

## Global finance has dysfunction at its heart

Sound fiscal policy alone won't solve this debt crisis. We need structural reform of the entire financial system

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The world economy is in turmoil again. We have seen two weeks of near-universal falls in major stock markets, prompted by the spread of the eurozone crisis to Spain and Italy, the phony fiscal crisis in the US manufactured by the Republicans, and the economic slowdown around the world. The first ever downgrading of the US debt by Standard & Poor's last weekend has certainly added to the drama of the unfolding events.

The debate focuses on how budget deficits should be controlled, with the dominant view saying that they need to be cut quickly and mainly through reduction in welfare spending, while its critics argue for further short-term fiscal stimuli and longer-term deficit reduction relying more on tax increases



Barack Obama's debt crisis deal may have averted catastrophe in the US, but only structural reform can prevent future crises. Photograph: Jason Reed /Reuters

While this debate is crucial, it should not distract us from the urgent need to reform our financial system, whose dysfunctionality lies at the heart of this crisis. Nowhere is this more obvious than in the case of the rating agencies, whose incompetence and cynicism have become evident following the 2008 crisis, if not before. Despite this, we have done nothing about them, and as a result we are facing absurdities today – European periphery countries have to radically

rewrite social contracts at the dictates of these agencies, rather than through democratic debates, while the downgrading of US treasuries has increased the demands for them as "safe haven" products.

Was this inevitable? Hardly. We could have created a public rating agency (a UN agency funded by member states?) that does not charge for its service and thus can be more objective, thereby providing an effective competition to the current oligopoly of Standard & Poor's, Moody's, and Fitch. If the regulators had decided to become less reliant on their ratings in assessing the soundness of financial institutions, we would have weakened their undue influence. For the prevention of future financial crises we should have demanded greater transparency from the rating agencies – while changing their fee structure, in which they are paid by those firms that want to have their financial products rated. But these options weren't seriously contemplated.

Another example of financial reforms whose neglect comes back to haunt us is the introduction of internationally agreed rules on sovereign bankruptcy. In resolving the European sovereign debt crises, one of the greatest obstacles has been the refusal by bondholders to bear any burden of adjustments, talking as if such a proposal goes against the basic rules of capitalism. However, the principle that the creditor, as well as the debtor, pays for the consequences of an unsuccessful loan is already in full operation at another level in all capitalist economies.

When companies go bankrupt, creditors also have to take a hit – by providing debt standstill, writing off some debts, extending their maturities, or reducing the interest rates charged. The proposal to introduce the same principle to deal with sovereign bankruptcy has been around at least since the days of the 1997 Asian financial crisis. However, this issue was tossed aside because the rich country governments, under the influence of their financial lobbies, would not have it.

There are other financial reforms whose absence has not yet come back to haunt us in a major way but will do so in the future. The most important of these is the regulation of complex financial products. Despite the widespread agreement that these are what have made the current crisis so large and intractable, we have done practically nothing to regulate them. The usual refrain is that these products are too complicated to regulate. But

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then why not simply ban products whose safety cannot be convincingly demonstrated, as we do with drugs?

Nothing has been done to regulate tax havens, which not only deprive governments of tax revenues but also make financial regulations more difficult. Once again, we could have eliminated or significantly weakened tax havens by simply declaring that all transactions with companies registered in countries/territories that do not meet the minimum regulatory standards are illegal.

And what have we done to change the perverse incentive structure in the financial industry, which has encouraged excessive risk-taking? Practically nothing, except for a feeble bonus tax in the UK.

A correct fiscal policy by itself cannot tackle the structural problems that have brought about the current crisis. It can only create the space in which we make the real reforms, especially financial reform. Without such a reform we will not overcome this crisis satisfactorily nor avoid similar, and possibly even bigger, crises in the future.

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