SOMO Briefing Note
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Financial reforms from a developing country perspective: the EU should rethink its financial and economic reforms

The new report *Fixing Global Finance - A Developing Country Perspective on Global Financial Reforms* by Kavaljit Singh (published by Madhyam and supported by SOMO) provides interesting analyses and important recommendations on global and regional financial reforms from a developing country perspective. Singh, an Indian expert on financial markets and financial crises, not only looks at the negative impact the financial crisis has had on developing countries and the poor world-wide. He also highlights the interdependent and global nature of the problem by which the current financial and economic reform agenda of the European Union (EU) will have important impacts on developing countries. This briefing highlights those recommendations from the report that should be taken into account by policy makers when they decide on particular EU financial reform laws.

EU should rethink its principle of free capital movement

The report deals with the current contested issue, subject to intense international disagreement, whereby some countries are implementing interventions to keep the value of their currency low. These interventions, practiced among others by South Korea, Indonesia and Brazil, are intended to prevent that too much foreign short term capital is entering their economies. The large inflow of foreign money, in search of higher profits than in the EU or US, increases the value of the currency of the host country, whose exports therefore become more expensive. Further, as the 1997 and 2008 financial crises have shown, foreign money can quickly leave a country all at once, causing huge financial, economic and social instability. Some governments have therefore imposed different forms of controls and restrictions on inflows and outflows of capital in recent months.

The report recommends the use of restrictions on, and control of, the cross-border movement of capital as one of several useful tools by which countries can avoid financial instability. For the EU, this would mean a reversal of how it is currently negotiating freedom of capital movement in the trade and investment agreements that the EU is signing with developing countries. These agreements, e.g. the new EU-South Korea free trade agreement, prohibits restrictions on capital movement except in exceptional circumstances, and then only for a short period of time. This hardly allows countries to take preventive measures and apply the precautionary principle.

In fact, EU trade and investment agreements impose the EU's own rules of freedom of capital movement on developing countries. The Lisbon Treaty (Art. 63-66) only allows temporary interventions to restrict cross-border capital movements with third countries in exceptional circumstances after difficult procedures. This problem has hardly been dealt with by the EU. This is one illustration of the importance of Singh's recommendation for a fundamental rethink of the economic and financial free market principles that dominated the EU's economic policy before the financial crisis. The EU should therefore review its resistance towards a Financial Transaction Tax (FTT), even if it would only be imposed at the EU or Euro level.

Reform of financial markets and investors urgently needed

The freedom of capital movement has allowed innovative financial products and players to move into developing countries in major ways. The report indicates how the increasing investments by private equity funds in developing countries can have damaging effects e.g. by channelling profits out of the country. Hedge fund activities affect developing countries by speculating through derivatives in commodities and food, the prices of which have important impacts for the poor's access to food as well as income from commodity exports. The EU should therefore not only swiftly agree on, and implement, new rules for hedge funds and private equity funds (Directive on "alternative investment fund managers"). There is also an urgent need for EU proposals, agreement and implementation of more stringent rules on all derivatives markets, elimination of excessive and non-transparent speculation and prevention of market manipulation.

European banks in developing countries: serving the poor?

The report further demonstrates how important regulation has been for the resilience of the Indian banking system. Re-regulation of European banks is urgently needed but still under way in the EU.

The report recommends to rethink whether and how European and other foreign banks are being allowed to enter developing countries. The experience of foreign banks in countries such as India shows that foreign banks are not interested in serving the poor and the rural areas. This relates not only to problems how banks are getting access to developing countries through problematic rules of free trade agreements in financial services (including through the World Trade Organisation) which the EU is pushing for. The report also recommends that the new supervisory structures, which were agreed by the EU in September 2010, should be implemented so as to guarantee full cooperation and sharing of information with supervisors of developing countries where European banks are operating.

Financial stability: a common good through global cooperation

A general yet central recommendation of the report is that the EU and its member states need to better cooperate at the international level to avoid economic and financial or currency imbalances at the global level. The EU should promote improvements and reform of international decision making, such as at the IMF, to achieve developing country participation and more equal global representation. Reforming the EU's regional cooperation on financial regulation, economic governance, and management of the Euro will also benefit developing countries. Financial stability needs to be considered as a common good and should never again be left to self-regulation by the financial sector, Singh argues. The aim of financial reforms should be to promote inclusive and sustainable development worldwide, something which the EU still fails to incorporate in its current financial and economic reform efforts.

Notes:

- The report by Kavaljit Singh *Fixing Global Finance - A Developing Country Perspective on Global Financial Reforms,* was supported by SOMO and can be downloaded from the website of Madhyam (http://www.madhyam.org.in/index.php) and SOMO (http://somo.nl/dossiers-en/sectors/financial)
- For more information about the state of current EU reforms of the financial products and markets mentioned in this briefing, see the latest Newsletter on EU Financial Reforms of 8 October 2010 (http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/october-2010/view])
- For more information about the liberalisation of financial services in free trade agreements, see [SOMO publications http://somo.nl/dossiers-en/trade-investment] or contact m.vander.stichele@somo.nl