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Report on scenarios for future global engagement

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Abstract: The aim of this paper is to map out possible scenarios of international financial development and supra-national governance, and identify opportunities for positive engagement by the EU and emerging countries. Additionally, it examines the prospects for international monetary relations and charts the possible roles of the US and the EU, G8, G20, multilateral credit institutions (e.g., IMF and World Bank) as well as the role of China and sovereign wealth fund countries (e.g., in the Middle East) in future monetary and financial relations. It proposes an alternative form of supra-national governance which Europe could champion, that is simultaneously more inclusive and potentially beneficial to Europe.

Key words: global engagement, supra-national governance, sustainable wealth creation

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I) Introduction

The issue of coordination of the plans and actions of economic agents, with different and sometimes opposed interests, in a market economy that lacks a central planner, lies at the heart of political economy since Adam Smith. While coordination at the nation-wide level is a challenge, coordination at the supra-national level is arguably the challenge. This is because of the added complexity of different national interests of countries at different levels of development, and its potential impact on sustainability-environmental, social and economic. It is therefore not surprising that the issue of sustainability-compatible supra-national governance is very high on the agenda of economics and political economy scholars (Pitelis, 2013).

The conventional economics approach to supra-national governance, has been encapsulated in the hegemonic stability hypothesis of Charles Kindleberger (1986), according to which an international hegemon, such as the US now and earlier the UK and other 'empires', enjoys efficiency advantages (such as economies of scale) in the provision of international public goods (such as stability and peace) for which in the absence of the hegemon, market failures due to costs of coordination and free riding are likely to lead to their under-provision. In return, the hegemon enjoys advantages pertaining for example to the ability to shape outcomes in ways perceived as national interest-serving. Without always explicitly stated, the hegemonic stability hypothesis (or similar ideas), seems to underlie the development and functions of international organisations and approaches to international development and supra-national governance, such as the so called 'Washington Consensus' institutions (IMF, World Bank) and policies.

Following the emergence and economic success of East Asia and more recently the BRICs (Brazil, Russia, China, India) and other emerging and emergent countries which have explicitly and purposefully defied the Washington Consensus approach (see Pitelis, 2014), as well as the recent financial and economic crisis in countries sharing the Washington Consensus perspective, there has emerged a realisation that the tenets of hegemonic stability and the Washington Consensus, might be in need of adjustment so as to account for shifts in the global landscape, and the concomitant threats to sustainability. In this

context, a debate that looks for opportunities for alternative ideas, frameworks and policies towards supra-national governance and bigger multilateral engagement, is opportune.

In particular, the recent and still current financial crisis has helped highlight the limitations of both domestic regulatory and supervisory systems, as well as the interconnectedness of national economies and financial markets on a global scale, hence a supra-national governance system based on these now appears unfit for the purpose of anticipating, managing and mitigating (the results of) financial and economic crises. This has prompted a search for more effective approaches to the 'supranational governance' and engagement of the international financial system through reforms based on the emergence of a larger, much more inclusive group, such as the G-20, as a main platform for dealing with the containment of the 2008 global financial and economic crisis and prevention of future global financial crises. At the same time, there has been an understanding for a need to reform of international financial organizations (IFIs), like the International Monetary Fund, alongside the establishment of stricter international codes and standards, an example of which is Basel III.

In particular, one of the main lessons of the 2008 global financial crisis is that the global financial governance system needed to be reformed to make IFIs more transparent, accountable and effective in delivering financial and wider stability. Despite significant progress made, at their 5th annual BRICS Summit in South Africa on 27th March 2013

, the BRICS members has once again expressed concern over the slow pace of the reform of the IFIs (particularly in making them more representative and appreciative of the growing weight of the five-member grouping and other developing countries)¹.

The implications from concerns of the BRICS countries are not trivial as the BRICS have also recently announced the creation of their own BRICS-led development bank. Commentators observe that "The US and the EU, now preoccupied with domestic concerns- are in fact not able to set global rules and expect others to fall into line".² Increasing the

¹ <http://www.brics5.co.za/about-brics/summit-declaration/fifth-summit/>

² Rodrik, (2012) www.project-syndicate.org/commentary/leaderless-global-governance

representativeness and relevance for today's world supranational economic governance is hence very important so that emerging powers are more willing to engage in international cooperation and increase their degree of integration in the globalising economy. In this context, there is an appreciation that it may no longer be adequate to address the issue of reform of the extant global governance system from a mere regulatory perspective³, and that instead one should explore more comprehensive revamp of the supra-national governance structures and institutions.

In this report we first provide a historical excursion to the institutions and organisation of supra-national governance, then look at triggers for change, notably the financial crisis, and the rise of BRICs, and then explore the possibility for changes in supra-national governance that are more inclusive, hence more sustainable, but to the extent possible without compromising, and even by fostering more, efficiency.

More specifically, the aim of this paper is to identify opportunities for positive engagement by the major players in the international financial system in shaping the future of supranational governance. It begins with an introductory section, which provides a brief overview of the global structures governing international finance in the period 1944 up to the global financial crisis of 2008. The report then looks at the substantive and structural reforms that have been proposed or implemented thereafter in the emerging international financial architecture in the post GFC period, as well as the role of the G20 in global regulatory reform and international financial governance.

According to the 2012 UNCTAD Report on Development and Globalization⁴ for example, the rising imbalances in international trade and financial flows that preceded the 2008-2009

³ For example, Avgouleas (2012), proposes a 'formal international law structure' resting on the following four pillars: the IMF as systemic risk regulator; the FSB as micro-prudential supervisor for global systemically important financial institutions (G-SIFIs); a 'regulation and knowledge management body overseeing the TRNs' in the legal personae of the Organisation for Economic Cooperation and Development (OECD) and the Bank of International Settlements (BIS); and, finally, a global resolution authority which would be responsible for cross-border resolution of financial groups.

⁴ <http://dgff.unctad.org/pages/overview.html>

global financial crisis “were part of the build-up of financial fragilities at the core of global finance in key developed countries that provided the precondition for the global crisis of 2008–2009”. In terms of extant debates, one perspective blamed the tax regulation, accommodating monetary policy, and inadequate savings in the United States, whilst others including Alan Greenspan and Ben Bernanke, have blamed the large pool of liquidity generated by high-savings countries in East Asia and the Middle East, which helped increase asset prices to unsustainable heights in the US hence leading to the bubble and crash of the financial system (Dunaway, 2009).

To this end, Sections IV and V first take a look at the major economies relevant to global imbalances (either on account of their current account deficits or surpluses, or because they represent a very large share of world output) such as China, the Euro zone, Japan, the US and also major sovereign wealth funds (SWFs) countries in the Middle East (e.g. the United Arab Emirates, Kuwait). It then examines how these underlying macro economic relations can play an important role in the debate for reform of our global governance system.

Lastly, the concluding section, advocates the strong need for reform with an eye to developing a more effective supranational governance system that fosters economic sustainability, not least by identifying opportunities for positive engagement by stakeholders in the global financial system.

II) Background to the Current Global Governance Structures

The need to establish institutions to govern global economic relations became apparent in the aftermath of the Second World War and especially, on the back of the experience from the failure of the League of Nations to create a foundation for economic cooperation during the Great Depression (J. B. Boughton, 2004). In 1944, delegations from 44 countries met at Bretton Woods, New Hampshire, and established two institutions, the International Bank

See also Steven Dunaway (2009), Global imbalances and the Financial Crisis, Council on Foreign Relations Center for Geoeconomic Studies
and <http://www.project-syndicate.org/commentary/will-global-imbalances-return->

for Reconstruction and Development (IBRD), later to become known as the World Bank, and the International Monetary Fund (IMF), both of which would aim to govern international economic relations. The role of the IBRD would be to aid in the industrial reconstruction of Europe and the industrialisation of developing countries, whilst the IMF would aid in operating the existing system of fixed exchange rates, where all currencies were pegged to the US dollar, which in turn was fixed with respect to the price of gold.

Even though the role of the World Bank has generally not changed much, a number of important historical events⁵ have taken place that changed the described above role of the IMF. For the purpose of this paper we focus on two main historical events; the collapse of the fixed exchange rate system in 1971 and importantly, the debt crises of the 1980s, which greatly shaped the institution's practices and moulded its contemporary emphasis on structural and institutional reform. The fall of the gold standard, was primarily understood to have been due to the highly mispriced value for gold and a difference between inflation objectives of Europe and the US. The price of gold was set at 34\$ per ounce in 1934 by President Roosevelt, whilst the price of other metals more than doubled in the same time period. At the same time, the US began to run a trade deficit in order to provide liquidity to the international monetary system and partly in order to pay for its war in Vietnam. The problem as suggested by Triffin (1960) was that if the deficit continued, the US dollar currency would lose its credibility as the 'international reserve currency' and as a result, other countries would seek to convert their dollars into gold. As a matter of fact, beginning with France in 1967, some countries started to convert their reserve dollars into gold and in 1971, leading the US to abandon the convertibility of the dollar.

From 1943 to 1971, the IMF played a secondary role under the Bretton Woods system of fixed exchange rates, apparently as the structure allowed limited scope for agency-the

⁵ A 2004 IMF paper, notes ten main events that shaped the role of the IMF. The first three events, the Paris peace conference, the Great Depression and WWII, were said to have catalysed the creation of the IMF whilst, subsequent events ('the rise of multiple economic centres', the Cold War, the African independence, the Vietnam War, the 'globalisation of financial markets', the 'international debt crisis' in the 1980s, and finally, the collapse of Communism, caused the IMF to change its practices in order to be able to stay relevant in a changing world (J. B. Boughton, 2004)

institution. This dramatically changed in the 1980s, where the IMF found a new, important role as conditionality lender (based on detailed macroeconomic programs) and financial crisis manager. When Mexico and other South American countries declared that they could not meet their loan repayments in 1982 to international banks, the IMF became the central coordinating agent to avoid a series of defaults that would destroy these banks' capital. From 1983 to 1985, the IMF focused on "concerted lending", whereby it would guarantee assistance in exchange for increased credit exposure on the part of banks. This did not appear to be particularly effective, and in 1985 the IMF began to implement the Baker Plan, which aimed in restoring economic growth in heavily indebted nations with support from banks, multilateral development banks and the IMF itself. When this strategy turned out to be fruitless, with creditors realising that the indebted countries were unlikely to ever be able to exit from their debt crisis, direct debt reduction techniques were employed under the Brady Plan of 1989 (Boughton, 2001). The debt crises of the 1980s, helped establish a perception that the IMF will help countries to indebt themselves in order to avoid a possible collapse of international banks.

Following the collapse of the Bretton Woods system in 1973, finance ministers from a number of key developed countries laid the foundations and on March 25, 1973, ministers of Britain, France, Germany and the United States met and formed the 'Library Group', named after the venue of their initial meeting - the White House Library. In September of the same year, they were joined by the Japanese finance minister; later, this group became known as the Group of Five (G5) (Hajnal, 2013).

Following these meetings, in 1974 the French President invited the heads of government from Japan and Italy to a summit held the subsequent year, and by 1976 the group was extended to seven, with the addition of Canada. In the early 1990s, Russia started participating in a number of the sessions with G7 leaders during their conventions at their invitation; Russia officially joined the group in 1997 and hence, the G7 became the G8 (Hajnal, 2013).

The initial formulation of the G8 mirrored the dominant economic powers of that era, sharing the further characteristics of being democratic, largely 'Atlantic-oriented' and

militarily allied to the United States (Smith, 2011). A critical attribute of this 'club' was its fairly small size, which meant that the heads of government knew each other relatively well and that gave them the opportunity to talk off the record and with a degree of mutual trust. The inclusion of Russia currently may seem out of tune, however at the time efforts were being made to motivate Russia to become a free market economy, and pledge to abide by the international processes and norms that the G7 considered as standard. This attempt has been a partial success as Russia remained largely different from the original seven members, culturally, politically and economically (Talbott, 2002).

Over the course of the following years, although the agenda has continued to be focused on economic and financial affairs, leaders have also taken on board a more extensive set of issues, including security matters, developmental and environmental concerns. For the most part, the G8 is said to have grown into a comfortable 'club' by the turn of the century, an established facet of the international landscape, that helped enable and encourage policy coordination and ensured a good photo-op for leaders, which helped project a perception of international presence and substance to their relevant domestic political audiences (Smith, 2011).

By the late 1990s, a series of financial crises concentrated mostly in Latin America and Asia⁶, persuaded the G8 finance ministers that important emerging economies were inadequately integrated into global economic management efforts. Led by the Canadian Finance Minister Paul Martin and US Treasury Secretary Lawrence Summers, debates commenced on whether to take in an array of new players. After four initial meetings in 1998 and 1999 including larger groups of countries (the G22 and G33), in December 1999 a set group of 20 was inaugurated, composed of the G8 alongside crucial regional powers, as well as the European Union⁷ (Smith, 2011).

The limitations of the rather non-representative character of G8 membership were becoming more apparent and the need to account for this was confirmed when the chair of

⁶ Mexico 1994, Indonesia/Korea/Thailand 1997–98, Russia 1998, Brazil 1998–2002, Turkey 1999–2002 and Argentina 2000–01.

⁷ The additional countries are Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Saudi Arabia, South Africa, South Korea and Turkey.

the 2005 G8 summit, United Kingdom (UK) Prime Minister Tony Blair, invited five principal developing countries to the Gleneagles, Scotland meeting, namely Brazil, China, India, Mexico and South Africa (Smith, 2011).

The 2007 Heiligendamm Summit in Germany standardised the relationship between the 'G8+5', instituting an agenda for regular ministerial meetings among the 13 countries to address four major areas:

- i) promoting research and innovation;
- ii) enhancing freedom of cross-border investment;
- iii) defining joint responsibilities for development in Africa; and
- iv) improving energy efficiency with the intend of reducing CO2 emissions (see summary report of the Heiligendamm Process, 2007).

To all intents and purposes however, the 'Heiligendamm Process', which only invited heads of government of significant emerging economies to the occasional meal during summits controlled by developed countries, had started appearing more offensive than inclusive to developing countries and their leaders. As the Canadian Finance Minister recalls:

"the image of Hu Jintao, the president of China, and Manmohan Singh, the prime minister of India - leaders of the two most populous countries on earth, quite possibly destined to be the largest economies on earth within our lifetimes - waiting outside while we held our G8 meetings, coming in for lunch, and then being ushered from the room so that we could resume our discussions among ourselves, is one that stayed with me... Either the world will reform its institutions, including the G8, to embrace these new economic giants, or they will go ahead and establish their own institutions..." (Martin, 2008: 358).

Despite such limitations, the Heiligendamm Process could be argued to have constituted an intermediary step in the direction of greater inclusiveness. With the outbreak of the 2008 financial crisis, institutional change became necessary and provided a vehicle for further inclusion. By the autumn of that year, the US economy was in dire straits, with bank failures and a housing market collapse. Stock markets around the world plummeted. It soon

became apparent that the political and economic institutions in place - the IMF, the G8, the United Nations (UN) or the G20 grouping of finance ministers - were unable to orchestrate on their own an adequate response to the financial crisis (Smith, 2011).

At the end of October 2008, en route for the US presidential election, President George W. Bush brought together the leaders of the G20 countries to "...review progress being made to address the current financial crisis, advance a common understanding of its causes and, in order to avoid a repetition, agree on a common set of principles for reform of the regulatory and institutional regimes for the world's financial sectors" (Perino, 2008). Subsequently, in London in April 2009 and in Pittsburgh in September of the same year, leaders worked out a mutual approach, which involved coordinating economic stimulus packages, thwarting protectionism, tackling global imbalances, boosting the financial resources of the IMF and constructing and putting in place more rigorous rules and regulations for banks, hedge funds and other financial institutions (Smith, 2011).

In the above context, the following section revisits some debates on causes that led to the current financial and economic crisis, as well as the reasons why leaders and global political and economic institutions sought to adopt common measures to tackle it. In our concluding sections we discuss the degree of success of these measures, as well as the opportunities for mutually beneficial engagement and the future of global governance system and institutions.

III) Triggers for Change - the 2008 financial crisis and the Rise of BRICs

IIIi) The 2008 Financial Crisis

The sources and the course of the worst financial crisis since the Great Depression has been extensively debated; some academics claim that a housing market bubble that originated in the late 1990s was at the heart of the crisis, peaking as banks pushed mortgage sales to NINJA (no income, no job, no assets)-type households purchased at (endogenously) overvalued (given the easy of borrowing, hence increased demand) prices. For example White (2010) argued that all market players had overconfidence in housing

prices which continued to increase, and that the centre of the problem was the commercial banks' excessive sub-prime lending to households with weak balance sheets. At the same time, banks earned large fees securitising mortgages, selling them to capital markets in the form of mortgage backed securities (MBSs) and collateralised debt obligations (CDOs), as well as servicing them once they were sold.

At the time, it was widely believed that banks distributed most of these mortgages to capital markets as asset-backed securities and it was expected that little if any bank risk was involved in this process. Institutional investors, for example hedge funds and insurance companies demanded these complex, risky products as they were given high - often the highest AAA - ratings by the credit rating agencies.

In this context, scholars have also highlighted the problems resulting from such credit rating agencies, "whose opinions had been at the heart of the capital standards arbitrage that allowed banks to back subprime mortgages with so little equity capital" (Calomiris, 2010: 541). The rating agencies played a critical role by converting sub-prime mortgages into A-rated securities, thus allowing these securities to be held by pension funds and ensuring the continuous flow of liquidity to the mortgage market (Stiglitz, 2010). Importantly, rating agencies were characterised by some skewed incentives (indeed potential conflicts of interest), as they were paid by those they are rating, hence having an incentive to produce good grades for their customers.(ibid, 2010). Less appreciated in literature, is another problem of rating agencies. In their often very sophisticated algorithms, they usually relied on projections from historical macroeconomic data, such as GDP growth, hence effectively assuming away any possibility for a crisis (which is definitionally characterised by a break from historical averages)!

Unsurprisingly, then, the entire procedure intensified high leverage so when the subprime mortgage crisis erupted in mid 2007, it dragged much of the financial sector down due to relatively low capital levels (White, 2010). The crisis commenced in the US, but since mortgage-based financial products had been spread around the world, it quickly turned out to be a global phenomenon. Consequently, one part of the academic literature pointed out that the underlying original cause of the subprime mortgage market failure could be found

in the unsound institutions and practices of what is often mentioned as the New Financial Architecture (NFA)-a term that refers to the integration of contemporary financial firms and markets with its related regime of minimum government regulation, in conjunction with the macroeconomic conditions of the period pre- 2008 (namely low interest rates, risk spreads, along with high profits and rising stock prices). Another part of the literature, which does not necessarily contradict the aforementioned ideas, contended that the 2008-2009 financial crisis has in effect revealed that global imbalances persevere in our current international financial system, and that these increasing imbalances in international trade and financial flows prior to the 2008-2009 global crisis “were part of the build-up of financial fragilities at the core of global finance in key developed countries that provided the precondition for the global crisis of 2008-2009” (UNCTAD, 2012). Proponents of this view argued that “...it is impossible to understand this crisis without reference to the global imbalances in trade and capital flows that began in the latter half of the 1990s” (Bernanke, 2009).

Preceding the financial crisis of 2008-09, many observers identified the mounting international imbalances in the trade of goods and assets as a focal cause of vulnerability for the U.S. and the global economy (Roubini and Setser, 2005; Obstfeld and Rogoff, 2007; Krugman, 2007). The U.S. trade deficit had been on the rise since the mid-1990s, reaching 6% of gross domestic product (GDP) at its peak in 2006, mainly financed by emerging Asia (especially China) and the oil-exporting economies. In a powerful speech, then Fed Governor Ben Bernanke (2005) credited these imbalances to a ‘Global Saving Glut’ (SG), which he explained as a surplus of saving in developing countries largely directed towards apparently riskless assets in the United States. Given these asymmetrical patterns of international exchange, many feared that a sudden loss of appetite for U.S. assets by international investors might lead to a sudden change of its current account deficit, with grave potential consequences for the global economy (Justiniano et al, 2014).

Although a catastrophic financial crisis did ultimately occur, its epicenter was the American housing market, rather than the international market for assets and goods. As a consequence, most of the early literature on the causes and consequences of the crisis

focused on the features of U.S. financial markets such as regulation, risk-management, securitization, funding models, that contributed to the credit and housing boom of the first half of the 2000s, whose reversal was the immediate apparent cause of the crisis (Justiniano et al, 2014).

A more recent perspective in the literature has brought back into focus the link between the global imbalances prior to the crisis and the credit and housing boom that triggered it. On the empirical side, this literature pointed to the discouraging impact of capital inflows on U.S. interest rates and spreads, whose low levels added to the boom in mortgage debt and house prices before the crisis (Bernanke et al., 2011; Bertaut et al., 2011; Warnock and Warnock, 2009). Bertaut et al. (2011), for example, suggested that the purchases of Treasury and Agency debt by the SG countries during the period 2003 to 2007, adding up to nearly 1 trillion dollars, reduced long-term interest rates in the U.S. by roughly 110 to 140 basis points. Furthermore, extensive work by Bertaut et al. (2011) in tracking the flows of capital to and from the United States, has revealed an additional path through which international capital flows might have contributed to easier financial conditions in the U.S. prior to the crisis, namely the role European banks played in the market for secure U.S. assets post 2003, particularly the AAA tranches of private label asset-backed securities (ABS), which turned out to be far from harmless in the crisis (Justiniano et al, 2014).

Since Europe's current account *vis-à-vis* the U.S. was more or less balanced, these gross positions of European banks in ABS were funded by direct borrowing in the dollar wholesale credit market. As a consequence, these financial institutions became a central component of the financial intermediation sector in the U.S., in direct competition with domestic financial institutions (Acharya and Schnabl, 2009; Justiniano et al, 2014). Shin (2012) referred to these gross flows from international banks into mortgage products, even in the absence of analogous net imbalances, as the 'Global Banking Glut' (BG), in combination to the Global Saving Glut linked with the U.S. current account deficit. According to Shin, the flow of funds linked with the BG played a significant role in facilitating financial conditions in the United States throughout the boom, equivalent in scale to that of the purchases of Government debt by the SG countries.

In Shin's (2012) model of global banking, spreads are negatively correlated to the total sum of funds intermediated by the financial system. When risk decreases, banks increase their balance sheet and spreads drop. Hence higher total intermediation generated by European banks, seems to have lessened the spreads amid safe funding rates and the returns on ABS, and consequently on mortgages. In line with this view, Bertaut et al. (2011) estimated that the boost in the demand for ABS and instruments alike by European banks over the period 2003–2007, contributed to a fall in their yield of between 60 and 160 basis points, based at least on their instruments and methodology. When the boom turned to stagnation and the market for private-label ABS in which European banks were most vigorous subsided, the mechanism worked in reverse, hence contributing to the spread of the U.S. financial crisis around the world (Acharya and Schnabl, 2009; Obstfeld, 2012).

Regardless of the mounting empirical evidence on the effects of net and gross capital flows on U.S. credit markets and interest rates, only a small amount of papers have examined quantitatively the overall impact of the global saving and banking gluts on the U.S. macro-economy, as well as on the credit and house-price boom of the 2000s in particular. Some scholars, analysed this question using a quantitative dynamic equilibrium (DSGE) model (Christiano et al., 2005; Smets and Wouters, 2007; Justiniano et al, 2014). Based on the typical medium-scale DSGEs first considered by the aforementioned authors, others have developed models including borrowing and lending among heterogeneous households, as well as from abroad, with houses used as collateral (Iacoviello, 2005). These studies have concluded that real estate prices played a significant role in determining the level of household debt. Due to its characteristics, DSGE models have been argued by some scholars to be a useful tool to study the macroeconomic effects of the SG and BG on the US economy, as well as their contribution to the credit and real estate boom of the 2000s (Justiniano et al, 2014).

More specifically, in order to analyze the impact of the SG, the aforementioned study assumed that the observed U.S. trade deficit and associated capital inflows were exogenous. This exogeneity assumption was argued to help tilt the inter-temporal consumption profile of domestic agents towards the present, which could be optimal in the

case of an interest rates decline. The rest of the adjustment in the domestic economy would follow from this fall in the domestic rate of return. As lower interest rates would stimulate the demand for nondurable consumption, investment and housing by the lenders, the resulting upward pressure on house prices would then relax the collateral constraint of the borrowers, who could hence consume more. Finally, preferences parameterised to deliver a small wealth effect, could prevent this expansion in consumption from resulting in a sharp fall in hours worked. This chain of events was what the authors referred to as the 'Global Saving Glut channel'. Quantitatively, the SG would imply that consumption and investment increase by roughly 5% and 12% above the balanced growth path, while the effect on GDP would be more muted because of the deterioration of the trade balance. Furthermore, at the peak the ratio of household debt to GDP would be 8% higher, while house prices would increase by 13%.

Among the first papers to officially study the saving glut hypothesis were Caballero et al. (2008) and Mendoza et al. (2009). These contributions placed emphasis on the dissimilarities in financial market development across various economies that made riskless U.S. assets an especially attractive store of value for the excess saving in the rest of the world. In their quantitative analysis, Mendoza et al. (2009) also pinpointed the dynamic implications of global financial liberalization on international imbalances and portfolios.

The literature on the causes of the current financial crisis is far from unanimous on the significance of this international conduit for macroeconomic developments in the United States. At one extreme, Favilukis et al. (2012, 2013) have found essentially no impact of the foreign purchases of Government bonds on house prices and domestic credit. In the model they employed, the decrease in the risk-free rate coupled with the flow of international resources into the U.S. economy, was counterbalanced by a rise in the risk premium on housing, due to the portfolio reallocation forced on domestic agents by the foreign purchases of safer assets (Favilukis et al, 2012/2013). On the other hand, other models have not accounted for risk, and found no significant portfolio choice, since agents were assumed to have perfect foresight (Justiniano et al, 2014). Such results underline the inter-

temporal substitution mechanisms related with the decrease in interest rates, precipitated by the trade deficit. On the one hand, this orthodox macroeconomic focus comes at the cost of disregarding a possibly significant portfolio path. On the other hand, the inappropriateness of portfolio choice in these models allows for a more inclusive analysis of the saving glut, without having to be concerned with the constitution of the capital inflows. In addition, this allows for the standardisation of the foreign appetite to the total trade deficit, rather than just to the fraction equivalent to the purchases of Treasuries (Favilukis et al., 2012; Justiniano et al, 2014).

More recently, Justiano et al. (2014) employed a quantitative equilibrium model with houses, collateralized debt and foreign borrowing to examine the impact of global imbalances on the U.S. economy in the 2000s. Their results indicated that the dynamics of foreign capital flows accounted for between one fourth and one third of the rise in U.S. house prices and household debt that paved the way for the financial crisis. A key to these results was that their model generated the sustained low level of interest rates observed during that period.

In relation to the 'global savings glut' (GSG) hypothesis, Bertaut et al (2012) aimed to present a more comprehensive view on how capital flows contributed to the financial crisis, paying attention to the significant inflows from European investors into U.S. private-label asset-backed securities (ABS), including mortgage-backed securities and other structured investment products. As noted, the GSG hypothesis argued that the increase in capital inflows from emerging market economies to the United States led to significant declines in long-term interest rates in the United States and other industrial economies. In turn, these lower interest rates, when combined with both innovations and deficiencies of the U.S. credit market, appeared to have contributed to the U.S. housing bubble and to the build up in financial vulnerabilities that precipitated the financial crisis. Because the GSG countries for the most part restricted their U.S. purchases to Treasuries and Agency debt, their provision of savings to ultimately risky subprime mortgage borrowers was necessarily

indirect, pushing down yields on safe assets and increasing the desire for alternative investments on the part of other investors.

In all, differences notwithstanding, the current financial crisis has led to discussions on the sustainability of international finance development and global governance. Our aim so far was to present some current debates on the causes of the crisis, focusing on global imbalances and how these might have led to the US housing bubble and economic crash. In effect, our critical account, helps highlight the interconnectedness of global finance, pointing to the need for a higher than extant degree of cooperation and inclusion between countries and aiming at a more sustainable, and mutually beneficial, financial system. In a sense the perils of a US-EU-dominated global financial system would characterise any hegemonically-orchestrated supra-national stability. In this context, the following section examines the role of rising powers particularly, the BRICs, and Sovereign Wealth Fund (SWF) countries.

IIII) Global imbalances, the rise of BRICs and SWF Countries and Impact on International Relations and Governance

The rising influence of Brazil, Russia, India and China (BRICs), as well as sovereign wealth funds (SWFs) countries in global finance has been a great interest to scholars, policy makers and managers alike. The BRICs are major emerging economies of importance and relevance to global imbalances, while major sovereign wealth fund countries in the Middle East (e.g. the United Arab Emirates, Kuwait) can potentially play an important role in global investments, hence the global economy as a whole, which in turn relates to the debate about reform of the global governance system.

According to the International Monetary Fund's 2014 World Economic Outlook, 2013 was the first year where emerging markets accounted for more than half of global GDP in terms of purchasing power parity (IMF, 2014). Between 2003 and 2011, the share of world output attributed to the emerging economies increased by one percentage point per year. This impressive rate of growth marks a principal economic transformation in modern history.

Since the late 1990's the economic landscape has dramatically changed with 73 percent of developing countries not only achieving 'catch-up-growth', but outpacing the US at a 3.3 percent a year.

BRIC countries were at the forefront of this transformation with the most impressive growth record. Today they make up four of the largest ten national economies worldwide. As a result of the remarkable growth of emerging market economies and particularly BRICs, the world economy is experiencing major transformations. Among others, commodity prices initially grew whilst manufacturing and labour costs collapsed, global poverty rates fell, and the growing and more accessible pool of labour contributed to wage stagnation and growing income inequality in developed economies. These global economic imbalances might have contributed to financial vulnerability and have paved the ground for global economic malaise.

There were various reasons why the timing for BRICs was right. In the 1980's the so called second stage of 'unbundling' was initiated; the business world has experienced lower shipping and communication costs, the revolution of cooperation, the offshoring of activities-tasks and 'networked FDI' (Baldwin, 2009; Baldwin and Okubo, 2012). One of the immediate results of this 'second unbundling' was the growth of 'time-sharing' activities over distance mostly facilitated by technological advances and ICTs. Hence, longer supply chains were created and places were connected with a vast pool of accessible labour. In this context, emerging economies opened-up 900 million non-farm jobs in comparison to a mere 160 million in developed economies between 1980 and 2010.

The emerging role of BRICs came in an era of globalisation where living standards were diverging. By the early 1990's China and India's share to global output was just 7 percent, despite the fact that their joint populations amounted to 38 percent of the world's total. The return of these economies in the global economic landscape was what some scholars called 'convergence with a vengeance' (Subramanian and Kessler, 2013). China's transition to a more market oriented economic system and India's booming a main base of offshored jobs, were initially received with confidence and relaxation by the US, perhaps due to the transfer of know-how and potential expansion of western firms among others. The

immediate result of this vast pool of cheap accessible labour contributed highly to global trade. Merchandise exports boomed from 16 percent of world GDP in the mid-1990s to 27 percent in 2008. The Chinese share of global exports reached 11 percent, with trade accounting for more than half of the country's GDP, granting to China the etiquette of the first 'mega-trader' since Britain's imperial zenith (Subramanian and Kessler, 2013).

As anticipated, China's increased involvement in global trade was followed by an increase in demand for commodities benefiting supplier-nations including Russia and Brazil, but also many lower-income nations in Africa. These economies supplied China with energy and raw materials including iron ore, copper and lead hence contributing to a larger scale boom. From 1993 to 2007 China's mean growth rate reached 10.5 percent per annum. India followed with a 6.5 percent and their combined share of world output amounted to 16 percent. As a result, economic imbalances escalated and from 1999 developed economies were running on economic deficits reaching 1.2 percent of rich-world GDP with emerging economies' combined surplus reaching 4.9 percent of GDP in 2006.

In addition, emerging economies accumulated dollar reserves, thus keeping exchange rates lower than otherwise and exports relatively inexpensive. The BRICs dollar reserves seem to have contributed to a global savings glut and the resulted low interest rates stimulated public and private borrowing in the developed world. In this context, many argued that emerging economies were engaging in currency manipulation in order to avoid increased domestic consumption of imports and hence, any potential export offsets in big markets, such as the US.

The increase of Chinese exports to advanced economies has been for many scholars an important reason behind the US employment 'sag' of the 2000's (Acemoglu et al., 2013). Even before the current financial crisis U.S.'s employment rates were suffering, primarily due a shrinking manufacturing employment. In this context, some scholars claimed that the rapid increase of import competition from China was the prime contributor for the contraction in U.S. manufacturing employment, as well as for the overall setback of the U.S. employment growth (ibid, 2013). More specifically, some estimates indicated that job

losses due to China's increased import competition, and the U.S.'s taste for them, during 1999 to 2011 ranged between 0.6 and 1.25 million (Acemoglu et al, 2013).

The effects of the rise of BRICs are likely to continue to leave their mark on the rich world's economy for a long time. Among others, the pool of talent has grown significantly, alongside greenhouse gas emissions and local environmental damages. However, BRICs growth rates and the share of world output have been decelerating in recent years, and so have commodity prices. In 2007 China's economy expanded by a staggering 14.2%, India by 10.1%, Russia 8.5% and Brazil 6.1%. According to the IMF, China would grow by just 7.8%, India by 5.6%, and Russia and Brazil by 2.5% in 2013 (IMF, 2014).

Sovereign wealth funds (SWFs), generally defined as "public investment agencies which manage part of the (foreign) assets of national states" (Beck and Fidora 2008, p.349) have also recently received substantial public attention. Since the late 1990s, the formation of SWFs has been on the increase. This rise was in part due to the growth of substantial foreign exchange reserves by emerging economies, of which a growing number have created new SWFs. Despite their earlier cautionary treatment by policy makers, the Great Recession led to a shift in their attitude, from cautious and apprehensive to now considering these entities as possible 'lenders of last resort' during times of financial and economic hardships (Curzio and Micelli, 2010). The reason for that is that SWFs can provide liquidity, but also investments in Western firms creating this way a common interest for the performance of their investments. By 2014, SWFs were estimated to control assets amounting almost \$7 trillion⁸. Hence, it is not surprising that some consider SWFs as one the most important "power brokers" in the global economy (Farrell et al., 2008).

The increase of SWFs has been linked to rising commodity prices and global payment imbalances. SWFs however, have also been criticised as potential destabilizers of the financial system, not least due to the fact that they manage financial wealth owned, beneficially at least, by governments, which raises a question of national security. In this context, from an international relations perspective their intrinsic motivation is challenged,

⁸ Based on data (updated January 2015) from Sovereign Wealth Fund Institute website – see <http://www.swfinstitute.org/fund-rankings/>

specifically as to whether they are maximising national interests vs. profits (Drezner, 2008). This could in part explain the distrust some recipient countries show that could lead to the adoption of protectionist measures. Other policy concerns include potential lack of transparency, and risks for the overall global economic stability (Beck and Fidora, 2008). We analyse these below. The economies that have primarily formed SWFs are countries affluent in resources benefiting from until recently inflated oil and commodity prices, themselves in part a result of the rise of BRICs.

There are two prevailing views in the literature for SWFs. The first view considers SWFs as being contributors to market liquidity and financial resource allocation. As previously mentioned, SWFs have been considered a sort of a buffer during economic and financial distress. A reason for this is that Arab SWFs undertake long-term oriented investments, unlike private equity and hedge funds, which are more immune to short-term volatility. Hence, they can reduce asset price volatility and attenuate liquidity risks in contrast to shorter-term investments (IMF, 2007).

On the other hand, others claim that the lack of accessible information on some SWFs, their varied objectives and their unclear institutional structures and investment management, make it hard to evaluate their impact on capital markets. Their asset management activities for example lack public accountability with the potential for drastic changes in their investment policies that may be little understood or predicted and may stimulate market volatility in various asset groups (IMF, 2007). In addition, the public sector nature of SWFs may generate capital account restrictions in order for recipient economies to avoid certain types of foreign direct investment (FDI) for example, for reasons of national sovereignty (IMF, 2007).

With the increasing importance of SWFs 'multi-level governance' became a prominent topic and the division of 'best practices' a priority. Policy division was undertaken by the G20 Finance Ministers, which then passed on to the IMF, the Organisation for Economic Co-operation and Development (OECD) and the World Bank. The end result was a set of 'international best practices', namely the Santiago Principles (Norton, 2010). In 2009 the International Forum of SWFs was established, which initiated a process for implementing

these Principles, as well as further promoting their global integration in the post global financial crisis international economic landscape. These developments added new constituents to the global capital markets and raised questions about the roles of extant Hegemonic stability-inspired international organisations such as the IMF, and World Bank, , as well as the OECD, the United Nations, International Labour Organization and World Trade Organization (Norton, 2010). We address these issues in Section V.

Among the most significant reasons for the aforementioned potential challenges and need for a more inclusive global policy network, are the creation of multilateral networks and currency wars. The rise of BRICs opened up a broad discussion on the reasons why institutionalised cooperation between these countries began. Some literature suggests that this phenomenon was due to the global financial crisis in developed countries coupled with relative economic stability in emerging economies, which led to a global financial order destabilisation that initiated an unprecedented cooperation between emerging economies in the context of the BRICs network (Stuenkel, 2013). This provided the last mentioned with an increased presence in the agenda of supra-national governance. In addition, intra-BRIC cooperation in international finance led to a more rounded cooperation, like anti-tax evasion and noncompliance practices, leading to potential spill-over effects. This highlights the prospects for a continuous cooperation after the end of the global financial crisis that contributed to BRICs initial formation (Stuenkel, 2013).

As noted, the impact of emerging economies and SWFs is not restricted to the economy, but has implications for the prospects of global governance and the role of the G8 and G20. There is significant literature discussing this shifting of balance. It is worth noting that the global financial crisis demonstrated that even short crises in the legitimacy of global governance can lead to the establishment of alternative institutions, like the BRICs bank, which can become part of the global governance architecture.

More generally, there are two main diverging views on the convergence debate and a new world order. The first perspective suggests that the economic convergence of developing economies with more advanced ones -in real and per capita terms- is a successful outcome of progress achieved in the past decades. Therefore, reconsidering the global agenda that

led to this success would be unnecessary, if not frivolous (Kahler, 2013). Given their increased commitment in the global economic and governance agendas, especially in the case of Brazil, India and China, the future for global convergence should be to become more accommodating. On the other hand, others claim that shifts in power are accompanied by a significant risk of conflict and disorder. According to this view, rising powers will seek to influence the new international institutions in ways which will however, differ remarkably from those supported by the present powers and their status quo (Kahler, 2013).

It is now apparent that the post-global financial crisis era will be increasingly influenced by China and the U.S. Irrespectively of cooperation or conflict between these two economic powers, both may strive to place their diplomacy imprint on the multilateralism of the G20 (Garrett, 2010). The challenge here however, lies in the level of difficulty for the management of the economic relations of the G2. The economic imbalances between the two economies, where China purchases U.S. debt and the latter exhibits a huge appetite for Chinese imports, may remain for the foreseeable future. Before the crisis, these imbalances were promoting and sustaining stability between the countries' relations. However, it may well be the case that after the crisis, these imbalances could engender frustration and conflict. In order to promote and sustain more stable economic relations between China and the U.S., the G20 agenda may need to progress from managing the crisis to devising strategic policies for the global economy, as well as to becoming more institutionalised (Garrett, 2010).

In general, China has its own perspective on global governance and foreign policy. Some literature has argued that despite China's preference with pleasing certain developing countries, e.g., in Africa, this preference may lead China to conflict with advanced economies over the ways to deal with global affairs, not least those of humanitarian nature. While China's view is still unfolding there are doubts on whether Western economies will be willing to accommodate the practices that China has adopted (Chan et al, 2008). This is not only the case for China, but also for the rest of BRICs. Despite the fact that some

preferences on the ways of global governance seem to converge, their increasing engagement with the global economy have also increased negotiations for reform and an effective international regulatory framework (Kahler, 2013). Therefore, preferences can diverge in future, especially due to increasing economic capabilities, for example due to market size which can be a key bargaining advantage. In this context, increasing capabilities, like the swift growth of internal markets and export-oriented economies, may result in a switch in preferences on the content and form of global governance (ibid).

The global financial crisis, accordingly, as well as the emergence of BRICs and SWF countries, has exposed structural flaws of the global financial and fiscal architecture and highlighted the need for increased international cooperation. Due to the recent trend of global economic integration, cooperation may be vital for the reform of the international financial system and the adoption of effective global regulatory standards. In this context, the importance of the global governance system and the G20 has arguably increased (Ozkan, 2011). The role of the G20 in the restructuring of the international financial and monetary system has been the subject of many studies. Its effectiveness and legitimacy have been examined within the context of global governance reform. Negotiations between advanced and developing economies about the reshaping of the global financial architecture, as well as international and domestic political barriers to global governance reforms and representativeness, coherence and compliance deficits of the G20 have all been explored in the literature (ibid, 2011).

So far, the G7 (G8 minus France) have not been open to much of a public discussion for essential reforms of the international monetary system within the G20 procedure. Nor has they offered to discuss further actions to develop the use of Special Drawing Rights (SDRs) as a bargaining tool to produce more space for negotiations on exchange rates and economic imbalances. A key aspect that could influence any change in the negotiating agenda is the way in which the Obama administration interprets the international financial and economic crisis that the US is experiencing (Chin, 2010). For example, to what extent is the prevailing concern of the US Treasury to shield America's long boom against foreign intrusions? The latter was a chief priority for the U.S. from the 1994 Mexican currency crisis

through the crises that followed in Thailand and the Asian region and eventually the crises in Brazil and Russia. In this context, transparency is necessary on whether, or to what extent, the Geithner–Summers–Volker team has since adjusted America's macroeconomic and geo-economic policy agenda. With the global recession receding, and the US economy seemingly having made the shift to recovery, there may be a temptation to focus primarily on minimising the effects of the global crisis instead of contemplating more far reaching, radical change (Chin, 2010).

It is sometimes argued that the current financial crisis has strengthened the significance of global governance and that the G20 can moderate the levels of representativeness, coherence and compliance deficits of the global governance system (Ozkan, 2011). Nevertheless, due to the U.S., the E.U. and developing economies' diverging interests, it is also possible that global governance reforms and the restructuring of the international financial landscape will progress only gradually (ibid, 2011).

IIIIii) Prospects for international monetary relations

For the past 50 years or so, the dollar's de facto position as global reserve currency has arguably provided considerable political and economic clout to the United States. The current economic crisis has created some doubts on the ability of the dollar to act as the chief reserve currency. Hence, it is claimed by some that the dollar may be substituted by the euro, or the Chinese renminbi (Eichengreen, 2011), or indeed a basket of currencies.

Some scholars have also challenged the view that there should be only one predominant global currency. On the other hand, it is suggested that the dollar will lose its world class status only if the U.S. fails to successfully restructure the current financial landscape. Hence, the future of the dollar lies in part with the hands of the U.S. economic policy decisions rather than with China or the European Union (Eichengreen, 2011).

It is argued by some that the world could be characterised by multiple international and reserve currencies within the next decade (Eichengreen, 2011; Lin and Rosenblatt, 2012). This transition is thought to lead to a more stable and secure financial structure, in that the presence of alternatives will ensure higher market discipline by countries that hold reserve currencies (Eichengreen, 2011; Lin et al, 2012). These currencies may possibly include the dollar, the euro and the Chinese renminbi.

At present, there is substantial pessimism regarding the euro. It is still doubtful how EU member states under the experience of draconian budget cuts can bounce back without reinstating their national currencies. However, even if a euro-area country defaults, this may not result in the end of the euro. Europe is in need of monetary restructuring and integration, however, the basic steps needed are known. For example, the issuance of reduced amounts of bonds with the support and credit of all member states of the EU is a first step needed for introducing a deeper and more liquid treasury bond market similar to that of the United States (Eichengreen, 2011).

The main challenge of introducing a new international monetary system lies in that the old system was hampered before a new one had developed to substitute it. In addition, reforms are proving more challenging, as the international economic system is still functioning. (Friedman, 2013).

For the past two centuries the international monetary system has been experiencing sporadic crises with a global financial impact. In order to ensure a smooth transition into a new financial system it is argued that three vital elements need to be in place: exchange rate policy coordination (Lin and Rosenblatt, 2012), fewer or no restrictions on current payments and no dis-equilibrating capital movements (Friedman, 2013).

As previously mentioned, some literature suggests that putting in place a more competitive set of reserve currencies can prove to be more stable in the future. The reason is that there would be additional and more varied set of assets for central banks to invest, as well as increased competition that may foster discipline to reserve currency countries' macroeconomic policies (Eichengreen, 2011; Lin et al, 2012). Conversely, when considering

swift movements in market perceptions, the important monetary challenges in high income countries in combination with the growth challenges of emerging economies could result to even bigger regional and international instabilities than those taking place over the past decade. There is a variety of challenges that the new monetary system should address, for example politics (Lin et al, 2012). The political process implicated in addressing pension and health reforms in high-income nations, tackling income inequality or other social tensions in emerging countries. In this context, it may prove difficult to avoid periodic crises in future, followed by high volatility of financial flows, with a probable undesirable impact on developing countries as manifested during the 2008-9 financial crisis. Reshaping the global financial landscape, including the banking sector and other financial regulatory instruments, should be at the heart of a more courageous reformist policy agenda (Lin et al, 2012).

There is little question that the reform agenda of the international monetary system could experience numerous practical difficulties in defining and agreeing on the particular role of the international monetary system that would assist in the international structural transformation (Friedman, 2013). So far, the international community has not reached a consensus on the particulars of this transformation and its implementation. The priority should lie with establishing the principle underpinning these reforms. In order to achieve this, collaboration and cooperation between international authorities and other concerned agencies is of the essence (Friedman, 2013).

In all, the shifts in the balance of power and the effects on the prospects of global governance in terms of the G8 and G20 represent another trigger for change towards a novel global governance structure. Below, we evaluate the role of incumbent powers and institutions in global finance.

IV. The EU, the US and Global Finance

As noted already, in the aftermath of the 2008-09 financial crisis, the need for reform of global financial governance became apparent. The debate was driven by two separate

strands: one on the substantive content of regulations and the other on the organisational structural design of their governance. These two different views of policy makers have been reflected in academia, where post-crisis analyses of financial governance have remained largely disengaged from revived dialogues about the nature of financial markets. Some however, have claimed that this separation is profoundly unsound (Mügge and Perry, 2014). When considering interactions between standards for banking, credit rating, accounting, and derivatives trading, the suitability of the organisational architecture of global financial governance is essentially dependent on the ways financial markets work. Particularly, if financial markets are not linked to external “economic fundamentals” but rather display reflexivity, then the joint interactions between the various regulatory arenas can require significantly more organisational coordination than hitherto available (ibid).

As a result, it is arguable that the G20 has to carry out the vital task of guiding the restructuring of the organisations in charge for reforming financial market regulations. The substantive policy debate has resulted in vigorous criticisms on ‘regulatory liberalism’ (Gamble, 2009) and related economic ideas such as ‘equilibrium finance’, which were the prevailing ones pre-financial crisis. These criticisms were embedded in an opposing set of ideas challenging the underpinning theories of equilibrium finance, which some call ‘reflexive finance’ (Mügge and Perry, 2014). In contrast to substantive ideas, the organisational architecture debate was less pronounced, mostly portraying pre-crisis concerns about the lack of engagement of emerging economies at global standard setters, like the Basel Committee on Banking Supervision (BCBS). Besides the increase in participation and accountability, the one significant organisational reform that proceeded was the advancement of the Financial Stability Forum to the Financial Stability Board (FSB), aiming at synchronising reforms and managing regulatory gaps (ibid, 2014).

The current international organisational structure in setting financial standards remains fragmented, characterised by a functional division of labour. Banking regulation is managed by the BCBS; the International Organization of Securities Commissions (IOSCO) controls the rules for securities markets and credit rating agencies. The International Accounting Standards Board (IASB) is the principal global accounting standards setter, with

the exception of the United States that has its own (Mügge and Perry, 2014). However, other aspects of financial governance, such as the regulation of hedge funds, have been coordinated primarily by national or European establishments that may not be characterised by a strong appetite for international standard setting. The current global financial crisis has highlighted the urgency for restructuring the international financial architecture. As mentioned earlier, while a number of short-term reforms are already in progress, some scholars envision more potent reforms of the international financial architecture that can be executed over the next decade or so (Eichengreen, 2009). These include among others, standardising the expansion of IMF quotas and the regulation of exchange rate surveillance. In addition, the suggested agenda includes an extended role for convertible SDRs in international transactions, which would entail someone, such as the IMF, to act as a market architect. It also considers proposals for reemploying Glass-Steagall-like restrictions on commercial and investment banking, something that will require international coordination in order to be viable (ibid, 2009).

Other proposals include capital insurances for banks, posing the question of who would be on the other side of the market, allowing scope for a role for the IMF. Furthermore, there are suggestions for a new group or institution to deal with cross-border bank insolvencies. Any such body will need personnel support, which might possibly come from the IMF. Lastly, some insist that international circles of regulators are not adequate and that it is advisable to create a World Financial Organization (WFO) with the authority to penalise members whose national regulatory policies are not up to international standards. A WFO will equally need personnel support, for which the Fund would be one probable source. All these suggested reforms presume effective IMF governance reform so that the institution has the legitimacy and efficiency to undertake these extra responsibilities. (Eichengreen, 2009).

In addition, the discussion in Section IIIii and points raised above have opened up the way for questioning the usefulness, of the G20 process as opposed to a 'new Yalta' or new G5 arrangement, and also the coexistence of smaller and larger 'G-type' meetings, with the required coordination between them. In case the Great Powers would consent to such a

small group meeting, the benefit of a Yalta-type discussion would be that the smaller group of geo-economic powers could concentrate on debating a 'grand bargain'. This type of negotiation would necessitate considerable confidence-building measures, and cross-verification of data and information (Chin, 2010). The risk in holding a Yalta-type summit in present conditions is that the incumbent Great Powers (including the US, China, Russia, Japan and the EU) would not have the 'benefit' of intelligibility on the hierarchy of international power that typically emerges from a great war. In addition, they would not be able to draw from the additional impetus for grand strategic vision that runs high during periods of war, nurtured by wartime propaganda (ibid, 2010).

While comprehensive negotiations on national currency reserves and imbalances may sound improbable, particularly in the case of China, there are instances of analogous negotiations with China in the recent past (Chin, 2010). For example, the WTO negotiations over the level of domestic agricultural subsidies that would be compatible with China's accession into the global trading regime were based on reaching a new consensus on the Chinese government's national food security policy, in particular the level of national self-sufficiency in grain that China could sustain. In return to the new accommodation that was struck, the Chinese authorities adjusted the country's national grain reserves system. The WTO negotiations concerned quantifiable subsidy limits (Chin, 2010). Although ensuring strict compliance on multilateral agreements is always a challenge, these negotiations did lead to a new accommodation and international accountability measures.

In brief, it has been suggested that the formulation of reliable options for decreasing China's reserves or Brazilian self-insuring in exchange for an improved measure of collective insurance, will call for the reserve accumulation issue to be considered in relation to the larger question of systemic reform (Chin, 2010). The latter has been the result of the increasing scepticism towards the IMF and the World Bank, particularly in developing economies, which also strengthened the motive of countries to self-insure. The impression has been that the Fund's adopted measures have been rather obstructive, invasive and influenced by the goals of American policy-makers (ibid). The latter was one of

the main reasons for the criticisms that international institutions have received regarding legitimacy and inclusion.

All the aforementioned suggested reforms highlight perhaps a much deeper crisis than the financial one, a crisis of politics, representation, legitimacy and democracy. An immediate result are debates on the role of the EU and the U.S. and consequently of the G8 and G20 in global governance, and their effectiveness in fostering inclusion. The G20 is a rising international organisation and standards setter, primarily a result of the severing financial conditions that alarmed some British and American decision-makers. Amidst the financial crisis, most analyses on the G20 had focused on its adopted measures for tackling the financial crisis, instead of examining its capability and legitimacy in the context of orchestrating and setting governance standards of the post-crisis global landscape (Payne, 2010).

In a broader perspective, the role of the G8, the core unit of the G20 since the mid-1970's, and the latter's emergence is of the essence. In this context, some literature highlights the importance of the G20 as a more representative and inclusive body able in setting global standards and handling global affairs. G20 member countries account for around 90 per cent of global gross national product, 80 per cent of world trade (including EU intra-trade), as well as two-thirds of the world's population. Due to these and its expanded membership, the G20 has been claimed to have higher economic weight and more legitimacy and influence over the management of global imbalances and the global financial system (Payne, 2010). Critics however, are sceptical about these claims, suggesting that the sustainability of present international organisations and the G8/G20 is far from obvious.

The aforementioned context could provide opportunities for positive engagement by the EU provided that Europe too revamps its financial landscape, a task on which the EU has already made some progress. The introduction of a European Systemic Risk Board and a European System of Financial Supervisors, for example, has strengthened the ability to monitor financial sector risks and thus, to prevent crises.

However, there is a long way to go concerning crisis management and resolution, especially for cross-border banks. In this context, some propose an integrated European agenda for crisis prevention, management, and resolution. The agenda should consist of a European Resolution Authority, with the authorization and apparatus to tackle cost-effectively with failing systemic cross-border banks. This faces some technical challenges, primarily as it requires strong political leadership. In addition, strengthening macroeconomic, financial and structural policy coordination is of the essence. The latter will ensure that future imbalances remain to the minimum. Lastly, concerning the boosting of growth and addressing unemployment, cooperation between EU member states for a sustained recovery is of the essence (Pitelis, 2014).

In the above context, in the short term EU's policies should aim in promoting growth and smoothing the way for adjustment in countries that suffered most from fiscal and current account imbalances. Strict austerity policies implemented during crisis should be eased or abandoned and policymakers should aim in implementing actions boosting structural competitiveness and increased aggregate demand, notably through public and private investments. These will reinstate confidence in Europe's fiscal sustainability. In the long run, emphasis should be placed on promoting structural competitiveness (Pitelis, 2014). Hence, in the aftermath of a mighty economic crisis, Europe should make a commitment towards greater integration and cooperation. In effect, this primarily entails strengthening institutions, invigorating the economic foundations of the union and expanding the merits of peace and prosperity to all European nations.

Last but not least, the running and viability of the European Union (EU) eventually depend on its peoples discovering common cause and building a shared sense of political community. Nevertheless, in recent times, scholars have voiced some level of uncertainty about whether the EU's increasing cultural, religious and economic diversity is damaging the growth of citizens' shared sense of political community, in particular subsequent to its eastern expansion (Klingemann and Weldon, 2013). This question has been examined in literature using data on a chief facet of political community, namely transnational dyadic trust (ibid). While acknowledging the significance of diversity for trust judgments in the

short run, the popular belief that it is also a long term barrier to integration has been challenged.

Instead, some scholars have claimed that citizens from different cultural and economic backgrounds can discover ways to build trust between them and eventually develop a sense of political community through better cooperation and interconnectedness (Klingemann and Weldon, 2013). This theory has been empirically tested with data on bilateral trade density, which is viewed as a proxy and precursor for other forms of cross-national interconnectedness. Moving beyond existing research and testing the theories over time, research suggests that ultimately mutual trust and a sense of political community can in fact develop in diverse environments, hence highlighting further the importance of European integration (Klingemann and Weldon, 2013).

As previously mentioned, despite current opportunities for positive engagement by the EU and US the space for reform provided by a liberal global world order is placed under question. One reason for that is that the landscape of economic and political power is shifting from Western developed countries to non-Western developing ones (Ikenberry, 2011). This fact suggests the increasing opportunities for positive engagement by developing countries. The diverse cultural, political and economic backgrounds of fast-emerging countries, i.e. Brazil, China, India, sets out a different set of priorities and agenda for future global governance – perhaps a less liberal, more state orchestrated one (Ikenberry, 2011). For these reasons, it has been argued that global politics is going through a transition of ideas and principles that characterise the world order. Some claim that this transition will be shaped primarily by China and other emerging-market states that “are learning to combine market economics with traditional autocratic or semiautocratic politics in a process that signals an intellectual rejection of the Western economic model” (Halper, 2010).

Furthermore, emerging states may have an interest in an open and rule-based system, which is characterised by more openness and hence, access to other countries for trade, investment, and knowledge sharing opportunities. The unrestricted investment from the United States and Europe of the past several decades has facilitated the growth and

development paths of China and the other emerging economies (Ikenberry, 2011). As the latter grow, they will stumble upon protectionist and discriminatory policies from slower-growing states threatened with a potential loss of jobs and markets. Consequently, the emerging states will question the rules and institutions that sustain non-discrimination and equal access. The World Trade Organization, the most official and advanced institution of the liberal world order, embodies these rules and norms, and emerging economies have been keen on joining the WTO and gain the rights and protections it contains. China is by now deeply involved in the global trading system, with an impressive 40 percent of its GNP composed of exports - 25 percent of which end up in the United States (Ikenberry, 2011).

However, there is growing influence of internationalist-oriented elites in Brazil, China, India and other emerging powers creating a growing global constituency for an open and rule-based international order, hence welcoming the rules and institutions of the old order. These elites would like the protections and rights that derive from the international order's Westphalian protection of sovereignty. They are concerned about greater power-authority, desire the protections and rights relating to trade and investment and they would like to utilise the rules and institutions of liberal internationalism as platforms to protrude their influence and gain legitimacy at home and abroad. The UN Security Council, the G20, the governing bodies of the Bretton Woods institutions are all stages on which emerging non-Western states can obtain great-power authority and engage in global leadership (Ikenberry, 2011).

Much of the above debate falls short of exploring the type of supranational governance best suited for the purpose of economic sustainability in today's semi-globalised economy. The aim of the next section is to provide a political economy-based rationale for a novel, sustainability-compatible framework for supranational governance that goes beyond extant proposals. This we call a public-private-polity- partnership (PPPP)-based approach. We submit that despite limitations, such an approach can help identify and leverage opportunities for global mutually beneficial engagement, hence serve as an alternative scenario to the ones already identified and discussed.

IV) A More Accountable Supra-national Governance for World-Wide Economic Sustainability as a condition for more Participative Engagement

As noted, the foundations of the extant supra-national governance lay at (variants of) the hegemonic stability hypothesis. Fundamental changes as a result are likely to require a foundational revisiting and provision of alternative to this hypothesis. We take a first step towards this direction below, proposing a more accountable private-public-polity-partnership-based supranational governance instead.

Extant literature on supra-national governance underplays the links between different types of governance (private/corporate, public and supra-national) and the agency structures within these. It is arguable that identifying these and achieving some form of alignment between them is fundamental for improving extant supra-national governance structures (Pitelis, 2013). The last mentioned author, identifies a multitude of “agencies” which, moreover, are hierarchically layered. While the range of potential agencies is likely to be very high, three are identified as the most critical. These are between the (‘controlling group’ of a) corporation, and the corporation as a whole, the nation and the corporation, and the world on the one hand, and the nation, on the other.

Besides corporate governance, the governance of a nation as a whole by its controlling group, usually its government (public governance), and the governance of the world as a whole (supranational governance), as well as the potential ‘agencies’ between them, and the need for incentive alignment, can be of critical importance for the sustainability of world-wide value and wealth creation. Typically national governance involves the institutions, laws, and policies that a national government puts in place, in order to foster its objectives. It includes macroeconomic and micro-supply-side policies, such as regulation, industrial and innovation policies. Public governance is typically exercised by an elected government through majority voting. Supra-national governance is typically orchestrated through a hegemonic power that provides international public goods (Kindleberger, 1986), or a constellation of powerful nations, such as the G8, or G20.

It is arguable that the pursuit of its own interests by the 'controlling group of a corporation (here the agent), can prejudice those of the corporation as a whole (here the principal). This, will be the case when, for example, the former pursue strategies that favour short-term share valuation growth and personal compensation packages and perks, beyond those required to provide them with adequate incentives to pursue the longer term interest of the corporation as a whole and undermine its sustainability. The continuing debate and even uproar (such as the 'occupy the Wall Street movement), on executive compensation, and the bonuses of, for example, bankers, in a context of failure and value destruction, attest to that possibility.

The impact of monopolistic practices on social welfare has been explored extensively in the Industrial Organization economics literature, in the context of the 'welfare losses of monopoly' power (see Scherer and Ross, 1990). The potential detrimental effects of 'strategic trade' policies, especially by developed nations on the ability of developing nations to develop and therefore on long-term value creation at the world level, on the other hand have been discussed, in the context of the 'new' (or strategic) trade theory (see Krugman, 1986, 1987, 1992; Rodrik, 2009; Pitelis, 2009b). The wider effects of 'rent-seeking' and a rent-seeking society have been explored by political economists (see for example Krueger 1974; Zingales 2011). The general idea is that the way in which one pursues and achieves their interests, matters. If these are achieved through rent-seeking (for example entrepreneurship that focuses on value capture and value redistribution, not value creation), this will tend to undermine inter-temporal value creation (Mahoney et al., 2009).

An example on how the pursuit of narrowly conceived 'national interest', may undermine global value creation (and therefore in the long-term national interest as well), according to some scholars such as Nobel laureate Joseph Stiglitz, can be the attitude of Western Governments and international organizations such as the IMF and the World Bank towards the 1997 East Asian Crisis, as compared to the recent financial crisis of the Western World. The advice to the Asian governments was to liberalize financial markets and increase interest rates. This led to a worsening of the crisis for the countries that followed this

advice, in contrast to those who did not follow it (such as India and China), which were least affected. In contrast, during the recent crisis Western Governments such as the US, reduced interest rates and bailed-out, even nationalized, companies, despite the 'moral hazard' problem that this entails (Hart and Zingales, 2010). For Stiglitz (2007) this is no less than 'financial hypocrisy', explicitly aimed to serve the interests of a group of people, mainly from a handful of countries. Such financial 'hypocrisy' and the pursuit of sectional interests is a classic case of 'rent-seeking' that could undermine inter-temporal world-wide value creation.

In the above context, the pursuit of national competitiveness need not lead to world-wide sustainable value creation. Much depends on how each agent pursues their interest to capture value. When they do so through restrictive practices, and/or 'rent-seeking', this undermines overall world-wide value creation, leading to a 'systemic failure'. This may also come about because of 'myopia', mistakes and time inconsistencies (Mahoney et al, 2009). Importantly, 'system failures' can arise even when there exists interest alignment; see for example Metcalfe (2003). All these render of the essence, the issue of the type of governance most conducive to world-wide economic sustainability. The critical point to make is that the three types of governance identified here, all share a neglect of the need for sustainability through checks and balances, by taking the view that the pursuit of self interest, profits and rent is good in that it eventually benefits all. The idea that such an approach may contribute instead to embedded power structures that could prejudice sustainability, is rarely if ever contemplated. This idea is currently challenged not least as a result of the financial crisis.

In the above context, diagnosing the complex hierarchy of "agencies", questioning their underlying assumptions and trying to align these in a way that they all foster sustainable outcomes, is a major prerequisite for addressing the issue of (supra-national) governance for world-wide economic sustainability. This is more critical than ever, in the presence of what is arguably one of the biggest systemic failures of capitalism, and the failure of neoclassical economics to anticipate and regulate it. For some, such anticipation and regulation, requires a recognition of the importance of institutional and organizational

configurations, which help create knowledge, and challenge concentrated and embedded power structures (Cowling and Sugden, 1999; Cowling and Tomlinson, 2011), that have arguably contributed to the recent crisis (Zingales, 2011).

Both national and supranational governance, as currently exercised, face limitations in terms of degree of monitoring and possible collusive behavior by the lead players. These are well rehearsed issues in literature on regulatory capture and hegemonic power failures (Pitelis, 1991). A possible alternative to the extant dominant model could involve the fostering of pluralism and diversity, both intra and inter-national, alongside a representative supra-national organisation, aiming to foster sustainable world-wide value creation. This type of governance, is not without limitations, but might well be better than the extant approach, that, in view of the current systemic failure, stands discredited (Pitelis, 2013).

Indicatively, in all countries, there exist a host of organisations and institutions, such as the family, the church, NGOs, state-owned enterprises, that can impact on the ability of firms' and governments' incentives and capabilities is to foster value and wealth creation. These are usually referred to as the 'third sector', albeit in our view a better description would be the term 'polity'. In this context, value is in effect co-created by complementary and co-specialised economic agents (Pitelis and Teece, 2009). This renders critical the identification of the respective advantages and capabilities of the co-creating agents, as well as the specialization and division of labour between them. Competition and co-operation (co-opetition), self-interest and altruism, big businesses and smaller ones, especially when co-located in clusters, can all help foster value creation. This renders important the identification of the respective advantages and capabilities of the co-creating agents, as well as the specialization and division of labour between them. It is arguable that firms are relatively "better" in commercialisation for profit, markets in exchange for realisation of profit, states in policy-making, ideology, and legitimacy and the 'polity' in social capital and sustainability. Within the corporate sector, small firms can have advantages in flexibility, large ones in unit cost economies. Inter-firm cooperation, for example, in clusters, can benefit from 'external economies' and foster innovation,

productivity and value creation (Porter, 1990). The interplay, pluralism and diversity of institutions, organisations, individuals, ideas, cultures, religions, norms, customs and civilizations, can in part, play the role of a 'steward' and 'monitor' of each other, hence also promote the realisation and pursuit of enlightened self-interest by all, notably the most powerful, stakeholders. This can serve as a better approximate configuration to economic resilience and sustainability than the extant one.

At the same time, however, it is important that this process is "managed", "guided", and "moulded" through informed, motivated and (self) monitored agency, so that 'democracy' is aligned to performance-sustainable value creation. It is arguable that a representative supra-national organization with economic sustainability as its Core Agenda and Mission could help serve this purpose. This could be fashioned in the model of the 'third party' (the Board of Directors) of the corporation, in the work of Blair and Stout (1999). Similar considerations, relating the need to sustain the investments of actors with co-specialised and complementary capabilities for value creation apply at the supra-national level, as they do to the corporate and national ones. Allocating the role of the guardian of economic sustainability to a Global Board of Directors, with representatives from the private-public-polity nexus, and aimed at fostering the systemic interest in sustainable world-wide value creation, may appear utopian, but it could be one way through which, crises such as the present one, may be anticipated and their strength and impact at least moderated.

To summarise, for corporate governance to help foster sustainable world-wide value creation, it should be aligned to public and supra-national governance. Corporations and all economic agents should be expected and required to internalise the potentially negative externalities from their operations, to the environment and the society as a whole. For this to happen, internal and external controls may be required, including national and supra-national incentives and sanctions. Concentrated and embedded power structures, hence corruption, should be eliminated at all levels: intra-firm, intra-country (regulatory capture), between host governments and multinationals, and supra-nationally.

It is a fascinating feature of the recent European crisis, that so much attention is paid to corrupt politicians-receivers of bribes, and so little to their pay masters, yet all know that it takes two to tango (Pitelis, 2012). Improving upon this, requires also a trust, social capital and the 'ethical dimension'. Exclusive focus on self-interest may well be the biggest foe of economic sustainability. The recent crisis attests to this (Hart and Zingales, 2010). Fostering pluralism, diversity, the polity and a representative and self-monitored Global Board of Directors, can serve as a move in the right direction.

However, there are no panaceas. For one, a self-interested and/or captured Global Board can be worse than just diversity, and even than what we now have. Yet what we now have is in need of a major revamp. In this context, we hope for to open up further discussion on the need, prerequisites and mechanisms for supra-national governance for world-wide economic sustainability, as a topic worthy of further investigation.

To summarise the argument in this section, the successful capture of value by (especially large) firms need not be beneficial for the economy as a whole, if it thwarts competition and innovation. Public policies to capture value for a nation, such as strategic trade, neo-protectionist ones, may thwart the process of sustainable world-wide value creation. For sustainable world-wide value creation to be fostered, economic agents should internalise the negative externalities of their actions, which may prejudice the sustainability of system-wide value creation, and eventually their own success. Public policy should aim to enhance competition through innovation, by regulating anti-competitive practices and promoting productive entrepreneurship (Baumol, 1990), and new firm creation and growth. Nation states (especially developed ones) should eschew from 'strategic trade policies' and/or the pursuit of sectional interests of powerful groups, at the expense of the wider interest of economic sustainability. Pluralism and diversity, through the fostering of the 'polity', such as NGOs, consumer associations, public-private partnerships, clusters and overall 'social capital' creation (see Moran and Ghoshal, 1999; Putnam, 1993; Branston et al., 2006) should be encouraged, in order to ensure a degree of mutual stewardship and monitoring that aims to address the problem of 'who monitors the monitor' (Alchian and Demsetz, 1972), and motivates a more enlightened appreciation of 'self interest'. In practical terms this

implies the avoidance of 'regulatory capture' and other types of concentrated and embedded power structures, by 'elites' in pursuit of rent-seeking (Stigler, 1971; Olson, 1971; Krueger, 1974).

Setting-up a supra-national organization, a representative Global Board of Directors, that places world-wide economic 'sustainability' at the centre-stage of its Agenda, could be another complementary way of fostering sustainable world-wide value creation. Such an organization can, however, may also be captured by organised sectional interests. In this context, diversity and our proposed supra-national organisation are not panaceas. In the longer term, decency, dignity and culture, alongside pluralism and diversity, may hold the key to world-wide economic sustainability.

V) Summary, concluding remarks and opportunities for Europe

To summarise, from our analysis so far, we can draw important conclusions regarding the implications of the recent global financial crisis for global governance and the institutions that promote it. In particular, in Section II, we analysed the underpinning theories of global structures, focusing on the formation of the G8 and G20, as well as other key players in the global financial landscape, like the IMF. Following that, we provided an overview of the causes of the 2008 global financial crisis. Particularly, we discussed the role of global imbalances that persisted before the crisis and the credit and housing boom that followed. In the next Section we examined the role of global imbalances further, the role of other emerging economic and political structures including the BRICs and SWFs, the future of monetary relations and the opportunities for European engagement in this context. Lastly, we explored the various views on the role of the U.S. and EU in global finance, especially in the context of the G8 and G20 and supra-national institutions, like the IMF and World Bank. Our overview and analysis on global governance literature and current agenda has raised significant questions regarding the future of global governance architecture.

In the last section, we have aimed to provide a fresh scenario that aimed to go deeper in challenging the foundational premises of extant supra-national governance and its institutions, namely the hegemonic stability hypothesis, thereby answering to calls by policy-makers and analysts for higher levels of representation and legitimacy in global governance organisations and standard setters, as well as for sustainability-promoting structures and policies. The reason for that is not only due to the increasing mistrust towards these organisations, but also due to the apparent inability of national states to effectively tackle situations of economic distress. However, the evolution of global governance bodies, which will be based on international cooperation, is at the heart of post-crisis economic restructuring of the global landscape (Jeffry, 2012). Our proposal is for supranational governance that leverages the comparative advantages of private, public, and 'third sector' (polity) actors, within countries and supra-nationally. We claim that despite limitations, this could take the debate a step further and provide a fresh scenario-opportunity for global engagement, not only of different groups of countries and international organisations, but importantly of different groups within nations, notably the least enfranchised ones. Fuller implications from this perspective need to be analysed in more detail, yet we consider it important to raise the issue and rise to the challenge.

There are two major types of opportunities for beneficial engagement opened to Europe that emanate from our discussion so far. The first, narrower one, pertains to the possibility to engage with the emerging players from a position which is less encumbered by the challenges and legacies of 'hegemony'. In addition to the negative perceptions often associated with hegemonic peers, Europe traditionally is more closely linked culturally with the BRICS, for example Spain and Portugal with Brazil, Britain with India, Germany with Russia, Europe as a whole with China. These advantages could be leveraged towards the direction of mutually beneficial engagement of the new powers in the era of post crisis, post supra-national governance.

A second wider advantage of Europe relates to its social democratic traditions, its stronger social participation, diversity and pluralism than the USA. This 'variety of European capitalism' is arguably closer to popular aspirations in the BRICs than the more neo-liberal

counterpart of the USA. This places Europe in a better position to 'understand' and engage with the emergent powers. To the extent moreover Europe appears to be genuine about the need for more representative supra-national governance that could help further benefit from its role in helping institute this. In this sense the more pluralistic governance proposed here can serve also the more narrow interests of Europe.

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THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?

THE PARTNERS IN THE CONSORTIUM ARE:

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1 (Coordinator)	University of Leeds	UK
2	University of Siena	Italy
3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
5	Pour la Solidarite, Brussels	Belgium
6	Poznan University of Economics	Poland
7	Tallin University of Technology	Estonia
8	Berlin School of Economics and Law	Germany
9	Centre for Social Studies, University of Coimbra	Portugal
10	University of Pannonia, Veszprem	Hungary
11	National and Kapodistrian University of Athens	Greece
12	Middle East Technical University, Ankara	Turkey
13	Lund University	Sweden
14	University of Witwatersrand	South Africa
15	University of the Basque Country, Bilbao	Spain

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