open2.net
INTERDEPENDENCE DAY

International finance and interdependence

http://www.open2.net/interdependenceday/internationalfinance.html

Phil Sarre unpicks some of the global finances which bind us together

The international financial system is one of the main ways in which interdependence operates. Whereas the Bretton Woods financial architecture set up in the late 1940s was one of 'high friction' (strong constraints over the movement of capital and exchange rates), the system that emerged in the 1970s, was entrenched by the Reagan and Thatcher governments, and has dominated up to the present, is one of low friction (in that capital can move easily and quickly).

It has been much criticised, both by national and international official bodies and more recently by a range of major non-governmental organisations.

Crime and corruption

From the earliest days of the Caribbean tax havens, there have been fears in the US that they were being used to launder the proceeds of crime. Initially the fear was focussed on profits from the drugs trade, but since 2001 terrorist finances have moved up the agenda.

The high level of secrecy of offshore financial centres, coupled with the huge volume of financial flows, makes it very difficult to trace any particular laundering process or estimate its total volume.

A particular focus of media and official attention has been embezzlement by dictators. General Abacha leads the field, having looted $55 billion from Nigerian state finances, followed by General Suharto of Indonesia ($35 billion) and President Marcos of the Philippines ($10 billion). It has been estimated that corruption may be looting as much as $50 billion a year, mostly from poor countries.

High Net Worth Individuals

In 2005 the Tax Justice Network surveyed a range of data and concluded that about 8 million individuals with liquid assets of $1 million or more now hold $12.5 trillion offshore - out of their total wealth of $38 trillion (itself a third of total global financial assets). This implies an avoidance of onshore taxes in the region of $255 billion per year. This phenomenon of capital flight affects emerging economies even more than developed ones: 40% of Middle East and Asian `high net worth individuals' assets are held offshore and 50% of Latin American assets.

TNCs

Trans-national corporation tax avoidance schemes sometimes stray into illegality. KPMG, one of the big four global accountancy firms was found in 2003 to have promoted illegal tax shelters which cost the US treasury billions, and agreed to pay fines of $469 million. In 2002 Citibank, the biggest American bank, was expelled from Japan for promoting tax evasion.

The problems for poorer countries are even greater, according to Oxfam. Faced with an urgent need for investment, they are routinely pressed to grant tax concessions as a condition of investment. In a 2000 report Oxfam calculated that, with normal rates of return and tax rates, the known total of Foreign Direct Investment in developing countries should yield $85 billion a year in tax but actually yields only $50 billion, indicating $35 billion a year of tax lost to concessions. Later authors have suggested that this may be a significant underestimate.

Growth and Instability

A recent International Monetary Fund (IMF) paper concluded: "The empirical evidence has not established a definitive proof that financial integration has enhanced growth for developing countries. Furthermore, it may be associated with higher consumption volatility."

This analysis showed that volatility is greatest for shares and bank lending, while Foreign Direct Investment is positively associated with growth, and that volatility had more negative effects on a group of 22 more integrated industrialising countries than on 33 less integrated and developed countries.

In a 2004 study, economist Barry Eichengreen showed that the frequency of financial crises was greater from the 1970s to 1990s than over the whole century, whereas it had been lower in the 1950s and 1960s. Their magnitude had also increased, since both Indonesia and Argentina lost 20% of their Gross Domestic Product in the 1990s, whereas on average crises cost 9% of GDP.

He concluded that 'A growing body of evidence shows that financial liberalisation is a two edged sword'. So in practice, the new system seems not only to have benefited criminals, but also to have allowed corporations to markedly reduce their tax burden, often requiring states to shift taxation to less well off citizens and contributing to growing inequality.

Moreover, the expected benefits in economic growth have not been delivered and increased financial volatility has had disastrous effects on many developing economies.

Phil Sarre is Lecturer in Geography at the Open University