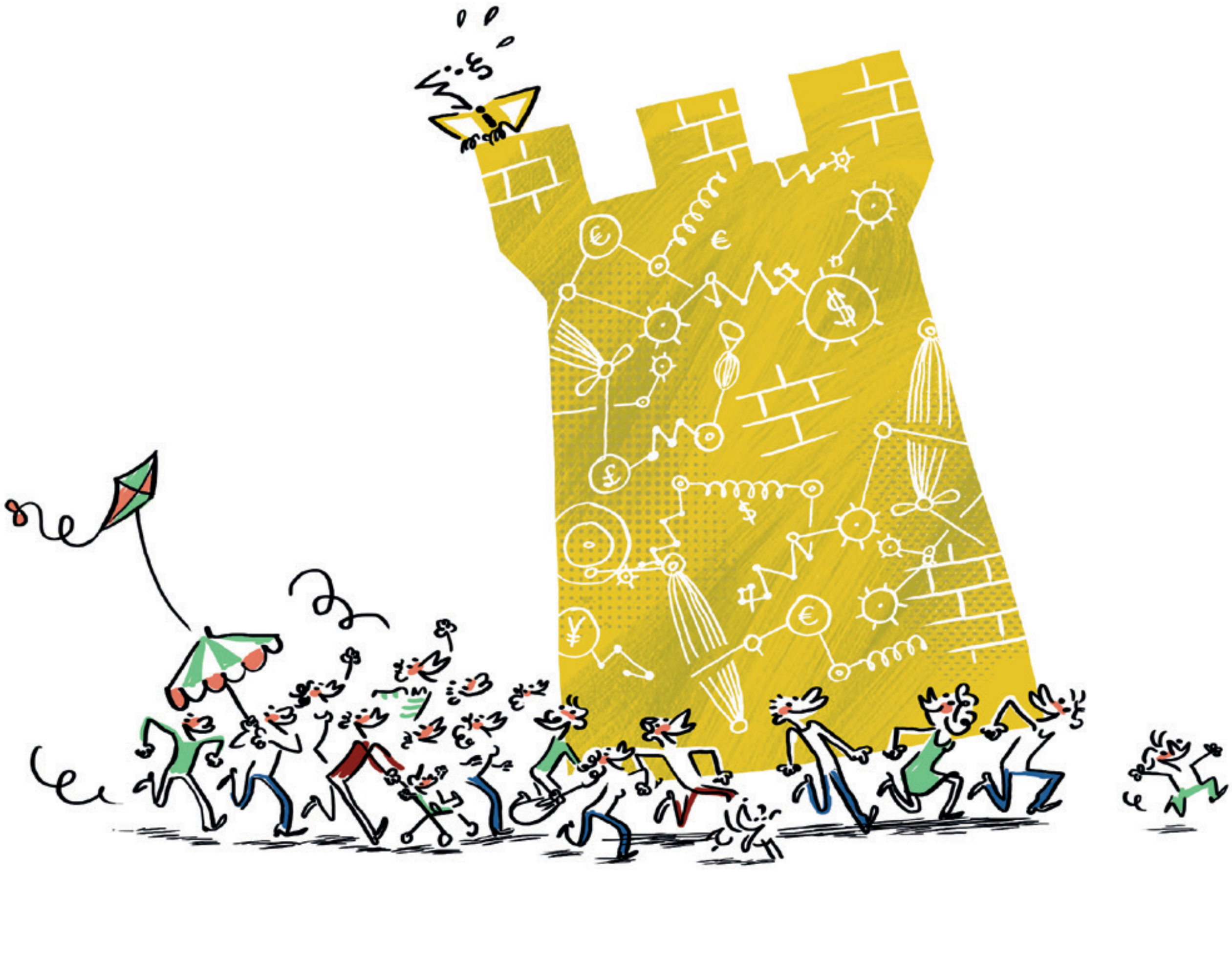
EXECUTIVE SUMMARY

FINANCE TO CITIZENS

MAKING FINANCE SERVE GENERAL INTEREST



A report from Secours Catholique - Caritas France

FINANCE TO CITIZENS

« Today, in view of the common good, there is urgent need for politics and economics to enter into a frank dialogue in the service of life, especially human life. Saving banks at any cost, making the public pay the price, foregoing a firm commitment to reviewing and reforming the entire system, only reaffirms the absolute power of a financial system, a power which has no future and will only give rise to new crises after a slow, costly and only apparent recovery »

Pope Francis, Laudato Si, 189

« **Finance to citizens: making finance serve general interest** » is the guiding thread of a research on the interactions between finance, poverty, inequality and the pursuit of the general interest. This research work is underpinned by the quest for political economy frameworks in which all stakeholders contribute to building fair societies. It also encompasses the complexities and tension between the essential role of the economy on the one hand, and the devastating effects of deregulation on society and the planet on the other.

Thus, this six- part report aims to analyze the role and patterns of the worldwide financial system, to explain its impacts on poverty and inequalities, and to propose reforms that would make the financial system serve society as a whole.

It is a fact that banks and finance play a key role in the worldwide economy, far beyond the financial system itself. As they are operating today, financial markets generate private profits, but hardly serve society as a whole. This adds to poverty, increases inequalities, and carries financial resources away from societal purposes.

The first part of this report explains why the way the financial and banking systems are operating is a general interest concern. The second part sets out the significant changes that took place in the global financial system over the past forty years (since the end of the fixed exchange rates monetary system referred to as “Bretton Woods” in 1973). The third part outlines that the 2008 crisis was partially resolved with the support of the Central Banks, and shows that it failed to revitalize the economy.

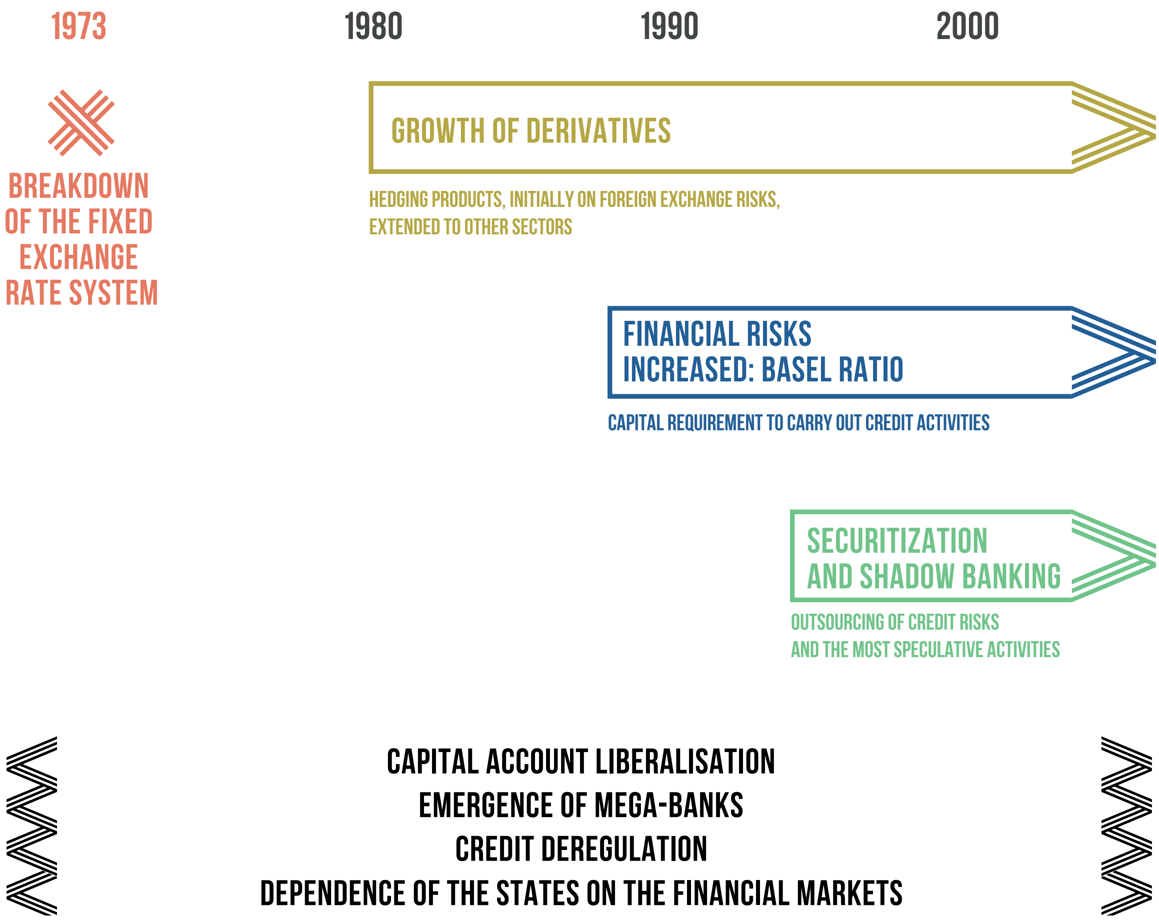
Parts 4 and 5 highlight the misalignment of the present financial system and general interest, both in advanced countries and in emerging and developing countries. This misalignment contributed to slowing down economic development and to deepening inequalities.

Key data

- **100.000 billion $,** total global bonds oustanding as of end 2014 (10.000 in 1990). This market grew 2.7 times faster than world GDP
- **75.500 billion $,** world GDP
- **33.300 billion $**, the capital market operations of the largest european banks, ie 70% of their operations
- **15.000 billion $,** the gross amount of derivative products, ie the amounts invested in those products (of which less than 10% concern the non-financial economy)

The last part concludes with a proposed set of measures to really regulate finance, aiming to launch the debate on how to make finance serve society.

THE FOUR MAJOR STAGES AND FOUR PARALLEL PHENOMENA IN THE CONSTRUCTION OF THE CURRENT FINANCIAL SYSTEM



1. FINANCE AND GENERAL INTEREST

Finance plays an essential role in the economy, insofar as it creates and directs financial resources towards the economic agents who require them.

When credit grows faster than output, the price of existing goods will increase, possibly up to the point when asset price bubbles form. When economic agents borrow in excess of their repayment capacities, those asset price bubbles may burst, and create recessions, which do not affect just the financial sector, but also the economy as a whole. For instance, in the US, wages increased 2.4% over the 2000 to 2007 period; while real estate prices rose by 90% and real estate lending grew by 134%. Such imbalances paved the way for the major 2008 burst.

In each country, banks are under the control of the Central Bank, which can influence the global quantity of money being used in the country. This amount in turn influences the currency's exchange rate, which affects the cost of imports and the price of exports, and, in the end, each and every citizen's daily life.

Therefore, the way banks and financial systems operate plays an essential role in the functioning of the economy as a whole. The issue is directly relevant to the general interest in at least three areas: the operation of payment systems, the management of credits, and the value of the currency.

But, despite its crucial role for society, finance is not given a prominent place in the citizen debate or in economic research. What's more, policy makers are often close to the financial elites, and States have become more dependent on the financial sector since capital markets were made the main source of financial borrowing for them.

- « It makes bubbles
- But does it work?
- Yes
- Well, then, that's okay. »

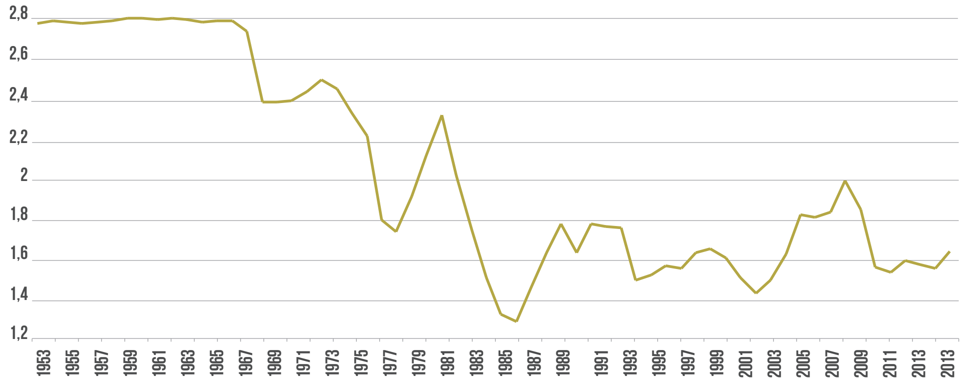
Bubbles form as credit increases faster than production

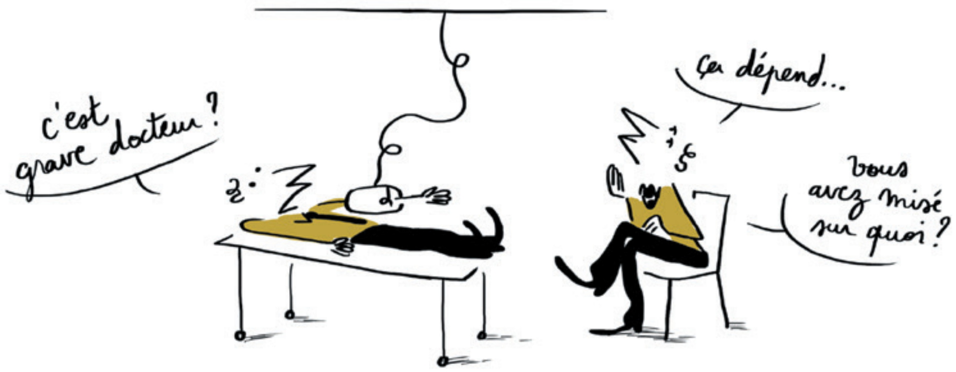
2. GLOBAL FINANCE: 40 YEARS OF GRADUAL DEREGULATION

Since the breakdown of the fixed exchange rate system in 1973, global finance was progressively deregulated. Global finance was transformed with new products, called « derivative products », and new actors. The fluctuating exchange rates created new threats for economies, and triggered the **emergence of derivative products**, that were initially designed to hedge against exchange rate variations. They subsequently expanded to hedge other risks, and became themselves tradeable products. The use of derivative products for trading purposes gradually took over their initial role as hedging instruments. As of today, for instance, oil derivatives represent more than ten times the volume of physical oil traded.

The expansion of derivative products and the increased volatility in asset prices, notably currencies, deeply changed the business model of banks. During the 1980s, in order to address mounting risks on banks' balance sheets, central bankers designed the so-called **Basel prudential regulation**, which required banks to hold minimum amounts of equity capital to cover for credit risks. The **development of securitisation** was a way for banks to avoid this requirement, since it enabled them to offload credit risks to non-banking structures. This gave birth to a huge so-called "shadow banking" system, a parallel credit system that does not have to abide by banking regulation, and comprises both securitisation vehicles and several kinds of investment funds.".

EVOLUTION OF THE POUND STERLING EXCHANGE RATE AGAINST THE US DOLLAR FROM 1953 TO 2013





- Is it serious, Doctor?
- It depends… What did you bet on?

Source : Exchange rate history, http://fxtop.com/fr/historique-taux-change.php?A=1&C1=GBP&C2=USD&MA=1&DD1=01&MM1=01&YYYY1=1953&B=1&P=&I=1&DD2=01&MM2=01&YYYY2=2018&btnOK=Chercher

Comment : The exchange rate of the pound sterling against the dollar has fluctuated significantly since 1973 (over the previous period, exchange rates were fixed and changed only in rare and exceptional devaluations).

At the same time, under the influence of economic guidance from the IMF, **cross border capital flows were liberalised. Credit and bank regulation was loosened all around the world, and those trends triggered concentration in the global banking sector and the emergence of multinational financial institutions**, deemed « too big to fail ». This deregulation was one of the main factors behind the rapid increase in credit growth, not aligned in quantity with needs of economy, and not aligned by destination with the requirements of these needs. Notably, mainly in advanced economies, too much credit growth went to real estate - not to new buildings but to existing assets in desirable urban locations – and to speculative activities. This aggravated poverty and inequalities and eventually created bubbles, which could lead to both a financial and an economic crisis.

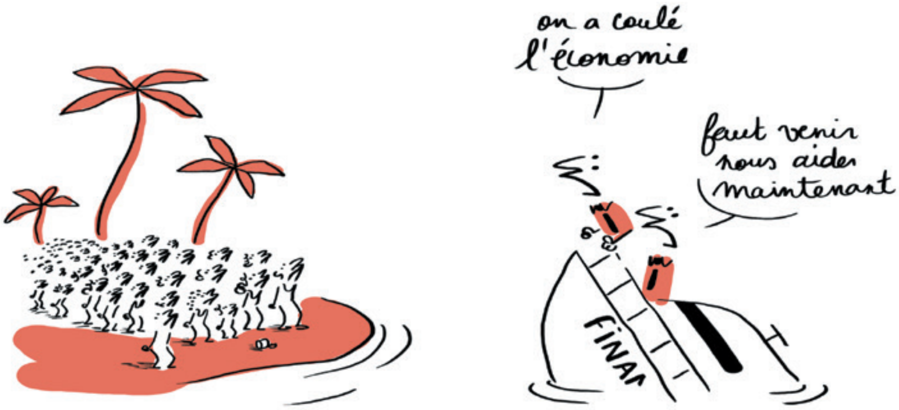
Last, but not least, **in emerging countries initially, and then in advanced economies as well, States became borrowers on international capital markets**, on which they are today highly dependent for their funding needs. This dependency of public actors on private finance considerably restrained the capacity of States to fund public policies and investment needs, at a time when the economic crisis increased social safety needs, when the unfolding climate crisis increased the need for public investment in climate adaptation and mitigation, and when development needs in Global South are still far from being met.

All in all, those evolutions gave global finance a disproportionate importance in the economy, with a strong weight on public policies and a structural contribution to growing instabilities.

3. INSUFFICIENT REFORM AFTER THE 2008 CRISIS

The 2008 crisis shed light on the dysfunctions of global finance. The institutional response has been multiform, but unfortunately insufficient. It aimed at fixing the financial system itself, without addressing the central question of the interaction between finance and the economy as a whole, and of whether the financial system as it is is fit for the purpose of serving society and the general interest.

The 2008 financial crisis started with the bursting of a real estate asset price bubble, with some US households unable to service the debt on their mortgages. It then spread like a powder trail to the global financial system worldwide, notably because of the widespread securitisation of those mortgages and the massive amount of derivative products they backed, and because of the free flow of capital across borders. There was a general panic in the financial system, with actors unable to assess the risk of their own holdings, or that of their counterparts.



- We sank the economy
- you have to come and help us now

2008 Financial crisis

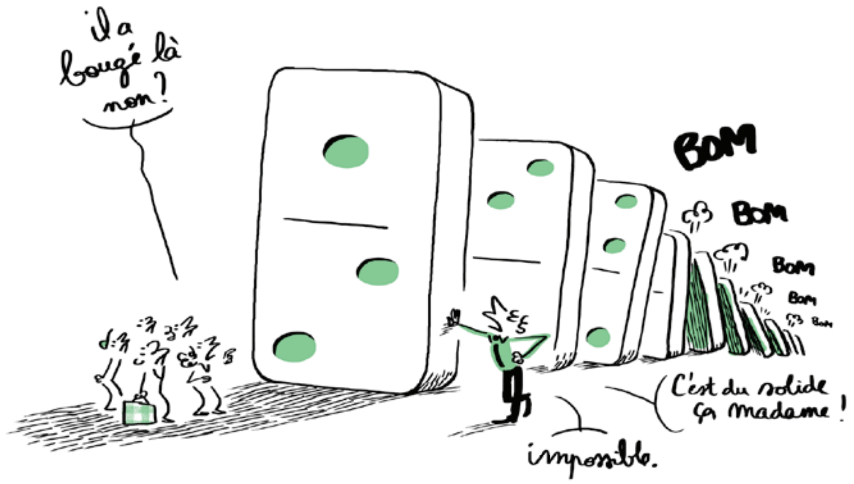
Central banks replied to the crisis by embarking on non-conventional quantitative easing policies, which consists in injecting newly created money into the banking system by purchasing assets from banks. This policy failed to boost the economy. It did enable a recovery of the banking sector, but also contributed to maintaining asset price bubbles on financial markets, and to deepening inequalities between financial asset holders and the rest of society.

... and thnaks a lot agains You're amazing, don't change anything.

Fixed financial crisis

New financial regulations were devised both in the US and in Europe aiming at stabilizing the financial sector, so as to avoid further taxpayer bail-outs of banks. Although generally well oriented, those measures were weakened by a strong resistance from a financial sector which is close to policy makers, and some of the main issues were not addressed: the attractiveness of speculative trading remains too high, the vast shadow banking sector is still unregulated, banks are still too large, and credit and investment are still lacking in the real economy…

Overall, the reforms of the financial system have not sufficiently addressed the contribution of finance to the general interest and the financing of social, economic and environmental objectives.



- it seems it moved, doesn't it?
- Impossible. That's solid, ma'am.

Contagion spreads to the rest of the world

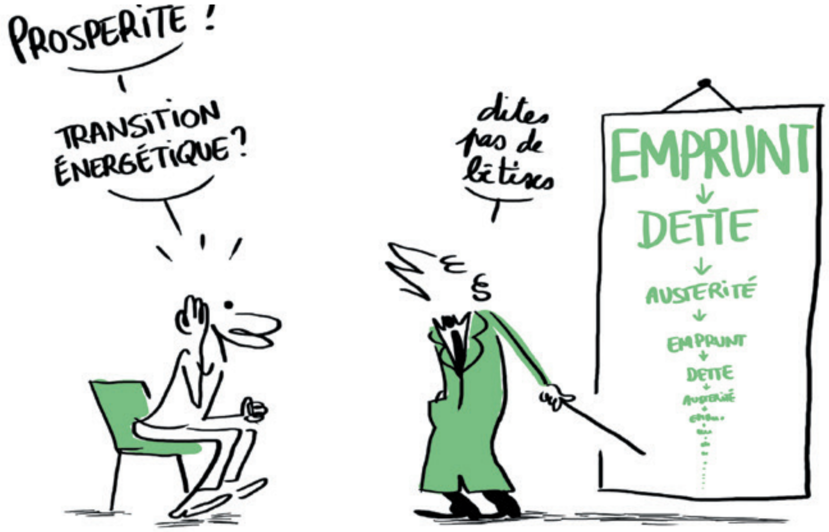
4. TOO MUCH FINANCIALIZATION AND DEEPENING OF INEQUALITIES IN ADVANCED ECONOMIES

Beyond the impacts of the 2008 financial crisis on economies and people, **the increasing financialization of economies since the 1970s is impacting the very structure of societies, by deepening inequalities.** When a crisis like that of 2008 occurs, economies and people bear the cost of the disproportionate level of risks on financial markets. In 18 OECD countries, inequalities rose faster between 2007 and 2010 than during the whole of the 12 preceding years.

- I'm out of money.
- I can sell you some.
(Bank)

Wages stagnate, credit develops

Since the 1980s, **credit grew faster than output and wages, which led to a debt overhang**. Besides, the accumulation of wealth in purely financial assets deprived the real economy of investment, slowing down non financial economy, keeping a high proportion of people unemployed in advanced economies, and deepening wealth and income inequalities.



- Prosperity… Energy transition ?
- Don't talk nonsense.
(Borrowing – Debt –Auserity – Debt…)

Recommended reigning optimism

The economic slowdown after the post 2008 crisis deepened the deficits of States in advanced economies, as their incomes decreased with the economic slowdown and their expenses grew out of increased social support expenses. The States' private creditors favor austerity policies, which harm the general interest and cannot succeed in reigning in light of the very high level of State indebtedness. Meanwhile, **the level of equity in the banking sector is still too low and the threat of future bail-outs still weighs on State finances** and their ability to meet ongoing social costs.

5. THE CONSEQUENCES OF INCREASED FINANCIALIZATION FOR EMERGING AND DEVELOPING ECONOMIES

The overall evolution of the global financial system over the past forty years has not benefitted the emerging world. Poverty may have been reduced, but it remains way too high. The development policies that were encouraged since the 1960sand 1970s, ie at a time when global finance was expanding rapidly, did not succeed in reducing inequalities between countries, and the differences in standards of living are still huge.

As a rule, **emerging and developing countries lack the hard currencies that they would need to be able to implement ambitious public policies**. The global financial system as it operates now favors the flight of hard currency capital from emerging to developed economies, hampering local investment. It does not remedy the **lack of local institutional systems to channel local currency savings towards the long term infrastructure investment that is required to support sustainable development**.

The structural adjustment policies promoted by the IMF and the World Bank in the 1980s favored excessive external borrowing from these countries. The resulting debt overhang swallows their financial resources and prevents them from acquiring the necessary techonologies and fixed capital that would permit them to implement public development policies in line with the current and future stakes.

Besides, the globalization and financialization of commodities markets have led to the integration of production and trade into multinational businesses. Those multinational companies capture a large part of the value added by agribusiness and energy production chains, away from local people and States.

A few multinationals end up controlling everything

Thus, as it operates now, **the global financial system creates obstacles instead of helping the developing countries. Moreover, those countries are largely absent from the international institutions that design financial regulation and promote policy orientations**. This situation is not acceptable in light of the investment that emerging and developing countries need to finance public development policies, and an energy and ecological transition.

- everyone's here, I suggest we start the meeting.

Developing countries are absent from rule-setting bodies

6. HOW TO MAKE FINANCE SERVE GENERAL INTEREST ? PROPOSED MEASURES

It is possible to regulate finance, to remedy its excessive size and its harmful impacts on society. That means however changing the rules of its game, rather than adjusting such or such aspect of current financial regulation. A single keyword to sum up the reform proposals could be: **control.**

The proposals aim at a structural, long term and ambitious reform of global finance, and are sequenced in a chronological order, alongside 4 streams. First, in order to protect society and the general interest, it is necessary, but not sufficient, to **stabilize the global financial system in order to avoid the risk of financial crises.** Second, **financial flows should go to the needs of a sustainable and inclusive economy**. Public authorities should therefore be able to **use supervision and control mechanisms** in order to attain this. Last, **we need an immediate stimulus** to address two major current problems: the global debt overhang and the continuing threat to the value of currencies caused by the deregulation of cross-border capital flows.

- Come on… let's return power to the citizens now
- My preciouuus…

Weaning the financial system

Five measures to stabilize the financial system

A1. Restrict banks business to commercial banking : collecting deposits, granting credit and operating payment systems

Intermediate step: ring-fence capital markets activities and draw up separability plans

A2. Allow a maximum leverage ratio of 5 for banks

A3. Set for all investment structures a maximum leverage of 5, and forbid banks to lend to investment structures

A4. Register and supervise shadow banking activities

A.5 Taxing Financial Transactions (FTT)

Energetic transition

B. Five measures to direct credit towards socially useful activities

B1. Use bank reserve requirements to guide credit allocation

B2. Increase bank prudential capital requirements for real estate credit

B3. Set up a supporting/penalizing factor according to ecological criteria in banks' prudential capital requirements

Intermediary step: Implement a brown penalizing factor on projects involving exploration and production of fossil fuels

B4 Ensure that carbon emissions are priced at a sufficient level to reach the objectives of the Paris Agreement

B5 Promoting the diversity of banking business models

Directing credits towards socially useful activities

C. Two measures to make the general interest drive the financial sector

C1. Review the board composition and accountability of financial regulatory bodies.

C.2 Create a worlwide finance regulatory body involving the whole international community

D. The monetary and fiscal stimulus avenues

D1. Allowing central banks to fund a fiscal stimulus

D2. Taxing certain incoming and outgoing capital flows

The purpose of these proposals is to **put forward a wide debate on how finance can be changed to serve general interest.** In the present circumstances, **empowering civil society** with this debate is an absolute must. It is also necessary to open this **debate with the financial sector itself, as well as with supervisors and regulators.**

- It was about time.

Directing credits towards socially useful activities

A report from Secours Catholique - Caritas France
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