the international banking network." *Bank of England Working Paper No. 41*. March 2011.

The amount of contagion flowing outside the fixed modules from 1989 Q3 has increased since the end of the 1980s and it peaked in 2008 quarter two (Q2), just before the Lehman Brothers' default. It remains at a relatively high level. When financial stress crosses many national boundaries, it is more problematic in the systems approach. This is partly because different legal systems and political preferences have to be compromised (see Chapter 6 in relation to financial transaction taxes and legal systems). For example, London School of Economics Law and Financial Markets Project (2009)<sup>225</sup> explain that Lehman Brothers' global business operated with over 100 data systems that were owned and managed by some of the 6,000 legal entities within the group worldwide.

Claessens, Dell'Ariccia, Laeven and Igan (2010)<sup>226</sup>, and Tucker (2010)<sup>227</sup>, emphasise difficulties in international coordination over crisis resolution. A corollary is that a network where financial stress can move rapidly across national boundaries should feature a greater systemic crisis. As comprehensive as the data is, they may not capture all the channels of contagion that mattered for this (2008) crisis. For example, banks' exposure to risk through derivatives such as credit instruments or swaps (CDS) and futures<sup>228</sup>, are difficult to measure, because of the opaque nature of trades, more usually through sophisticated networks.

Also absent are off-balance-sheet positions through special bank-sponsored investment vehicles (SIVs). The BoE says, "we do not have complete data on other non-bank financial institutions that became *commingled* with banks in the build-up to the crisis, the so-called shadow banking system". These missing links certainly mattered in transmitting the crisis. The current crisis is operating and affecting unidentified market players outside regulated and monitored networks. In addition,

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<sup>225</sup> London School of Economics Law and Financial Markets Project (2009). *Containing insolvency risk in the markets*, in Rebuilding Confidence in Financial Markets, Institutions and Regulators LSE Law and Financial Markets Project Conference, 12 March 2009. Report of Conference Proceedings Vol. 3.

<sup>226</sup> Stijn Claessens, Dell'Ariccia, G, Laeven, L A and Igan, D. *Lessons and policy implications from the global financial crisis*. International Monetary Fund. International Monetary Fund Working Paper No. 10/44. 2010

<sup>227</sup> Paul Tucker. *Resolution of large and complex financial institutions: the big issues*, Speech at the European Commission's Conference on Crisis Management in Belgium on 19 March 2010, Bank of England. 2010.

<sup>228</sup> Miguel, Segoviano A. and Singh, M. (2008) *Counterparty risk in the over-the-counter derivatives market*, International Monetary Fund, International Monetary Fund Working Paper No.08/258.

European banks funded themselves through purpose-built and supposedly independent off-balance-sheet vehicles that lent long-term back to their bank creators. These conduits (investment banks including Goldman Sachs) funded investments by issuing, and rolling-over shorter-maturity paper, sometimes using a complex repackaging of the securitised assets of their creators as collateral<sup>229</sup>. These sophisticated networks were severely tested in 2007–2010.

Even though losses only appeared in some of the components of composite assets, these instruments were sufficiently difficult to disentangle that investors' confidence and the whole market was shattered across the board and the contagion theory took hold<sup>230</sup>. As the banks that created these damaged vehicles took them back on to their own balance sheets, they acknowledged their exposure to this correlated risk. Other non-bank financial companies, such as United States money market mutual funds, had purchased many of these assets<sup>231</sup>. Other non-bank financiers and entities, such as monoline (Credit Default Swaps) insurers, had guaranteed payments and both became embroiled in the global financial crisis. The argument that “modellers” present in their defence is that models were correct, but they simply did not have enough credible historical data on sub-prime mortgages.

The international interbank market was already growing in 1985. The market grew strongly until 1987, and then after a brief pause following the stock market crash in 1987, picked up speed again to finish the decade in strength. An important driver of this expansion was Japanese banks, which were channelling surplus domestic funds onto world markets. European banks also became increasingly active in cross-border lending over this period as foreign exchange controls were removed in France and Italy, and as the prospect of greater financial and trade integration in the region loomed. It might have also mattered that many countries independently placed lower capital requirements on interbank lending than on commercial credits during the 1980s and that many banking centres liberalised their domestic financial regulations as discussed in Chapter 2.

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<sup>229</sup> Frances A Longstaff. “The subprime credit crisis and contagion in financial markets”. *Journal of Financial Economics*, Vol. 97, No. 3, pages 436–50. 2010.

<sup>230</sup> Joshua Coval, Jurek, J and Stafford, E. “The economics of structured finance.” *Journal of Economic Perspectives*, Vol. 23, No. 1, Winter, pages 3–25. 2009.

<sup>231</sup> Carol C Bertaut and Pounder, Laurie. “The financial crisis and US cross-border financial flows.” *Federal Reserve Bulletin*, Vol. 4. November 2009.

This first systemic boom petered out by the end of the decade (1990). The United States, Japan, Sweden and Finland suffered a sequence of domestic banking crises and world growth slowed down. There was also turbulence associated with the speculative attacks on the European exchange rate mechanism. International interbank flows remained subdued until 1994. Japanese banks in particular began to withdraw lending to other major international banks from 1989 quarter four (Q4), although they soon started to lend to other Asian banks. The second growth spurt came to an end with the catastrophic Southeast Asian crisis (1997 and 1998) and the collapse, and potential systemic contagion, of the United States based hedge fund Long Term Capital Management (LTCM) (1998). Once growth was halted, the rise in United States' interest rates in 1997, fears over the costs of European economic monetary union and deleveraging of earlier excesses combined to enforce an international slow down, thus international interbank market grew at low or negative quarterly rates until 2002.

Importantly, Bernard and Bisignano<sup>232</sup> explain how this second boom (1884 to 1997) was related to an excess of liquidity and low market interest rates, just as in the build-up to the recent Global Financial Crisis and current sovereign debt crisis. Cheap money from Asia, Japan and China entered the global arena, whilst growth in United States investment banks and their sophisticated trading mechanisms began significant gearing (leveraging of external funds). At this time European banks increased their share of this rapidly expanding market. Many funds were channelled through offshore centres, in another parallel with the more recent credit build-up.<sup>233</sup>

Post-LTCM shocks, when the market picked up again, invigorated fast and for a long time. This was the “long boom” which led up to the current crisis. It was the beginning of a sustained period of low interest rate policy settings. Bulletins published through the Bank for International Settlements Quarterly Reviews over this period cite and analyse the investments of Asian economies, petro-dollars, the role of offshore financial centres and hedge funds, and more generally excess liquidity as causal factors. Between 2001 and 2010 over-the-counter interest rate derivatives trades in the United Kingdom rose from US\$238 billion to US\$1,235 trillion in average daily

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<sup>232</sup> Henri Bernard and Joseph Bisignano. “Information, liquidity and risk in the international interbank market” *BIS Working Papers No 86, March 2000* ([www.bis.org/publ/work](http://www.bis.org/publ/work))

<sup>233</sup> Dixon, L. ‘Financial flows via offshore financial centres as part of the international financial system’ *Financial Stability Review, June, pages 105–16*. 2001.

turnovers. In Australia, the average daily turnover in this market rose from US\$10 billion (2001) to US\$42 (2010).<sup>234</sup>

Importantly, many nation-state banks shared in this expansion, and hence it can be thought of as a truly international expansion. This third boom ended between 2007 and 2008 with the Bear Stearns and Lehman Brothers collapse. Once the international banks began to suffer losses on investments with third parties (in the United States sub-prime market), they cut back from lending to each other. While this had happened at least twice before since the mid-1980s, the drop in interbank lending since 2008 is remarkably abrupt: in just over a year annual growth decelerated from 30 per cent to -20 per cent!

In 1985 Q1, the United States formed an offshore haven module with the Cayman Islands. Over 25 per cent of all United States finance and wealth was domiciled there. These two banking groups remain together, reflecting that the Cayman Islands are the principle offshore centre for the United States banking system. The IMF recently estimated that 57 per cent of the assets of the Cayman Islands banking system are overnight “sweep accounts” in branches of US banks). High-net-worth individuals are based in this haven. But in this latest systems-based crisis, contagion could well have traversed this apparently innocuous route – Cayman Islands residents were large foreign holders of private-label United States mortgage-backed securities leading up to the crisis Robert Tamborini<sup>235</sup> suggests:

All learned reconstructions (of the world financial crisis) of the disaster agree on the points that (1) buyers and sellers of financial products have created too much risk, (2) the market prices for these products are dramatically wrong in that they grossly understated their riskiness, (3) there has been an unprecedented growth of production and trade of these products, and hence of the total mass of risk (the so-called systemic diversifiable risk) (4) derivative and insurance markets have contributed to, and have been swept up by, this general mispricing as they have alimented the most dangerous financial illusion: the disappearance of risk. On top, negative financial externalities have been persuasive by way of financial contagion, the process whereby toxic assets have spread all over the world, and defaulting intermediaries have infected their interconnected partners.

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<sup>234</sup> *Location of Interest Rate OTC Derivatives: Turnovers*. Bank for International Settlements Quarterly Review March 2012.”

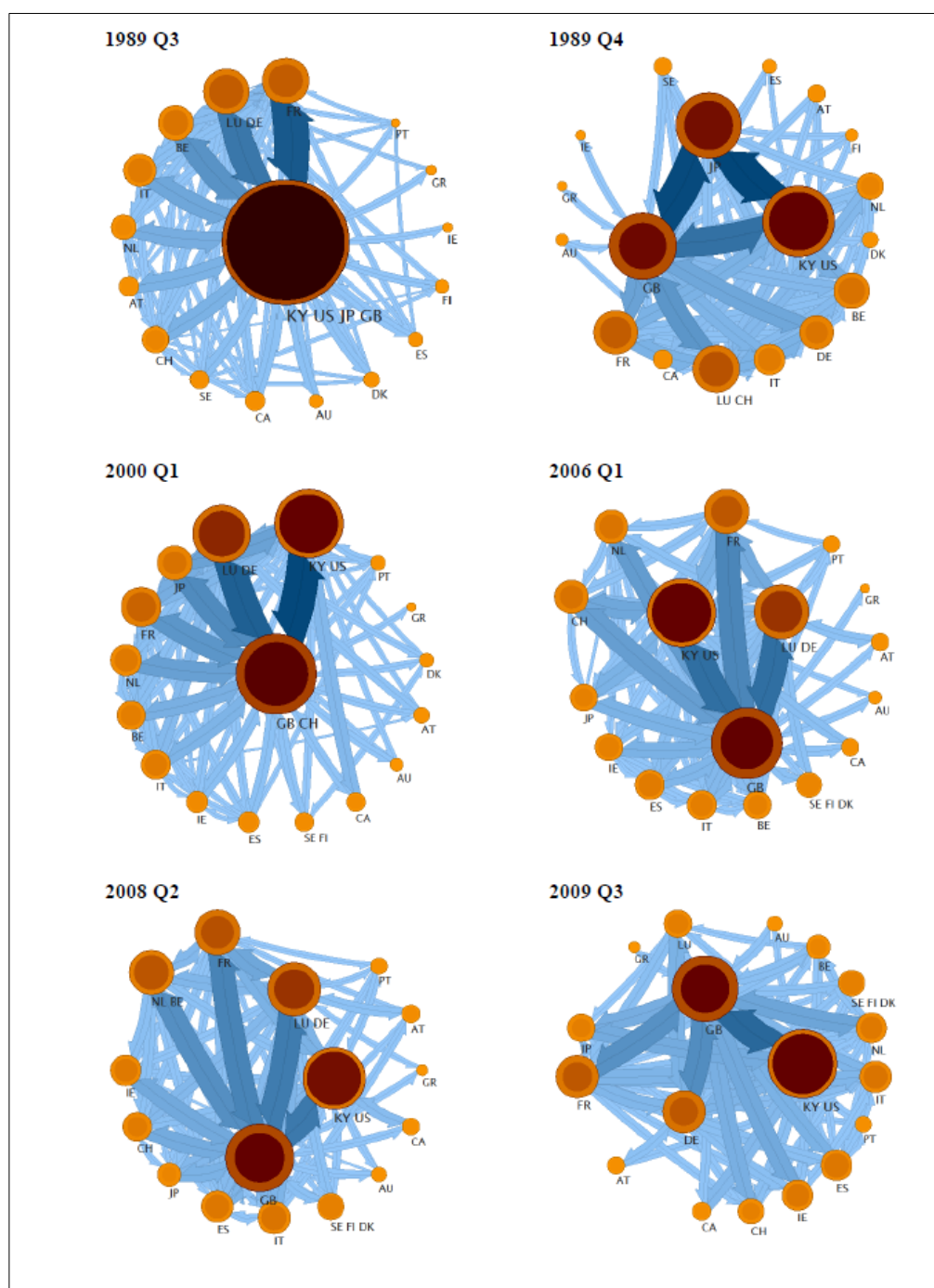
<sup>235</sup> Roberto Tamborini, *Time for a Financial Transaction Tax*. Roubini Global Economics – Global Macro Econometer. 17 November 2010. (<http://www.roubini.com/globalmacro-monitor/260019/>)

Another module containing only the United Kingdom is about 23 per cent of the overall tax zone system. It turns out that the United Kingdom banking group is always in the most influential module (or the second most prestigious module for the entire sample located in Figure 4.7) , no doubt given its role as a host to many foreign-owned banks as well as the international nature of its own banks. After these two large modules come four others with much smaller in terms of prestige (size and influence in the offshore systems). Japan, Belgium, France and Germany and Luxembourg together, have prestige scores ranging from 9– 7 per cent. At the other extreme, within the chart, there are seven modules that have prestige under one per cent which includes Australia. Apart from the US–Caymans and Germany–Luxembourg modules, all countries are in their own modules. It is perhaps not surprising that Luxembourg forms a module with Germany.

Importantly, the network now has fewer propensities to absorb contagion when compared to the turn of the century, and certainly when compared to 1989. In this contagion network, the United Kingdom is singled out as the central hub in this metropolis where stress arrives and is likely to be sent out again to many destinations. A year or so later, stresses from the United States' sub-prime market dysfunctions began to make themselves felt on international banks. Tellingly, this system remained in this contagious state right up until 2008 Q2 (just before the collapse of Lehman Brothers).

In late 2011 the international financial system remains in a broadly contagious state. In Figure 4.7 (Bank of England), the areas taken up by the blue arrows, or the outer rings, in the panel for 2009 Q3 are relatively large compared to a decade or two decades earlier? Despite the massive retrenching during these crisis years, the network at this date had not returned to how it was in 2000 and is not that different to its state when the sub-prime crisis struck. Abstracting from the question of the average quality of investments, that is on cross-sectional grounds alone; the Bank of England concludes that financial stress could still be transmitted rapidly around the international banking network arguing:

If financial stress can be contained within a few countries, it can be more easily dealt with. When the network is so interconnected that stress criss-crosses many national borders, it becomes truly systemic. In these circumstances, resolution is more complicated, the probabilities of default are higher and the losses given default are larger.



**Figure 4.7<sup>236</sup>: Bank of England: International Financial Systems.**

The scaling of the arrows and the circles are fixed across all of the diagrams so that their respective areas are comparable across time. If at one time a prestigious module is absorbing, the circle will be large and within that, the inner circle will dominate and the outer ring will be narrow. If at another moment, the module is as prestigious but

<sup>236</sup> World Economic Outlook- Chapter 6: *Divergence of Investment* October 2008. Source: IMF, US Treasury 2008..(www.imf.org/external/pubs/ft/weo/2008/02/pdf/c6.pdf)

more contagious, the outer ring will be thicker taking up more of the area of the circle of the same size.

Opportunities for trade mispricing grew and expansion of the global shadow financial system – particularly island tax havens – accommodated the increased outflow of many nation states’ illicit capital flight.

The Tax Justice Network International Secretariat<sup>237</sup> warns that sophisticated tax evasion (through havens) is the biggest problem facing nation-state governments around the world, both developing and developed. The losses to national accounts of tax from corporate operations undertaken on sovereign territory and secreted to havens is a profound problem and one that is highlighted in the current crisis of deficits and debt. Australia loses US\$20 billion a year. A functioning tax system is the foundation of good government and a key to the wealth (or poverty) of nations.

Corporations, big companies and wealthy individuals benefit from the onshore benefits of tax – like infrastructure, education and the rule of law – while using the offshore world to escape their responsibilities. Civil society increasingly bears the burden. Corporate losses requiring tax payer funds as bailouts seem anathema to the notion of equity and transparency in wider financial systems. The entire system lacks basic social, moral or economic integrity. Whether bailouts are funded by fiat money or taxpayer based real economy resources, the principals of *free markets* remain compromised.

The Tax Justice Network argues that tax havens offer not only low or zero taxes, but something broader. What they do is to provide facilities for people or entities to get around the rules, legal systems and regulations of other jurisdictions, using secrecy as their prime tool. We therefore often prefer the term “secrecy jurisdiction” instead of the more popular “tax haven”. International tax haven infrastructure allowing élites to escape tax and regulation is also widely used by criminals and terrorists. As a result, tax havens are entrenching inequality and poverty, corroding democracy, distorting markets, undermining financial and other regulation and curbing economic growth, accelerating capital flight from poor countries, and facilitating corruption and crime around the world. The offshore system is a blind spot in international economics. No

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<sup>237</sup> *Tax Justice Focus*. The Tax Justice Network Research Edition Volume 4, Number 2.

models include huge levels of unmitigated tax evasion. The issues are multi-faceted, and tax havens are steeped in secrecy and complexity – which helps explain why so few people have woken up to the scandal of offshore havens, and why civil society has been almost silent on international taxation for so long. The problem of tax havens is one of the great challenges of our age.

Assets held offshore, beyond the reach of effective taxation, are equal to about a third of total global assets<sup>238</sup>. Over half of all world trade passes through tax havens.

Developing countries lose revenues far greater than annual aid flows. The amount of funds held offshore by high-net-worth individuals and corporations is about US\$20 trillion (2011)<sup>239</sup> and this is estimated to be growing by more than US\$1.2 every year. Offshore finance is not only based in islands and small states, “offshore” has become an insidious growth within the entire global system of finance. The largest financial centres, such as London (Canary Wharf), New York (Wall Street), and countries like Ireland, Switzerland, Singapore and Vanuatu, offer secrecy and other special tax advantages to attract foreign capital flows.

Whilst economists and policy makers grapple with the tensions between free markets and undesirable effects on social services, the United States Federal Reserve Board argues that:

The recent decline of asset values both in absolute terms and relative to GDP has been historically large. Total losses of private retirement funds (including IRA, s) are about US\$ 2.9 trillion<sup>240</sup>.

In financial markets the institutions that create and market complex financial instruments are in effect *the house* and the house always wins as Satyajit Das (2006) and Richard Bookstaber (2007) show. Wall Street institutions manufacture risky assets such as securitised subprime mortgages and provide a wide array of hedging strategies to shift risk, as well as credit default “insurance” and buy back assurances in case anything goes wrong. Moreover these institutions charge fees

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<sup>238</sup> Tax Justice Research Edition. Volume 4, Number 2. Tax Justice Network. 2008

<sup>239</sup> “The fight against tax havens, avoidance and evasion” *ABC Television Lateline Program*. Narrator Ticky Fullerton. Guest John Christensen (co-founder of the Tax Justice Network). 23 November 2011.

<sup>240</sup> Federal Reserve Board “*Flow of Funds Accounts of the United States 1945-2008*. Federal Reserve Statistical Release Z1. Washington DC. Board of Governors of the FR System June 2011. Quoted in “The Trouble with Pensions: Toward an Alternative Public Policy to Support Retirement.” in Wray, Randall and Yeva Nersisyan. Levy Economics Institute and Bard College. Public Policy Brief Highlights No. 109A 2010.

for all the instruments they are selling, ensuring that pension funds will on average net less than a risk free return and be left with massive contemporary risk as the hedges, insurance, and assurances go bad.

#### **4.7 Financial Reform to Counter Market Risk**

Making financial markets accountable is the largest and most vexing social and economic policy question of our time and one, which demands urgency. Lord Adair Turner,<sup>241</sup> Chair of the London UK based Financial Services Authority, has argued for a tax on financial transactions and that states should have the power to gather information on all significant unregulated financial institutions (e.g. hedge funds, high-net-worth individuals, and investment schemes) to allow assessment of overall system-wide risks. Turner argues that regulators should have the power to extend prudential regulation of capital and liquidity or impose other restrictions if any institution or group of institutions develops bank-like (such as speculative trading platforms) features, which threaten financial system stability or otherwise become systemically significant.

Additionally, Turner argues that offshore financial centres should be covered by global agreements, policies, and oversight on regulatory standards. The systemic risks highlighted in Figure 4.7 (Bank of England) above suggest that although risk remains a major issue, two years have passed without resolution of any high level regulatory measures. Whilst bailouts and quantitative easing have been macro responses, there is a growing bipartisan recognition that financial transaction taxes would considerably lessen risks, particularly systemic risk related to short term speculative trades. Financial transaction taxes would make traders recognisable and lift the secrecy component of market players; exactly the position players are intent on preventing.

The systemic architecture is based on lightly regulated trading centres from Wall Street to Canary Wharf, Hong Kong to Sydney, and Dubai to Moscow. These dynamics changed in 1998 when the United States Securities and Exchange Commission (SEC) authorised the formation of technologically sophisticated

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<sup>241</sup>Lord Adair Turner. “*Shadow Banking and Financial Instability*” The Harvard Law Review 16 April 2012.

exchanges for the specific purpose of opening up markets for electronic trades to compete with established markets, such as the New York Stock Exchange<sup>242</sup>.

This effectively created new vastly different trading theatres, and secrecy, to those “traditional” stock exchanges and financial trading theatres (developed from Wall Street’s first organised stock exchange in 1792), which were based on agreements signed by leaders in the markets, and guided by rules, regulatory policy, and openness. Former Treasury Secretary in the Clinton Democratic Presidency, Robert Reich<sup>243</sup> argues that (since the late 1970s):

...a fundamental change has occurred in democratic capitalism in America, and that change has rippled outward to the rest of the world. Capitalism has triumphed, and not simply as an ideology. The structure of American - and much of the worlds - economy has shifted toward the far more competitive markets. Power has shifted to consumers and investors.

Meanwhile, the *democratic* aspects of capitalism have declined. The institutions that undertook formal and informal negotiations to spread the wealth ....have been eclipsed. The real explanation involves the way technologies have empowered consumers and investors to get better and better deals – and how these deals in turn, have sucked relative equality and stability, as well as other social values, out of the system.

In contemporary political economies, new systems have evolved to change the entire regime. The new system is based solely on speculation in a fast growing derivatives-based market featuring options and futures contracts, sophisticated technology, and this has fundamentally altered the relationships required to produce profits and trade globally. The evolution of financial markets has changed significantly, along with their influence over production, consumption and social welfare<sup>244</sup>.

Sassen<sup>245</sup> argues that that today’s global financial markets are unlike other current and past markets and “approximate and even enact, key principles of neo-classical market theory”. Further, Sassen states:

...since 1980 the stock of financial assets has increased three times faster than the aggregate gross domestic product (GDP) of the twenty three highly developed Organisation for Economic Cooperation and Development (OECD) countries, and the volume of trading in

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<sup>242</sup> Banque de France. *Financial Stability Report: Liquidity: Special Issue*. Paris. February 2008.

<sup>243</sup> Robert Reich. *The Road to Supercapitalism*. Chapter two in “*Supercapitalism: the transformation of business, democracy and everyday life*. Scribe Publications, Victoria, Australia. 2008.

<sup>244</sup> Karin Knorr Cetina, and Alex Prada. *The Sociology of Financial Markets*. Oxford University Press. New York. 2008

<sup>245</sup> Saskia Sassen. *The Global City*. Videri Press. New York. December 2009

currencies, stocks and bonds has increased five times faster. Most of this activity is financial market activity. For example, the global foreign direct investment stock was US\$6 trillion in 2000, while the worldwide value of internationally traded derivatives was over US\$80 trillion and rose to US\$192 trillion in 2002. In 1983, on the largest financial market in terms of volume of transactions, the foreign exchange market, transactions were ten times as large as world trade (the economic exchange of goods and services), but in 1999 they were seventy times larger, even though world trade also grew significantly during this period.

Sassens argument provides substance to the consistent evidence in this thesis that market growth, particularly finance capital market growth is unparalleled at any time in history. Speculative capital trades now account for over US\$700 trillion<sup>246</sup> in derivatives markets alone.

This section has dealt with the systemic risk associated with offshore financial centres and the concentration of ever increasing amounts of capital into smaller clusters of high-net-worth individuals and corporate players, regulated and unregulated. Development of these high-risk markets could not have been achieved without highly sophisticated high technology advancements. Leading edge technology in this scenario also equates with low supervision and oversight of markets. Exactly what trading elites aim for.

#### ***4.8 High Frequency, Flash Trading and Dark Pools***

Every 24 hours US\$4 trillion plus is traded globally in currency markets. This section of the speculative market is minor compared to other derivate trades.

The development of new ways to transfer transactions has been extraordinary and facilitates, within markets, desire to be quicker and more responsive to gain an edge on competitors. Smart traders are capturing the vital margins so necessary in trades. This is a new system dynamic that has changed political, economic and social conditions, detrimentally, into the future. This is a sophisticated and often dysfunctional system of trading by high-net-worth individuals with very strong political influence. This new system is based on sophisticated trading platforms using a combination of proprietary, secret algorithms, and the fastest flash trade computer

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<sup>246</sup> Bank for International Settlements Quarterly Review. *Amounts outstanding of Over-the-Counter (OTC) Derivatives*. March 2012

networks available<sup>247</sup>. High frequency trades account for over two thirds of all global trades within systems. Most trades are lightly or not regulated.

The advent of this super-sophisticated, super-secretive enabling model for capital trade convoys has changed the dynamics for those able to access the technological science. A summary of these trading mechanisms is useful. Randall Dodd<sup>248</sup> (2010) argues that three innovations in electronic trading of stocks and options have been in the headlines recently: high-frequency trading, flash trades, and dark pools. Technical improvements such as these are usually assumed to raise efficiency, but these innovations challenge such assumptions and may pose some public interest concerns because of their effect on financial stability, and the security of nation states.

Dodd suggests that studying market microstructures illuminates the processes through which prices are determined. Markets often appear to be magic black boxes. Supply and demand go into the boxes and an invisible hand pulls out the price – much like a magician producing a rabbit from a hat. But important things happen inside those boxes.

In the case of electronic trading of securities and derivatives, the microstructures inside the box includes the mechanisms for submitting buy and sell orders (that is, bid and offer quotes) into a market, viewing of those quotes by market participants, and executing trades by matching orders to buy and sell. If this is done in an immediate and transparent manner that enables all market participants to see and trade at the same prices, then reality approaches the ideal of the efficient-market hypothesis<sup>249</sup>. When markets become segmented and informational advantages are built into market mechanisms, efficiency is impaired and fairness undermined. This is sought by most market traders looking for an edge on competitors, but it is risk prone.

High frequency trading, flash trading, and dark pools all have their origin in two key marketplace innovations – electronic trading and the closely related alternative trading systems (ATS). Electronic trading has quickly come to dominate traditional trading,

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<sup>247</sup> Chris Rose *Dark Pools and Flash Orders: The Secret World of Automated High Frequency Trading*, Walden University. Presented at the Ninth Annual IBER & TLC Conference Proceedings. 2009.

<sup>248</sup> Randall Dodd, “Finance and Development.” March 2010. *Overhauling the System*. Finance and Development. 2009, and “A forward looking analysis of the global economy.” ([blogs.worldbank.org/prospects/architecture/archive/201003](http://blogs.worldbank.org/prospects/architecture/archive/201003))

<sup>249</sup> Jacques –Olivier Charron. *Disambiguating Efficiency: a question of points of views, transparencies and research designs*. Finance in question/Finance in Crisis conference. Manchester. CNAM (Conservatoire National des Arts et Metiers) LIPSOR. April 2010

both on exchanges and in over-the-counter markets. Computer systems automatically match, buy, and sell orders that were themselves submitted through computers. Floor trading at stock and derivatives exchanges has been eliminated in all but the largest and most prominent markets, such as the New York Stock Exchange (NYSE), and even in those markets floor trading coexists with electronic trading. ATS are computer-automated order-matching systems that offer exchange-like trading opportunities at lower costs but are often subject to lower disclosure requirements and different trading rules.

High-frequency trading (HFT) (also called black box trading), uses high-speed computers governed by algorithms (or instructions to the computer) to analyse data, identify investment opportunities, and manage order flows to markets. An HFT firm can submit a thousand orders a minute to an exchange and just as quickly cancel them and submit different ones. An estimated 90 per cent of orders submitted by high-frequency traders are cancelled. For example, if a share has a \$9.90 bid price (to buy) and a \$10 offer price (to sell), an HFT firm might seek a small but low-risk profit by raising the bid to \$9.91 and lowering the offer to \$9.99 (an 8-cent spread) if the algorithm deems that these changes will have a sufficiently high probability of triggering immediate trades. If these improved quotes result in immediate trades, the HFT firm gains the 8-cent bid-ask spread on each share traded in this manner. The risk is that only one leg of the deal will be executed immediately, with a delay in fulfilling the other leg after a change in market prices that result in a loss. If the HFT firm buys at \$9.91 but finds no takers for the offer at \$9.99, and the market prices drop below \$9.91, the HFT firm has a short-term loss.

Competition for lucrative HFT business is so fierce that firms pay to locate their computers as close as possible to those of the exchanges and Alternative Trading Systems (ATS)<sup>250</sup> to minimise “latency,” or delays in communication. Some pay to locate at the same place as the order-matching engines, close to existing exchanges. A microsecond delay in submitting an order can mean the difference between being at the front of the line – and executing the trade – and being back in the queue with an unfulfilled executable order. The gain on each trade may be small – Rosenblatt Securities estimates that the average revenue for HFT in equities is between \$0.001

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<sup>250</sup> Alternative Trading Systems, the SEC's general classification for equity exchange alternatives in US equity trading

and \$0.002 a share – but the volume is enormous, and some exchanges and ATS pay rebates to the HFT firm for generating the volume. HFT firms received \$3.7 billion in such rebates in 2008. Today, HFT generates an estimated *73 per cent of the total trading volume on United States stock markets* and about 20 per cent at options exchanges. Randall Dodd (2012) suggests, “All the securities and derivatives involved in the financial turmoil that began with a 2007 breakdown in the U.S mortgage market were traded in [over-the-counter] markets.”<sup>251</sup>

Many calls have been made to ban flash trade orders. Euronext NYSE which operates the New York Stock Exchange has been a critic of flash orders as several traders have developed trading methods that have gained a higher edge of market share. William Donaldson, the former Chairman and chief executive of the New York Stock Exchange and now an adviser to a large hedge fund, said that, “this is where all the money is, if an individual investor doesn’t have the means to keep up they are at a huge disadvantage”. However, market players have raised concern that regulation would crimp markets<sup>252</sup>. With more and more trading coming through this speculative medium, it is obvious that high-level players deploy lobbyists to persuade politicians to allow a “hands-off” approach despite well-documented risks of a systemic nature.

Dark pools are owned by exchanges, broker-dealers, or independently, and use a more efficient electronic trading platform to negotiate large deals and do not require a firm to identify, or the prices at which it is willing to trade. Transactions made through dark pools are recorded as over-the-counter, not exchange, transactions, and the size, price, and time of consummation are not publicly disclosed. Trading in dark pools allows firms to make large trades without the risk that their large order will move the market price away from their preferred price. In open trading, firms expose their orders – that is, they disclose them to the public when they are displayed through exchanges. When large orders are exposed, market participants could react by raising their offers or lowering their bids. HFT has accelerated the speed at which the market price responds to new orders.

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<sup>251</sup> Randall Dodd. “Markets: Exchange or Over-the-Counter”. *International Monetary Fund. Finance and Development*. 28 March 2012.

<sup>252</sup> “Ban on Flash Orders is considered by the SEC.” *Wall Street Journal*. 5 August 2009.

In respect to the increase in volume, John Lanchester<sup>253</sup> (2010:55) states that in the United States alone the finance tied to credit default swaps (CDS), collateral debt obligations (CDO), American Insurance Group (AIG) (the recipient of US\$200 billion of public funds), and monies paid to Goldman Sachs to bail out the private investment banker is in excess of US\$173 trillion alone. The inherent risks involved at a quantum, political and social level alone should be sufficient to convince political leaders and policy makers to regulate and provide oversight. A condensed number of elite sophisticated players in this intense trading space continue to record high profits. They are intertwined and inter-related to systemic market regimes.

#### **4.9 Systemic Debt and Leverage**

Systemic sovereign debt problems besetting European countries and the United States have been described in an array of theories, which posit blame on a combination of events and pre-existing circumstances. Anastasia Nesvetailova<sup>254</sup> locates the associated slide towards a wholesale “global credit crunch” as a crisis in Anglo-Saxon capitalism. Nesvetailova argues that theories enquiring into the long-term causes suggest trends to overlap the political, social, economic, cultural and ideological foundations of market based capitalism:

Thus emphasising the historical origins of the current crisis, structural theorists view it as a specific, but largely predictable result of the operation of a type of economy that had replaced the Keynesian welfare state of the 1950s – 1960s with a neo-liberal model of capitalism. The financial meltdown of 2007 – 2009 is thus only a reflection of many other deep –seated crisis tendencies structured in the brewing of this model – a crisis brought about by a combination of short-term policy targets, debt financed consumption, minimal savings, deregulated capital markets, the consumer-driven pattern of recovery from previous crises and a general hedonistic basis of socio-economic relationships that have come to define the culture of American defined capitalism<sup>255</sup>.

Alongside the new sophisticated algorithm and flash trade growth is a correlated social discount. In the United States, over the decade of intensified systems growth,

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<sup>253</sup> John Lanchester. *Whoops! Why Everyone owes Everyone and no-one can pay*. Penguin, London. 2010.

<sup>254</sup> Anastasia Nesvetailova. *Financial Alchemy in Crisis*. Pluto Press. London. 2010.

<sup>255</sup> Elmar Alvatar. “Financial Crises at the Threshold of the 21<sup>st</sup> Century.” *Socialist Register*. 1997 and see Alvatar, E. (2002) “The Growth Obsession.” *Socialist Register*. and Pettifor, A. (2003) “Coming Soon: the New Poor”. *The New Statesmen*, September 1.  
Tily, G. *Keynes General Theory, The Rate of Interest and Keynesian Economics*. Basingstoke: Palgrave MacMillan. 2007

(2001–2011) personal debt jumped from US\$55,000 to US\$145,000 whilst the ratio of debt to disposable income went up from 93.4 per cent to a post-1945 record of 139 per cent (Adair Turner)<sup>256</sup>. George Soros<sup>257</sup> called this a “super- bubble, a concoction of a housing bubble, an explosion of leveraged buyouts and other financial excesses ... these in turn were unleashed by a regime of historically cheap and easy credit which was made possible in the era of low consumer price inflation and aggressive competition among financial institutions for new profits.” In the United Kingdom this group of middle class “new poor” account for the bulk of personal debt, with over 1.5 trillion pounds. Total private sector debt rose from 133.5 per cent of GDP to 227.4 per cent during the 10 years of the Tony Blair New Labour Government, higher than any other industrialised economy<sup>258</sup>.

Unsustainable as this consumer credit bubble became the ensuing avalanche of crises was precipitated by extraordinary levels of banks and investment balance sheet leverage which firstly brought down the Northern Rock Bank (UK) in September 2007, causing a public “run” on funds by small bank account investors; a bank run that had not been witnessed in the United Kingdom for over a century. So many individuals demanded their savings in cash that nearly AU\$2 billion (five per cent of the bank’s total assets) was paid out in one day. Several months later the government bailed out the bank (effectively nationalising the bank in a free market economy) for AU\$50 billion; at that stage the largest amount of money any government in world had extended to any private banking corporation, to start an era of socialisation of debt.

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<sup>256</sup> Lord Adair Turner, Interview with the Financial Times. 17 October 2008.

<sup>257</sup> George Soros. *The New Paradigm for Financial Markets*. New York. Public Affairs. 2010.

<sup>258</sup> Anastasia Nesvetailova, (2010) *How the crisis has been mis-understood*. “Financial Alchemy in Crisis.” Pluto Press. London.

#### ***4.10 Systemic Meltdowns: Taxpayers to the Rescue.***

In the United States, massively leveraged and poorly risk-managed banks were starting to feel the risk of balance sheets tainted with layers of toxic sub-prime debt in the structured tranches of collateralised debt obligations and credit default swaps. The global system was reeling from negative speculation over the over-extendedness of banks' balance sheets, the gravity of sub-prime investment, activities by credit rating agencies, and a contagion of housing market dysfunction in the form of default and home investment value slides. This system failure led to a crisis in the investment banking industry, first in the United States, before spreading to Europe.

Wall Street investment bank Bear Stearns collapsed in March 2008, and then Fannie Mae and Freddie Mac, the underwriters of a significant section of the whole American mortgage industry, became the largest nationalisation in global history on September 7, 2008. Eight days later the largest invest bank Lehman Brothers became the largest bankruptcy in the world as it transitioned into voluntary receivership. The following day (8 September) the largest insurer in the world AIG became the biggest bailout of a private company in history with the United States Government, taking a 79.9 per cent share in the stricken and chronically overleveraged company.

Merrill Lynch (investment bank) was taken over by the Bank of America on 14 September 2008. In the United Kingdom's, Lloyds of London undertook the largest "merger" when it acquired the largest United Kingdom home mortgage lender (20 per cent of the entire market), HBOS. On 21 September 2008, Goldman Sachs, the world's largest investment bank, and Morgan Stanley, a flagship of corporate America, were forced to convert their legal status from "investment" to "holding" banks, allowing them to access taxpayers' money in return for high levels of government supervision. Across Europe, a wave of banking and investment fright culminating in the weekend of 11–12 October 2008 when the entire United Kingdom's banking system was on the point of collapse.<sup>259</sup>

The American insurance giant AIG was the primary holder of market asset class credit default swaps (CDS), the insurance vehicle held against collateralised debt obligations (CDOs)(containing pools of sub-prime debt tranches) whose price collapse after

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<sup>259</sup> John Lanchester. *Whoops! Why Everyone owes Everyone and no-one can pay*. Penguin London 2010

revelations about their over-rated nature led to the Global Financial Crisis. Had AIG been allowed to fail, not only would the entire financial system collapse but AIG held global reinsurance lines including aviation insurances which would have immediately precipitated the grounding of aircraft around the world, causing social and economic chaos of dimensions not witnessed before.

Conscious of perilous state of the entire asset class structures globally, AIG was deemed “Too Big to Fail”, even though, post Lehman, AIG was known to have toxic assets with values much higher than Lehman. They (AIG) needed to borrow (from the United States Government) massive collateral (loans) to cover massive account risk. The seeping leaks that began as sub-prime mortgage failure became rivers of system-leveraged debt, sweeping through homes, gouging great holes through bank balance sheets across the world, with most risk held in the CDS market managed by AIG. Even in the excess of free market ideology, no one could afford to let AIG go under.

Following the initial response of the US government to take over 79.9 per cent of AIG for an amount of AU\$85 billion (effectively allowing the corporation to draw on the public account), on 9 October another payment of taxpayer money of US\$38 billion was transferred from the public to the private account. On 10 November, the United States Treasury bought US\$40 billion worth of new AIG stock and then on March 1, 2009, the US Treasury again transferred another US\$30 billion to the ailing corporation.

The next day the corporation announced a loss of US\$62 billion for the quarter (not the year), the worst corporate loss in history. Against these AIG senior executives were forced to disclose bonuses received of US\$165 million. It was also disclosed by AIG that the company had paid out CDS contracts to international banks of over US\$70 billion for losses incurred in speculative trade markets, effectively with United States public funds.

#### ***4.11 Lobbyists and Political Donations***

With the financialisation of the global economy (Chapter 2), huge fortunes have been made by executives and employees in the privileged and highly politicised speculative market sectors across the globe, but principally in the sophisticated trading hubs of Canary Wharf in London and Wall Street. This sector has “owned capitalism”. The sector has been strongly supported by centre-left and conservative governments. The

sector is driven by an army of politically motivated lobbyists (12,000 in Washington and New York, and an estimated 5,000 in London). The speculative casino type of trades through derivatives (options and futures) drew risk in every sense and to make money (60 per cent of an investment banker's pay); traders took on more risk with high levels of leveraged capital.

Lobbyists in the United States are at “Resistance Central” when it comes to blocking moves to regulate and provide oversight to speculative trades that enable most international movements of capital. Lobbyists have been resisting calls for a financial transaction tax for four decades. Decisive lobbying has enabled major financial inducements to politicians to delay, stall or fundamentally change proposed legislation aimed at curbing the excess risk dynamics inherent and embedded in speculative trades. Recent banking legislation saw US\$600 million offered to politicians and party hierarchies to block reform.

Lobbyists have been central in influence and favour. No modern political party structures could survive without them. A report cites 243 government employees have turned lobbyists, with 202 having worked in Congress and the remainder in the White House. The report estimates that six banks – Goldman Sachs, Bank of America, JP Morgan Chase, Citigroup, Morgan Stanley and Wells Fargo – spent US\$600 million on donations and campaign contributions since the first major federal bailout of Bear Sterns in March 2008<sup>260</sup>.

Robert Kaiser<sup>261</sup> suggests that the “monumental growth of lobbying in Washington D.C. undermines effective government and pollutes politics. Kaiser, who monitored politics in the United States for the *Washington Post* for over 50 years, explains how Washington became a dysfunctional capital with special interest groups using campaign contributions and lobbyists to influence government decisions and money being demanded by congressional candidates to pay for expensive campaigns.

Kaiser says that in 1974 the average winning campaign in the United States Senate would cost US\$437,000 and that by 2006 the cost had grown to US\$7.9 million. Lobbyist have created a mutually beneficial, mutually reinforcing relationship

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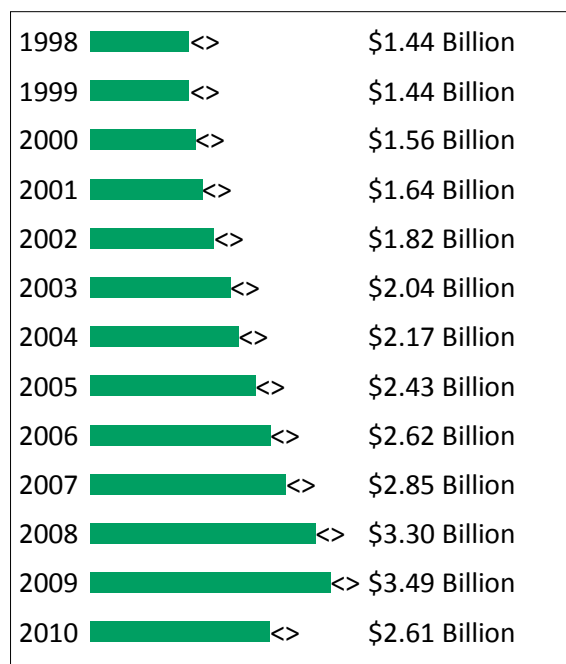
<sup>260</sup> “Big Banks hire DC Heavyweights.” *Reuters*. 5 November 2010.  
( <http://www.politico.com/news/stories/0510/37051.html>)

<sup>261</sup> Robert Kaiser (2009) *So Damn Much Money: The Triumph of Lobbying and the Corrosion of American Government*. Alfred A. Knopf. New York 2009.

between special interest groups and elected representatives, and in doing so have created a new class of very wealthy lobbyists in Washington. Kaiser notes that one lobbyist Gerald Cassidy amassed a personal fortune of US\$100 million in the Washington system.

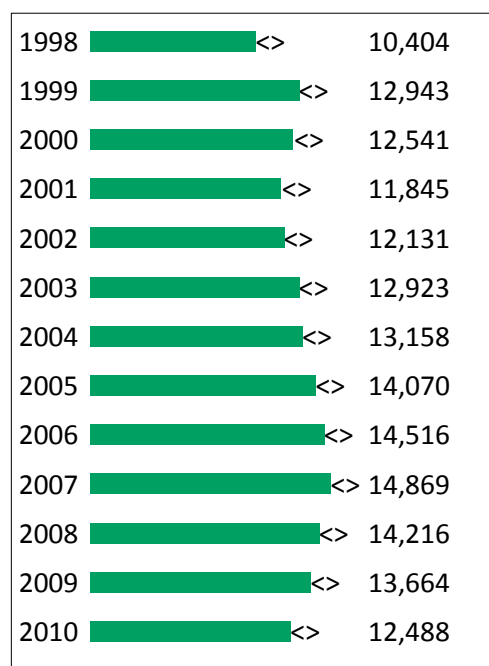
In addition to campaign contributions to elected officials and candidates, companies, unions, and other organisations spend billions of dollars each year to lobby Congress and federal agencies. Some special interests retain lobbying firms, many of them located along Washington’s legendary K Street; others have lobbyists working in house<sup>262</sup>.

The following graph evidences growth in the lobbyist and political campaign contributions sector.



**Figure 4.8: Total Washington Lobbying Spending, 1998–2010.**

<sup>262</sup> Figures are on this page are calculations by the Centre for Responsive Politics based on data from the Senate Office of Public Records. Data for the most recent year was downloaded on July 26, 2010.



**Figure 4.9: Total Washington Lobbyists, 1998–2010.<sup>263</sup>**

In the United Kingdom, the Cameron Conservative Party received more than £10 million towards their election war chest in just three months –. The flood of cash into the Tory Party campaign funds enabled the party to outspend Labour in pre-elections. The Conservative Party reported gifts worth £10,481,949 in the last quarter of 2009, compared with £4,962,886 collected by Labour and £1,055,717 received by the Liberal Democrats. The figures released by the Electoral Commission also show that the Conservatives raised some £26 million in party funds during 2009, while Labour received about £16 million over the year. The largest Tory donor was the property magnate David Rowland, who handed over £738,000 to the party. Stanley Fink, described as the “godfather” of hedge funds, gave £501,640<sup>264</sup>.

Many of the most successful names in the Mayfair hedge fund industry are to be found among David Cameron’s backers. They include Michael Hintze, the former Goldman Sachs head of equity trading who founded CQS fund in 1999; Stanley Fink, former chief executive of listed fund Man Group; Crispin Odey of Odey Asset Management; David Harding, who sold his AHL business to Man Group before going on to found Winton Capital; Paul Ruddock, of Lansdowne Partners; Alan Howard and

<sup>263</sup> The Centre for Responsive July 26, 2010. *ibid*

<sup>264</sup> , Nigel Morris “Conservatives' election war chest tops £10m.” *The Independent*. 25 February 2011

Christopher Rokos of currency and bond-focused Brevan Howard; and Michael Farmer, founder of metals trading hedge fund Red Kite.

In its *Plan for Sound Banking* document issued in July 2011, the Tory party indicated it would not rush to clamp down on the alternative investment industry, which will come under the auspices of the Bank of England as part of the party's radical overhaul of regulation. However, they still fired a warning shot across its bows. "The activities of hedge funds and private equity firms were not at the heart of this crisis," said the Conservative plan. "Therefore it would be wrong to assume that dramatically curtailing activities in these industries will necessarily increase financial stability ... However, it is right to look at the sector and consider whether reform would benefit financial stability now and in the future."

Tory donors from the hedge fund and private equity industry including Stanley Fink (£1,961,141 cash, £4,325 non-cash), Michael Farmer (£2,343,750), Michael Hintze (£1,125,430 cash, £1,200 non-cash), Paul Ruddock (£435,500 cash, £8,981.30 non-cash), Ryan Robson (£265,929.45) and various others in the £100,000 cash bracket<sup>265</sup>.

Coincidentally both the United Kingdom and the United States are the major traders of unregulated speculative finance capital and both auspice tax havens from which decisions on high-level finance transactions are made by domiciled capital elites. Decades of association between elites and political operatives guarantee that very little will change despite to obvious anomalies in financial and social systems. Simon Johnson (May 2009) explains that this lobbyist support process was a vital part in how the US became a "banana republic":

The financial industry has not always enjoyed such favoured treatment. But for the past 25 years or so, finance has boomed, becoming ever more powerful. The boom began with the Reagan years and it only gained strength with the deregulatory policies of the Clinton and George W Bush administrations. Several other factors helped fuel the financial industries ascent (Federal Reserve Chairman Paul Volcker's monetary policy in the 1980s and the increased volatility in interest rates that accompanied it, made bond trading much more lucrative. The invention of securitisation, interest rate swaps, and credit default swaps greatly increased the volume of transactions that bankers could make money on. And an

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<sup>265</sup> Source: United Kingdom Electoral Commission

ageing and increasingly wealthy population invested more and more money in securities, helped by the invention of the IRA and the 401k plan. Together these developments vastly increased the profit opportunities in financial services. Not surprisingly Wall Street ran with these opportunities. From 1973 to 1985, the financial sector never earned more than 16 per cent of domestic corporate profits. In 1986 that figure reached 19 per cent. In the 1990s it oscillated between 21 per cent and 30 per cent, higher than it ever had been in the post-war period. This decade it reached 41 per cent. Pay rose just as dramatically. From 1948 to 1982, average compensation in the financial sector ranged between 99 per cent and 108 per cent of the average of all domestic private industries. From 1983, it shot upward, reaching 181 per cent in 2007. The great wealth that the financial sector created and concentrated gave bankers enormous political weight – a weight not seen in the US since the era of J.P. Morgan (the man). In that period, the banking panic of 1907 could be stopped only by coordination among private-sector bankers: no government entity was able to offer an effective response. But that first age of banking oligarchs came to an end with the passage of significant banking regulation in response to the Great Depression: the re-emergence of an American financial oligarchy is quite recent.<sup>266</sup>

#### **4.12 Conclusion.**

This chapter has explained the political economy of the current regime of free market economics. Clearly, a new complex emerging set of circumstances contribute to the economic and social crises that have befallen most advanced economies. It is too simplistic to attribute these circumstances on structural dynamics in respect to the relative balance of economic powers involving the emergence of China, India and Southeast Asian economies as they interact with traditional western economies of the United States and the United Kingdom.

What is clear, however, is that unregulated capital markets, legal protection of the status of tax havens and tax-exempt zones, political lobbying interests that empower capital actors, and representatives on the elite geopolitical stage are disconnecting from state-based real economies and concomitantly the capacity of the real economy to provide public goods (including functioning and inclusive economic conditions) for its citizens.

Winding back services and austerity campaigns designed to de-link the state from its inherent role of service provision to its citizens is not sustainable in political, economic and social terms in the long term if capital elites usurp democratic

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<sup>266</sup> Simon Johnson. ‘The Quiet Coup.’ *The Atlantic*. May 2009. (<http://www.theatlantic.com/doc/200905/imf-advice>)

principles. Untouchable elites are contrary to equitable systems of social enterprise. Markets could provide integrity and fair equity if they are required to do so by elected politicians. They have the capacity but not the regimentation in their organising systems.

The next chapter will argue that a financial transaction tax on global speculative capital trades could provide mechanism for oversight of the now unregulated sector and allocates funds from a miniscule tax impost on each trade to the real economy of public goods provision

Further, the next chapter argues that protectors of unregulated markets must be brought to account before the capital market system causes more public sector pain.

Financial transaction taxes are seen a progressive public policy response to a real problem. Whilst European nation states have initially endorsed an approach to investigate a financial transaction tax at a European Union level, a concerted effort by opposing forces has reduced the universal enthusiasm for a broad approach. Likewise, in Australia, the forces opposing any form of progressive regulatory approach have dominated the debate.

## Chapter 5

### The Case for a Financial Transaction Tax

#### 5.1 Introduction

The global economic crisis has placed the ideas of taxation over speculative financial transactions back on the political agenda with governments faced with crippling budget shortfalls and public debt, after financing bailouts and economic stimulus packages. The critical issue addressed in this chapter is that financial product engineering, sophisticated IT systems, offshore tax havens, institutional betting on currency and interest rates places huge and unequal burdens on both the state, and citizens of the state.

Governments and politicians are informed by growing public demands that the financial sector should pay a proportionate share for the turmoil that has beset markets, and the resultant cuts in social spending, services and infrastructure. Nation state economies are the actual interface between returns from financial markets and cuts in social policy settings. This chapter provides evidence and supports the rationale reasons that an FTT is functional and efficient as an instrument to draw revenues to the public sector from markets operating under the type of loose scrutiny that is plainly not appropriate in this global political economy.

On the one hand, this is the time when an international tax on speculative casino type betting on the three base financial asset class markets (equity, debt and currencies) could make a “world of difference”. On the other hand, however, politicians are influenced by donations to fund electorate campaigns and clearly much of the campaign funds are derived from “high finance” or, more specifically, finance capital market players. The civil society should demand action on a financial transaction tax for ethical reasons. Groups such as Occupy Wall Street have brought public attention to this issue. The collusion between nation state governments and high finance urgently needs to be addressed. Polychroniou<sup>267</sup> argues, “the main problem is the power that finance capitalism exerts over domestic society and the abuse it inflicts.”

Chapter 5 provides an argument for a global transaction tax with a local target for achieved revenue sources. The recent and continuing sovereign debt crisis (as phase two of the financial crisis) has revealed fundamental weaknesses in the international financial system.

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<sup>267</sup> Christos J. Polychroniou. *Reconceiving change in the age of parasitic capitalism: writing down debt, returning to domestic governance, and setting up alternative financial systems –now*. Levy Economics Institute of Bard College. Policy Note. 2012.

The period before the sub-prime market imploded in the United States triggered a global contagion of toxic debt, was characterised by excessive credit growth and a build-up of systemic imbalances. Developments were severe in economic and social terms, and facilitated by inadequate oversight of risk management by governments, companies and supervisors. Reforms are urgently required to make the financial system accountable and transparent. This latter issue of transparency is being highly contested by market players. Without transparency, regulation and independent oversight, future shocks are assured. A financial transaction tax could achieve effective regulation and provide a response to the disruptive short-term trades.

A major appeal of a financial transaction tax (FTT) is based on its revenue capacities. Potential revenues are significant. In Australia (the world's eighth ranked international financial market player), receipts from a 0.05 per cent tax on inward and outward trades could be as much as AU\$30 billion a year. In terms of absolute dollar returns and in the context of debt repayments on government borrowings to cover the Nation Building and Economic Stimulus Package and bank assistance (through public funded guarantees) during the immediate aftermath of the Global Financial Crisis, this additional revenue would provide a broad fiscal response to loan payment through structural adjustments. The current economic and political climate should be a very appealing rationale for political parties of all persuasions. An FTT would be most appealing to the Australian Greens, given the influence that finance interests have over both other major parties operating in the Australian political environment

This chapter promotes the use of FTT revenue streams within Australia as an effective resource mechanism to reduce the gap between rich and poor. This thesis argues for the use of FTT resources for the provision of sustainable long-term social housing in Australia, an area that has been underfunded and misaligned in the wider provision of social services. Specific commitments to fund this sector would be of inestimable benefit not only in the provision of assets to assist lower income Australia but to benefit this specific target group with all the ancillary benefits that flow from sustainable housing, including better health outcomes, opportunities for education, and stronger communities. This social policy provision is achievable through this tax mechanism and is described further in the Section 5.12 (Revenue and Stabilising Effects) of this paper.

Chapter 5 focuses on the revenue-raising potential and the likely economic implications of an FTT. This section looks first at the specific design and functionality of the models put forward over recent years. It describes the potential of additional revenue against the likely interruptions to markets that have been unregulated and populated by opaque operations based in tax havens (Cayman Islands, Jersey, Guernsey, and Vanuatu) or more importantly Wall Street and Canary Wharf, London. Specifically, it is known that a uniform tax rate FTT (0.05 per cent) would hamper short-term high frequency trading in derivatives, particularly in the intraday highly leveraged markets which are traded both on and off exchanges in the highly liquid over-the-counter (OTC) markets<sup>268</sup>. The benefits of a global FTT are that market finance capital players will be transparent.

## **5.2 *Financial Transaction Tax – Rationale***

The rationale put forward in this chapter is not for a tax on financial transactions for a specific cause or global event. Whilst the mitigation of the dreadful consequences of climate change and global poverty have been raised by interest groups (Occupy Wall Street, Oxfam, trade union organisations – local and global – and Greens politicians – local and global), this chapter argues that an FTT is needed to ameliorate the loss to Australia, and other nation states, of considerable amounts of revenue as a result of the transfer of taxpayers' money toward state-sponsored fiscal stimulus spending, quantitative easing processes, and private sector bailouts. This, in turn, leads to loss of public services, public programs and support networks.

No claim is made for one target group, or reason, against the other; one life saved, one vital service maintained or replaced, is an important reason for this socially progressive tax. Rather, this dissertation argues a compelling case for a global tax which would provide a fair and just return to states for the significant effect of unregulated speculative trades that have so disrupted the public account; trades that are transacted by exclusive financial speculators, sophisticated, secretive and operating within an opaque arena of margins on financial trades, intercontinental in nature, and largely protected by governments influenced by lobbyists. This chapter puts the case for a universal tax to provide respectability and stability and system integrity.

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<sup>268</sup> An effective FTT should recognise the three underlying markets of equity, interest rate and currency trades (asset classes), as well as the derivatives that are priced off these “underlying” markets, such as futures and options. An FTT should have the broad coverage of “venues” that deal in these trades and all the highly sophisticated design mechanisms that are used in trades. Failure to encapsulate all venues and all instruments would provide strategic advantages to non-engaging market players or venues.

The Global Economic Crisis has put much-berated proposals for taxation on financial transactions back on the political agenda. Governments faced with massive budget deficits and huge public debts after financing bailouts and economic stimulus packages are in search of funding sources. Politicians are also keen to meet public demands that the financial sector should pay its fair share, but that cuts in social spending, environment and public goods or rising tax burdens on citizens should be minimised. Developing countries are facing additional problems of tackling multiple socioeconomic crises with limited resources. In this context, financial transaction taxes are seen as a possible innovative mechanism to ensure stable and predictable flows of complementary development finance to meet these additional needs. In addition, excessive trading in unregulated financial markets and the predominance of short-term speculation have contributed to volatile assets prices as well as large fluctuations in exchange rates, stock prices and commodity prices, reinforcing the effects of the financial crisis.

There is serious underlying risk in the high quantum value of markets and the failure of political leaders to regulate credit default swaps to force accountability of this oversize market by putting trade taxes on exchanges. This is a major error over the past two decades. It almost guarantees market failure. In order to make markets accountable, political support needs to be strong and consistent, with effective arguments based on research modelling.

### **5.3 Political support for FTTs**

Financial transaction taxes (FTTs) have been debated widely in the wake of the global financial and economic crisis, primarily through an increasing number of political leaders and lobby groups who acknowledge the need for a counter measure to disappearing government accounts in developed countries. As described in Chapter 4, pressure on public accounts has been intense. Policymakers see the benefit of global and local FTT's. Politicians are more measured by financial interests. New French President Hollande has bravely accepted the challenge and as of 1 August 2012 France has a Financial Transaction Tax<sup>269</sup>:

- The UN General Assembly's Commission of Experts on Reforms of the International Financial and Monetary System (the "Stiglitz Commission") mentioned a financial services tax as a way of providing more stable and sustainable development finance that would help to stabilise markets.

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<sup>269</sup> *French Financial Transaction Tax: Frequently asked Questions. Eurex Clearing 2012.* Quoting material from "Blueprint for Financial Transaction Tax, Version 1" Euroclear France. ([www.eurexclearing.com/download/.../French\\_Fin\\_Transaction\\_Tax](http://www.eurexclearing.com/download/.../French_Fin_Transaction_Tax))

- The European Parliament and the president of the European Commission, Jose Manuel Barroso, have spoken out in favour of taxing financial transactions.
- A number of European countries including Belgium, Spain and Austria made clear political decisions to support currency or financial transaction taxes.
- The chair of the British Financial Supervisory Authority, Lord Adair Turner supports the global tax. British Prime Minister David Cameron has said that he would support the idea of a global rather than a local FTT, although considerable financial industry backlash has tempered this leader's response.
- G20 leaders tasked 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."
- The Leading Group on Innovative Financing for Development – an intergovernmental forum with representation from all continents – recently established a Taskforce on International Financial Transactions for Development.
- The Catholic-Church-based development alliance CIDSE was among the pioneers to promote a tax on currency transactions as a response to the Asian crisis in the late 1990s. CIDSE developed a more comprehensive position on taxation as means to finance development for the UN Follow-up International Conference on Financing for Development in Doha in December 2010. CIDSE has updated its position, by publishing a review in June 2011 estimating that as much as US\$635 billion could be raised each year from a global FTT at a rate of 0.05 per cent.
- The Europeans for Financial Reform (EFFR) continue support for a financial transaction tax (FTT). Forty thousand emails were sent in response to the European Commission's consultation on tax in the financial sector.
- The above response was backed up on 14 April 2011 as the Party of European Socialists outlined a declaration specifying five demands. These included a commitment to go ahead with an FTT within the European Union; to enact EU legislation as soon as possible; to set a clear percentage (0.05 per cent); to use any funds raised for a progressive agenda; and to particularly target financial transactions

of a short-term nature that are considered to be detrimental to civil society. A thousand economists from 53 countries<sup>270</sup> have written to G20 Finance Ministers met in Washington (June 2011) to urge the adoption of a financial transaction tax. The Economists wrote: “The financial crisis has shown us the dangers of unregulated finance, and the link between the financial sector and society has been broken. It is time to fix this link and for the financial sector to give something back to society.” Several Australian economists have supported the letter.

- Professor Geoff Harcourt, Professor Emeritus (Adelaide) and Emeritus Reader in the History of Economic Theory (Cambridge) said: “A financial transaction tax would reduce the amount of speculative funds circulating and make people concentrate on funds associated with real and beneficial economic activity.”
- The above Australian economists joined professors from many of the world’s leading universities, including Harvard, Oxford, Cambridge, the Sorbonne, Berkeley and Kyoto, in signing the letter. Signatories include Jeffrey Sachs, Director of the Earth Institute, Colombia University and special advisor to UN Secretary General Ban Ki Moon; Dani Rodrik, Professor of Political Economy at Harvard University; Professor Ha Joon Chang from Cambridge University; and Christian Fauliau, a former World Bank senior economist.
- Professor Sachs said: “It is time for the G20 to agree to a tax on financial transactions to help poor countries struggling with climate, food, and economic crises they did nothing to cause. The tax would also be a fair and efficient way to help close budget deficits in our own countries as well.”
- The French Government commissioned global entrepreneur Bill Gates to report on the potential sources of revenue from an FTT. The report was presented to G20 leaders in November 2011 at the G20 Summit but events in Europe overran debate on FTTs.
- In 2012, the United Kingdom defied strong support from European countries by rejecting FTT proposals and as such blocked the larger FTT European project, which required unanimity across all member states.

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<sup>270</sup>The Robin Hood Tax Coalition (Australia). Draft Submission to the Australian Tax Forum. 15 September 2011.

- In June 2012, German Chancellor Merkel, under strong pressure from Socialist coalition parties, has stated that she is to begin lobbying for a German FTT.
- In August 2012 the French Government under newly elected President Hollande, announced that it was to introduce a national FTT and to the surprise of many supporters Hollande doubled the recommended levy on transactions and derivatives trades to 0.02 per cent and 0.002 per cent respectively.
- In September as the French FTT was commissioned the European Parliament announced a decision that 11 member states would introduce a FTT under the Enhanced Cooperation Act. The Parliament had been advocating the FTT for over two years.
- On the 29 October 2012 the Dutch Government announced that the Netherlands would support a FTT. The newly elected government of Social Democrats and Liberals became the eleventh government in Europe to support FTT proposals.
- Increased debate in the United States has seen a Bill lodged formally supporting a FTT.
- In the United Kingdom a renewed effort is being made to investigate FTT's. and in particular former Financial Services Authority, Lord Adair Turner, is leading the renewed interest which has been taken up by more conservative news outlets<sup>271</sup>.

Algirdas Semeta, European Commissioner for Taxation<sup>272</sup>, spoke about the growing support for a tax on speculative financial transactions saying that:

My visit to Washington this week has prompted requests from many of my U.S. counterparts to discuss the financial transactions tax. The interest is clearly still here, even if the debate is more tentative than across the Atlantic. In Europe, we will forge ahead in trying to implement a financial transactions tax, convinced of its merits. We remain open to cooperating with any country that wants to join us, now or in the future. The discussion on the financial transactions tax at the recent Group of 20 Summit in Cannes, France, gave me cause for optimism. True, there was not the agreement on global implementation that we Europeans, and others, had hoped for. Nonetheless, there was a visible

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<sup>271</sup> Anthony Hilton. "Too much banking can be a bad thing" *The London Evening Standard*. 31 October 2012.

<sup>272</sup> Algirdas Semeta. "Europe Ready to Lead on Transactions Tax." *European Union Commissioner for Taxation, Customs Union, Anti-fraud and Audit*. (<http://thehill.com/opinion/op-ed/196739-europe-ready-to-lead-on-transactions-tax>) 1 December 2011.

shift in attitude among world leaders to the idea of this tax. We saw an unprecedented openness to at least discussing the financial transactions tax as a very viable option. This change in approach can be seen, perhaps, as true democracy at work. World leaders could not ignore the millions of ordinary citizens who are crying out for justice when it comes to the financial sector. By justice, I do not mean retribution. The financial sector has an essential role to play in our economies, and punitive tactics to make it pay for the financial crisis would be folly. By justice, I simply mean fairness. The days in which it was acceptable for the financial sector to be under-taxed compared to all other sectors are long gone. In fact, the question resonates as to how it was ever reasonable for financial institutions to receive such favourable tax treatment, when every other sector — even the most basic commodities — must contribute to public budgets. The time has come for the financial sector to pay its fair share to society: no more, no less. On this principle, the participants at the G-20 Summit were very much united.

Clearly, growing support across the globe is evident but the area of hostility is Canary Wharf and Wall Street where vested interests have high-level political influence.

Following a round of statements from G20 leaders (November 2011) in support of a European-based FTT, Europe has gone ahead with landmark proposals to tax the financial sector, ignoring United States opposition in a move which provoked condemnation in the United Kingdom where London fears capital flight from the City. London's Canary Wharf is the largest capital-trading centre in Europe. The European Union's FTT proposal had been on the drawing board for more than a year. The plan went before the 27 European Union heads of state and government at an October 17–18 summit, and was put to a summit of G20 leaders in Cannes on November 3–4. The G20 Summit failed to conclude a way forward despite strong support. European Commission President Jose Manuel Barroso said the tax could generate around 55 billion Euros (AU\$75.77 billion) a year as he lodged the draft legislation with the European Parliament in Strasbourg. "The tax would be levied on all transactions on financial instruments between financial institutions when at least one party to the transaction is located in the EU," a commission statement said. "House mortgages, bank loans, insurance contracts and other normal financial activities carried out by individuals or small businesses fell outside the scope of the proposal"<sup>273</sup>.

The aim of the European Commission was to ensure that the financial sector "makes a fair contribution" after European Union governments ploughed 4.6 trillion Euros into bailouts, mainly for banks caught in a US-triggered sub-prime credit meltdown in late 2008, only for taxpayers to suffer as public finances had to be cut as a result of instability and huge

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<sup>273</sup> Jean-Robert Lain. "EU Presses on with Controversial Tax." *The Sydney Morning Herald*. 29 September 2011

deleveraging processes. The commission also has another key goal in mind: some of the receipts from the tax, which would not be implemented before 2014, would go directly into the EU's budget, giving Brussels more independently raised resources than under the present system of contributions from national governments.

#### ***5.4 Objectives of an International Tax on Financial Transactions***

A global financial transaction tax (FTT) has the potential to contribute to global justice and development objectives by fulfilling key functions of taxation: revenue raising and regulation as well as redistribution of wealth to contribute to global justice, not only within states but also at the international level. Taxing financial transactions is one way in which the fast-expanding financial sector would contribute towards sharing the social infrastructure, welfare programs, and domestic policy burdens of governments. Revenues generated by such taxes should be used to support global efforts to achieve internationally agreed development goals. At the same time, this type of taxation would play a role in the stabilisation of the fragile global economy. Although action at the national level is possible, highly interlinked global financial markets on the one hand and the high concentration of activities (flash trades) on the other, suggest regional and international cooperation. Joint action through regional and international taxes could contribute to the strengthening of representative democratic global institutions and a sense of global responsibility. A local FTT at a European level could see trades diverted to tax-free zones.

A uniform FTT would cover all spot and derivate transactions on organised exchanges (shares, bonds, securities and derivatives, including trade of futures and options related to stocks, interest rate securities, currencies and commodities). In addition, should be extended to over-the-counter (OTC) transactions directly related to asset prices, in particular to exchange rate and interest rate trading procedures through derivatives. The tax would be automatically collected at the exchanges and borne equally by buyers and sellers using the electronic settlement systems. Control and regulation could fall to the Bank for International Settlements (BIS), or a special agency, as an established and independent supervisor. This should be easy to implement in organised markets and involve little administrative costs. It would be limited to transactions between financial market actors. Thus, the tax would have minimal direct impact on the real economy.

A phasing-in approach could be considered as a possible option; that is, the introduction of an FTT at a low rate and a gradual increase of the latter in order to augment revenues and

improve the counter-speculative and market-stabilising effect of the tax. Given the state of global nation state sovereign debt, it would appear that an urgent full tax would be of benefit.

A general FTT is more comprehensive as it covers all types of financial markets. Due to the enormous volume of the multitude of financial transactions, the tax could yield significant revenues even at a low rate. There has been wide consensus of European nation states toward a European-wide tax, although this is not supported by the United Kingdom. Clearly, a global tax is preferential to individual nation states approaches. Taxes levied in individual zones would have the immediate effect of capital flight to tax-free zones in the same way that Wall Street and the City of London dominate through tax advantage. The following section covers promotion activities related directly to the FTT.

### ***5.5 Arguments to Promote a Tax on Financial Transactions***

As a contribution to global justice, a tax on financial transactions is a measure of political fairness and social justice as it would ensure contributions by the financial sector (which was at the core of the crisis) towards crisis resolution and possible global recovery. It would also shift the burden of taxation from wages and consumption to capital, thus making the overall tax system more equitable. Using the ensuing revenues for financing development and global public goods (affordable housing and homelessness reforms – see the following sections in this chapter), would contribute to more just international distribution of wealth and to the reduction of inequalities. Possible revenues depend on the rate and scale of introduction. All estimates suggest that substantial revenues could be achieved with a low tax rate of 0.05 per cent on options and futures trades, and 0.005 per cent on derivatives. Even when assuming a reduction of transaction volumes due to taxation in North America and Europe, estimated tax revenues would range between 0.5 per cent and 2.4 per cent of global GDP if all transactions are covered<sup>274</sup>.

At the European level, even a tax at a minimal rate of 0.01 per cent would generate income of about €100 billion per year (up to €500 billion for a rate of 0.1 per cent). In Australia, the world's seventh largest financial transaction trader, an amount of up to AU\$10 billion could be achieved.

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<sup>274</sup> Stephan Schulmeister. *The Trade Union Committee to the Organisation or Economic Development*. 2009.

## 5.6 Targeting FTT Resources for Australian Housing and Homelessness Services

Proposals for expenditure of revenue from an FTT have varied from poverty alleviation, to boosting the tax base of nation states feeling the effects of financial instability through the continuing recessionary effects of the Global Financial Crisis. Most developed states now have strong financial sectors and contrasting social issues related to the inability of nation states to fund services adequately to those who miss any benefits of resource growth.

A Roy Morgan Research survey commissioned by the Australian Salvation Army<sup>275</sup> revealed that over 60 per cent of respondents considered the gap between rich and poor had widened. Two million Australians were deemed to live in poverty. An Australian Council of Trade Union<sup>276</sup> commissioned study revealed that the richest 20 per cent of the Australian population controlled 60 per cent of the nation's wealth (primarily in housing), whilst the poorest 20 per cent shared just one per cent of that wealth. The top 20 per cent of income earners receive over 50 per cent of total income in Australia, while the bottom 20 per cent earns 5 per cent. Further, the report stated that "9.5 million Australians felt that taking action to reduce poverty should be a high priority".

In the United States and the United Kingdom, the concentration of wealth is even more pronounced. Australia has, in comparison to the United States and European states, a relatively vibrant economy, although it is linked exponentially to the world economy. Recently Robert Zoellick<sup>277</sup>, former President of the World Bank, warned that the global economy had entered "a very difficult phase" and he warned that the "world was slipping into a new danger zone."

Housing affordability in Australia is amongst the highest in the developed world. Concentration of populations in main coastal cities intensifies this dynamic. Very high personal debt ratios accentuate the lack of affordable housing and homelessness issues. A financial transaction tax (FTT) in Australia would provide a new macro revenue source of upwards of AU\$10 billion to ameliorate the undesirable social and economic effects of market downturns. Taxation revenue from FTTs targeted directly to this sector would provide an effective government response to Australians caught in the "two-speed" economy.

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<sup>275</sup>"Perceptions of Poverty." *Roy Morgan Research survey commissioned by The Salvation Army 2010.* (<http://www.salvationarmy.org.au/media-centre/current-media-releases/perceptions-of-poverty-report.html>)

<sup>276</sup>"Australian Attitudes towards Wealth Inequality and Progressive Taxation." *The Australian Council of Trade Unions.* 15 April 2011. (<http://www.actu.org.au/images/Dynamics/attachments/7484/ACTU/Reports> )

<sup>277</sup> Robert Zoellick. "The End of the End." *The Spectator.* 25 February 2012.

Given the policy direction of the current Gillard Government toward balanced budgets, there is a risk that current social housing funding will not be continued. Whilst the Gillard Government has shown no appetite for the progressive social and economic outcomes from an FTT, it is clear that a specific social, affordable, and homelessness target could provide a resource provision that would otherwise be consumed in the macroeconomic budgetary issues. No better rationale could be applied to a tax on elite finance capital players, the high earners and manipulators of over-the-counter finance in Australia who presently are radically unmoored from the fundamental values otherwise measured in Australia as equality and kinship. A FTT in Australia targeted to social housing would be a rational sustainable and equitable solution to the social and economic issues that confront the Australian Government.

### **5.7 Global Revenues**

Globally an amount of US\$800 billion could be generated on a tax rate of 0.05 per cent, with the major part stemming from derivate transactions on organised exchanges. According to the Austrian Institute for Economic Research (WIFO), a general and uniform financial transaction tax (FTT) on all kinds of financial asset transactions would have a stabilising effect on financial markets, even if introduced at a low rate. The FTT would increase the cost of speculative trading and thus help mitigate fluctuations of asset prices in stock markets, of exchange rates and commodity prices. At the same time, it would have minimal effect on the real economy, and thereby improve the general macroeconomic performance. Above all, it would reinforce a level of integrity into markets as finance capital would be required to contribute to revenue bases.

A global FTT is technically feasible because of the use of standardised electronic settlement systems. Circumvention of electronic platforms would be very costly and hence unlikely. The FTT could be introduced systematically, in terms of both geographic expansion and coverage of types of financial transactions. Regional introduction is possible. Due to high concentration of trading, there is a possibility that a two-tier (two-rate) FTT (based on the model of Professor Paul-Bernd Spahn) which is a version of the proposal popularised by James Tobin in the 1970s could be examined. According to this concept, a low rate tax would be applied on ordinary foreign exchange transactions, while a higher “normalisation” duty would be levied during periods of high currency volatility resulting from speculation with the aim of stabilising the respective exchange rates. Thus, such an FTT would simultaneously moderate the effects of rapid speculative runs on currencies, thus contributing to the

prevention of major currency crises, and generate substantial revenue for development financing. An FTT would provide for much more stability by a tax imposition on flash trades (high frequency).

Paul Bernd Spahn is a Professor of Finance Theory with the University of Frankfurt. He has been an advisor to the IMF. In March 2002, the UN “Finance for Development” conference was held in Mexico and the German Ministry for Development commissioned Spahn to write a paper for presentation at the conference. Spahn produced a study entitled “On the feasibility of a Currency Transaction Tax”. In that study, Spahn concluded that an FTT made sense from an economic point of view and that its implementation was extremely desirable given the considerable blowout in currency and other financial trades on a global basis<sup>278</sup>.

The extent of the global trade had far outweighed what could have been envisioned when Tobin first looked at the problem in the early 1970s, and now (2012) far outweighs the position and interest that Spahn had taken on the subject throughout the 1990s. Spahn, however, continues to argue that the implementation was technically as well as economically feasible and that an FTT would allow for stabilisation of exchange rates. Additionally he argues that for developing countries the FTT would be complemented by his two-tier model which would reduce volatility and have the effect of stopping major in-flows and out-flows (runs) of speculative capital. Spahn argued that the only real impediment was to do with the will of policymakers. He argued that the impediments should be debated.

It is clear that lobbyists hold disproportionate weight in contemporary political economy systems. This provides capital players with a strong influence in public policy settings. It is also clear that social democratic governments with the right balance (between their support for business and civil society) can put a charge on all capital and industry players who choose to operate within their jurisdictions. Socially progressive political groups have been pleading the case for an FTT for the past decade. Polychroniou<sup>279</sup> (2012) suggest that “if governments continue to be proxies to finance capital, and aspiring political leaders, cheerleaders for their financial backers, a catastrophic economic scenario is not really as far-fetched as some might like to think. Yet the implications of this crisis (2007–2012) continue to elude us, largely

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<sup>278</sup>Peter Willans. “The Political Economy of Currency Transaction Taxes.” *University of Tasmania* 2007.

<sup>279</sup> Chronis J. Polychroniou. (2012) *The ‘Masters of the Universe’ Outsmarted Themselves*. Economic and Political Weekly 48. No. 43 (October 25, 2008:14 quoted in “Reconceiving Change in the Age of Parasitic Capitalism: Writing down Debt, Returning to Democratic Governance, and Setting up Alternative Financial Systems.” Levy Economics Institute of Bard College. London.

because many people are in the grip of the neo liberal orthodoxy and refuse to acknowledge the need for large-scale economic, social and political change”.

The German model will cover all financial products including over-the-counter derivatives trades. Against a background of outright global opposition and political resistance, Germany’s brave new move is a significant watershed in global political economy. Germany’s Chancellor Merkel has taken a lead but the history of support is poor. It may be reflected in the vast wealth that unregulated markets and individuals have to influence political leaders. Had it not been for the depth of debt crippling nations, FTTs would remain in the background.

### **5.8 A Brief History of the Financial Transaction Tax (FTT)**

One of the most significant breakthroughs for proponents of FTT’s came with the recent introduction of the French FTT in August 2012. Against strong opposition from the finance sector newly elected President Hollande stood by his election commitment to legislate this tax. Opposition to the FTT has been very effective during the past decade as financial trades and finance capital has been expansive, especially between London and Wall Street. It is useful to look at the immediate history.

The first financial transaction tax was effectively a stamp duty on legal documents covering the purchase of shares through the London Stock Exchange. It is the oldest tax in existence in the United Kingdom<sup>280</sup>. The meaning of the term financial transaction tax relates to a tax placed on a specific type of financial transaction and not a tax placed on a financial institution. It is therefore payable only when a trade is actually transacted. If a firm or individual only undertakes one trade, it would be subject to a tax if the country of origination had a law in place to tax transactions. This principle was first explained by Rodney Schmidt, Researcher, in 2010, at a conference in Canada<sup>281</sup>. It is not a bank or an activities tax. The rationale is to provide equitable distribution of revenues received across wider tax systems. It is ethically based.

The case for an “international tax” to be applied to financial transactions has been controversial since the subject was first proposed by John Maynard Keynes in 1936. Keynes’

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<sup>280</sup> Dieter Herbert, “Reshaping globalisation: a new order for international financial markets.” *Institute of Global Dialogue*. 2003.

<sup>281</sup> Schmidt, Rodney. *The North-South Institute Peoples Summit*. North-South Institute. Toronto, Canada. June 2010.

proposal<sup>282</sup> was to apply a tax to discourage excessive speculation without discouraging any other activity; an important rationale to consider in the contemporary circumstances given the opposition from stakeholders in the present socioeconomic climate. Keynes considered the tax as a way to provide stability to the Wall Street financial sector at the time, saying “Speculators may do no harm as bubbles on a steady stream of enterprise. But the situation is serious when enterprise becomes a bubble on a whirlpool of speculation”. In 1936, Keynes had raised the spectre of speculative bubbles, which in the modern context have the most obvious association with speculative and socially disruptive financial market activities.

Nobel Laureate Economist James Tobin followed this theme in 1972 when he proposed a tax on currency transactions (originally as a tax on spot conversions of one currency into another) primarily to dampen down (throw sand in the wheels) of short-term (round trip) transaction between countries. The Tobin Tax concept was introduced at the Janeway Lectures at Princeton University in 1972 as a currency transaction tax to deal with the stabilisation of currencies on a “larger, global scale”<sup>283</sup>. In 2001 as James Tobin reflected on the 1994 economic crisis in Mexico, the 1997 Asian Financial Crisis and the 1998 Russian Crisis when he said:

My proposed tax on foreign exchange transactions dissuades speculators as many investors invest their money in foreign exchange on a very short-term basis. If this money is suddenly withdrawn, countries have to drastically increase interest rates for their currencies still to be attractive. But high interest is often disastrous for a national economy as the nineties crises in Mexico, South East Asia, and Russia have proven.<sup>284</sup>

In 1994 Belgian economist Paul Bernd Spahn re-examined the Tobin Tax and described a number of discrepancies in its original form, further proposing his own version on June 1995, saying that “most difficulties of the Tobin Tax could be resolved, possibly with a two-tier rate structure consisting of a low-rate financial transactions tax and an exchange surcharge at prohibitive rates”. This new form of the “Spahn Tax” was approved by the Belgium Federal Parliament in 2004.<sup>285</sup> Consideration to the Tobin and Spahn models along with other

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<sup>282</sup> Keynes, John Maynard. (1936) *The General Theory of Employment, Interest and Money*. (<http://biblioconomics.googlepages.com/KeynesJohnMaynard>)-

<sup>283</sup> James Tobin. “A Proposal for Monetary Reform,” *Eastern Economic Journal*. Eastern Economic Association. July/October 1978

<sup>284</sup> Der Spiegel – German interview translated to English (September 3 2001) *James Tobin: They are misusing my name*. Spiegel Online International.

<sup>285</sup> Paul Bernd Spahn. *International Financial Flows and Transactions Taxes: Survey and Options*. University of Frankfurt/Main. Paper originally published with the IMF as Working Paper WP/95/60. 16 June 1995 (<http://www.wiwi.uni-frankfurt.de/profs/spahn/pdf/publ/7-041.pdf> )

research is covered in a Master of Arts (Political Economy) Research thesis by Willans (2006).<sup>286</sup> The proposals by James Tobin and Paul Bernd Spahn were in response to the growing volumes of currency rate speculation that appeared because of the Bretton Woods decision to free international currencies from the constraints of the Gold Standard in 1971.

In 1971, the United States suspended the convertibility of the dollar to gold at US\$35 an ounce, thus formalising the devaluation of its currency. This allowed major international currencies to “float” on the strengths and weaknesses, or supply and demand, of nation states economies. Responses to currency crises started during this period and have continued. The foreign currency markets, not central banks, determined the value of each currency but central banks often intervened to influence exchange rates. As described in previous chapters, more than US\$4.5 trillion is traded daily in currency markets. This is approximately five times the cumulative amount of foreign exchange reserves held by Eurozone countries and 25 times that of the United States Federal Reserve Bank. Less than five per cent of all daily transactions can be traced to commercial operations. Ninety-five per cent are speculative capital movements<sup>287</sup>. It is these speculative trades that attract casino type bets, which in turn perpetuate instability. Finance capital is increasingly disconnected from most other financial systems<sup>288</sup>. Wolf<sup>289</sup> (2012) argues that “before the crisis (2008) the rise of sophisticated modern finance was thought to render redundant the role of central banks as guardians of financial stability. It has long been believed that their role as financiers of government brought only inflation”. Prices in most markets are influenced by speculation not underlying values. It is betting in a pure sense. Mauldin<sup>290</sup> (2012) adds that “for the better part of 100 years, and especially in the past five, we have socialised the risks of high finance. All too often, the bankers who take risks do not bear them themselves. By all means let the capitalist keep the upside. But let them bear their full share of the downside”.

Following the Global Financial Crisis, many economists and governments have re-examined the concepts and potential of an FTT, which would identify traders and provide funds to restructure economies. The appeal of an FTT is to create a fairer, broader based tax system

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<sup>286</sup> Peter Willans. “*The Political Economy of Currency Transaction Taxes*” University of Tasmania. 2007

<sup>287</sup> Laurent L. Jacque. (Professor of International Finance and Banking) “Global Derivate Debacles: from Theory to Malpractice” *WorldScientific*. 2010 as quoted in *Le Monde Diplomatique*. January 2011.

<sup>288</sup> Hugo Banzinger. “Did the Globalisation of Finance Undermine Financial Stability? Lessons in Economic History.” *LSE Financial Markets Group*.

<sup>289</sup> Martin Wolf. “After the bonfires of the Verities.” *The Financial Times*. 1 May 2012.

<sup>290</sup> John Mauldin. “A Gold Standard: Thoughts from the Frontline.” *Weekly Investment Newsletter*. 28 April 2012.

structure inclusive of the speculative financial sector. Policymakers have provided exclusive mechanisms for capital players, which involve the setting up of tax-free or tax light offshore centres from where capital firms have traded. As discussed in previous chapters on financialisation, Margaret Thatcher and Ronald Reagan provided legislation for free trading through Canary Wharf, London, and Wall Street, New York, and markets expanded exponentially.

Fraser Reilly-King of the Canadian-based Halifax Initiative proposed an FTT as a means of bringing balance to all parts of the economy globally and locally.<sup>291</sup> Joseph Stiglitz, the former Senior Vice President and Chief Economist of the World Bank has been a strong campaigner for an FTT along with world leaders Merkel (Germany), Hollande (France), and importantly Lord Adair Turner of London-based Financial Services Authority (FSA). Larry Summers, previously Director of the National Economic Council in the Obama Administration, has also written extensively of the perceived benefits of a global FTT. Stiglitz claimed that the new direction of an FTT would be “much more feasible today than when Tobin first introduced his modelling”<sup>292</sup>.

The nature of trades has also substantially changed. The philosophies of traders and, of politicians, has also substantially changed, perhaps depending on the individual benefits one or other is likely to accrue. Banzinger<sup>293</sup> argues that because of financial systems integration “the financial industry is today the biggest spender on IT and the majority of data pumped around the globe is relates to finance”.

Economist Rodney Schmidt of the North–South Institute in Canada recently concurred that an FTT was more technically feasible than the “bank tax” which has been proposed in many quarters. Popular news and articles in influential press journals such as the *Atlantic* and *Financial Times* have maintained coverage of progress toward a tax in recent times. French President Sarkozy vowed to introduce a tax to the current session of the Group of 20 (G20). Following the G20 November 2011 Summit, and its inability to agree on FTTs, Sarkozy, in comments, said a financial transaction tax would remain one of his top priorities as leader of the Group of 20.

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<sup>291</sup> Fraser Reilly-King. *Halifax Initiative*. 20 June 2010.

<sup>292</sup> Joseph Stiglitz. “Joseph Stiglitz calls for a Tobin Tax on all financial trading transactions.” *Telegraph Media Group*. May 2011.

<sup>293</sup> Hugo Banzinger. “Did the Globalisation of Finance Undermine Financial Stability?” *Spiegel Online* 2012

In late 2009, United States Democratic Congressman Peter DeFazio proposed the Let Wall Street Pay for the Restoration of Wall Street Bill<sup>294</sup>, which included a domestic (United States only) financial trade's tax. Information is more publicly available in broadsheets that provide news and developments on issues related to the limited means available for governments to not only cope with diminished funds for social programs but also a restless public desperate for initiatives that might be in some way positive. A recent example of this public information approach was the *Boston Globe* article<sup>295</sup>, which put forward a reason to consider an FTT as:

President Obama and Congress wrangle over how to close a yawning federal deficit, an obvious place to look is the financial-services industry that precipitated the recent recession. A tax on financial transactions — on the order of a fraction of 1 per cent — could cool speculative fevers on Wall Street even as it helps refresh a federal treasury depleted by unemployment benefits and aid to reeling states. When the commission studying the 2008 financial collapse at last reported back to Congress this week, its six Democratic members placed the blame on excessive borrowing, poor federal regulation, and a “systematic breakdown in accountability and ethics.” The panel's four Republican members dissented, and most signed onto a separate explanation that noted, among other things, an international credit bubble and flaws in the securitization and credit-rating process. Yet in some ways, both accounts add up to the same thing — regulators aren't omniscient; traders look out for quick profits; a lot of so-called financial innovation makes markets less transparent and more volatile. A trading tax would discourage churn in the markets without having regulators looking over every trader's shoulder. If, as generally expected, a tax on the buying and selling of stocks, bonds, derivatives, and credit-default swaps were to reduce short-term trading in favour (sic) of longer-term investment, the overall effect on the US economy would be beneficial. Such a tax could also raise revenue; low estimates run to about \$100 billion a year, but anticipated revenues could run much higher.

The Invade Wall Street movements have caught the public sentiment in respect to campaign slogans critical of the wealth accumulated by the top one per cent of society. This protest movement has been visited by Jeffrey Sachs, Joseph Stiglitz and FTT campaigners across the globe. The pressure is now on to convince politicians and leaders. One clear message from the recent social movements criticising global finance and speculation is the lack of galvanising specific outcomes that may be forthcoming from FTT, s or more equitable tax distribution proposals. An FTT would replenish sorely depleted public accounts. It would provide revenue to replace public funds politically redistributed to bailout the private sector.

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<sup>294</sup> Charles Pope “DeFazio calls for tax on financial transactions but critics abound” *The Oregonian*. 3 December 2009 (<http://www.oregonlive.com/politics/index.ssf/2009/12/defazio>)

<sup>295</sup> “Transaction Tax works against deficits, financial recklessness” *Boston Globe Editorial*. 29 January 2011.

Clarity on the use of FTT revenue provided an effective campaign tool for President Hollande of France. The social benefits from a redistributive social and economic policy linked to a FTT provided the linkages that FTT proponents had failed to gain traction on in recent times. Articulating the social scope of FTT, s is difficult in an environment dominated by conservative press moguls, and political leaders often funded by the financial sector. The social scoping of FTT's is the most difficult to project.

### **5.9 Social Scope of a Financial Transaction Tax**

Recently, in the aftermath of the Global Financial Crisis and the attendant disruption to the economic order questioning the economic viability of nation states, increased interest and support for such a financial transaction tax (FTT) proposal has been forthcoming from leaders<sup>296</sup> of developing economies, leaders of community groups, and political economist around the world. Against any form of regulation of financial markets has been a growing number of capital interest players including hedge funds, offshore financial centres, and more importantly an army of lobbyists based in the United States (see Chapter 4) and the United Kingdom, both states which dominate the corridors through which financial trade convoys of unregulated, secretive trades pass. A line has been drawn in the sand. Two entrenched positions have presented.

Public unrest about the disruptive nature of financial trades, excessive growth in derivatives and global financial speculation instruments such as options and futures, has prompted responses from conservative based news syndicates including CNN Money; a news outlet not noted for its support of issues normally the domain of the left. CNN argued<sup>297</sup>:

We're headed into the deficit debate, and one attractive idea has been left on the sidelines – the notion of a financial transactions tax. Most of our stock transactions these days come out of a computer. They offer nothing of value to the public, enhance risk and feed a desire for more dangerous bets that could (and often do) cause financial crashes. As a society, even if we had no need for more revenue, we would do well to limit this growing financialisation in the economy, and that goes hand-in-hand with limiting stock transactions. And one great way to use market forces to reach that goal is through a small tax on each transaction.

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<sup>296</sup> “Hollande plans for EU Growth. *Sky News*. 26 April, 2012. French election favourite Francois Hollande's (a long-time supporter of FTT's) campaign has gained strength and credibility as the key plank in his economic strategy won tacit support from top European leaders. Hollande's call for the EU fiscal pact to be renegotiated to include ways to boost growth had been derided by his poll rival President Nicolas Sarkozy as naive and dangerous, a breach of France's word to its partners. However, on Wednesday, European Central Bank governor Mario Draghi threw his weight behind proposals to attach pro-growth plans to the treaty, and Germany's Angela Merkel conceded that new measures were needed.

<sup>297</sup> David Dayan “The Antidote to Deficit Hysteria: The Financial Tax”. *CNN Money*. 11 January 2011

The Centre for Economic and Policy Research (CEPR) stated that a tax on trades of stocks, options, futures and other financial instruments could generate US\$150 billion a year (or over one per cent of US gross domestic product). The CEPR study looked at a 0.25 per cent tax on stock trades in the United Kingdom and estimates that an equivalent tax in the United States could raise an additional \$40 billion a year for the Treasury. “This is not hypothetical,” said Dean Baker, co-director at CEPR and author of the report. “The UK has used a Finance Services Tax (FST) to collect large amounts of revenue,” adding that the International Monetary Fund, “is currently advocating the tax in recognition of the enormous amount of waste and rents in the financial sector.” As Baker<sup>298</sup> states, this United Kingdom tax is already in place in Britain, and as a result, the City of London still stands, and mass exodus from the stock markets in the United Kingdom has not transpired.

The common rebuttal from the business communities to an FTT is that business will transfer to other less tax or no-tax countries. Baker argues, “first of all, given the harm which the financial industry has caused the US economy, my first response would be ‘Do you need help finding a ticket?’” Second, Baker shows that the non-hypothetical example indicates that a financial transaction tax does not lead to business flight. As a result, “individual investors who make a low number of trades a year will not even feel a tax like this, but hedge funds and investment banks who use algorithms and the like will feel it enough to potentially limit their risky trades. And if not, they’ll provide the government with a healthy source of revenue to cover the damage to individuals in the event their risk leads to another crash”. On the subject of volatility of asset prices, Economist Baker<sup>299</sup> asserts that it is possible that FTTs will reduce the volatility of financial markets, although the evidence on the relationship between volatility and transactions taxes is quite mixed<sup>300</sup>. As noted above, an FTT will raise transactions costs and therefore reduce the volume of trading. Further, Baker contends:

There is an extensive literature on this theory of “noise trading” which dates back to Keynes. More recently it has been developed in a series of papers that included Lawrence Summers, the former U.S. Treasury Secretary and current head of the National Economic Council, as a co-author<sup>301</sup>. Other

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<sup>298</sup> Dean Baker. “The Deficit Reducing Potential of a Financial Transaction Tax.” *Centre for Economic Research Issue Brief*. January 2011.

<sup>299</sup> *The Benefits of Financial Transaction Taxes* (Statement to the German Bundestag) May 17 2010. ([www.cepr.net](http://www.cepr.net)). Also see “The Benefits of a Financial Transaction Tax.” *CEPR*. December 2008.

<sup>300</sup> A fuller discussion of the research on this issue can be found in Pollin, R., D. Baker, and M. Schaberg, *Political Economy Research*. 2002. “Financial Transactions Taxes for the U.S. Economy,” Amherst: MA: Institute, (<http://www.peri.umass.edu/236/hash/ae97d8d65/publication/172/>).

<sup>301</sup> DeLong, J.B., A. Shleifer, L. Summers, and R. Waldmann, 1987. “The Economic Consequences of Noise Trading,” *National Bureau of Economic Research, WP # W2395*.

scholars have continued to follow in this framework<sup>302</sup>. Efforts to measure the impact of FTTs, transactions costs, and trading volume on volatility have produced mixed results. Several studies have found that higher transactions costs are associated with higher volatility<sup>303</sup>. However, other studies have found no significant relationship between volatility and transactions taxes<sup>304</sup>. In an interesting study, Roll (1989) found that markets with transactions taxes had no greater volatility in the period around 1987 stock market crash than markets without a tax<sup>305</sup>.

Previously in this thesis (Chapter 2) I have outlined the financialisation of global economic markets over two decades (see Figure 5.1 below on futures contract trading), the social consequences that have flowed from market dysfunction, and the contemporary systems of political economy that enable the advent of sophisticated trading models that are supported by the political model of free market fundamentalism that is neoliberalism. The era of the current global crisis has many of these symptoms.

Specifically, states receive little or no revenue return from trades taking place in, and from, their legal territories. In contrast, hedge fund managers make fortunes<sup>306</sup>. States have absorbed the consequences of dysfunction in global markets, which has transferred negatively on their public accounts. This equates to services cuts to citizens. States also continually push up infrastructure (water, power, health charges to offset already depleted budgets), and find ways to push up charges on taxes levied on civil society. Debt levels unequalled in modern society represent enormous burdens to civil society, and policymakers, charged with counteracting the negative forces of global gambling on unregulated markets.

The International Monetary Fund (IMF) released data that suggests that the public debt of the 10 leading rich countries of the OECD will increase from 78 per cent of GDP in 2007, to 114 per cent by 2014. Governments of these states will then owe the equivalent of US\$50,000 for

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<sup>302</sup> Stephan Schulmeister, 2010. "Boom-Bust Cycles and Trading Practices in Asset Markets, the Real Economy and the Effects of a Financial Transactions Tax," *WIFO Working Papers* 364/2010, ([http://www.wifo.ac.at/www/jsp/index.jsp?fid=23923&id=38641&typeid=8&display\\_mode=2](http://www.wifo.ac.at/www/jsp/index.jsp?fid=23923&id=38641&typeid=8&display_mode=2)).

<sup>303</sup> For example, see Jones, C. and P. Seguin, 1997. "Transactions Costs and Price Volatility: Evidence from Commission Deregulation." *American Economic Review*, 728-37.

<sup>304</sup> Hau, H. and A. Chevallier, 2000. "Estimating the Volatility Effect of a Security Transactions Tax," (*INSEAD Working Paper* (<http://faculty.insead.fr/hau/Research/tobin46.pdf>)).

Hu, S. 1998. "The Effects of the Stock Transaction Tax on the Stock Market: Experiences from Asian Markets," *Pacific Basin Financial Journal*, pp347-364.

<sup>305</sup> Roll, K. 1989. "Price Volatility, International Market Links, and Their Implications for Regulatory Policy," *Journal of Financial Services Research*. 211-246.

<sup>306</sup> Jesse Westbrook. "Alan Howard Tops Hedge Fund 'Rich List' Sunday Times says" *Bloomberg News*. 26 April 2012. (Reporting that Brevan Howard Asset Management LLP founders personal fortune increased 44 per cent over the past year to 1.4 billion pounds (AU\$2.3 billion) putting him on top of the Sunday Times list of wealthiest hedge fund managers). (<http://www.businessweek.com/news/2012-04-26/alan-howard-tops-u-dot-k-dot-hedge-fund-list>)

every one of their citizens. The IMF estimates that the present value of the fiscal cost of population aging is 10 times the average of the Global Financial Crisis. If unchecked, the combined public debt of wealthy economies will increase to 200 per cent of GDP by 2030<sup>307</sup>.

Proposed measures to reverse regressive taxes on middle-income workers throughout the developed world, recover capital from offshore tax havens and introduce a financial transaction tax would gradually reverse the income inequality of the past decades<sup>308</sup>.

Meanwhile, the shadow economy has not changed its growth pace, although there has been a strong concentration of funds away from agriculture and other infrastructure sectors to purely speculation financial sector futures trading (see Figure 5.1 below).

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<sup>307</sup> “The Biggest Bill in History.” *The Economist*. 11 June 2009 and *Financial Alchemy in Crisis*. Anastasia Nesvetailova 2010.

<sup>308</sup> Jack Rasmus. “Epic Recession: Prelude to Global Depression.” *Pluto Press*. London. 2010.

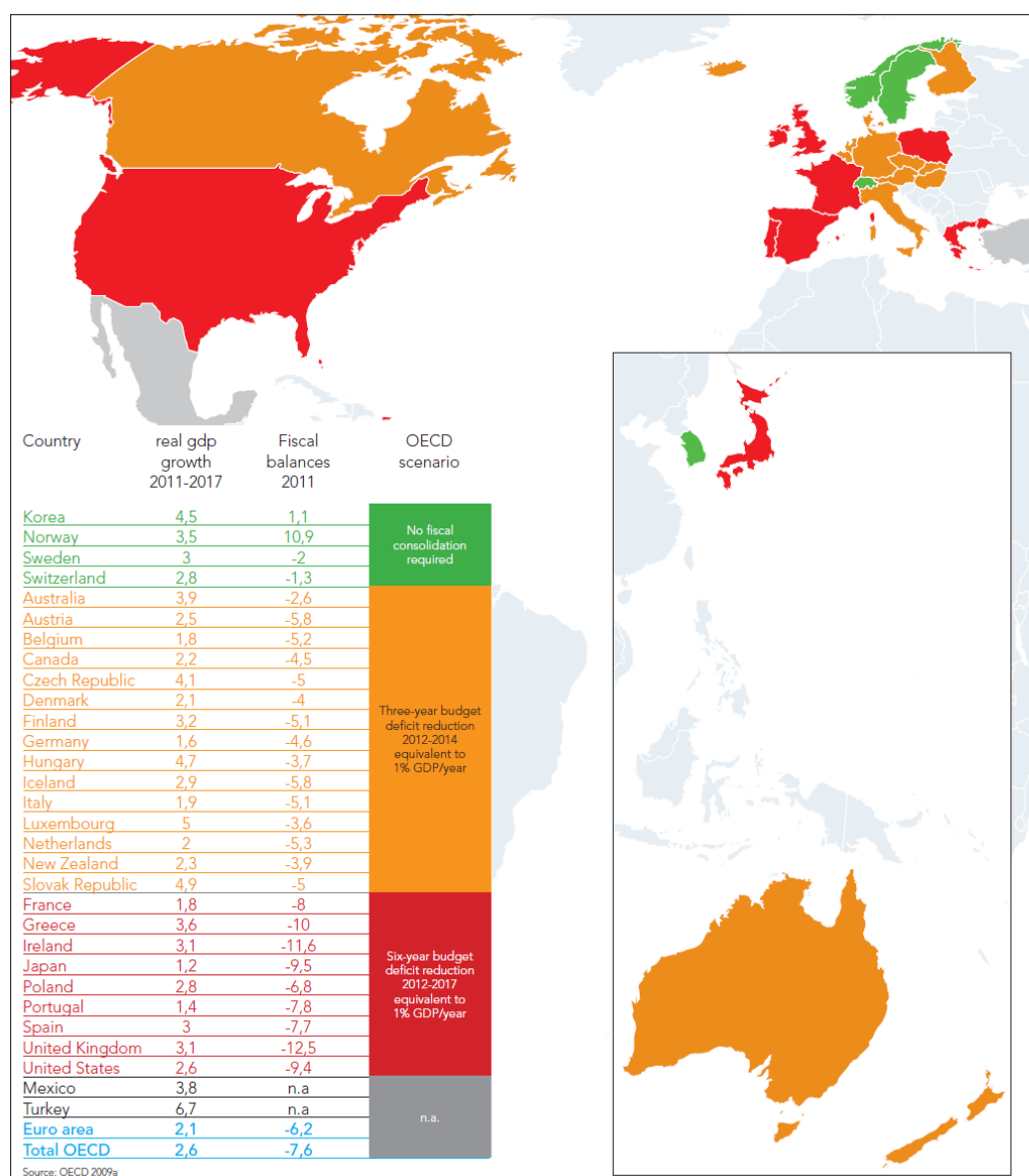


Figure 5.1: OECD Projections of Budget Deficits, 2011–2017<sup>309</sup>.

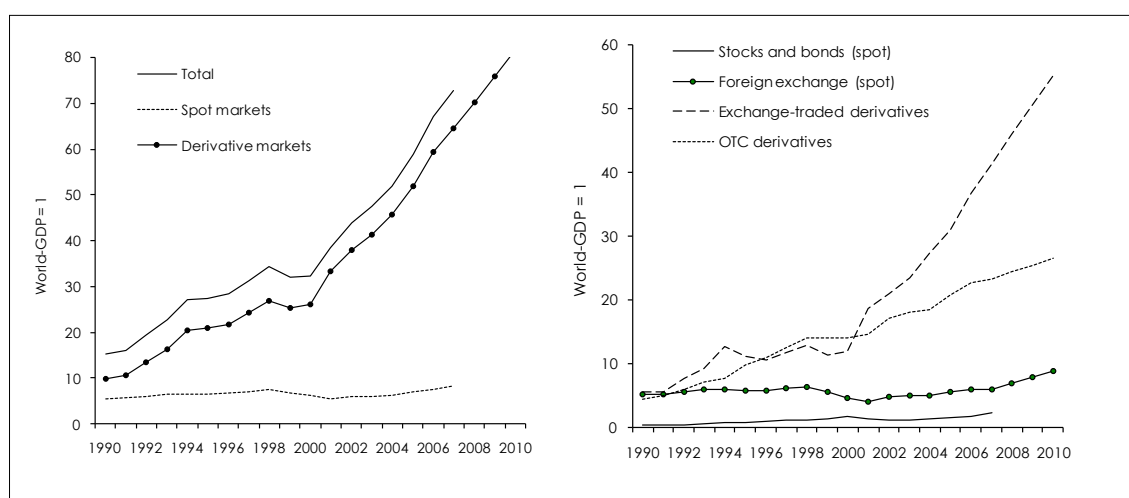
### 5.10 Global Capacities

The socialisation of debt (transferring corporate debt to the public account) has not been a local phenomenon confined to the United States, as evidenced in the extraordinary amount of credit issued to sub-prime markets through the mid 2003–2007 period. The result of this failure of fiscal and social policy has left public funds diminished to unprecedented levels. The OECD chart in Figure 5.1 above clearly shows that for developed countries in Europe and the United States, budget deficits are severe and lasting. The erosion of public accounts is

<sup>309</sup> The Trade Union Advisory Committee to the Organisation for Economic Cooperation and Development (OECD) *The Parameters of a Financial Transaction Tax and the OECD Global Public Goods Resource Gap 2010-2020*. Projection of Public Deficits.

in those countries that have been the recipients of the free trade paradigms of easy money and unregulated financial flows. These are the countries suffering most hardship and paradoxically the countries that will benefit most from an FTT that skims revenue from every trade in and out of their borders. Spain, in considerable debt, has been a strong proponent of an FTT to place funds back into public accounts and to place integrity into the balance between the negative effects on its civil society by shadow economy traders. There is no other conceivable way other than further borrowing to stimulate the economy. That means higher debt repayments over a long period. If indeed, that is now possible. These states are effectively bankrupt. Recently (December 2011) European Central banks pledged further taxpayer funds to support ailing corporations. The debt cycle seems unstoppable. Shadow economies are buoyant. Real economies are increasingly depressed.

The exponential market expansion of financial transactions is therefore one of the most typical characteristics of the latest phase in a “finance-capital” development (together with the rising instability of those asset prices which are most important for the “real economy” like exchange rates, commodity prices and stock prices). Financial transactions continue apace, despite the now US\$14 trillion deficit in the real economy in the United States.



**Figure 5.2<sup>310</sup>: Financial Transactions in the World Economy, 1990–2010.**

In contrast to struggling civil society communities Wall Street compensation and benefits at publicly traded banks and securities firms hit a record US\$135 billion in 2010, up 5.7 per cent

<sup>310</sup>“BIS releases the latest figures on OTC Derivatives” Source: BIS, WFE, OECD. *FuturesMagazine* ([http://www.futuresmag.com.?News?2010/Pages/BIS-releases latest statistics-on-OT](http://www.futuresmag.com.?News?2010/Pages/BIS-releases%20latest%20statistics-on-OT)) .

from 2009.<sup>311</sup> An increase in revenue was recorded at 25 large financial firms that have reported full year figures for 2010. Revenue has risen by US\$417 billion, and Wall Street firms are beginning to pay executives the bonuses and deferred payments that have been the source of considerable public angst in this continuing period of financial instability (2008–2012).

Coincidentally, one of the largest recipients of the taxpayer bailouts, Goldman Sachs received US\$2.9 billion for its own account from a US\$3.4 billion credit default swaps (CDSs) payment made by the giant corporation American International Group Inc. (AIG). These payments were made immediately after the Federal Reserves' US\$9 trillion payout. According to a report by the Financial Crisis Inquiry Commission (FCIC) in the United States, the US\$2.9 billion “was for proprietary trades” (that is trades made entirely for Goldman Sachs' benefit rather than on behalf of a client). The money (US\$3.4 billion), from AIG to Goldman Sachs, was not included in a United States Government bailout specifically for AIG that retired US\$62 billion in contracts by fully reimbursing banks, including Goldman Sachs and the French corporation Societe Generale the Federal Reserve Special Investment Vehicle called Maiden Lane.<sup>312</sup> Financial markets require an urgent oversight to find a level of integrity to underpin a framework of equality.

One of the most important facts in the present era (2011-2012) of political economy is that apart from high profits for select elite, the world economy is slowing. Bankers and finance elites in the regulated sectors continue to enjoy unprecedented profits whilst businesses across the world falter. A recent report shows how countries are stagnating as businesses record losses.

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<sup>311</sup> Aaron Luchetti and Stephen Grocer. “On Street, Pay Vaults to Record Altitude” *The Wall Street Journal*. 2 February 2011. (<http://online.wsj.com/article/SB100001424052748>).

<sup>312</sup> “Goldman Got \$2.9 billion for Own Bets in AIG Bailout, FCIC Says”. *Bloomberg News*. 27 January 2011.

Global Manufacturing PMIs					
	Current	Previous	3 Months Ago	6 Months Ago	12 Months Ago
<b>Global</b>	-	50.6	51.1	50.5	52.6
US	49.7	53.5	53.4	53.1	55.8
Brazil	48.5	49.3	51.1	49.1	49.0
Canada	-	54.7	52.4	54.0	53.3
<b>Euro Area</b>	45.1	45.1	47.7	46.9	52.0
Austria	50.1	50.2	51.5	49.0	53.0
Czech	49.4	47.8	52.1	49.2	55.1
Denmark	53.0	54.0	52.5	59.3	59.1
France	45.2	44.7	46.7	48.9	52.5
Germany	45.0	45.2	48.4	48.4	54.6
Greece	40.1	43.1	41.3	42.0	45.5
Ireland	53.1	51.2	51.5	48.6	48.8
Italy	44.6	44.8	47.9	44.3	49.9
Netherlands	48.9	47.6	49.6	46.2	52.1
Poland	48.0	48.9	50.1	48.8	51.2
Russia	51.0	53.2	50.8	51.7	50.6
Spain	41.1	42.0	44.5	43.7	47.3
Switzerland	48.1	45.4	51.1	49.1	54.2
Turkey	51.4	50.2	49.6	52.0	52.3
UK	48.8	45.9	51.7	50.1	51.8
China	48.2	48.4	48.3	48.7	50.1
Hong Kong	-	49.4	52.0	49.7	50.3
India	55.0	54.7	57.5	52.0	58.0
Japan	49.9	50.7	51.1	50.2	50.8
Korea	49.4	51.0	52.0	48.4	51.1
Singapore	-	50.4	50.2	49.5	50.4
Taiwan	49.2	50.5	54.1	47.1	49.9
Australia	47.2	42.4	49.5	50.2	52.9
New Zealand	48.2	55.7	54.0	52.0	53.9
Israel	53.2	60.0	46.3	42.7	52.3
Saudi Arabia	-	60.4	58.7	57.7	62.8
South Africa	48.2	53.6	55.1	49.4	54.2
UAE	-	53.8	52.3	51.7	55.2
<b>% Expanding</b>	12%	27%	30%	15%	58%
<b>% Contracting</b>	61%	48%	33%	61%	18%
<b>% Neutral</b>	9%	24%	36%	24%	24%

\*current percentages do not add to 100% due to PMIs yet to be released

Source: RBC Capital Markets, Haver, Markit

**Figure 5.3<sup>313</sup> The World is Slowing: according to the Purchasing Managers Index (PMI).**

An examination of corporate problems as demonstrated in the PMI chart, against the nature of financial instability should inform politicians of the urgent need for accountability in global markets. An international FTT is both a vehicle for accountability and oversight and mechanism to raise revenues. It will have a stabilising effect across markets.

<sup>313</sup> The details may not be entirely discernible but the point is to notice the "red" developing in the world PMI numbers. Definition of 'Purchasing Managers Index - PMI'. The PMI is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change. Prior to September 1, 2001, the acronym (PMI) stood for Purchasing Managers' Index. The Institute of Supply Management (ISM) now uses only the acronym, PMI. Although the ISM publishes several indexes, the PMI is the most widely followed and is sometimes referred to as the ISM index.

### 5.11 Financial Transaction Tax Proposals

Many early proponents of a Financial Transaction Tax (FTT) have provided modelling based primarily on data from the 1980s and 1990s. Although equations of revenue available were significant, this earlier work missed the huge growth in financial and speculative trading in asset classes, both in the underlying cash and derivative markets parallel to the rise in the financialisation of political economies over the past two decades<sup>314</sup> (see Chapter 2). It also missed the massive injection of funds into the banking sector immediately after the demise of Goldman Sachs in September 2008, which injected a minimum of US\$10 trillion dollars into the United States financial system from state-based taxpayer funds, the largest socialisation of debt in history. Since that time the regime of quantitative easing (QE) (governments printing money) has become politically acceptable as a “natural” model of delivering injections of funds to dry fiscal wells. Recently the European Union Tax Commissioner<sup>315</sup> advised the United Kingdom’s House of Lords Committee that an FTT would not affect market growth. Darvas and von Weizsacker<sup>316</sup> argue that financial transaction trading volumes have increased dramatically in recent years. They say that annual turnover for the main “spot” and derivatives markets represented 70 times the world’s GDP in 2007. Eighty-eight per cent of this figure constitutes derivatives trades.

Unsurprisingly, asset prices, including exchange rates, stock prices, and commodity prices (especially for crude oil) have undergone wide value fluctuations lasting several years. Fluctuations are the key dynamic that provide market-betting spreads. However, economic policy has not attempted to mitigate these price swings; for example, by investigating the range of proposals and models for currency and broader financial transaction taxes (as proposed by Keynes (1936)<sup>317</sup>, for stock trading, and by Tobin (1978)<sup>318</sup>, for currency trading).

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<sup>314</sup> Bill Barclay. *A Financial Transaction Tax: Revenue Potential and Economic Impact*. Chicago Political Economy Group Working Paper 2010.

<sup>315</sup> “Financial Transaction tax would not affect growth, says EU Commissioner.” *Reuters CFO World*. 17 February 2012. (<http://www.cfoworld.co.uk/news/governance/3338318/financial-transaction-tax-would-not-affect-growth-says-eu-commissioner/>)

<sup>316</sup> Zsolt, Darvas, and Jacob Von Weizsacker “Financial Transaction Tax: Small is Beautiful” *Bruegel Policy Contribution*. February 2010 ([www.bruegel.org](http://www.bruegel.org)). Briefing paper prepared for the European Parliament Economic and Monetary Affairs Committee’s public hearing “*Financial transaction taxes: making them work*” 2 December 2009.

<sup>317</sup> John Maynard Keynes, *The General of Employment, Interest and Money*. MacMillan. London. 1936.

<sup>318</sup> James Tobin. “Proposal for International Monetary Reform.” *Eastern Economic Journal*, 1978, 4, pp.153-159.

Keynes argued that a tax should be levied on dealings on Wall Street where he saw excessive speculation had increased volatility in markets. In fact, many similar taxes have been abolished over the past 20 years. The earliest known tax of this nature was implemented by the London Stock Exchange in 1694<sup>319</sup> as a tax payable (covering official stamp on the legal document) by the buyer of shares. It is still in existence in the United Kingdom on these products).

Volatility and instability of financial markets together with their global interdependence and related crises in the 1990s through to the current global recession starting in 2007–08 have reignited the debate over the pros and cons of a currency transaction tax<sup>320</sup>. Many economists including Ul Haq, Kaul and Grunberg cite the issue of volatility being a key finance capital dynamic as an enabler of trades<sup>321</sup>. Global markets that are stable and lack volatility in fact do not provide optimum trading environments as positions are placed (as bets) on the inherent fluctuation of unregulated pricing mechanisms. This gives the market its position mechanism on trades, either up or down the various scales. The ensuing discussion led to new and more elaborate proposals on how to implement a Tobin Tax in practice<sup>322</sup>. Asset prices motivated the Austrian Institute of Economic Research (WIFO) to consider the pros and cons of a general and uniform FTT. Such a tax would be imposed on transactions of all kinds of financial assets and, hence, would not be restricted to specific markets like the original proposal by Keynes (stock market), the Tobin Tax (foreign exchange market) or securities taxes implemented in the past (stamp duties, stock exchange transaction taxes).

Recent papers summarise the results of a study by Schulmeister et al, Darvas and von Weizsacker<sup>323</sup>, which contribute to the debate with the intention of drawing attention to a more fair, and equitable tax model that includes those income earners at the top end of the spectrum.

Whilst proposals for financial accountability have resulted in legislation in Australia to locate finance secreted to offshore tax-free destinations, the main institutional players have well

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<sup>319</sup> Stamp duty was first introduced in England in 1694, during the reign of William and Mary under "An act for granting to Their Majesties several duties on Vellum, Parchment and Paper for 4 years, towards carrying on the war against France"

<sup>320</sup> Presentation at the European Parliament in Brussels on April 16 2008

<sup>321</sup> Mahbub Ul Haq, Kaul, I., Grunberg, I. "The Tobin Tax: Coping with Financial Volatility." *Oxford University Press*. New York–Oxford. 1996.

<sup>322</sup> Paul Bernd Spahn, *On the feasibility of a tax on foreign exchange transaction*, Report to the Federal Ministry for Economic Cooperation and Development. Bonn. February 2002.

<sup>323</sup> Zsolt, Darvas, and Jakob Von Weizsacker. *Financial Transaction Tax: Small is Beautiful*. February 2010. *ibid*

established income secretion models in politically supported tax havens such as Guernsey, Jersey, the Isle of Man, the Cayman Islands and Vanuatu close to Australia. It should be noted that the upsurge in trading volume, innovation in financial engineering, and vastly improved electronic transfer models make supervision of trades and oversight difficult.

Conceptually, a general FTT seems, “prima facie,” more attractive than a specific transaction tax for at least three reasons. First, a general tax does not discriminate against specific types of markets, and it prevents tax avoidance by substituting taxed by untaxed transactions. Second, due to the enormous volume of the tax base, the tax rate could be very small and yet the tax receipts might be considerable. Third, such a tax could be implemented in a stepwise fashion so that (a group of) countries willing to impose it would start with domestic markets, which can be taxed at almost no administrative costs (e.g., it is easier to levy a rather miniscule tax of 0.01 per cent on spot and derivatives transactions on organised exchanges as compared to transactions in a dealership market like the global foreign exchange market).

Recently (October 2010) Stephan Schulmeister<sup>324</sup> concluded that evidence presented in his report to the Austrian Institute of Economic Research did not prove the efficacy of introducing a financial transaction tax; however the report showed that:

- Long swings in asset prices in either direction result from the accumulation of persistent upward (and downward) mini runs lasting longer than counter-movements over an extended period of time.
- The most popular banking practices; for example, technical analysis, focus on the exploitation of such price trends.
- The widespread use of technical trading systems reinforces the boom and bust pattern of asset price dynamics as a sequence of persistent price movements interrupted by “whipsaws”.
- Technical models, including “automated trading systems” are used at ever-increasing data frequencies. This development has strongly contributed to the tremendous rise in transaction volumes in asset markets, particularly in derivatives markets.

Further, Schulmeister argues that:

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<sup>324</sup> Stephan Schulmeister. *Short-term Asset trading, Long –term Price Swings, and the Stabilizing Potential of Transaction Tax*. Austrian Institute of Economic Research. October 2010.

These observations provide “circumstantial evidence” for the view that the increasingly short-term oriented, non-fundamental speculation contributes strongly to the overshooting of asset prices. A small FTT would then dampen the volatility of asset prices over the short run as well as the magnitude of the swings over the longer run. The implementation of an FTT would not constitute a great technical problem. Reaching a political consensus will be more difficult because the idea of taxing transactions in the “freest” markets calls implicitly into question “Weltanschauung”<sup>325</sup> which has become mainstream in economics and politics over the past decades.

In the United States, two proposals were put forward in an economics report “A Budget Blueprint for Economic Recovery and Fiscal Responsibility” delivered to Congress<sup>326</sup>. One proposal is the concept of a financial crisis responsibility fee, which recommends the adoption of President Obama’s proposal to impose a “financial crisis responsibility fee” designed to recoup taxpayer losses associated with the Troubled Asset Relief Program (TARP), which primarily benefitted major financial institutions. The fee would apply only to financial institutions with over \$50 billion in assets (estimated at 60 institutions) and would be equal to 15 basis points (0.15 per cent) of a financial institution’s covered liabilities.

The fee proposed in the president’s budget is projected to raise \$9 billion in 2015 and \$90 billion over 2011–20, and it will continue until all of the costs associated with TARP are repaid. The Congressional Budget Office estimates that the fee would have a negligible effect on economic growth. These proposals signal the willingness of Obama to look at revenue options however, the President’s early willingness to examine FTT’s appears to have been retracted through lobbying by Lawrence Summers<sup>327</sup> and others linked to finance capital. Many policy specialists believe that it is not too late for the president to revisit some of his earlier positions in support of progressive economic policies, including financial transactions taxes.

In a sign that the Obama Administration is ready to face the critical macro responses required to arrest the dramatic decline in the United States’ deficits, now US\$14 trillion, the administration appears to be considering a financial transaction tax to provide budget relief. The *New York Times*<sup>328</sup> reported:

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<sup>325</sup> “Weltanschauung” Interpreted as a comprehensive view of the world and world life.

<sup>326</sup> The United States Economic Policy Institute and the Century Foundation. 29 November 2010.

<sup>327</sup> Sarah Anderson. “Obama Supported Financial Transactions Taxes - Before Summers Nixed It.” *Institute for Policy Studies*. September 20, 2011

<sup>328</sup> “Budget Battles: Tax and Spending Myths and Realities.” *The New York Times*. 14 April 2011.

Here are two numbers to keep in mind when thinking about the House Republicans' budget plan: They want to cut spending on government programs over the next decade by \$4.3 trillion. And they want to cut tax revenues over the same period by \$4.2 trillion. As a matter of fairness, raising income taxes must start with requiring the richest Americans — who have been the biggest beneficiaries of Bush-era tax cuts — to pay more. But even that won't dig the country out of its hole. The middle class is also going to have to pay higher taxes. That is the only way to pay for needed reform. That means higher income taxes further down the income scale than Mr Obama has previously called for, and new sources of tax revenue, like energy taxes or a financial-transactions tax. Government spending needs to be brought under control. But slashing vital services just to pay for more tax cuts is bad public policy and bad economics.

As part of proposed reforms, the United States has investigated a financial speculation tax.

While a speculations tax would not eliminate speculation or necessarily stave off financial crises, instituting disincentives to short-term speculating would be a step toward building a more resilient financial sector. The tax could generate revenue to fund investments to strengthen the economy in the wake of the financial-crisis-induced recession. In 2004, the Congressional Research Service estimated that a 0.5 per cent tax on stock transactions would raise roughly US\$65.6 billion a year, assuming no reduction in trading volume. Adjusting for nominal GDP growth and assuming a 25 per cent reduction in transactions, it is estimated that a financial transactions tax would raise US\$77.4 billion in the United States by 2015.

Expanding the tax to derivative financial products would generate significantly more revenue.

The “Let Wall Street Pay for Wall Street’s Bailout Act (H.R. 1068)” financial transaction tax bill – which would tax stock, options, futures, and swap transactions – was estimated to raise roughly US\$150 billion a year. The United States used to have a financial transactions tax, and many advanced economies, including the United Kingdom, collect revenue from financial transactions without any noticeable harm to economic performance. This policy would complement the “financial crisis responsibility fee”, discussed above, and revenue from the tax could be used to invest in jumpstarting the broader economy.

### ***5.12 Revenue and Stabilising Effects*** <sup>329</sup>

The following transactions could/should be subject to a general financial transaction tax (FTT):

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<sup>329</sup> This section summarises some key results of a comprehensive study on the possible effects of a general financial transactions tax (Schulmeister – Schratzenstaller – Picek, 2008). A shorter version is Schulmeister (2009E). See also Baker et al. (2009), Baker (2008), Jetin – Denys (2005), Pollin – Baker – Schaberg (2003), Schmidt (2008).

- All spot and derivatives transactions on organised exchanges, e.g., trades of stocks and interest rate securities, as well as trades of futures and options related to stocks, interest rate securities, currencies and commodities.
- Those over-the-counter (OTC) transactions, which are directly related to asset prices, in particular to exchange rates and interest rates. The first group of transactions is clearly defined. The second group covers all transactions reported by the “Triennial Central Bank Survey” plus OTC spot transactions of interest rate securities and stocks

An FTT would specifically dampen very short-term oriented trading in derivatives markets. There are two reasons for that. First, an FTT makes trading the more costly the shorter its time horizon is (e.g. technical trading based on intraday data). Second, an FTT would dampen derivatives trading since the tax rate refers to contract value (e. g. the effective tax on the margin “invested” is, by the leverage factor, higher than the tax relative to the notional value).

Since long-term asset price trends (“bulls/bears”) are brought about through the accumulation of (very) short-term runs, an FTT would also dampen the “long swings” of exchange rates, commodity prices and stock prices. Hedging, as well as “real-world-transactions” (this would only concern foreign exchange transactions stemming from international trade), would hardly be affected by a low FTT between 0.1 per cent and 0.01 per cent.

The size of this reduction effect depends on the tax rate, the pre-tax transaction costs and the leverage in the case of derivatives instruments. For each tax rate and type of instrument, a low, medium and high “transactions reduction scenario” (TRS) is specified. In the case of the medium TRS, it is assumed that transactions would decline by roughly 75 per cent at a tax rate of 0.1 per cent, at 65 per cent at a rate of 0.05 per cent and by roughly 25 per cent at a tax rate of 0.01 per cent. Table 5.2 represents the estimated FTT revenues at a tax rate of 0.05 per cent under the assumptions of the medium TRS (based on 2007 transactions data – based on 2010 data, revenue estimates will be by roughly 30 per cent higher). Overall revenues would amount to 1.21 per cent of world GDP or US\$661.1 billion. More than half of the revenues would stem from derivatives transactions on exchanges. Taxes on spot transactions would amount to only 0.11 per cent of global GDP.

This study estimates the potential revenues of a general FTT for three tax rates, namely, 0.1, 0.05 and 0.01 per cent (see Tables 5.1, 5.2 and 5.3 below).. The calculation assumes that the tax base is the notional value of the respective transaction. This design implies that the tax burden, relative to the cash invested to acquire a certain instrument, grows as transaction costs fall and the leverage effect rises. Such an FTT would hamper specifically those transactions that involve high leverage and, hence, a high risk (chance) of great losses (of profits). The revenue estimates are based on the assumption that transaction volumes will be reduced by the introduction of an FTT. The size of this reduction effect depends on the tax rate, the pre-tax transaction costs and the leverage in the case of derivatives instruments. For each tax rate and type of instrument, a low, medium and high transactions-reduction scenario (TRS) is specified.

Tables 5.1 and 5.2 present the estimated revenues of a general FTT for the world economy as a whole as well as for the main regions. In the case of the medium TRS, overall tax revenues would amount to 1.52 per cent of world GDP at a tax rate of 0.1 per cent, and to 0.49 per cent at a tax rate of 0.01 per cent. In North America and Europe, tax revenues would be similar in size (relative to nominal GDP); in the Asian-Pacific region FTT revenues would be lower by roughly one third than in North America and Europe. In the rest of the world, revenues would be negligible. It is interesting to note that the estimated revenues of a general FTT at the low rate of 0.01 per cent come close to the hypothetical revenues from a VAT on financial services.

In Europe, FTT revenues at a rate of 0.01 per cent are estimated to lie between 0.59 per cent and 0.78 per cent of GDP (Tables 5.1 and 5.2). If financial services were not exempt from VAT, the latter would yield roughly 0.7 per cent of GDP (this estimate implies a share of the financial sector in overall value added of 3.5 per cent and an average VAT rate of 20 per cent<sup>330</sup>). Hence, the introduction of a general FTT would roughly compensate for the (distorting) exemption of financial services from VAT. In addition, a general FTT would affect the (relative) profitability of different types of activities within the financial sector. Financing, insurance and risk transformation would practically remain unaffected by an FTT, whereas short-term trading would become more costly (in particular derivatives transactions).

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<sup>330</sup> Harry Huizinga. "A European VAT on financial services?" *Economic Policy*, October 2002.

The following tables 5.1 (Hypothetical Transaction Tax Receipts), 5.2 Currency and Derivatives Potential Revenues from a FTT) and 5.3 Cash, Spot and Futures Markets Potential Revenues provide evidence of substantial resources that could be available to nation states that are prepared to embrace the potential for market equality.

**Table 5.1: Hypothetical Transaction Tax Receipts in the Global Economy 2009.**

**Tax rate: 0.05%**

	World		Europe		North America		Asia and Pacific	
	In % of GDP	In Bill. \$	In % of GDP	In Bill. \$	In % of GDP	In Bill. \$	In % of GDP	In Bill. \$
Spot transactions on exchanges	0.11	60.9	0.12	21.2	0.18	28.3	0.16	10.3
Derivatives transactions on exchanges	0.65	358.1	0.69	122.7	1.28	198.7	0.51	32.8
OTC Transactions	0.44	242.0	0.82	145.1	0.33	50.8	0.67	43.6
All transactions	1.21	661.1	1.63	289.0	1.79	277.8	1.34	86.7

**Table 5.2: Currency and Currency Derivative Trading: Potential FTT Revenues.**

<b>2007 (BIS) Data</b>	<b>Daily Traded Value as at 2007</b>	<b>Financial Transaction Tax (FTT) Proposed Rate</b>	<b>Revenue (estimated) per Year</b>
Currency Traded Value (US share =25%)	<u>\$800 billion (US)</u>	0.01%/side	US\$40 billion
Currency Derivative Traded Value (US Share = 50%)	US\$4 Trillion	0.01%/side	US\$200 billion
Total			US\$240 billion
Dollar Derivative Traded Value (US share = 90%)	US\$7.2 trillion	0.01% side	US\$360 billion

**Table 5.3: Cash, Spot and Futures Markets: Revenue Estimates.**

<b>Product</b>	<b>2007 Traded Value (USD trillions)</b>	<b>2008 Traded Value (USD trillions)</b>	<b>FTT Rate (per side)</b>	<b>Revenue Raised 2007 (USD billions)</b>	<b>Revenue Raised 2008 (USD billions)</b>
Cash Equity	\$52.30	\$64.10	0.0025	\$130.75	\$160.25
Index Futures	\$50.00	\$54.60	0.00125	\$62.40	\$68.30
Index Options	\$36.00	\$32.25	0.00125	\$44.80	\$40.25
Total (one side)				\$236.95	\$268.80
Total (both sides)				\$473.90	\$537.60

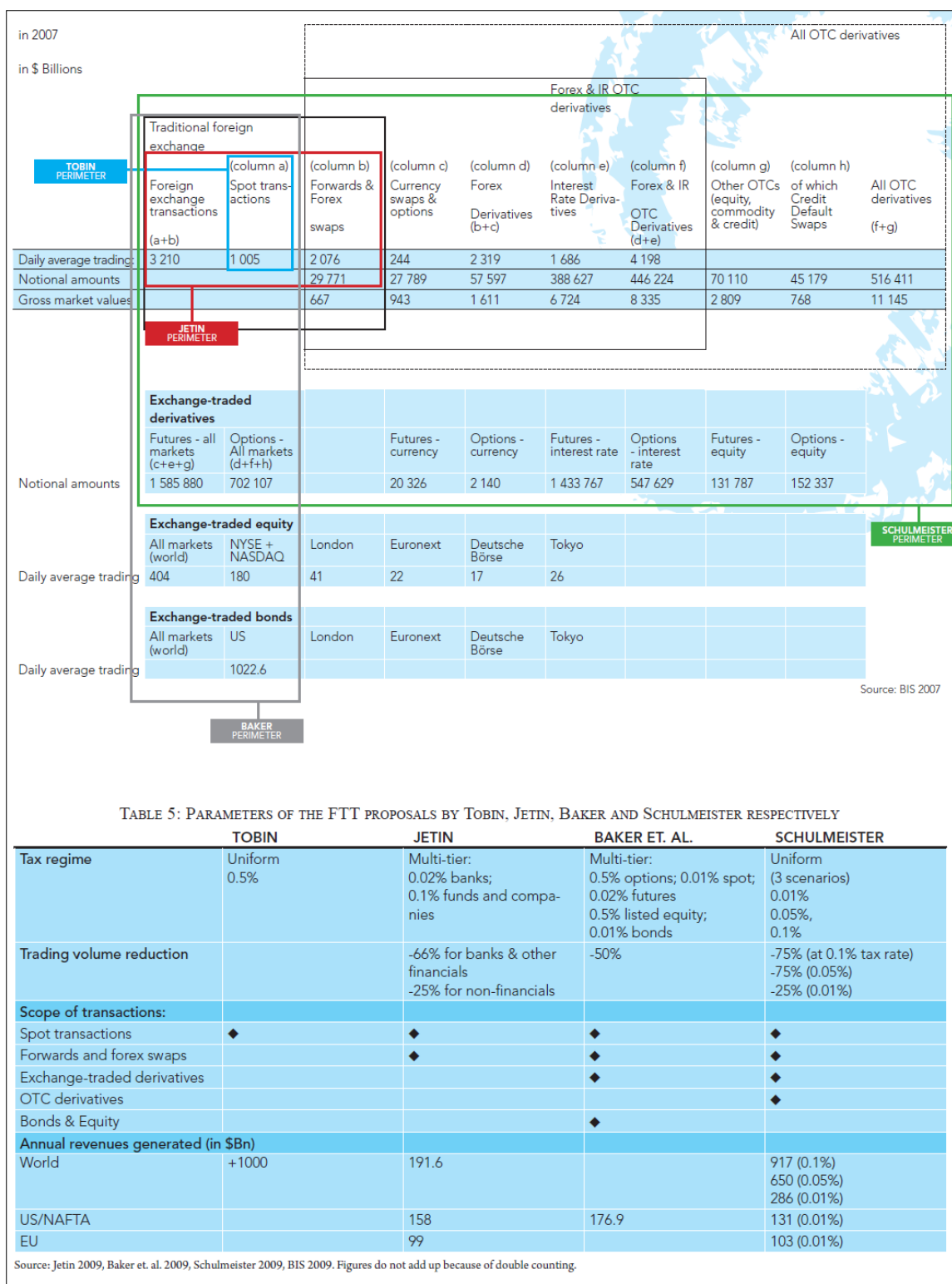


Figure 5.4<sup>331</sup>: Size of Exchange and Over-the-Counter Derivatives: Markets and Taxes.

<sup>331</sup> Stephan Schulmeister. 2011. Figures and tables 5.1 to 5.4. Trade Union Advisory Committee to the Organisation for Economic Cooperation and Development. (OECD) 2011. *Size of Foreign Exchange, Exchange Traded, and OTC Derivatives Markets and Parameters of Tobin, Jetin, Schulmeister and Baker*. Sourcing data from the Bank for International Settlements 2011.

An international financial tax on all trades would ameliorate some of the gross structural losses as governments grapple to explain recovery theories to constituents that are seeing public funds being used to pay government debt. A minimal tax applied to trades at the top-end of the market would not only increase market transparency and accountability but would for the first time allow states and global citizens an opportunity to share the massive and disproportionate monetary gains taken by a relatively small group of the population who have politically engineered the global political economy to benefit their goals of short-term accumulation of wealth, aided and abetted, by state compliance. It is no coincidence that the accumulated speculatively derived wealth models across developed countries are anathema to the orderly wellbeing of the global citizen.

In France, –past President Sarkozy<sup>332</sup> had been a long-term campaigner of an FTT (albeit without supportive traction from opposition parties in the run up to the election). The past French President told an anti-poverty summit in New York that state funding will not be sufficient to meet ambitious global development goals by the deadline of 2015. “I want to share with you my conviction that we won’t get there with just public funds and that we will have to associate ourselves with the private sector,” he told the UN general assembly at the start of a three-day summit. Newly elected President campaigned on a platform of financial accountability in France. His first task was to legislate the FTT into law.

Recently the head of the United Kingdom based Financial Services Authority, Lord Adair Turner<sup>333</sup>, stated that it would be wrong to exclude policies related to the introduction of financial transaction taxes saying that regulatory arrangements to ensure larger capital requirement are held at bank levels against risk:

However, even with higher capital requirements, financial trading activity may continue to grow both within the banking system and outside it, and those high levels of trading activity may continue to support unnecessary rent extraction by the financial sector, and may generate economic instability. If that is the case, and if society is worried about the consequences, either for financial instability or for the size and remuneration of the financial sector, then it should not exclude consideration of taxes on financial transactions. Anyone who thinks such taxes would prevent all or even most rent extraction in the financial sector, or that they could be designed to tune, the liquidity of markets to precisely its optimal level – neither too liquid nor insufficiently liquid – is fooling themselves. But in the real

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<sup>332</sup> Harvey Morris. “Sarkozy wants private finance to help meet global targets.” *The Financial Times*. 20 September 2010.

<sup>333</sup> Lord Adair Turner, “Responding to the financial crisis: challenging past assumptions.” 30 November 2009 Speech by Adair Turner, Chairman, FSA British Embassy, Paris

world of imperfect instruments with which we seek results at least a bit better than those we see today, they should not be excluded from consideration.

The following section (5.6) describes the macroeconomic effects that would flow from an FTT introduced globally. Often described as dysfunctional in times of crisis, financial trades after the introduction of an FTT would be dampened during the times of high volatility (international runs on currencies and capital flight). Short-term speculation would draw a cost, with each cross-border transaction, (resultant of the accumulation of extremely short-term runs (based on intra-day data) and likewise high volume transactions would be taxed strongly. Whilst large speculators may not feel the charges, it is sure to be factored in by the vast numbers of private traders operating from homes around the world. This system provides ethics and integrity to the markets. Dampening volatility is a positive potential outcome, which would tend to steady “herd effects” of trading “runs”.

### ***5.13 Excessive Liquidity and Price Volatility in Financial Markets***

The main observations about transactions volumes and price dynamics in financial markets can be summarised as follows:

- There is a remarkable discrepancy between the levels of financial transactions and the levels of the “underlying” transactions in the “real world”. For example, the volume of foreign exchange transactions is almost 70 times higher than world trade of goods and services. In Germany, the United Kingdom and the United States, the volume of stock trading is almost 100 times bigger than business investment, while the trading volume of interest rate securities is even several 100 times greater than overall investment.
- For all types of assets, these discrepancies have risen since the late 1990s. In other words, finance capital transactions have expanded several times faster than transactions in the “underlying” markets for goods and services (real-world economic transactions).
- Trading in OTC derivatives markets has expanded significantly stronger than trading in spot markets; this holds true for any kind of asset/instrument. In the world economy, derivatives trading volume is roughly 50 times higher than world GDP, whereas spot trading amounts to “only” 7.5 times world GDP.
- Asset prices like exchange rates, stock prices or crude oil prices fluctuate in a sequence of long-term upward trends (bull markets) and downward trends (bear markets) around its fundamental equilibrium.
- These trends are the result of the accumulation of extremely short-term runs (based on intra-day data) which last longer in one direction than the counter-movements. When the market is “bullish”, upward runs last longer than downward runs, when the market is “bearish”, the opposite is the case.

These observations suggest that financial markets are characterised by excessive liquidity and by excessive long-run volatility of prices (i.e., strong and persistent deviations from their fundamental equilibrium). This can be concluded from the empirical evidence for the following reasons:

- Price expectations of market participants must be (very) heterogeneous and must have become progressively more so (otherwise trading opportunities would not have raised so much faster than transactions in the “underlying” goods markets) (real economy).
- The spectacular rise of derivatives trading cannot be caused primarily by hedging activities because the volume of derivatives transactions is just much too big to be accounted for by hedging.
- Therefore, the greatest part of derivatives transactions has to be attributed to speculative trades between actors with heterogeneous price expectations.
- The pattern of asset price dynamics as a sequence of very short-term runs which accumulate to “bull markets” or “bear markets” and, hence to long swings around the fundamental equilibrium, suggests that the cumulative effects of increasingly short-term transactions are destabilising rather than stabilising.
- This evaluation of the empirical evidence suggests that asset markets are characterised by excessive liquidity and excessive price volatility leading to large and persistent deviations from their fundamental equilibrium.
- The growing importance of technically sophisticated trading systems in financial markets contributes significantly to the volume and volatility of asset prices over the short run as well as over the long run.
- Speculative financial markets are prone to the effects of “herd mentality” amongst traders and runs on currencies, for example, are magnified by investor sentiment rather than accrued and informed opinion.
- The effects on nation states from active speculators in “herd mentality” have been documented through all recent currency crises including the spectacular run on the British Pound by hedge fund “herd leader” George Soros.

A global FTT would render such transactions more costly the shorter their time horizon. Hence, it would tend to dampen technical trading, which is increasingly based on intraday price data. At the same time, technical trading strengthens price runs, which in turn accumulate to medium-term trends that involve growing departures from long-run

fundamental levels. Therefore, an FTT would be expected to reduce excessive liquidity stemming from transactions, which are very short-term oriented and that can be destabilising at the same time.

Since an FTT would increase transaction costs, the lower they are (before tax), it would generally hamper derivatives (options and futures) trading largely than spot trading. Since spot transactions are more long-term oriented and, hence, based to a larger extent on market fundamentals than (speculative) derivatives transactions (such an assumption seems plausible at least with respect to stocks and interest rate securities), it is assumed that an FTT would hamper primarily short-term, non-fundamental transactions. At the same time, derivatives transactions for hedging purposes would not be affected by a low FTT (between 0.1 and 0.05 per cent) since a trade usually needs just one transaction for hedging an open position stemming from “real-world-transactions” (e.g. future export earnings in foreign currency).

#### ***5.14 An FTT Will Reduce High Frequency Trades***

High frequency trades (see Chapter 4 section 4.8) create market irregularities/instability and the dominant trend in market capacity. Whilst sophisticated trading systems have changed market growth in terms of volume and trade numbers in and out of trading ports, it is the light speed flexibility of traders who have determined the clinical frameworks within which trades are undertaken.

Flash trades take just milliseconds, read buy/sell prices, and enable trades to take place only if the price range is within a pre-set model. Flash or high frequency trades are market leaders and are engineered and financed at a cost factor determinant well outside the affordability range of ordinary traders. High frequency traders have also concentrated their interests.

Instability in financial markets has a destabilising effect on local and global markets. A recent occurrence within the Wall Street high technology flash trading theatre created instant chaos in global trading markets when shares of Accenture Plc, a technology-consulting firm, sold for US\$40 on the afternoon of 6 May 2010. Then, without precedent, the stock and the system, suddenly seized up. For 22 seconds there were no recorded trades. The next occurrence came in the form of a new transaction below US\$10. In the next eight seconds, Accenture Plc free floated in cyber land, its price changing more than 80 times before flat lining at one cent. Then just as abruptly, the share price rebounded to US\$40 and stayed there. The super-low trades have since been reversed by the exchanges, but the record of

them lives on as a reminder that markets have an innate capacity for rapid change with or without the intervention of humans. Similar incidents have been recorded in Australia.

Accenture was just one of the many companies whose shares were wracked by the 6 May 2010 market crash, which briefly reduced the value of US stocks by more than US\$800 billion. The vast liquidity that automated trading systems supposedly provide the stock market vanished instantly that day, as computer programs shut down in confusion. It is becoming clear that 6 May 2010 was not a one-time convulsion. Fifteen United States companies have had their trading halted after wide swings in their price since June 2010, including Citigroup Inc. and Progress Energy Inc., according to Bloomberg<sup>334</sup> data.

These specific trading events represent a microcosm of the larger instability of markets. In macro market terms, banks on Wall Street and Main Street over-lent, leading to the worst economic downturn since the Great Depression. Following the collapse of Bear Stearns and Lehman Brothers, investment banks were bailed out using public funds. Nation state public funds are now severely depleted and require ongoing rounds of quantitative easing.

Once bailed out, the banks resumed speculative trading and paying huge trading bonuses at pre-crisis levels. Freeland<sup>335</sup> suggests that some of the biggest winners in the post-2008 Federal Reserve intervention have been individuals, not institutions. Freeland argues that the hedge fund manager John Paulson, for instance, singlehandedly profited as much from the crisis of 2008 as Goldman Sachs. Now corporations are cranking up their trading operations in a way that imperils the financial system once again. Gary Gensler, a former Goldman Sachs Group Inc. executive who heads the Commodity Futures Trading Commission, compared one firm's trading strategy in the crash to driving on "autopilot into a ravine." With governments seemingly willing to accept risk, firms are fearless.

System reform and oversight of these issues is not a matter of patching up the current system, as the United States' Securities and Exchange Commission is attempting to do. It is time to step back and consider the proper role of finance in the global economy and the regime of globalisation of finance that has delivered considerable benefits in the opening up of global economies, but has created a major intersect between financial traders and the real world. Such is the calibre of this problem that it effectively threatens the sovereignty of nation states

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<sup>334</sup>Peter Coy. "Financial Taxes May Solve U.S. High-Frequency Trading Mess." *Bloomberg*. 12 November 2010.

<sup>335</sup>Chrystia Freeland. "The Rise of the New Global Elite." *The Atlantic Monthly*. February 2011,

already reeling in debt. Systemic unregulated financialisation has created major problems in global markets.

Harvard University economist Benjamin M. Friedman asks the right question – “Is our financial system serving us well?”<sup>336</sup> Friedman points out that from the 1950s through the 1980s, profits earned by financial firms excluding insurance and real estate accounted for 10 per cent of total US GDP profits. Their share of profits grew to 22 per cent in the 1990s and to an astonishing 34 per cent from 2001 to 2008. Asking “why is this system not serving us.”

Friedman argues that “fantastically high salaries and bonuses have attracted more than a quarter of Harvard’s graduating job seekers to investment banks, hedge funds, private equity firms and the like”. That, Friedman notes, was just before the surge in borrowing; securitisation and derivatives finance began to transform itself into a “world-class crisis” effectively creating the socialisation of credit across developed nation states. Friedman argues that the bigger the financial industry gets, the more dangerous it becomes. High-frequency traders are engaged in a costly technological “arms race” to decrease the latency of their trades so they can exploit fleeting arbitrage opportunities before their rivals do.

### **5.15 Conclusion**

I have argued that to make finance safer and ethical, especially through the introduction of financial taxes, will be vociferously opposed by Wall Street and The City, London, whose profits are sustained and amplified by leverage.

The Financial Transaction Tax offers a fair and equitable way forward whilst allowing the continuation of the vast speculative and risk laden finance industry. Of course, the financial industry has powerful allies in Washington, exemplified by a Bloomberg News report on 9 November 2010 that high-frequency trading firms such as Getco LLC, Hard Eight Futures LLC, and Quantlab Financial LLC have more than quadrupled their political contributions over the last four years.

Lobbyists have influenced the negative political narrative outlining the effects on the finance industry. However, with the severity of the Global Financial Crisis and its second wave of defaults and sovereign debt crises across most developed countries, a new wave of support appears to be forthcoming from conservative politicians, joining the continuing informed

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<sup>336</sup> Benjamin Friedman Essay in the December 2010 issue of *Daedalus*, *The Journal of the American Academy of Arts and Sciences*.

discussion from progressive leaders. Half of the nation states in the European Union support an FTT in Europe. The United Kingdom supports a global FTT.

This chapter outlined the objectives and rationale for global and local tax models, and revenues available. The wave of public support has never been stronger. Political lines are drawn between provision of public goods and services through FTT revenues or the continued dominance of the global political economy by an elitist politically supported financial sector, and the concomitant risk inherent in speculative financial markets.

This chapter argues for an accountability of financial markets, specifically for accountability of finance capital, the market dynamic that involves speculative trades. To enable markets to operate without their inherent instability requires of policymakers a degree of separation from vested market interests. Whilst this may not be possible, it is important to identify the risks in the market in terms of global finance and to examine evidence of macro issues that create the possibilities for change.

The following chapter looks at these risks and possibilities for the introduction of an FTT.

## **Chapter 6**

### **Financial Transaction Taxes: Risks and Possibilities**

#### **6.1 Introduction**

Chapter 5 posited the case for a financial transaction tax and examined the current modelling by leading proponents. Whilst the case is clear in terms of the socially progressive nature of a financial transaction tax (FTT), it is not clear how the entrenched obstacles in its path could be removed. Political deficits across most advanced developed countries provide considerable obstacles to the rationale for logical debate. In Australia, a country with a defined two-speed economy<sup>337</sup>, Treasurer Wayne Swan has emerged as a leading protagonist on the FTTs. Openly opposed to debate on FTTs, Swan is now at odds with a growing and enthusiastic chorus of support for either introduction of FTTs or debate on the merits of such a proposal across Europe. Australia's Treasurer led the FTT opposition lobby heading in to the critical decisions at the G20 conference in November 2011. Chapter 6 draws evidence of a deteriorating global macroeconomic climate and places the FTT as the central policy lever to ameliorate the detrimental effects of dysfunctional global financial markets.

Whilst an FTT would enable a stream of funds to participating nation states (territorial transaction hubs), there is little or no support other than tacit platitudes from leaders of the United States and the United Kingdom, the two largest financial trading centres. Despite the growing public anger and populist rise (Occupy Wall Street), President Obama appears unable or unwilling to counter the revolving door of lobbyist pressure from financial interests. With an election looming and an opponent in Mitt Romney with high-level finance interests Obama is sensitive to adverse publicity, which would offend finance interests. The President depends on campaign funds from the business sector.

Global financial markets have been built over three decades through the support of left and right, centre-left, and conservative leaders including George Bush Senior and George W Bush (United States), John Howard (Australia) and Margaret Thatcher and Tony Blair (United Kingdom), all of whom adhered to the era of "Washington Consensus "style free markets" (neoliberalist), concomitant vast amounts of cheap credit (consumer debt) to their populace, and a concentration of enormous asset wealth that has been generated by free market regimes.

The accumulation of wealth within concentrated asset class elites is a feature of capital modernity – an elite finance capital grouping located disproportionately above a widening

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<sup>337</sup> See previous references to real and shadow economies.

social morass of disadvantaged, unemployed, homeless and increasingly angry middle class of citizens, across most developed nation states. Globally, the actions of elite financial market players are displacing millions of people through a concomitant contraction of employment, housing, education, and opportunities. Ironically, early signs of “de-globalisation,” because of the sovereign debt crises have caused a contraction in global commercial banks with widespread retrenchments. Commercial banks are closing overseas interests<sup>338</sup>.

This decade could be the downside to three decades of capital expansion. Free markets have distinct winners and losers, and this decade (2012-2022) is likely to introduce further significant social change. Within nation states in Europe, there has been immense change in the local economies of Spain, Italy, Ireland and Greece. High-level unemployment is a feature of developed states in transition from growth to decline. There are macro-economic forces at play including the economic power transition from the West to emerging Eastern economies. Unprecedented unemployment levels are resultant of the socialisation of debt, in turn leading states to cut services. This is the result of financial instability of global nature. Satyajit Das<sup>339</sup> argues that:

French philosopher Michel Foucault identified a *carceral continuum*, the system of cruelty, power, supervision, surveillance, and enforcement of acceptable behaviour affecting workers and their domestic lives. Banking has its equivalent.

Sociologist Zygmunt Bauman’s metaphor of *liquid* and *solid* modernity captures the shift from a society of producers to a society of consumers. Security gives way to increased freedom to purchase, to consume and to enjoy life. In *liquid modernity*, individuals have to be flexible and adaptable, pursuing available opportunities, and calculating likely gains and losses from actions under endemic uncertainty. It is a metaphor for the rise of financiers and the financialisation of everyday life in a volatile world where risk taking and speculation is an essential survival strategy.

Capital markets have been accountable only to a relatively small number of high-net-worth individuals in a distinct concentration of wealth and geo-political power structures. A financial transaction tax will present only a small impost to these elite market players. It will

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<sup>338</sup> “Global banks pulling back from overseas interests”. *China.org.cn*. 25 May 2012. ([http://www.china.org.cn/opinion/20102-05/25/content\\_25471992.htm](http://www.china.org.cn/opinion/20102-05/25/content_25471992.htm))

<sup>339</sup> Zygmunt Bauman. For Sociologist consumption was an ‘appeal to forever-elusive happiness’. Bauman’s phrase liquid-modernity described the process in which individuals reinvented themselves through consumption. In Chapter Twenty. *Masters of the Universe-Smiling and Killing, Extreme Money: Masters of the Universe and the Cult of Risk*. Satyajit Das. Penguin Group. Australia 2011.

have the benefit of considerable positive fiscal revenue streams for participating states that already have a tacit economic relationship with capital players particularly in respect to offshore structures and entities, which provide low tax and no tax bases.

Chapter 6 provides an argument to press for major social, political and economic reform before financial markets cause a meltdown with indescribable outcomes for millions of global citizens. Chapter 6 emphasises the implementation of an FTT against a background of deteriorating social and economic circumstances engulfing most developed global nation states. This chapter builds on the previous argument (Chapter 5) which demonstrated that models are available for immediate implementation.

Many leaders are behind the growing FTT movement. Ironically, only the leaders of two leading host nations, the United States and the United Kingdom, have prevented high-level debate at global forums. The political leverage of newly elected French President Hollande substantially strengthens the arguments for FTTs. This chapter provides a template for potential changes in support of an FTT to ameliorate the harmful nature of speculative finance capital.

## **6.2 *Black Ice Economics***

The era of globalisation has introduced a heavily biased tax system adjusted to favour the already well placed. In Australia over AU\$20 billion in revenue<sup>340</sup> is secreted to tax shelters every year<sup>341</sup>, and lost to the broader economy. Treasurer Swan, President Obama, and United Kingdom Prime Minister Cameron each recognise the threat to democracy of market instability and continuing social unrest but refuse to unshackle their thinking from neoliberal market pressure. By contrast, leading hedge fund player George Soros argues “financial markets are driving the world towards another Great Depression with incalculable political consequences. The authorities, particularly in Europe, have lost control of the situation. They need to regain control and they need to do it now”<sup>342</sup>.

There is no reason, particularly in these dire times of “The Great Correction”<sup>343</sup>, to treat one section of society, with vested structures of tax minimisation, over that of other citizens in societies. Continuing unrest and civil society disease over uneven political economy

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<sup>340</sup> Note that this amount does not include creative superannuation strategies that use offshore tax havens.

<sup>341</sup> “Tax system needs a dose of equality” *The Australian Financial Review*, 28 September 2011.

<sup>342</sup> “Hedge Fund Maestro: How to Stop a Second Great Depression”. *Hedge Fund News* 4 October 2011. (<http://www.hedgco.net/news/10/2011/hedge-fund-maestro-how-to-stop-a-second-great-depression>).

<sup>343</sup> The term The Great Correction is noted as referring to the period of defaults, massive debt, and unemployment, following the global financial crisis and financial deleveraging.

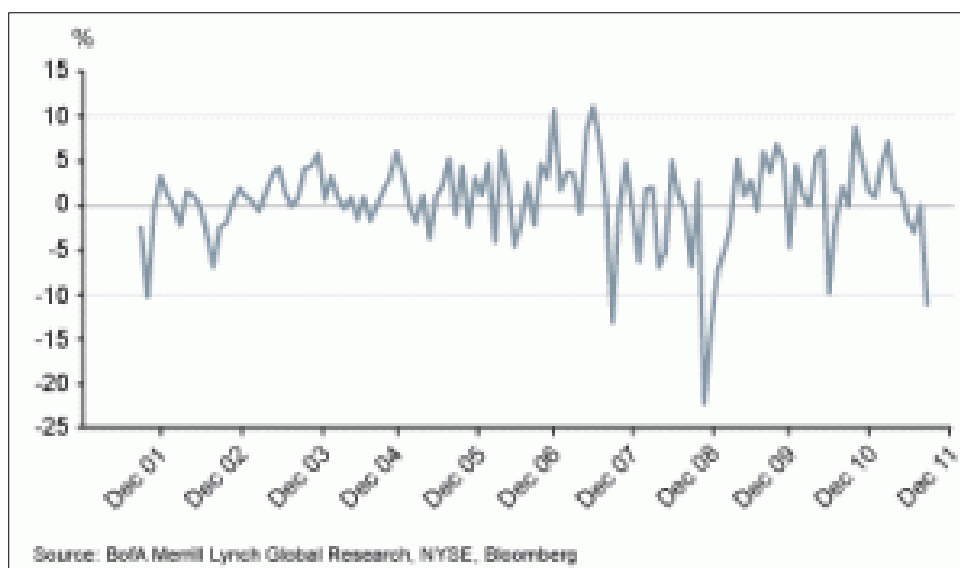
imbalances will eventually come to haunt the political and economic elite. Finding a solution that benefits many without major disruption to the finance capital elite is sensible and achievable politics. It requires a resolve to create mechanisms that more equitably distribute revenues. An FTT is designed for this space.

Whilst international financial markets deleverage in spectacular fashion during the market turmoils of 2008–2012, there is a clear indication that politicians, and government leaders are becoming nervous of the encroaching scenarios delivered by socioeconomic events in Europe. Spectacular rises and falls in speculative global trades in 2011–2012, have affected investment firms, many of which cover the retirement and superannuation investment of Middle Europe, Middle America, and Middle Australia. AUS\$100 billion was wiped off Australian shares in one month and AUS\$8000 of household assets in Australia<sup>344</sup>.

An example is hedge fund leverage, as measured by margin debt on the New York Stock Exchange, which declined in August 2011 by the most in a single month since the market meltdowns of November 2008, as managers cut their exposure to the markets amidst a backdrop of global market sell-offs and risk aversion, according to Bank of America Merrill Lynch's weekly hedge fund trade monitor (see Figure 6.1). Sovereign debt circumstances have caused widespread drops in Australian markets in May 2012. Fears of bank-runs in Europe are causing distinct financial market instability.

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<sup>344</sup> Sarah Michael "Market carnage wipes \$8000 off household assets." *News.com.au* 4 June 2012.



**Figure 6.1: New York Stock Exchange Margin Debt, September 2000 to August 2011.** <sup>345</sup>

Higher margin debt levels are regarded as a sign of increased speculative trading, as those trading on margins take on a risk by exposing themselves to margin calls during a sharp decline in stock prices. This requires traders to put up additional collateral to avoid their brokers selling their securities to cover the debt. Hedge funds entered August 2011 with their highest exposure to equities since 2007, according to figures from the Bank of America released earlier this month.

A proposal for the global introduction of an FTT had strong lobbying support and credibility although the *Economist* warned that the likelihood of a global FTT would be difficult to introduce given uncompromising opposition by US Treasury Secretary Timothy Geitner<sup>346</sup>. By contrast, the possibility of introducing a local FTT across the 27 Euro countries appears to be possible after Germany and France consolidated support for a tax to be imposed by the European Union alone. By June 2012, Germany has issued the most positive signs of a stand-alone FTT. The European Commission supports the idea. Michel Barnier<sup>347</sup>, the Commissioner for a Single Market, said his proposals would be “technically simple, economically bearable by the financial sector, financially productive and politically just”.

Many FTT supporters say the way to make the transaction tax workable and cost-effective is to incentivise the reporting of transactions and the payment of tax. The way to do this is to

<sup>345</sup> “Chart of the day: Hedge funds cut leverage” *Dow Jones News* 27 Sep 2011

<sup>346</sup> “Financial transaction tax in the Euro area: Shooting the bankers or themselves”. *The Economist*. 17 September 2011.

<sup>347</sup> “Shooting the Bankers, or Themselves.” *The Economist* 17 September 2011

legislate that transactions themselves will only be legally enforceable if there is a record that the FTT had been paid. Capital players might choose not to pay the tax, but if they want to enforce a trade, or debt obligation, they are on their own. If they want recourse to the courts, rights to exercise on margin/collateral or a valid claim in insolvency, then they pay the tax as their ticket to rely on the legal system. Finance capital players thus rely on state-based legal systems in the same way as citizens, and businesses, of the state. They lose their elitism.

Positive efficiencies demonstrated by FTTs provide an integrated equalising of resource distribution across societies as definitive social economic and political determinates. Many political economists and economic strategists argue that the era of neoliberalism has had profound and distinct influences on modern developed economies. Ulrich Beck<sup>348</sup> argues:

What is blocking Europe? The neoliberal self-delusion: the assumption that the economic integration of Europe is sufficient. Not only is more extensive social and political integration superfluous, according to this conception; it is even harmful. Europe should be nothing more than a huge supermarket—though a supermarket with a halo. European neoliberalism ultimately claims to be the better socialism, because overcoming national and global poverty and creating a more just world is possible only by means of free markets. That we are dealing here with a self-delusion of the European elites is shown by two contemporary developments. The first of these is neo-liberalization, and the second is neo-nationalization. The interdependence of these two is mostly ignored by these elites. A process of modernization has been unleashed under the banner of “market integration,” obliterating borders and principles and challenging the national foundations of parliamentary democracy, the welfare state, and the class compromise. The result is widespread fear.

Beck and a growing number of social commentators now openly question the free market philosophies that have created vast undercurrents of distrust in market philosophies that affect global citizens. Continuous use of taxpayers’ money to bail out ailing financial entities would seem reason enough to warrant an FTT to replenish a rapidly deteriorating national account. Beck’s assertion of a challenge to democracy in Europe alone is being drawn by the growing distrust of political leaders and institutions have recently been illustrated in articles<sup>349</sup> in the

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<sup>348</sup> Ulrich Beck. Professor of Sociology at Munich’s Ludwig Maximilian University and the London School of Economics. “This economic crisis cries out to be transformed into the founding of a new Europe” 13 April 2009, and “Understanding the Real Europe” *Dissent* 50 No 3 Summer 2003.

<sup>349</sup> Paul Kelly. “Australian excitement over US overlooks its gridlock on finance and politics.” *The Weekend Australian Inquirer Section*. July 21-22 2012.

press in the United Kingdom and Australia. Both alert to elements of democratic decline and the changing nature of political relevance to constituents<sup>350</sup>.

Three distinct strategic circumstances provide a scenario to the most dangerous global economic conditions in recent times. The political economies of developed nation states have reached crisis point and there may be no going back in what could be described as black ice economic events across continents.

The first strategic circumstance is an authority and economic contest between Western developed nation states and the emerging dynamic Eastern economies of Japan, South Korea, China, India, and Russia. Emerging South American economies are also located in the latter grouping of nation states playing a more dominant role in the global affairs of global political economy. The contest pits philosophical, social and economic forces at high levels.

China's savings, manufacturing and industrial production is diametrically opposed to the United States' model of essentially a consumer of manufactured goods and structured credit with successive United States governments acceding to the hollowing out of industrial and manufacturing heartlands in the United States whilst off-shoring jobs and technology to China and other Eastern hubs. Whilst this dynamic is hardly new, or unnoticed, it is becoming a critical issue in the United States' desperate attempt to re-employ, re-stimulate a stalled economy, and provide a semblance of growth amongst a background of national unsustainable debt.

Peter Coy wrote in *Bloomberg Businessweek*<sup>351</sup> "An honest assessment of the country's projected revenue and expenses over the next generation would show a reality different from the apocalyptic visions conjured up by both Democrats and Republicans during the (recent August 2011) debt ceiling debate, *it would be much worse*". On this theme, David Rosenberg<sup>352</sup> argues that "this is a country (US) with a US\$15 trillion national income stream, a US\$50 trillion capital stock and US\$80 trillion net worth in its household and business sector. The ability is there (to pay our debts) including the off-balance sheet liabilities. This is not some banana republic; it is not Greece, Argentina or Mexico".

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<sup>350</sup> Juliette Jowit "British democracy in terminal decline, warns report: Corporate power, unrepresentative politicians and apathetic voters leave UK "increasingly unstable" says study" *The Guardian*. 6 July 2012. (<http://www.guardian.co.uk/uk/2012/jul/06/british-democracy-decline-report/print> )

<sup>351</sup> Peter Coy "It Gets Worse" *Bloomberg Businessweek* 1 August 2011. P6 quoted in *The Credit Strategist* Volume 11, No 8 ([www.thecreditstrategist.com](http://www.thecreditstrategist.com))

<sup>352</sup> David Rosenberg. *The Credit Strategist*. 1 August 2011.

However, Rosenberg goes on to point out the heart of the problem as “a political deficit right now that is blowing the fiscal issue out of proportion”.

Many argue that there is a profound political deficit, apparent not only in the United States, but in Europe, and Australia. Following the defeat of French President Sarkozy by Francois Hollande there has been a growing list of politicians in Europe <sup>353</sup>who are at risk of losing office because of rising public anger over austerity measures and economic crisis<sup>354</sup>.

The recent Australian Tax Summit (4–5 October 2011) revealed high-level negativity to any change of macro prudential issues (including a complete rejection of FTT proposals). The power of financial markets, and their political sponsors, appears to have a tight grip on economic and social conditions in Australia and global developed nation states. Political leaders have failed abysmally to protect civil society against the known detrimental effects of unregulated financial markets. Financial market players, in contrast, have become stronger. Derivatives<sup>355</sup> markets continue to grow at significant pace.

The second strategic consequence emerges from the current global sovereign–debt crises (being experienced across Europe, and the United States) is the recent transfer of debt from private banking and finance entities to nation states’ public account, and how that debt transfer has radically altered the ability of nation states to provide an immediate and sustainable public goods and services supply. High levels of debt have cause for concern for most developed nation states (see Table 6.1 below).

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<sup>353</sup> “Continental Shift: Following the defeat by Socialist candidate Francois Hollande in the French election run-off, Nicolas Sarkozy joins a growing list of European leaders booted from office because of public anger over austerity measures and economic crisis” *The Mercury Newspaper* 10 May 2012. ([www.themercury.com.au](http://www.themercury.com.au))

<sup>354</sup> “Continental Shift.” *The World*. Thursday 10 May 2012.

<sup>355</sup> “Table 19 Amounts Outstanding of over-the-counter (OTC) derivatives: by risk category and Instrument. (June 2011) US\$707 trillion. *Bank for International Settlements Quarterly Review*. December 2011.

**Table 6.1: Global Financial Stability Report – Indebtedness and Leverage in Selected Advanced Economies<sup>356</sup>.**

	United States	Japan	United Kingdom	Canada	Euro area	Belgium	France	Germany	Greece	Ireland	Italy	Portugal	Spain
Government gross debt, 2011 <sup>2</sup>	100	229	83	84	87	97	88	80	152	114	120	91	64
Government net debt, 2011 <sup>2,3</sup>	72	128	75	35	67	82	78	55	n.a.	95	101	86	53
Primary balance, 2011 <sup>2</sup>	-9.0	-8.6	-5.5	-4.1	-1.7	-0.5	-3.5	-0.3	-0.9	-7.5	0.2	-1.6	-4.6
Households' gross debt <sup>4</sup>	91	74	107	93	72	55	69	62	68	129	50	103	90
Households' net debt <sup>4,5</sup>	-230	-231	-184	n.a.	-129	-204	-131	-130	-56	-60	-178	-126	-74
Nonfinancial corporates' gross debt <sup>4</sup>	76	138	128	n.a.	142	161	157	69	71	278	119	154	205
Nonfinancial corporates' debt over equity (percent)	105	176	89	72	106	43	76	105	218	113	135	145	152
Financial institutions' gross debt <sup>4</sup>	97	188	735	n.a.	148	139	148	95	21	664	99	65	113
Bank leverage <sup>6</sup>	13	23	24	18	26	30	26	32	17	18	20	17	19
Bank claims on public sector <sup>4</sup>	8	76	7	20	n.a.	22	19	25	27	28	32	16	22
Total economy gross external liabilities <sup>4,7</sup>	144	64	696	91	174	417	254	181	194	1,598	153	293	215
Total economy net external liabilities <sup>4,7</sup>	19	-52	14	7	13	-43	11	-39	99	102	20	106	90
Government debt held abroad <sup>8</sup>	32	7	27	20	29	68	64	53	61	59	47	57	50

Sources: Bank for International Settlements (BIS); Bloomberg, L.P.; EU Consolidated Banking Data; U.S. Federal Deposit Insurance Corporation; Haver Analytics; IMF, International Financial Statistics, Monetary and Financial Statistics, and World Economic Outlook databases; BIS-IMF-OECD-World Bank Joint External Debt Hub; and IMF staff estimates.

<sup>1</sup> Cells shaded in red indicate a value in the top 25 percent of a pooled sample of all countries shown in table from 1990 through 2009 (or longest sample available). Green shading indicates values in the bottom 50 percent, yellow in the 50th to 75th percentile. The sample for bank leverage data starts in 2008 only.

<sup>2</sup>World Economic Outlook projections for 2011.

<sup>3</sup>Net general government debt is calculated as gross debt minus financial assets corresponding to debt instruments.

<sup>4</sup>Most recent data divided by 2010 GDP.

<sup>5</sup>Household net debt is calculated using financial assets and liabilities from a country's flow of funds.

<sup>6</sup>Leverage is defined as tangible assets to tangible common equity for domestic banks.

<sup>7</sup>Calculated from assets and liabilities reported in a country's international investment position.

<sup>8</sup>Most recent data for externally held general government debt (from Joint External Debt Hub) divided by 2010 gross general government debt.

<sup>356</sup> IMF Global Financial Stability Report, April 2011. *Indebtedness and Leverage in Advanced Economies*. (Table shows per cent of 2010 GDP, unless otherwise noted.)

National corporate rescue packages in the United States (QE1 and QE2), Australia (Nation Building Economic Stimulus Package), and similar in the United Kingdom and Europe, have been government responses enabled with public funds. The consequential ability to provide public goods and services is diminished accordingly. In the United States taxpayers effectively funded struggling banks located across the globe with national based taxpayer funds; funds that would be most appropriate at this time to fund desperately needed services and programs for an ailing civil society. These sovereign debt crises are not limited to any nation state. They are recognisable in most developed nation states. A simple economic equation posits diminishing public accounts to a drawback in services available to civil society.

Meanwhile, economic instability and fiscal dysfunction within the European and United States economies is worsening. In June 2011, the United States' Federal Reserve released statistical data quantifying the credit market debt liability outstanding in all sectors of credit market instruments as US\$52.6 trillion. Standard and Poors estimates that the total amount of re-financing and new money requirements (Credit Overhang) for incremental financing and corporate debt restructuring over the next five years (2012 to 2016) at between US\$43 and US\$46 trillion., saying these factors plus the Eurozone crisis, a silt US economy and slowing Chinese growth “raise the downside risk of a perfect storm for credit markets<sup>357</sup>”.

Global market international credit default swaps (CDS) outstanding positions are currently US\$707 trillion (see footnote 300 above) A third of all European debt is speculative capital market instruments (collateral debt obligations and CDS), most originating from the United States. Thus, the risk of European default contagion or the default of any of the European countries could see a call on United States (CDS) issuers of proportions hitherto unseen.

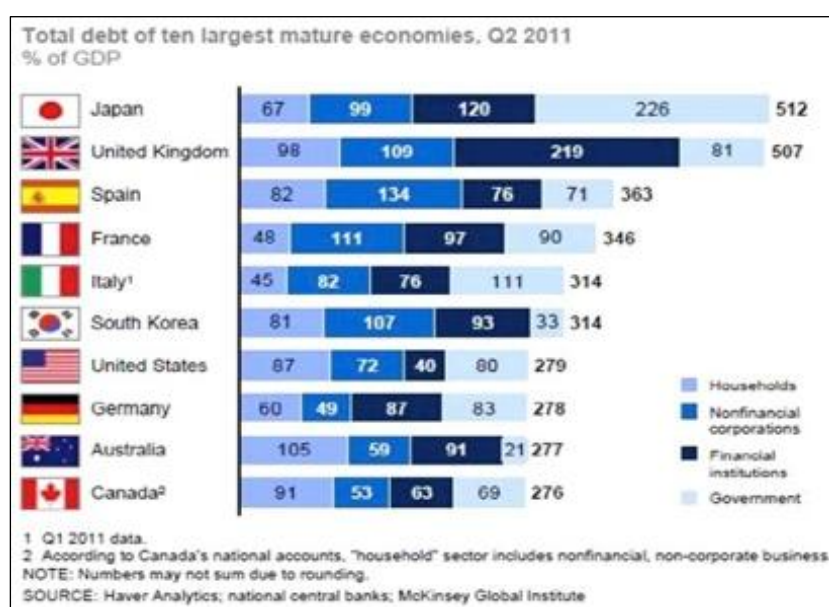
The potential for a major economic and social collapse is real. Financial market inability to fund defaults could trigger the next phase of the continuing global financial crisis. At an international level, the stakes are high. To emphasise this point (about market exposure to speculative financial instruments at play in Europe), the scenario of default is dire. If Greece were to default, approximately 94 per cent of the direct losses would fall on European creditors. United States banks and insurance companies have high-level exposure covering debt in Europe through issuance of credit default swaps.

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<sup>357</sup>“The Credit Overhang: Is a \$46 Trillion Perfect Storm Brewing” *Standard and Poors Market Analysis*. 9 May 2012.

United States banks would have to make 56 per cent of all default insurance payouts for a Greek default and 28 per cent and 44 per cent in the case of defaults in Ireland and Portugal respectively<sup>358</sup>. These figures demonstrate the eagerness of United States banks and finance entities to sell default insurance (CDS) and increase the international exposures and risks undertaken by financial institutions.

At a national level, the stakes are even higher in both social and political economy terms as developed nation states wrestle with the intractable problems of public debt, fiscal policy settings within depleted reserve scenarios, and the growing inability to provide services to citizens. Debt structures in the UK, Germany, and Italy are dire (see Figure 6.2 below).



**Figure 6.2: McKinsey Global Institute<sup>359</sup> – Composition of Mature Economy Debt.**

The transfer of private debt to nation states' public accounts is a monumental political policy disaster made worse by the fact that it has benefitted private firms, corporations, and capital elites that should never have been considered as worthy recipients of rescue packages. The crisis in service provision is likely to impact severely on those most vulnerable members of civil society who played no role in the global dysfunction, which is concentrated in the upper echelons of high finance. The problem is exacerbated by the rapid growth and political influence of elites.

<sup>358</sup> Bank for International Settlements Statistical Annex June 2011

<sup>359</sup> Debt and Deleveraging: Uneven Progress on the Path to Growth  
([www.mckinsey.com/mckinsey/debt%20and%20deleveraging](http://www.mckinsey.com/mckinsey/debt%20and%20deleveraging) )

Thus, “two-speed economies” (shadow finance systems as opposed to real local economies) are evident across most developed nation states. The “shadow” banking sector is back to its pre Lehman Brothers glory years with daily speculative trades of over US\$3 trillion in currency markets bets alone. Dangers also lay in the nature and concentration of high-level derivatives markets. A mere five entities account for more than 95 per cent of American financial firms’ derivatives holdings<sup>360</sup>. Of these, Morgan Stanley has the least cause for worry, since its swaps already sit in a non-bank subsidiary (see Figure 6.3 below). For the others, moving the business would be costly, because bank-holding companies generally have a higher cost of funding than bank subsidiaries. Estimates of the extra capital required vary from \$20 billion to several times that. A recent article in Australia brought to light some astounding figures in respect to debt funding:

The big concern if this were to prove a wider liquidity problem is the limited firepower available to monetary and fiscal authorities today compared with the onset of the last crisis. Ratings agencies Standard and Poor’s made that point this week when considering the looming funding challenge facing the non-financial corporate debt market<sup>361</sup>. It estimated that the total refinancing and new money needs of the US, Europe, China and Japan over the next five years at US\$43 to US\$46 trillion. Not surprisingly S&P worries with all the problems facing Europe, the slow pace of the US recovery and a potential winding back of Chinese growth that there is a downside risk of a perfect storm for credit markets. The bigger danger now is that governments and central banks have less fiscal and monetary flexibility to prevent serious problems emanating from future market disturbances.” The European corporate bond market looks likely to face the biggest strains given the extent of deleveraging expected among banks. S&P estimates up to 50 per cent of new funding may need to come by way of bond issuance against just 15 per cent normally<sup>362</sup>.

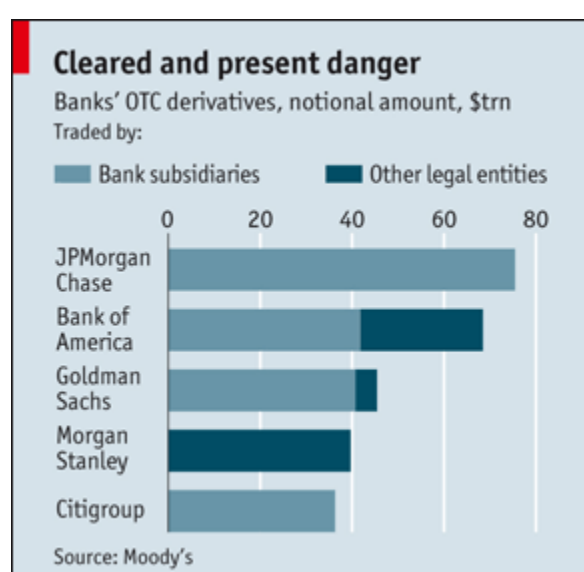
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<sup>360</sup>“A Pox on Your Swaps: Financial Regulation in America”. *The Economist*. 29 April 2010.

<sup>361</sup> Non-bank financial companies (NBFCs) are financial institutions that provide banking services without meeting the legal definition of a bank, i.e. one that does not hold a banking license. These institutions are not allowed to take deposits from the public. Nonetheless, all operations of these institutions are still exercised under bank regulation<sup>4</sup>. However this depends on the jurisdiction, as in some jurisdictions. Any company can do the business of banking, and there are no banking licenses issued. NBFCs offer most sorts of banking services, such as loans and credit facilities, private education funding, retirement planning, trading in money markets, underwriting stocks and shares, TFCs and other obligations. These institutions also provide wealth management such as managing portfolios of stocks and shares, discounting services e.g. discounting of instruments and advice on merger and acquisition activities. The number of non-banking financial companies has expanded greatly in the last several years as venture capital companies, retail and industrial companies have entered the lending business. Non-bank institutions also frequently support investments in property and prepare feasibility, market or industry studies for companies.

<sup>362</sup> Greg Mumford “JP Morgan \$2bn loss is Dimon own goal”. *The Weekend Australian Financial Review*. 12-13 May 2012.

Standard and Poor's is stating through research the issues that have been argued consistently through this thesis. That is, nation states have substantially reduced capacity to effectively deal with emerging social or economic difficulties because of the depletion of their public accounts. Because public accounts have been used to bail out the corporate sector. Only over the coming decade will the ramifications of this draw-down on public accounts be played out. The problem only gets worse as derivatives and speculative capital markets are given free rein to trade at truly massive levels. The following Figure (Figure 6:3) demonstrates the level of Over the Counter (OTC) derivatives traded by the top five banks in the United States. (JP Morgan has positions of nearly US\$80 trillion).



**Figure 6.3<sup>363</sup>: Moody's – Banks OTC Derivatives Notional Amounts.**

Information technology is becoming highly advanced to match and enable high-speed trades. A recent announcement by a leading global hedge fund service indicated that globally hedge funds were estimated to spend US\$2 billion on technology to enable trades in 2011<sup>364</sup>. This news was balanced by a further bulletin from the industry, which focused on high levels of instability in the industry similar to that, which is causing great concern to investors in stock markets globally. The world's largest listed fund manager Man Group PLC provided fear of

<sup>363</sup>“Banks OTC Derivatives Notional Amounts.” *Systemic Risk and Tri-Party Repo Clearing Banks*. 2010. (www.moody's.com/microsites/crc2011/papers/BruceTuckman)

<sup>364</sup>“Hedge Funds Spend \$2 Billion on IT.” *HedgeCo.Net Survey*:29 September 2011

another industry meltdown when it revealed a net US\$2.6 billion was redeemed between June 30 and July 26 triggering a sale of the company's shares, which dropped 25 per cent<sup>365</sup>.

Derivatives dealing has become one of the most profitable activities for Wall Street's giants. The business is thought to have generated revenue of around \$22.6 billion in 2009. JP Morgan Chase has said that fully one-third of its investment-banking profits came from OTC derivatives in 2006–2008.

Mark Mobius<sup>366</sup> who manages Templeton Asset Management's emerging markets group suggested, "There is definitely going to be another financial crisis around the corner because we haven't solved any of the things that caused the previous crisis." Mobius argues that the global derivatives market is where a new crisis is brewing. The notional value of the over-the-counter (OTC) global derivatives market is more than \$700 trillion, according to the International Swaps and Derivatives Association (ISDA). That is more than 10 times global GDP of \$50 trillion.<sup>367</sup> Evidence from successive quantitative easing programs (QE1 and QE2) indicate that the shadow economy has been enriched by direct access to new funds, whilst the majority of citizens, in the broader real economy, have been unaffected and remain in the same dire circumstances (post 2008), as the economy oscillates under the extremes of turbulent market pressure.

With stock markets in turmoil around the world, there have been unprecedented falls and corresponding high points in corporate profits over the past 12 months. Shilling<sup>368</sup> argues that the leaps in stocks and commodities were reversed in the last quarter of 2010, reporting that markets were entering a downward cycle that may be self-perpetuating. (Figure 6.4 below)

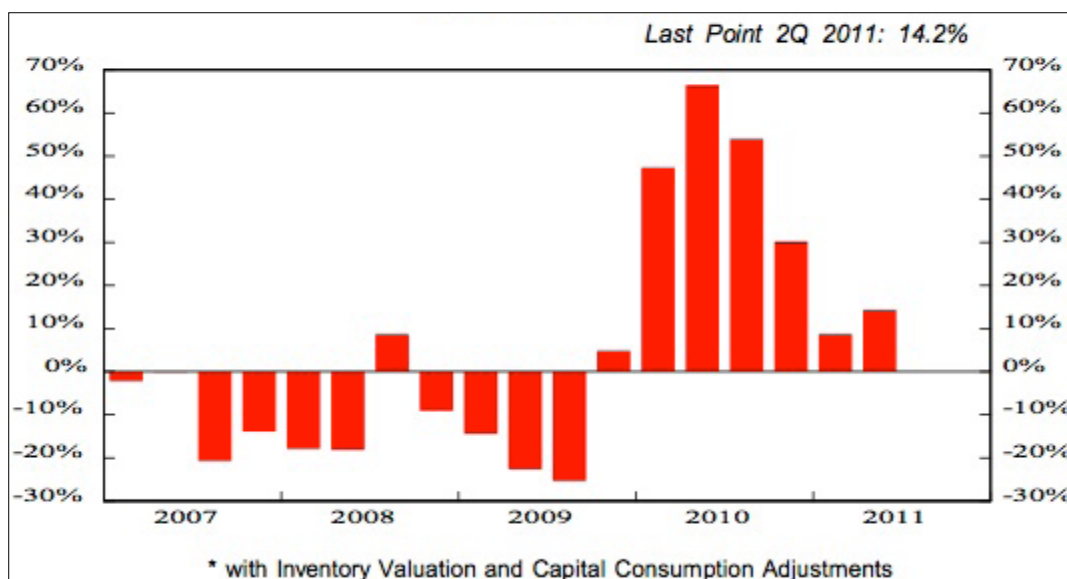
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<sup>365</sup> "Hedge Funds face new round of redemptions" *Market Watch*. (<http://www.marketwatch.com/story/hedge-funds-face-new-round-of-redemptions-2011> )

<sup>366</sup> "Mobius Says another Financial Crisis around the Corner." *Bloomberg News*. 30 May 2011. Reported at a speech to the Foreign Correspondents' Club in Japan.

<sup>367</sup> It is not always easy to understand how something like a derivative, which is a kind of financial abstraction, can destroy real asset values. Derivatives are financial instruments whose value is linked to some other asset. The biggest derivatives markets, by size, are in interest rates, bonds, and currencies. The ISDA reckons that 77% of OTC derivatives are interest rate derivatives.

<sup>368</sup> Garry Shilling. *Absolute Zero* 26 September 2011



**Figure 6.4<sup>369</sup>: Bureau of Economic Analysis – Pre-Tax Corporate Profits.**

Domestic economies are squeezed of funds in the “real” economies. Real economies are now substantially weakened through socialisation of debt from public funds to the opaque shadow systems. Players in the shadow systems are deriving huge profits in a greedy display of profit levels never before seen in the Western world. Hedge fund managers in the United States for example often take home a billion dollars in yearly pay, whilst services for the poor and underprivileged are continually rolled back. The top 10 hedge fund managers are rewarded with more than half a billion a year, some even more. This divide is unsustainable and will have an end point.

The third and perhaps the most important strategic circumstance are located with the political challenge to leaders in the developed nations to influence balanced long-term fiscal strategies. Leaders fail to acknowledge the disruptive and divisive layers of social disorientations being wrought on nation states and their citizens by secretive and dysfunctional international capital market elites, their representatives (lobbyists), and the growing conservative social orientation of wealth and power, emanating directly from the socialisation of debt. This socialisation of debt has been overseen by conservative politicians during the post terrorist 9/11 disasters in the United States in 2001.

Political lobbyists representing economic elites have a disproportionate influence on the governance of fiscal policy in the United States and Europe, including the United Kingdom

<sup>369</sup> Dylan G. Rassier. “The Role of Profits and Income in the Statistical Discrepancy.” *Bureau of Economic Analysis*. February 2012. ([www.bea.gov/scb/pdf/2012/](http://www.bea.gov/scb/pdf/2012/))

where the alliance of political and corporate favour was recently clearly demonstrated by Prime Minister David Cameron's close personal relationship with Rupert Murdoch and his operatives. The vast divide between politicians and electorate base is identified by Younge<sup>370</sup> who argues that in Britain:

Class privilege, and the power it confers, is often conveniently misunderstood by its beneficiaries as the product of their own genius rather than generations of advantage, stoutly defended and faithfully bequeathed. Evidence of such advantages is not freely available. It is not in the powerful's interest for the rest of us to know how their interest is attained or exercised. But every now and then a dam bursts and the facts coming forth. Such is the incestuous nature of the British ruling class and the gene puddle from which it draws its stock. Such is their brazen venality, complicity, contempt and mendacity. Eton, Oxford, Bullington, Westminster, – if you're looking for a tiny minority who are struggling to integrate, look no further than the Cabinet. Two things make this a matter of import as well as intrigue. The first is the lie it gives to the insistence on meritocracy at a time of acute economic crisis when benefits are slashed, the poor hammered. Cameron and his cabinet insist that the poor pull themselves up by the bootstraps, even as they, themselves, swan around in their parents expensive pairs of loafers. Today 40 per cent of MP's went to private schools (in 1997 it was 30 per cent. In terms of social mobility we are going backwards.

Downing Street and Fleet Street collude in much the same way as the revolving door between elite money market players and politicians operate between Wall Street and Washington. The United States will require immediate and strong solutions to avoid rapid deterioration similar to the fate of European countries that have permitted the power of economic and political elites to dominate policy, and economic direction and sovereignty. This last point (loss of sovereignty) is an emerging critical issue as economic paralysis threatens the entire European banking system. The central issue and one which appears to be the main driver for the willingness of European countries to at least investigate the merit of FTTs are both economic and sovereign.

Unveiling the European Union's proposal for a financial transaction tax in his State of the Union address, Jose Manuel Barroso, the European Commission President said the tax would provide approximately US\$75 billion a year to steady the depleted union coffers. "It is a

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<sup>370</sup> Gary Younge, "A web of privilege surrounds meritocrats: the social ties that bind our political, legal and corporate forces finally lie exposed on both sides of the Atlantic," *The Guardian Weekly* 11 May 2012.

question of fairness,” he said, arguing that the public sector (taxpayers) had contributed more than US\$6 trillion in guarantees to the banking sector<sup>371</sup>.

In Australia, the amount expected from the introduction of a global FTT would net approximately AU\$8 billion and would ameliorate the use of AU\$20 billion of taxpayers’ funds to stimulate the economy post 2008. If a 0.05 per cent FTT had been collected on Australian OTC (over-the-counter) and exchange traded financial market transactions between 2005 and 2008–09, an expected revenue return would have been AU\$48 billion<sup>372</sup>.

Another critical issue in Europe is related to the sovereign risk of accepting other countries’ (Greece, Spain, Ireland, Iceland, Italy, perhaps France, and Portugal’s) internal debt structures, which will have to be absorbed by the European Union. Germany and the United Kingdom as leading financial market players would have a considerable amount to gain from a financial transaction tax, although as most countries in the European Union are investigating the FTT, the United Kingdom’s Prime Minister David Cameron has indicated he would only be supportive if the FTT is global in implementation status; this is something that appears unlikely given the depth of lobbyist sector opposition in the United Kingdom. Reports that the European Parliament was planning to introduce the FTT as a value added tax (VAT) could circumvent the United Kingdom’s right to veto<sup>373</sup>.

The position of the United States appears weakened by the intransience of the Obama Administration to distance its policy settings from the intense influence of lobbyists in Wall Street, and in Washington. Politicians and lobbyists (8,500 in Washington) seem increasingly focused on their close elite clients who continue their concentration of wealth regimes, to the detriment of the nation. Open collusion between policymakers and capital playmakers in financial markets is obvious and rarely questioned. All this spells continuing troubled times ahead for Western developed economies, which have depleted political and economic mechanisms to provide basic services.

A review of donations to the conservative political parties in Europe and the United States clearly defines why politicians remain fearful of questioning the power, influence and relevance of high-level financial market elites. The relationships are enshrined in the legal

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<sup>371</sup> Joshua Chaffin in Strasbourg, Stanley Pignal in Brussels, and Jeremy Grant in London. “Business attacks transaction tax plan” *The Financial Times*. 28 September 2011.

<sup>372</sup> Professor Ross Buckley Figures from 2011 Australian Tax Forum article. *University of New South Wales*. January 2011.

<sup>373</sup> “MEPS plot to impose financial transaction tax on UK” *The Telegraph*. 4 October 2011. (<http://www.telegraph.co.uk/finance/personalfinance/consumertips/tax/8804932/MEPs>)

nature and status of tax havens. In Australia the *Henry Report: Australia's Future Tax System* suggested that at least AU\$20 billion in tax revenue was lost to the national account each year by Australian citizens holding capital and avoiding tax by using tax shelters<sup>374</sup>. The Australian tax system was said to “poorly target tax shelters”, a point that did not seem to make the agenda at the recent Australian Tax Forum.

Three strategic circumstances or contests have dominated the global political economy with varying social consequences over three decades. Two contests have been won. The first contest has been won by the new breed of capital elites, their dominance of the political economies of western (developed) societies with consequential diminished governance over speculative financial market players, and their interests (which caused the Global Financial Crisis).

The second, highly contentious, but lightly queried contest is the transfer of public funds to bail out private firms (banking entities) (which now translates to weakened public accounts). This international socialisation of debt has been approved and sanctioned by politicians of all persuasions. Global citizens have accumulated layers of debt and reduced circumstances, as they become disenfranchised and anxious about personal outcomes in the new global economy.

A new global economy is distinguished increasingly by cheap debt-accelerated bubbles, the power growth of the financial services sector at the expense of the manufacturing sector, and a savings glut in emerging markets. Developing countries are transferring their savings to debt-addicted developed economies<sup>375</sup> at a cost, which is only just being realised. The latter contest engulfs the former two.

### **6.3 Alternatives to the Efficient Market Hypothesis**

European markets are about to embark on a financial market socialisation process that will see governments bail out nation states and financial entities. Systemic market breakdowns has been evident, and continues as a correction/recession in the United States, first through the sub-prime market bubble of high leveraged loans at the base level and then default/toxic debt inherent in the financial engineered shadow economy system of collateral debt obligations, credit default swaps and the concomitant use of sophisticated trading market

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<sup>374</sup> “Tax System needs a dose of equality” *The Australian Financial Review* 3 October 2011.

<sup>375</sup> Allister Heath “This is going to hurt. The worldwide bond bubble will burst, and Britain is not prepared”. *The Spectator*. 17 September 2011. ([www.spectator.co.uk](http://www.spectator.co.uk))

systems through algorithm and flash trading feeding a global betting frenzy which effectively remains unaltered to this day.

What is different this time is the detachment of the shadow unregulated economy from that of the real day-to-day economies of nation states. Levered investment lending, bank executive compensation, bonuses out of kilter with any benchmarks, and trading secrecy, are as real as they were in 2008 and just as opaque as the transfer of money through tax havens, by hedge funds.

In reality, then, can the promotion of an FTT make a difference and if so what can be conceivably be achieved given the political systems in place? The emergence of continual disruption within unregulated financial markets leads to the question of what form of new governance models are available to protect civil society from conditions outside real economies.

Clearly, the Efficient Market Hypothesis (EMH)<sup>376</sup> has failed as prices generated by financial markets no longer represent the best possible estimate of the values of the underlying assets, as the underpinning philosophy of model<sup>377</sup>. Raj Patel argues that the EMH just doesn't work, saying that markets do behave irrationally, investors can herd behind a stock and push up its price in a way that is unrelated to the stock being traded.<sup>378</sup> Further Patel argued that governments enabled the finance sector's binge by promising to be there to pick the pieces, and they were as good as their word. When the financiers' bets broke the system, the profit they made from the bad debts remained untouchable. The profit was privatised but the risk was socialised.

Despite ample economic evidence to suggest it was false, the idea of efficient markets ran riot through governments. Alan Greenspan was not the only person to find the hypothesis a

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<sup>376</sup> The Efficient Market Hypothesis has its origin in the 1990s based capital market theory that it is impossible to earn abnormal capital gains or profit on the basis of the market information. It states that the price of a financial instrument (bond, share, etc.) reflects all the information currently available and, if the price is rumoured to increase in the near future, investors or traders will buy the instrument now thus driving its price up and negating the anticipated increase. In addition, that it is impossible to predict movement of prices with any degree of certainty because prices follow a random walk and therefore, on average, no one is likely to beat the market. The critics of this theory point out that only a few individuals are as rational as it presumes them to be, and that information gathering is expensive and tedious enough to make it unlikely to be reflected in the prices. Basis of the capital asset pricing model (CAPM), it was developed by Professor Eugene Fama (born 1939) of the University of Chicago in early 1960s, it has been superseded by the coherent market hypothesis (CMH).

<sup>377</sup> Eugene Fama, (1970) "Efficient capital Markets: A Review of Theory and Empirical Work" *The Journal of Finance, Papers and Proceedings of the Twenty-Eighth Annual Meeting of the American Finance Association*. New York, NY. December 28-30, 1969, 383-417.

<sup>378</sup> Raj Patel, *The Value of Nothing: How to reshape the market society and refine democracy*. Barnes and Noble 2010.

convenient untruth. By pushing regulators to behave as if the hypothesis were true, traders could make their titanic bets. For a while, the money rolled in. In mid 1990, the *Financial Times* felt able to launch a monthly supplement entitled “How to spend it”; to help it’s more affluent readers unburden themselves. The magic of the past decade’s boom also touched the middle class, who were sucked into the bubble through houses that were turned from places of shelter into financial assets, and into grist for the mill of the financial sector. .

Rapidly changing market conditions in the shadow economy and particularly in international “betting” on currency trades and commodity markets are influenced dynamically by a variety of market instruments and procedures that intervene to challenge the value of underlying assets.

#### **6.4 Unorthodox or Heterodox? Perspectives on Market Dynamics**

The relationship between orthodox efficient market hypothesis and the reality of current sophistication in money markets are poles apart. Global markets are completely dominated by market sentiment, a highly improbable connection with the actual real time trade dynamic of gambling mechanisms that capture markets in millisecond swings and gyrations. Nigel Dodd<sup>379</sup> argues that monetary markets, as described by Susan Strange, encompass a distinction between a *financial* system that is global and an international *monetary* system that remains largely territorial. This is, in sociological terms, the *financialisation* system that I have argued exist in previous chapters. The financial system is the so-called *shadow economy* and the *monetary* system is based on the so-called real economies of nation states with a variety of currency bases and in the case of Europe a joint currency with the context of a group of nations.

Drawing on the work of Strange, Dodd concludes:

Viewed in light of the present crisis Strange makes powerful use of the casino metaphor. Whether or not we choose to enter the casino she (Strange) remarks “all of us are involuntarily engaged in the days play. The financial casino has everyone playing the game of snakes and ladders (Strange<sup>380</sup> 1986:2). Few may gain, everyone can lose. Bad luck tends to be unevenly distributed, not just the tables, she implies, but the entire casino is rigged, affecting households, firms and entire countries unevenly. The global financial system links various forms of economic instability, inflation, the price of credit, and energy costs. It is the rootstock of disorder in international political economy.

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<sup>379</sup>Nigel Dodd, “Strange Money’ Risk, finance and socialised debt.” *British Journal of Sociology*. Volume 62, Issue 1, pages 175-194 Wiley Online Library.

<sup>380</sup>Susan Strange. *Casino Capitalism, Mad Money, States and Markets, and the Retreat of the State*. Cambridge University Press. Aylesbury. 1988

Further Dodd suggests:

this is the pathological stage of capitalism, characterised by volatility and excess, seemingly driven by a financial distension that overwhelms the real economy and threatens the integrity of money as a secure store of value.

In terms of governance and reporting structures, the efficiencies to be expected from an FTT in both the local context (Australia being one player in a global FTT) or an FTT in European countries only, would be expected to operate within the current market structures and models. This current structure is contentious as it has been designed and engineered to accommodate a vast number of trading mechanisms only available for elite capital market players. For example, the super sophisticated flash trades maintain platforms designed around stealth, speed and secrecy and the very nature of their sophistication places their operation within the grasp of an elite group of individuals and entities. They dominate markets and are likely to find a way around any regulatory process.

In fact, it could be argued that hedge funds manipulate markets through procedures such as shorting which can bear no direct relevance to the actual price or value of commodities or currencies, which layer the markets. Consequently, the new market variety of specific engineered financial products provide the machinery to enable highly geared sophisticated operators to manipulate prices and advantage trades through algorithm and flash trades which benefit only those players with high level resources to outplay competitors. These types of advantages are held in place and condoned by political economies whose actors draw favour from capital elites. From New York to Sydney, politicians have been and will continue to be swayed and influenced by market elites.

### ***6.5 Lobbying and Revolving Doors***

Running parallel to the strongest pro-unregulated financial market lobbying influence in government history, neo-liberal promoters of a “light handed government influence” would be encouraged that financial market oversight has been substantially weakened by the Obama Administration’s tacit support to continuing lax governance, and weak regulatory policy. In a period where much financial market revision was vaunted very little has been delivered.

Many observers have noted that the Obama Administration has shown a distinct lack of judgement at a critical time. When direct oversight of regulatory approaches was needed by in a number of government areas the reverse has been the case. The Obama Administration

appears to have been “leaned on” by forces opposing the tightening of market scrutiny. In an unprecedented era of global sovereign debt crises Eisinger<sup>381</sup> (2011) notes that:

After the worst crisis since the Great Depression, President Obama has unleashed an unusual force to regulate the financial system: a bunch of empty seats. With Sheila Bair soon to leave her post at the Federal Deposit Regulatory Office, the Obama administration will have five major banks regulatory positions either unfilled or staffed with acting directors. The administration has inexplicably left open the vice chairman for banking supervision; a new position at the Federal Reserve created by the Dodd-Frank Act, despite having a candidate that many people think is an obvious choice Danielle Tarullo. The new Consumer Financial Products Board chairman is unnamed. There are some lower-level positions that don’t have candidates, including the head of the Treasury’s Office of Financial Research and Compliance. Perhaps most important, the Office of the Comptroller of Currency, is being headed by an acting comptroller, John Walsh, who took over the agency last August. Nine months have passed without a leader who might better reflect the Obama administration’s views on banking regulation, a time lag made worse by the office’s coddling the banks even as they have acknowledged rampant abuse and negligence in the foreclosure process. The vacancies come at a time that calls for stiffer regulatory examination. The financial regulatory system was remade under Dodd-Frank and requires strong leaders to put the changes into effect. Though the acting heads insist they feel empowered to make serious decisions, they have roughly the same authority as substitute high school teachers.

Barbara A. Rehm<sup>382</sup> of *American Banker* noted that the administration was working on a package of nominations to send to Capitol Hill, suggesting “in a vacuum of leadership, conspiracy theories arise”. One is that Treasury Secretary Timothy Geithner is making a power grab and doesn’t mind that these roles aren’t filled. The idea is that he is asserting his influence over the Dodd–Frank rule-making process.

With the Geithner appointment, President Obama chose a path of continuity over regulation. Immediately, the Treasury Secretary became the personification of every Obama financial policy. Geithner remains the most politically costly appointment Mr Obama has made, saddling him with all the Bush presidency’s financial crisis, and financial market decisions. Geithner, as head of the Federal Reserve Bank of New York, was intimately involved in the emergency actions of September 2008. Republicans made great political capital tying Democrats to the Wall Street bailouts in the 2010 mid-term elections. Now with a dramatic change of political support from centre left to centre right, the Republican resurgence in the

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<sup>381</sup> Jesse, Eisinger, “At a Time of Needed Financial Overhaul, a Leadership Vacuum” *The New York Times Dealbook*. By ProPublica. 2011

<sup>382</sup> Barbara A. Rehm. “Carving up Big Banks Won’t Work, Any Way You Slice it.” *American Banker and SourceMedia*. 25 April 2012.([www.americanbanker.com/authors/83.html](http://www.americanbanker.com/authors/83.html))

United States (and the Liberal resurgence in Australia), Republican parties are benefiting from Wall Street donations to maintain pressure against a FTT and to discredit the Obama Administration for its drawn-out half-hearted attempts at reform<sup>383</sup>. At an international finance meeting in the Polish city of Wroclaw, Treasury Secretary Geithner “repeated to European Finance Ministers in a less-than-cordial encounter” that the United States opposes the FTT on the grounds that it would raise the cost of capital and weaken the already fragile economic recovery<sup>384</sup>.

## **6.6 Collusion and Corruption**

Former Clinton White House economic advisor and now independent economist Robert Reich<sup>385</sup> has written extensively about the collusion between ex-politicians and high-level capital traders in Washington and Wall Street. He takes a particular focus on inevitable corruption within the largest centre of market influence and trade in the world. What mainly influences Reich’s approach to this matter is the lack of oversight at a federal level in respect to profits taken at the public expense; profits made by financial market players with significant insight and knowledge of unregulated markets offering considerable opportunity to smart and insightful players. Reich observed as an insight to an authoritative expose by writers Morgenson and Rosner<sup>386</sup> into cross-over collusion at high levels, saying:

It’s hardly news that the near meltdown of America’s financial system enriched a few at the expense of the rest of us. Who’s responsible? The recent report of the Financial Crisis Inquiry Commission blamed all the usual suspects — Wall Street banks, financial regulators, the mortgage giants Fannie Mae and Freddie Mac, and subprime lenders — which is tantamount to blaming no one.

Gretchen Morgenson, a Pulitzer Prize-winning business reporter and columnist at the *New York Times*, and Joshua Rosner, an expert on housing finance, concentrate on particular individuals who play key political and economic roles, and deftly trace the beginnings of the current sovereign debt crisis sweeping the globe to a point in mid 1990s, when the Clinton Administration called for a partnership between the private sector and Fannie and Freddie to encourage home buying.

The authors suggest that:

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<sup>383</sup> Robin Hahnel, Professor Emeritus at American University in Washington.

<sup>384</sup> “Shooting the bankers or themselves” *The Economist* 17 September 2011.

<sup>385</sup> Robert Reich. “Washington and Wall Street: The Revolving Door.” *The New York Times*. 27 May, 2011

<sup>386</sup> Gretchen Morgenson and Joshua Rosner. *Reckless Endangerment*. Times Books/Henry Holt & Company. 2001

the mortgage agencies' government backing was, in effect, a valuable subsidy, which was used by Fannie's C.E.O., James A. Johnson, to increase home ownership while enriching him and other executives. A 1996 study by the Congressional Budget Office found that Fannie Mae pocketed about a third of the subsidy rather than passing it on to homeowners. Over his nine years heading Fannie Mae, Johnson personally took home roughly \$100 million. His successor, Franklin D. Raines, was treated no less lavishly. To entrench Fannie Mae's privileged position, Johnson and Raines channelled some of the profits to members of Congress — contributing to campaigns and handing out patronage positions to relatives and former staff members. Fannie paid academics to do research showing the benefits of its activities and playing down the risks, and shrewdly organized bankers, real estate brokers and housing advocacy groups to lobby on its behalf. Essentially, taxpayers were unknowingly handing the quasi-government entity billions of dollars a year to finance a campaign of self-promotion and self-protection.

Morgenson and Rosner provide telling details, such as when they describe how Lawrence Summers, then Deputy Treasury Secretary, "buried" a department report recommending that Fannie (Mae) and Freddie (Mac) be privatised. A few years later, Fannie Mae hired Kenneth Starr, the former Solicitor General and Whitewater investigator, who intimidated a member of Congress who had the temerity to ask how much the company was paying its top executives.

All this gave Fannie Mae's executives free rein to underwrite far more loans, further enriching themselves and their shareholders, but at increasing risk to taxpayers as lending standards declined. A company called Countrywide Financial became Fannie Mae's single largest provider of home loans and the nation's largest mortgage lender. Countrywide abandoned standards altogether, even "doctoring loans" to make applicants look creditworthy, while generating a fortune for its co-founder, Angelo R. Mozilla.

Meanwhile, Wall Street banks received fees for underwriting securities issued by Fannie Mae and Freddie Mac, and even more money providing lender Countrywide with lines of credit to expand their risky lending, and then bundling the mortgages into securities to their clients. Morgenson and Rosner (see reference above) say, Wall Street knew lending standards were declining but maintained and sustained arrangements because it was highly profitable.

Goldman Sachs used its own money to bet against its own collateral debt obligations making huge profits off the losses of its clients on the very securities Goldman Sachs had marketed to them. Eventually everything came crashing down in the major deleveraging of global financial crisis.

In a further revelation of potential conflict of interest between the White House and capital market elites, Richard Teitelbaum and *Bloomberg Markets Magazine* reported:

that in July 2008 Treasury Secretary Henry Paulson shared some confidential musings with a group of plugged-in New York hedge-fund executives at the offices of Eton Park Capital Management LP” According to the report, “Paulson mapped out for the assembled honchos -- many of whom had ties, like Paulson, to Goldman Sachs Group Inc., a scenario to put the government- sponsored entities Fannie Mae and Freddie Mac into conservatorship. Seven weeks later, the government did exactly that, an action that wiped out the companies’ shareholders”. Was it nothing more than “crony capitalism”? -- the idea that the rich always seem to get better information about the markets before anyone else -- as Janet Tavakoli, a former Goldman trader turned Chicago-based consultant, put it. Based on the evidence, Paulson did not divulge inside information on July 21 to the hedge-fund managers in New York. He shared with them one possible idea for solving the Fannie and Freddie problems. Since that was the solution that was eventually selected -- a month later -- in retrospect his conversation looks damning. But it wasn’t and it isn’t. Which isn’t the same thing as saying we shouldn’t be upset about it? The whole episode should be seen as further confirmation that hedge-fund managers, private-equity moguls and the top executives of large banks have long received special access to government leaders at the highest levels to plead their cases, or just to get a whiff of whatever might be on their minds. When it comes to getting access to powerful people, it’s not what illegal that’s the crime is, but rather what’s legal.<sup>387</sup>

Morgenson and Rosner suggest that the revolving door between Wall Street and Washington facilitated the charade, arguing that as Treasury Secretary, Robert Rubin, formerly the head of Goldman Sachs, pushed for repeal of the Depression-era Glass-Steagall Act that had separated commercial from investment banking – a move that Sanford Weill, the chief executive of Travellers Group had long sought, so that Travellers could merge with Citibank.

After leaving the Treasury, Rubin became Citigroup’s Vice Chairman, and “over the following decade pocketed more than US\$100,000,000 as the bank sank deeper and deeper into a risky morass of its own design<sup>388</sup>.” With Rubin’s protégé Geithner as its head, the New York Federal Reserve Bank reduced its oversight of Wall Street<sup>389</sup>. Geithner is now the most influential of politicians in the United States and many critics argue his background in diverse secretive and unregulated financial spheres is severely compromising his current position as Treasury head. Whilst the dangerous crossovers of high level political economy players is an

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<sup>387</sup> William D. Cohen. “Paulson Hedge-Fund Chat Just Business as Usual.” *Bloomberg News and Bloomberg Markets Magazine*. 5 December 2011.

<sup>388</sup> Tobin Harshaw and Stacey Shick. “How Art History Majors Power the US Economy.” *Businessweek*. 8 January 2012.

<sup>389</sup> William D. Cohen. *Money and Power: How Goldman Sachs came to rule the World*. Doubleday September 2011.

ever increasing dynamic in most global market spheres, this is a most critical phase in global economics and the boundaries are indistinguishable.

Political and economic relationships consistently connect Fannie Mae, Goldman Sachs, Citigroup, the New York Federal Reserve, the US Federal Reserve and the Treasury. Concomitantly federal, state and local politicians are embedded in this mire of loyalty, disloyalty, and immense consumer distrust grossly engineered through decades of free-ranging at high levels. Reich<sup>390</sup> states:

In 1996, Fannie (Mae) added Stephen Friedman, the former chairman of Goldman Sachs, to its board. In 1999, Johnson joined Goldman's board. That same year Henry M. Paulson Jr. became the head of Goldman (Sachs) and was in charge when the firm created many of its most disastrous securities — while Geithner's New York Fed looked the other way. As the Treasury Secretary under George W. Bush, Paulson would oversee the taxpayer bailout of Fannie Mae, Freddie Mac, Goldman, Citigroup, other banks and the giant insurer American International Group (A.I.G), on which Goldman had relied. As head of the New York Fed, and then as the Treasury secretary, Geithner would also oversee the bailout.

Jennifer Shotts suggests that Stephen Friedman “just could not outlast the waiver that was keeping him from illegally holding his New York Federal Reserve Chairman post while still remaining a Director and shareholder of the beloved Goldman Sachs Group Inc.”<sup>391</sup> arguing that

He cracked under the pressure of too many questions being raised about his controversial dual role and the \$3 million he just made on his recent Goldman stock purchase in December”. Friedman should have stepped down last fall when Goldman Sachs converted to a regulated bank from an investment bank. Since Bloody October (2008) investor confidence went out the window, it should be up to our government officials to begin to instil confidence again by not doing anything that raises more eyebrows. After all, we are still reeling from the lack of performance on the part of the Securities and Exchange Commission and Mr Christopher Cox. The smartest thing that man ever did was to resign in January as the Bush Administration was closing up shop. It is no secret that the SEC turned a blind eye to numerous heinous acts against investors from allowing hedge funds to continue naked short selling to Bernie Madoff's atrocious thievery. Who is policing these people, these government officials? Remember when Cox promised before Congress last fall that "several investigations were ongoing" regarding the activities that brought down Bear Stearns and Lehmann, whatever happened with that? It still remains curious to me that Lehmann was allowed to fail, but

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<sup>390</sup> Robert Reich. “Washington and Wall Street: The Revolving Door.” *The New York Times*. May 27, 2011

<sup>391</sup> Jennifer Shotts “Continued collusion between government and Wall Street, Friedman steps down” *New York Markets Examiner*. 8 May 2011

Goldman and AIG were propped up. It's nice to be friends with the right people". Meanwhile, Congress is currently considering a bill called the Federal Reserve Transparency Act of 2009. It hopes to reform the manner in which the Board of Governors of the Federal Reserve is audited by the Comptroller General of the United States. This may be a first step in shedding some long lacking light in the shadows of how the Fed works beneath the tables and in the dark corners of Wall Street itself.

American taxpayers have so far paid out US\$153 billion to keep Fannie Mae and Freddie Mac afloat and are still owed tens of billions from bailing out other financial institutions. Yet today James Johnson is a rich and respected member of Washington's political establishment (although he was forced to resign from President-elect Obama's advisory team after the press got wind of his cut-rate personal loans from Countrywide). Franklin Raines retired from Fannie with a generous bonus. Henry Paulson became a fellow at Johns Hopkins. Robert Rubin is affiliated with the Brookings Institution and Timothy Geithner remains Treasury Secretary in the Obama Administration.

Morgenson and Rosner<sup>392</sup> further argue that: "The failure to hold central figures accountable for their actions sets a dangerous precedent" and "a system where perpetrators of such a crime are allowed to slip quietly from the scene is just plain wrong." Reinforcing this Robert Reich<sup>393</sup> suggests:

that the real problem, is that Washington and the financial sector have become so tightly intertwined that public accountability has all but vanished. The revolving door is but one symptom. The extraordinary wealth of America's financial class (see Chapter Two) also elicits boundless cooperation from politicians who depend on it for campaign contributions and from a fawning business press, as well as a stream of honors (sic) from universities, prestigious charities and think tanks eager to reward their generosity. In this symbiotic world, conflicts of interest are easily hidden, appearances of conflicts taken for granted and abuses of public trust for personal gain readily dismissed. All told, the nation appears to have learned remarkably little from the near meltdown. Fannie and Freddie, now wards of the state, currently back more than half of all new mortgages, and their executives are still pocketing fortunes. Wall Street's biggest banks are a fifth larger than they were when they got into trouble, and the pay packages of their top guns as generous. Although the rest of America has paid dearly, we seem more recklessly endangered than ever.

The United States' economy is lagging the world because of systemic distortions in the financial system. Banks are exercising a tax on the real economy that is impeding global

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<sup>392</sup>Gretchen Morgenson and Joshua Rosner. (ibid) *Reckless Endangerment*. Times Books/Henry Holt & Company. 2001

<sup>393</sup> Robert Reich "The Great Switch by the Super Rich" 18 May 2011. Perspectiva Ciudadana and, [www.robertreich.org](http://www.robertreich.org)), and Robert Reich. "Washington and Wall Street: The Revolving Door."

recovery. As recently noted in London's *Financial Times*<sup>394</sup> regarding the structural imbalances in the financial system: “.as long as they are not addressed, the banks will make profits – or more accurately, extract rents – out of all proportion to any contribution they make to the wider economy.” The United States' economy is failing, despite some weak signs of recovery and is going in absolutely the wrong direction, lessening competition and strengthening the grip of its financial oligarchy through its policy of focusing relief efforts on a small group of Too Big to Fail Banks, at the expense of the broad economy. Despite assurances to the contrary, this is the policy being administered by Washington.<sup>395</sup>

This institutionalisation of distortion was easier to understand under the Bush Administration with Treasury Secretary Henry Paulson guiding policy, and the Clinton Administration under banking insider Robert Rubin. Analysts question why the financial and institutional distortion was knowingly allowed to continue. It would seem that the answer is centred on three men: Larry Summers, Tim Geithner, and Ben Bernanke. None of the three has practical experience in wider business experience. All three are creatures of the highly exclusive and secretive banking system, and are heavily indebted to the status quo. All three are entwined in the intensive collusion between the state and high level corporate players. All three have very high level capital finance experience.

Change is required. But while corruption hangs over the political process in Washington, where Big Money readily buys influence and control over legislation and regulation, there will be no significant changes, and no economic recovery. Recovery will be in appearance only whilst an ever increasing number of incredulous citizens remain horrified at the level of debt in the United States. As suggested in section 6.2, there are systemic strategic circumstances that provide an overlay to where likely changes can be made and foremost amongst these circumstances is the change in power in the political and economic axis between West and East. Power structures have already changed despite the vision of President Obama to reinvigorate the manufacturing and non-farm production sectors. This could not put 10 million people back to work, surely not when the policy settings of the last two decades at least has favoured sending manufacturing jobs offshore.

The United States Federal Government's financial condition deteriorated rapidly last year, far beyond the \$1.5 trillion in new debt taken on to finance the budget deficit, an analysis shows

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<sup>394</sup> “How the big banks rigged the market.” *The Financial Times*. 18 January 2010. ([www.ft.com/comment](http://www.ft.com/comment))

<sup>395</sup> “The Banking Oligarchy Must Be Restrained For a Recovery to Be Sustained” *Le Café Américain*. March 2010.

The United States Government added \$5.3 trillion in new financial obligations in 2010, largely for retirement programs such as Medicare and Social Security.<sup>396</sup> That brings to a record \$61.6 trillion the total of financial promises not paid for. This gap between spending commitments and revenue last year equals more than one third of the nation's gross domestic product.

Medicare alone took on \$1.8 trillion in new liabilities (more than the record deficit), prompting heated debate between Congress and the White House over lifting the debt ceiling. Social Security added \$1.4 trillion in obligations, partly reflecting longer life expectancies. Federal and military retirement programs added more to the financial deficit too. The \$61.6 trillion in unfunded obligations amounts to \$527,000 per household. That's more than five times what Americans have borrowed for everything else – mortgages, car loans and other debt. It reflects the challenge as the number of retirees soars over the next 20 years and seniors try to collect on those spending promises. Debt in Europe spirals from US\$14 trillion to over US\$21 trillion.

The political/financial sector collusion also has the added trauma of keeping elected members on both sides of the United States' political system unresponsive to change. Ironically, the financial transaction tax is fast becoming the arch enemy of politicians and advisors of all persuasions. Just at a time when politicians know that financial markets are a source of unprecedented revenue to financial traders and the reality is that this dynamic is likely to be stable, there is no political will to investigate an FTT, despite a clear call from academics and concerned citizens.

Against this, a new regime of cross-pollination of political and market players substantially alters the way that political and market players interact amongst the largest unregulated political economy. The London/New York hedge fund James Caird Asset Management has appointed Mary Goodman, former Specialist Assistant to the President for Financial Markets at the National Economic Council, and Senior Advisor to the Treasury, as its Managing Director<sup>397</sup>. Goodman will “provide strategic council on the global macroeconomic outlook and on monetary fiscal, financial regulatory and other policy as part of the firm's deliberation

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<sup>396</sup> Dennis Cauchon. *Funding for future promises lag by trillions*.  
([www.usatoday.com/2011-06-06.us.owes.62.trillion.in.debt](http://www.usatoday.com/2011-06-06.us.owes.62.trillion.in.debt))

<sup>397</sup> Alex Akesson, “People Moves: Former US Treasury Senior Advisor Joins Hedge Fund James Caird”, *HedgeCo.Net*. (<http://www.hedgeco.net/news/05/201/former-us-treasury-senior-advisor-joins-hedge>).

on investment decisions”. James Caird Asset Management has approximately US\$2.65 billion in portfolio investments as a major market player.

The SkyBridge Alternatives (SALT) Conference which convened in Bellagio Resort and Casino, Las Vegas, in May 2011, had 1500 participants according to the US\$7.8 billion global alternative hedge fund. Keynote speakers at the conference were former US President George W. Bush and former Prime Minister of Great Britain and Northern Ireland, Gordon Brown. Also present were leaders in the hedge fund industry and David Axelrod, Senior Adviser to President Barak Obama (2009–2011). Other keynote speakers included Christopher Dodd, Chairman of the Senate Committee on Banking, Housing and Urban Affairs. In his introductory speech Victor Oviedo, senior partner of SkyBridge stated:

We are excited to gather some of the world’s most influential public policy makers with top thought leaders of the investment community to share experiences, ideas and takeaway solutions for navigating the ever-evolving regulatory and economic environment<sup>398</sup>.

In conclusion there has been growing support for a FTT in Europe in the latter months of 2012, with eleven European countries agreeing in implementation. There is growing interest in the United States and the United Kingdom which has Stamp Duty on financial instruments. Collusion amongst political and financial players is likely to stall a global FTT which would be the optimal goal. Leyshon and French argue that the failure to challenge the rhetoric of financial markets is a result of the power of the “distributive coalition<sup>399</sup>” and interests, suggesting that:

(I)n light of the ascendant power of financiers and the near hegemony of neoliberal ideas over the last three decades, the mainstream political left has increasingly sought to court rather than oppose financial capital, and as such has in large measure itself become part of the “distributive coalition” of financialised capitalism in the US<sup>400</sup>.

Evidence suggests that there is a strengthening resolve amongst social democrats to draw attention to the social consequences of unregulated financial markets and the benefits that could flow from progressive global and local reforms. Leyshon and French identify the most influential form of opposition. The collusion between capital and political interests.

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<sup>398</sup> “Las Vegas “SALT Hedge Fund Conference 2011 Sold Out: George W Bush, Gordon Brown.” HedgeCo.Net. (<http://www.hedgeco.net/news/05/2011/las-vegas-salt-hedge-fund-conference-2011>).

<sup>399</sup> Jonathan Hopkin. “Class Mobilization, Decentralization and Redistribution: Exploring Territorial and Distributive Coalitions in Britain and Spain.” *Department of Government, London School of Economics and Political Science*. Paper presented to Conference of Europeanists, Montreal, 15-17 April 2010.

<sup>400</sup> Andrew Leyshon and Shaun French. *Environment and Planning A 2010*, volume 42 p2549 -2559.

## 6.7 Global Hedge Funds and Dominant Centres

The growing authority and re-emergence of hedge fund influence in international markets and local and global politics is likely to be the major blocking device to stall financial transaction tax (FTT) proposals in the immediate future. Consistent inter-location of players is likely to increase with the growth of markets as shown in the following figures describing hedge fund quantum returning to pre Global Financial Crisis levels of US\$2.1 trillion. It is estimated that 2011 figures will reach US\$2 trillion. Figure 6.5 provides evidence of capital held in global hedge funds and the number of funds during the period 2000 – 2010. This Figure shows that at the peak of hedge fund activity in the period immediately prior to the Baer Stearns precipitated GFC there were nearly ten thousand hedge funds holding capital of US\$2.2 trillion. This figure is close to present (mid-2012 levels). Figure 6.6 shows the dominance of the United States markets against those in the United Kingdom. This figure also shows that 17 per cent of market share originate from Massachusetts and Connecticut (states of the United States) and 24 per cent originate from offshore tax centres associated predominantly with the United States and the United Kingdom (Isle of Man, Cayman Islands).

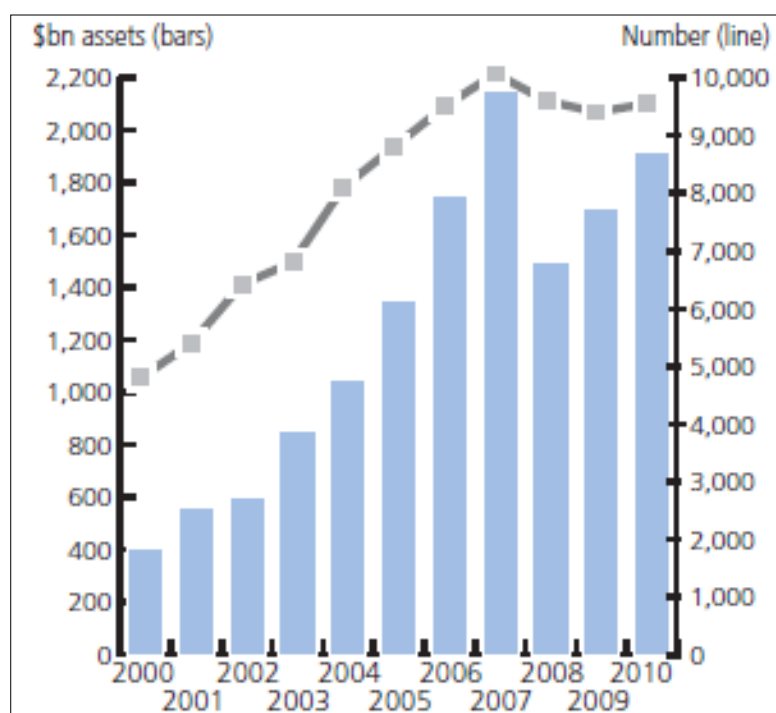
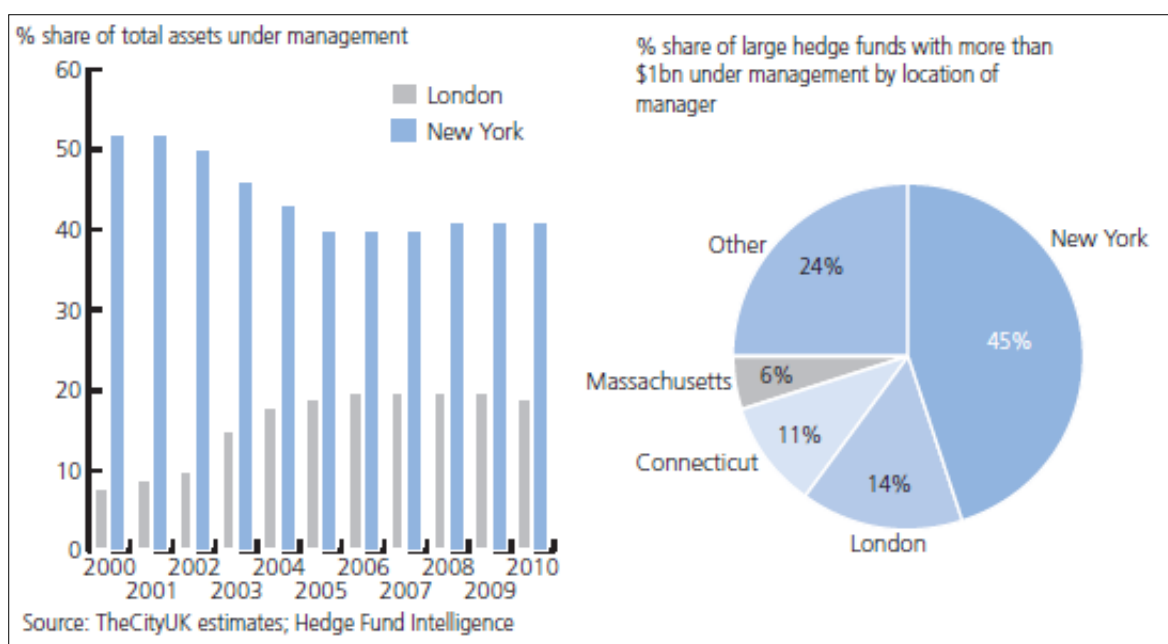


Figure 6.5<sup>401</sup>: Global Hedge Funds: Numbers and Assets. The City UK.

<sup>401</sup> The CityUK. *Global Hedge Funds* ([www.thecityuk.com/assets/Uploads/Hedge-funds-2011.pdf](http://www.thecityuk.com/assets/Uploads/Hedge-funds-2011.pdf))



**Figure 6.6<sup>402</sup>: Top Hedge Fund Global Cities.**

Whilst considerable interplays of government officials and elected members of both houses of politics into private enterprise banking and high level portfolios has been “par for the course” in the United States, Europe, Australia and Great Britain, the political and economic landscape has altered considerably post 2008. Voters are highly sceptical of the partisan interests of politicians, particularly in Australia, as neither party appears able to persuade the electorate that bigger issues (climate change, taxes on mining conglomerates, or taxes on purely speculative financial trades) are in the interest of the wider populace continually disadvantaged by higher services costs in a two-speed economy.

As is evident in the United States, the dividing lines between shadow and real economies of nation states have never been so evident. Quantitative easing in the United States has placed over 10 trillion dollars into the wider economy through banks and financial institutions. Very little “trickles through” to the real economy whilst hedge funds and financial corporations have never had such a bonanza of taxpayers’ funds to trade. Elected governments unable to provide leadership and independent fearless statesmanship against the persuasive power of the financial sector spell doom for the economy for decades.

<sup>402</sup> The CityUK. Global Hedge Funds.

## **6.8 Financial Reform Gains Global Political Momentum**

Deficits in the political system encourage finance capital players to maintain status quo trading, to press ahead with refinement of algorithm and flash trades whilst continually improving the electronic sophistication of financial engineering of products and programs. Lobbyists counter calls for reform. Despite dire warnings of the impending slip into recession of economies across developed countries, little has changed other than the quite remarkable inability of politicians to investigate, on behalf of constituents, how systems can be reformed to halt the continuous transfer of public funds to ailing banks and institutions. Popular protests in the United States and Europe are demonstrating public outrage. One protestor at the Occupy Wall Street rally said “we are not saving beached whales or the environment; we are trying to save the world.”<sup>403</sup> Decisions to reform global financial systems obviously out of control and out of fundamental governance are not just urgent, they are imperative, and require urgent intervention. Investment has been socialised. Society’s investments need protection by elected representatives.

The Europeans for Financial Reform (EFFR) continue to build on the growing calls for financial reform through a financial transaction tax (FTT). In April 2011, nearly 400,000 emails were sent in response to the European Commission’s consultation on tax in the financial sector. This response was backed up on 14 April 2011 as the Party of European Socialists outlined a declaration specifying five demands. They included a commitment to go ahead with an FTT within the European Union; to enact EU legislation as soon as possible; to set a clear percentage (0.05 per cent); to use any funds raised for a progressive social agenda; and to particularly target financial transactions of a short-term nature that are considered to be detrimental to civil society.

A thousand economists from 53 countries wrote to G20 Finance Ministers who were meeting in Washington to urge the adoption of a financial transaction tax. The economists wrote: “The financial crisis has shown us the dangers of unregulated finance, and the link between the financial sector and society has been broken. It is time to fix this link and for the financial sector to give something back to society.” Many Australian economists have supported the letter. University of Queensland Professor John Quiggin said, “The global financial crisis is evidence that self-managing markets do not ensure stability or reduce volatility. Governments

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<sup>403</sup> Australian Broadcasting Commission News Program 10 October 2011.

must intervene to manage risks including the implementation of a financial transaction tax<sup>404</sup>.”

Economist, Professor Jeffrey Sachs is among the 1,000 economists calling on the G20 to tax financial transactions. These economists have written to G20 finance ministers urging them to tax financial speculators to help the world’s poor, and to provide a continuous source of income for states reeling through waves of detrimental financial effects metered by dysfunctional activities in dysfunctional speculative markets. Professor Sachs said, “It is time for the G20 to agree to a tax on financial transactions to help poor countries struggling with climate, food, and economic crises they did nothing to cause. The tax would also be a fair and efficient way to help close budget deficits in our own countries as well.”

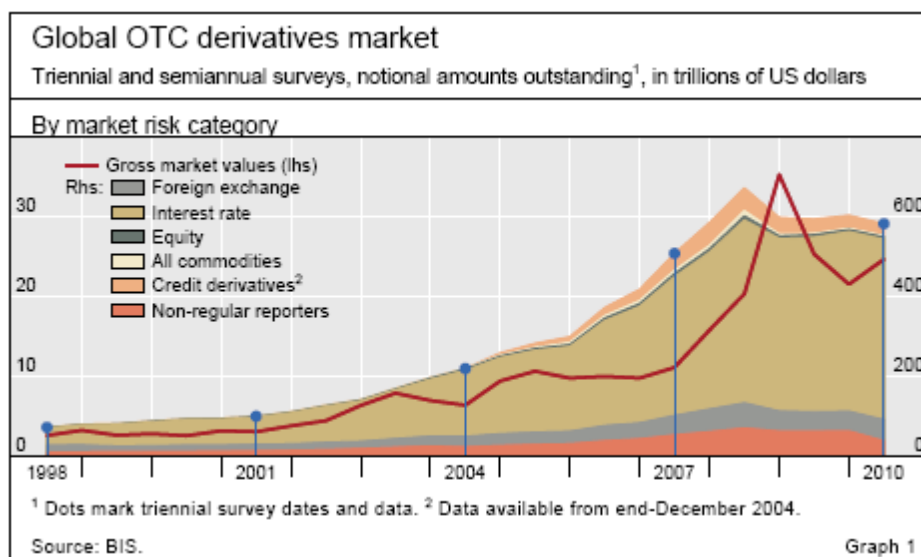
Bill Gates, philanthropist and founder of Microsoft has been asked by the G20 to examine innovative options to raise money for development and climate change. Gates has produced draft proposals for the Cannes G20 that indicate that although a global tax would be preferential, a tax would be feasible for a “like-minded group of countries that decided to go it alone”. Gates is said to be “won over” to the idea of an FTT which at least in the United Kingdom has strong public approval but is highly opposed within the City financial district<sup>405</sup>. The *Guardian* quoted Bill Gates’ note to the G20 which said, “If G20 members or some other set of countries (e.g. within the EU) can agree on the outlines of a financial transaction tax, it would generate substantial revenues. For example some modelling suggests that even a small tax of 10 basis points on equities and two basis points on bonds would yield US\$48 billion on a G20 wide basis, and substantially more if derivatives were included”. The massive growth in derivatives markets indicates global open trade positions reached in excess of US\$700<sup>406</sup> trillion.

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<sup>404</sup> “Thousand economists calling for a Robin Hood Tax:1,000 experts from 53 countries calling on G20 finance ministers to tax City speculators to help the world's poor” *The Guardian Newspaper*, Wednesday 13 April 2011

<sup>405</sup> “Bill Gates backs Robin Hood tax on Bank trades.” *The Guardian* 22 September 2011.

<sup>406</sup> Bank for International Settlement (BIS) *Global Report*. June 2011.



**Figure 6.7<sup>407</sup>: Global and OTC Derivatives Markets 2004–2011.**

In the United States, social, environmental and economic activist of long standing Ralph Nader has entered the cause pushing for the immediate introduction of an FTT. Nader has long been a campaigner for a tax on speculative traders and has advocated on behalf of citizens in New York State where he alleged the misuse of funds from a longstanding financial tax on Wall Street speculative trades.

A new FTT has been endorsed by a group of White House Democrats around Congressman DeFazio of Oregon. Green Party candidates from Laura Wells in California and Howie Hawkins in New York State have also called for a Wall Street transaction tax. Ralph Nader has recently contributed an article in the *Counterpunch*, in which he points out that New York state already has a type of Tobin Tax capable of yielding between \$US15 and US \$20 billion per year for the state, but that corrupt politicians have actually refunded the money to the speculators year after year since 1978, something which is obviously blatantly illegal and a huge political scandal. Among economists, Robert Kuttner of the *American Prospect* is also an FTT supporter. Nader<sup>408</sup> argued (January 2011) in a letter to Andrew Cuomo, Governor of New York State, that:

Greed, power, reckless speculation and theft of other peoples' money by Wall Street bankers collapsed the U.S. economy into a deep recession that started in 2007-08. These super-rich Wall Street bankers looted and drained trillions of worker pensions and mutual fund savings while

<sup>407</sup> The Bank for International Settlements. *Global and OTC Derivatives Markets 2004–2011*. June 2011

<sup>408</sup> Ralph Nader. "New York's \$16 Billion Gift to Wall Street Bankers." *The Speculator's Rebate*. 17 January 2011.

nationwide eight million jobs were lost. Panicked that their overwhelming avarice was pushing their companies over the cliff, the bankers rushed to Washington, terrified members of Congress with the help of ex-Goldman Sachs CEO turned Treasury Secretary Henry Paulson and propelled the Bush White House into a series of massive taxpayer bailouts and guarantees amounting to trillions of dollars during the last quarter of 2006. By the end of 2009, the Wall Street welfarists (sic) were recording once again record profits and sky-high bonuses. Month after month it became clear that the banks were not lending to small and larger businesses to get the economy moving again—a major reason given for the bailouts. A good slice of the money went to bonuses, mergers and other empire building by the remaining five giant conglomerate banks. Today these banks are sitting on mountains of cash. Never before has Wall Street made so much money from doing so little for economic and job growth.

Criticism of the United States financial sector elites is recorded in the *Fiscal Policy Institute*<sup>409</sup> who stated in April 2010:

Essential services like fire departments and schools, recession-buffering social safety net programs like homeless prevention and senior services, and critical infrastructure systems like hospitals, roads and mass transit all face severe cutbacks. The conditions where many regular New Yorkers live are grim. Poverty, unemployment, home foreclosures, and small business bankruptcies keep growing. But Wall Street is not suffering from the budget catastrophe or from the crash. ... The financial industry rang up \$61.4 billion in profits for 2009 alone—that is nearly triple Wall Street's previous record. These are truly windfall profits—they are courtesy of the taxpayer-funded bailout [and federal policies uniquely privileging the big banks with virtually free money] and not because the big banks made money from financing the recovery of American businesses.

## **6.9 Proponents of FTTs Meet Strong Resistance**

Hedge funds have made a quick rebound on the backs of American taxpayers and privileged tax policies. Low-to-moderate and middle-income workers for example in New York already pay a higher percentage of family income in state and local taxes than do the richest one per cent of New Yorkers located in the finance and investment sector. The power and influence of financial players, however, transcends that of the proletariat and hedge funds have little or no regulation or taxation requirements. The City of New York provides a sample of the larger market tax aversion across international borders.

There is a method available to eliminate the New York state deficit and prevent tens of thousands of layoffs and large service cutbacks. What most New Yorkers do not know is that for about a century there has been a state stock transfer tax on purchases of securities.

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<sup>409</sup>“New York Has the Ways and Means: How and Why Wall Street Should Give Back to Main Street” *A Report from the Centre for Working Families and the Fiscal Policy Institute*. April 2010.

Last year (2011) this tax, similar to ones imposed in 30 other countries, will amount to about US\$16 billion. Since 1979, this tax has been instantly rebated by New York State back to the financial brokers or clearinghouses that paid it. That is a 100 per cent rebate every year for the bailed out financial industry that caused the recession and its immense human damage. One citizen, Howie Hawkins from Syracuse, New York, is challenging both the big boys on Wall Street and the duopolists' candidates. Hawkins is behind the October 2011 Wall Street demonstrations and is the Green Party candidate for Governor of New York. The ex-marine, author, long-time citizen advocate, working blue collar worker and public interest thinker, challenged New York Mayor Cuomo asking<sup>410</sup>:

Why is Mr Cuomo, the anointed front runner, hiding the Stock Transfer Tax from the public when it is an obvious way to bridge the state budget deficit? Why does he rule out higher taxes on the rich when they have more money than ever, why won't he make them pay their fair share, when they'll still be rich after paying their fair share?" All the politicians in Albany act like we're out of money and debate over what services to cut, all the while refusing to tell New Yorkers about the \$16 billion they hand back to Wall Street speculators," adding that 'Mr Cuomo is a recipient of campaign contributions from hedge fund managers.

Figure 6.7 above shows the dominance of hedge funds in the United States with New York hosting fully 45 per cent of all global hedge funds and Massachusetts 6 per cent and neighbouring US state Connecticut 11 per cent. Sixty two per cent of the world's hedge funds are in this concentrated American location. One of the most interesting correlations is extrapolated between these states which host high concentrations of high-net-worth individuals and the very high level of public debt held against all citizens in the three states. In New York, per capita public state debt is US\$3,315 per person; Massachusetts is US\$4,606 per person, and Connecticut is US\$4,859 per person<sup>411</sup>.

## 6.10 Summary

This chapter has examined a number of key issues related to global financial markets. Section 6:2 argued that a number of macro-economic issues overlay the debate on the risks and possibilities of establishing Financial Transaction Taxes as a means of market accountability and more importantly as a resource to nation states for the replenishment of public accounts.

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<sup>410</sup> Centre for Responsive Politics based on data from the Senate Office of Public Records. Data for the most recent year was downloaded on 31 January 2011.

<sup>411</sup> Marc Faber, "Gloom Boom and Doom Report; Chuck Devore, Big Government." quoted in "Endgame: The End of the Debt Super cycle and how it Changes Everything" John Mauldin and Jonathon Tepper (page 193). (<http://biggovernment.com>)

Foremost is the balance of economic power between the East and West. This issue has very high level consequences given China's role as effective financier of the US debt. The second strategic issue is related to the transfer of state funds to bail out financial entities including banks. This socialisation of debt has weakened nation states abilities to fund social services. The third issue which has been discussed in this chapter is the collusion between policymakers and capital interests. Each of the three issues is serious. Each diminishes the role of governments to provide equitable responses to social needs.

This chapter acknowledges that social and economic circumstances are increasingly raising emotive responses. Emotions do run high with discussions and theoretical approaches to the equitable distribution of wealth to fund public goods and services. When public goods including taxpayers' funds in nation state public accounts, were used by policy makers to rescue corporate failures and stimulate economies, there was barely a whimper. Returning the favour creates negative emotions from capital elites. Capital elites and politicians, many elected with financial assistance from finance capital elites, have designed a sophisticated money machine that they are passionate about preserving. Many policymakers, unsupported by capital infusions, reflect the emotional pleas of civil society that the system is unequitable, divisive, lacks trust, and is unsustainable. Emotionally and economically bereft European nations struggle for relevance.

Values in this debate are complex and secretive. Values can focus on the macro issues of market place trades through today-traders and investors, and on the other side of the economy the relative savings and superannuation portfolios of middle Europe, Middle America or middle Australia. Apart from the real losses, in terms of individual wealth there is now an overriding pressure on governments to plan for additional shortfalls in support to self-funded retirees whose retirement funding is no longer adequate for sustaining retirement. Sociologically, and economically, values in this debate are complex, real, and in many cases unsolvable. Further, state intervention based on social and market equity is required.

Rationale for reform involves the high level conceptual modes of introducing a more equitable financial system, globally. These models could support market speculative trades, provide support for all modes of free market activities, whilst introducing, urgently, the types of reforms that introduce accountability and equitable tax arrangements commensurate to risk and sustainability of market practice. A global financial tax would be just the vehicle to reform grossly dysfunctional trading systems that are inherently destabilising and risk prone.

This chapter has also reiterated the case for such a tax as a progressive reform. There is a capacity to introduce this tax but there is also a strong political blocking mechanism on behalf of capital interests. Events in the European summer of 2012 may well set the stage for a political compromise. There appears to be a political imperative to deal with growing anger and social discontent with austerity measures which apply the pressure on social groupings far removed from the massive earnings of market elites.

## **Chapter 7**

### **Conclusion**

This thesis, drawing upon recent literature and analysis, considered the underlying social and economic implications directly related to the introduction of a tax on international financial transactions (FTT). The thesis supports known FTT architecture, and describes potential outcomes that will be of benefit to participating nation states.

Newly elected French President Hollande has introduced a French Financial Transaction Tax into law. South Korea has decided to introduce a FTT on all derivatives and financial trades. Fifteen European nation states have indicated their support for a FTT. Against this breakthrough of progressive reform and support for similar taxes in Europe there has been an intensive lobbying effort to deride and discredit the foresight and social morale galvanised by those who believe that an FTT could ameliorate the negative effects of largely unregulated finance capital players.

This thesis considered capital market growth and volatility. It provided evidence that growth in shadow economies has played a role in accentuating detrimental social outcomes i.e. inequalities within real economies of developed states. Furthermore, unstable and unaccountable finance capital markets have led to the weakening of developed states resource base to fund social services.

Recent references by political economists strengthen arguments that incompetence, greed and self-fulfilling ideologies amongst capital players have created a lasting legacy of social cost across the developed world. Austerity measures in Europe, rising unemployment, high level debt ratios to gross domestic product indices, and real economies in recession, are indicators of the changing nature of socio-economic structures across continents. Economies of the developed and developing world are slowing down. The fragility of global finance has significant overflow effects to developing states such as India and China with potentially lasting effects. My key claim is that a global FTT would provide a regulatory base, market player accountability, and a financial resource of significance to participating states. It would provide a degree of integrity to an otherwise opaque and secretive section within participating economies.

To support this argument I have examined the socialisation of debt and the rise of political, monetary, and fiscal policy that has supported the regime of financialisation. As part of this

examination, Chapter 2 (The Financialisation of Global Markets), detailed the rise of unregulated finance capital as the dominant politically endorsed economic structure, over three decades. In this chapter, I provided data showing the concentration of capital markets, “Shadow” economies and “Real” economies, and the history underpinning these events. Chapter 2 also considered the growth in financialisation and the integration of global markets over the past three decades. Integration in markets places direct control of markets into a concentration where 20 financial entities in the United Kingdom account for 99 per cent of speculative market turnover, and in the United States the largest 10 financial entities accounted for 95 per cent of turnover.

Chapter 3. (The Consequences of Financial Markets) raised the case for reform in financial markets by examining the systems that underpin global financialisation, global policy responses, and specifically the social policy implications of nation state public accounts being used to bail out corporate private debt. The seemingly incongruous issues of public funded corporate bailouts and economic stimulus packages is examined against the notion of a global concentration of wealth including evidence that \$US\$21 trillion is held in offshore tax havens around the world. Chapter 3. evidenced the rise of social “precariats”, a new grouping of global citizens who are increasingly marginalised by the unaccountable and uneven influence of global finance. From the social fallout from sub-prime markets in the United States to the continuing global recession the rise in the number of citizens affected by politically protected finance and tax systems, provide very unequal outcomes across continents.

Chapter 4 (Financial Systems Analysis) provided evidence of new highly sophisticated high frequency global trade networks are enabled by implicit and tacit support from political leaders. High frequency trades are the new engine room of shadow economies. They trade at record levels. In this chapter I argued that excessive risk is inherent in markets and provided evidence of the changing nature of risk on a locational basis. This chapter looked closely at risks associated with systemic meltdowns and public sector funding to the banking sector. Following this theme evidence was presented to support the theory that political lobbyists underpin decisions to enable unaccountable financial systems and tax havens, whilst influencing government decisions on bailouts in times of market crisis.

Chapter 5 (The Case for Financial Transaction Taxes) puts forward a series of options, and models that are immediately available to underpin FTT policy and proposals. Foremost being a tax on cross border financial transactions, using the same or slightly modified version of the

French FTT, as a new progressive social and economic reform with wide ranging benefits for real economies and a concomitant opportunity for removing the inherent secrecy of opaque forms of capital accumulation in the global political economy. Chapter 5. provided evidence of alternatives to the Efficient Market Theory that emphasises the inherent corrective capabilities of “free markets”. This chapter argued that heterodox economics provides an alternative framework that takes into account the variations inherent in new global finance, untied and unaccountable in its nature. Heterodox economics provides linkages and themes to social economics with variants that support market interventions in the form of FTT’s. It responds to collusion and corruption in markets.

The penultimate chapter, (Financial Transaction Taxes: Risks and Possibilities) I examined the potential revenue raising opportunities of a FTT against growing evidence of collusion between politicians and capital market players. In this chapter I concluded that a progressive social reform would provide market oversight and scrutiny, an element that is missed at this time, as well as bringing accountability to the wider global financial sector. I also articulated the overarching issues of balance of power between East and West as the critical interface in a dislocated world order. Financial reform is a growing and pressing issue for elected politicians searching for relevance in a rapidly changing world. There is a pressing need for financial market accountability.

In summary, this thesis explored the implications of the disconnect between shadow and real economies. It can be concluded that growing indebtedness of developed nation states is an effect of the change in global economic power from West to East. The socialisation of debt has paralysed European economies and has the potential to spread globally. This thesis argues for the immediate introduction of a global financial transaction tax to make speculative financial markets accountable.

Civil society and capital market players have a commonality in respect to nation states’ legal systems. This commonality underpins a legal system that provides the framework for financial trades from and into sovereign nation states. Other direct foreign trades in goods and services are required to operate under specific legal jurisdictions. Civil society is required to accept that elected governments can use taxpayer funds to bail out ailing corporations.

Governments could deny financial entities access to legal business frameworks. A solution to make finance capital accountable needs political courage. A financial transaction tax offers the best route to reinforce accountability and oversee uneven markets.

Globally the interest in FTTs has increased considerably but gaps do appear in the knowledge currently available in FTT modelling and affects current markets. The European Commission has released a proposal for a Council Directive on a common system of financial transaction tax with technical information on the tax introduced in France in August 2012 by President Hollande. It includes macroeconomic assessments and impact statements. This information will fill the gaps presently missing in knowledge. The new French Tax will provide opportunities to further study the impact of a working model.

Implementation of taxes on financial transactions should be global. A broad base covering all trading arenas is the preferred equitable solution to making global trades accountable. Whilst France has introduced a new FTT there is recognition that up to ninety per cent of speculative derivatives trades will transfer to non-tax domains. This may have benefits for France because the instability in Credit Default Swap markets is intense, and risky, to host countries. On the other hand, France may lose some liquidity benefits. France has defied staunch political opposition by introducing an FTT at double the rate recognised as being acceptable. France now imposes 0.2 per cent on shares speculative trades, and 0.02 per cent on derivatives. This is a bold policy position by a new President.

The European Union have been studying implementation proposals and have identified a “Common System” for the implementation of FTTs. They have identified a number of impacts. The Commission estimates revenues of EU55 billion annually, depending on market reactions and effectiveness of tax collection. The Commission estimates that (in European countries) the turnover in securities markets is assumed to decline by up to 20 per cent. The European Commission suggests there will be a decline in turnovers but a small impact on employment. Further, there will be no impact on monetary policy positions, whilst the revenue and effectiveness of financial markets will be positive<sup>412</sup>. Algirdas Semeta, the European Union Commissioner for taxation, suggested that he was ready to draw legislation to cover European countries wishing to adopt a tax. Nine European countries have shown interest. They are France, Germany, Austria, Belgium, Estonia, Greece, Portugal, and Slovakia. Italy has yet to commit to the European proposal.

United States Democrat Representative Keith Ellison and six other House Democrats have introduced legislation, (the Inclusive Prosperity Act (H.R. 6411), that would impose a

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<sup>412</sup> European Commission: Taxation and Customs Union. *The Commission Proposal for a Council Directive on a Common System of FTT*. 28 September 2011.

transaction tax on all stock, bond and derivatives trades made by Wall Street firms, which Ellison said would raise "billions" to pay for infrastructure and jobs programs. "The American public provided hundreds of billions to bailout Wall Street during the global fiscal crisis yet bore the brunt of the crisis with lost jobs and reduced household wealth," Ellison argued, "This is a phenomenally wealthy nation, yet our tax and regulatory system allowed the financial titans to amass great riches while impoverishing the systems that enable inclusive prosperity".

Under Ellison's Inclusive Prosperity Act, stock trades would face a transaction fee of 0.5 per cent, bond trades would be charged 0.1 per cent, and derivatives trades would be assessed a fee of 0.005 per cent. Ellison said it would be easy to charge these fees because these trades are all computerized. He also said it would make high-frequency trading "unprofitable" but suggested this would have the positive effect of reducing speculation on commodities<sup>413</sup>. Ellison suggested that forty countries currently have a transactions tax.

Growing instability in financial markets is not confined to the dynamics of speculative trades alone. Traders in the form of central and investment banks have been undergoing rigorous internal problems associated to the LIBOR and other banking scandals in 2012. As a result, banks have been shedding positions and markets are under threat. Whilst a FTT remains anathema to bankers and traders who have been politically protected for decades there are signs on dysfunction from within their own enclaves<sup>414</sup>.

In conclusion, this thesis has provided arguments on the positive benefits of a global financial transaction tax as base to ameliorate the most detrimental effects of a continuing global financial correction. Whilst acknowledging the challenges that arise for nation states seeking to implement a global FTT, the proposals as articulated in this thesis offer the best hope for averting another financial crisis in the years to come, through restoring market stability.

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<sup>413</sup> Kasperowicz, Peter "Democratic Rep. Introduces Bill To Tax Wall Street Transactions On Anniversary Of Occupy Wall Street: House Dems propose taxing equity trades to fund new federal programs" *The Hill Newspaper*. -17 September 2012

<sup>414</sup> "Dream turns to nightmare: Investment banking once delivered juicy profits. No longer." *The Economist* 15 September 2012. (<http://www.economist.com/node/21562925/print>).

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## **Appendix 1: List of Figures**

Figure 2.1: United States Federal Reserve – Emergency Loans Quantum.....	37
Figure 2.2: Foreign Bank Recipients of CPFF Program. ....	38
Figure 3.1: Shadow Bank vs. Traditional Bank Liabilities, 1952–2007. ....	66
Figure 3.2: The Creation of Securities from Loans. ....	68
Figure 3.3: Net Worth and Financial Wealth in the United States, 2007. ....	85
Figure 4.1: Global Current Account Balances 1993 - 2008. ....	113
Figure 4.2: Foreign Ownership of Marketable Bonds as percentage of Amounts Outstanding, Dec 1994 - Jun 2007. ....	113
Figure 4.3: UK Real Interest Rates (20 Year Bonds Yield at May 25 or Nearest Week Day), 1985 - 2005. ....	114
Figure 4.4: Household Debt as Proportion of Gross Domestic Product, 1987–2007. ....	119
Figure 4.5: The Growth of Securitised Credit: Securitisation Issuance Trends in United Kingdom, 1996–2007. ....	122
Figure 4.6: Growth in Outstanding Credit Default Swaps, 2004–2008.....	123
Figure 4.7: Bank of England: International Financial Systems. ....	132
Figure 4.8: Total Washington Lobbying Spending, 1998–2010. ....	146
Figure 4.9: Total Washington Lobbyists, 1998–2010.....	147
Figure 5.1: OECD Projections of Budget Deficits, 2011–2017. ....	173
Figure 5.2: Financial Transactions in the World Economy, 1990–2010.....	174
Figure 5.3 The World is Slowing: according to the Purchasing Managers Index (PMI). ....	176
Figure 5.4: Size of Exchange and Over-the-Counter Derivatives: Markets and Taxes.....	186
Figure 6.1: New York Stock Exchange Margin Debt, September 2000 to August 2011. ....	199
Figure 6.2: McKinsey Global Institute – Composition of Mature Economy Debt.....	205
Figure 6.3: Moody’s – Banks OTC Derivatives Notional Amounts. ....	207
Figure 6.4: Bureau of Economic Analysis – Pre-Tax Corporate Profits. ....	209
Figure 6.5: Global Hedge Funds: Numbers and Assets. The City UK. ....	225
Figure 6.6: Top Hedge Fund Global Cities.....	226
Figure 6.7: Global and OTC Derivatives Markets 2004–2011. ....	229

## **Appendix 2: List of Tables**

Table 2.1: European Debt as Percentage of GDP, 2010.....	49
Table 3.1: Distribution of Net Worth and Financial Wealth in the United States, 1983–2007. ....	84
Table 5.1: Hypothetical Transaction Tax Receipts in the Global Economy 2009.....	184
Table 5.2: Currency and Currency Derivative Trading: Potential FTT Revenues. ....	184
Table 5.3: Cash, Spot and Futures Markets: Revenue Estimates.....	185
Table 6.1: Global Financial Stability Report – Indebtedness and Leverage in Selected Advanced Economies.....	203