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The Future of Global System for Trade, Finance and Investment

The economic tectonic shift towards the EMEs and East of economic activity has already taken place, via production, trade and the savings-investment process. Emerging markets have contributed 2/3rd of global growth since 2002. The world's economic centre of gravity in 1976 was a point West of London, somewhere towards the middle of the Atlantic Ocean. But in the 30 years since then, that centre of gravity has drilled 1800 km - one third of the planet's radius - deeper into the Earth's crust, away from the US & towards the East and is now located somewhere between Dubai and Shanghai. In less-turbulent times, between 2002 and 2007, China's average contribution to world economic growth approached 66% that of the US, China and India's together was almost 85% while East and Southeast Asia's clocks more than 130%. The economic tectonic shift has also led to a shift in wealth and in wealth generation towards EMEs and resource-rich countries such as the GCC, Australia and Canada. Trade and investment wars will become natural resource wars. Hence, the move towards a multi-polar world as opposed to a unipolar world: is already visible – via changes in economic activity, geostrategic policies, cultural changes and financial markets.

Move towards a spider-web model & rising Emerging Markets stars

The global financial crisis signals the eradication of the hub-and-spoke model centered on London and New York that dominated financial markets in post WWII period and provide the impetus for a transition to a polycentric, 'spider-web' model of networked financial centres. In a spider-web model, instead of a small number of financial centres intermediating and reallocating the entire world's savings, there will be numerous international financial centres – including the prominent examples of Dubai, Mumbai and Shanghai, across the globe that have the capital market depth and regulatory sophistication to absorb excess capital from their own regions and elsewhere. Such a model will prevent the enormous accumulation of savings in just one or two financial centres and reduce systemic international financial market risk. This new international financial architecture needs to be supported by regional financial safety nets.

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To resolve global imbalances and accommodate the shift in economic & financial geography, major reforms are required – including growing local currency financial (money, debt and equity) markets in the emerging economies (EMEs) and implementing financial sector reform & capital market liberalization in China and creating a safety net that would gradually engineer a decline in Chinese saving rates. Data provide a clearer picture of the shift in financial geography - while the US accounted for 46% of global capital markets in 1999, its share dropped to 31% in 2010 (as of Sep). In comparison, emerging markets increased their share of global capital markets from 8% to 30% alongside a rise in the BRIC economies share from 2% to 17%. Meanwhile, the GCC increased its share from 0.3% to 1% in the same period. Surplus countries like the GCC countries need to invest in financial services capacity in order to locally manage and control their rapidly growing financial wealth. This adjustment is already happening in the Dubai International Financial Centre (DIFC) which is now the regional base for more than 300 international and regional banks and financial institutions. Building on the financial market spider-web model and cooperation among financial centres, the DIFC has signed MOUs for cooperation with a number of financial centres, including Hong Kong, Paris Europlace, and Luxemburg and most recently with the Madrid Financial Centre. We are also in the process of increasing cooperation with financial centres in the East, especially in China.

The crisis also brought into the forefront SWFs and SOEs. Western banks desperate for capital as they sought to deleverage, invited SWFs with deep pockets and long investing horizons. Some notable deals included the Abu Dhabi Investment Authority's Citigroup rescue by paying $7.5bn for a 4.9% stake; China Investment Corp.'s injection of $5.6bn into Morgan Stanley and Singapore's Temasek Holdings' chunky investments in Merrill Lynch & Co., Barclays and Standard Chartered. Several SWF investors have also faced political demands on their capital. Some — like the Kuwait Investment Authority, Ireland's National Pensions Reserve Fund and Russia's two funds, the Reserve and National Wealth funds — were tapped by their own treasuries to bail out troubled banks and some SOEs in their domestic economies. According to Deutsche Bank, SWFs control about 3% of all institutional money invested in global markets, and they are likely to enjoy strong inflows from oil and other commodity revenues and a recovery in export earnings. Based on current trends and prices, Deutsche Bank projects that sovereign wealth fund assets will more than double, to $10 trillion, by 2020.

Reforms in IFIs & the G20

A new international financial architecture required reforms in the practice and governance of the International Financial Institutions (IFIs) – IMF, BIS, WB, and IOSCO. This process has been initiated with the announcement by the Fund on Oct 23rd that 5-6% of board voting rights would be shifted to "dynamic, emerging economies" and that two board seats would be given to emerging countries after being relinquished by Europe. However, deeper reforms are required. The IMF should move to becoming the lender of last resort (need to strengthen global financial safety net through increasing SDR allocations, swap arrangements and the like) as well as expand its role from crisis lending to crisis prevention. This latter role is emerging in the form of the mutual assessment program for the G20 (calling for fiscal consolidation in advanced countries, boost internal demand in economies with surplus by spending on social safety nets and structural reforms); the set-up of early warning systems to identify the most relevant tail risks, to demonstrate how the possible emergence of these risks could be recognized, and to specify the policy changes that would need to be implemented if they were to materialize and the assistance in the creation of regional safety nets (currency swap facility, flexible credit line facility etc).

The IMF staff, in a paper titled "G-20 Mutual Assessment Process—Alternative Policy Scenarios" have quantified the potential benefits from collective action by the G20 countries to achieve balanced, sustainable global growth: global real GDP would be higher by $1.6 trillion (2.5%) in 2015. The direct benefit to Asia would be about $250bn, split roughly equally between Japan and emerging Asia. In the downside scenario, the loss in real GDP is estimated at$2.1 trillion for the world and $350bn for Asia. Because of its potential for rapid growth, openness, and diversity, Asia has a great deal to gain from international cooperation and a lot to lose if it fails. However, the IMF staff estimates did not quantify the consequences for Asia and the world of an increase in protectionism if the G-20 fails to achieve balanced global growth.

Systemic Risk & Basel III

The concept of systemic risk (SR) has become ubiquitous in economic papers discussing the recent financial crisis due to the outsized role it played in creating it. While there is no consensus over its precise definition, it generally denotes the risk of a system-wide failure of financial institutions. However, there has been no systematic approach to remedying SR. While there are signs of the beginning of a European framework for dealing with SR (an oversight body), there is no talk of any such entity at the global level and the current structure and governance of the IFIs effectively prevents such a role.

The new regulatory framework of Basel III, published in early September 2010 has been too little too late and fails to address a number of critical issues, such as what to do about banks considered too big to fail, and how to assure that banks have enough liquidity to fund day-to-day operations. The Basel Committee also has yet to set restrictions on leverage, or the amount an institution can borrow relative to its assets. Similarly, Basel has done nothing to corral the 'shadow banking system' that isn't bank based, referring to non-bank institutions such as hedge funds, pension funds, money market funds and insurance companies that have bank-like activities, such as making loans, which influence the amount of risk in the system and the inter-connectedness of institutions. Moral hazard, or the tendency to take risks in hopes of government bailouts if things go wrong, has been exacerbated as a result of the financial crisis. Finally, a major form of financial contagion to emerging markets –through trade finance- which threatens the global economy's main growth engine, requires a special provision.

Currency wars and skirmishes: the Redback vs. the Greenback

The emergence of the euro, changes in the value of the dollar, and the financial market crisis have posed a significant challenge to the dollar's long-standing position in world markets. However, a study on the role of the dollar across critical areas of international trade and finance suggests that the dollar has retained its standing in key roles[2]. More than 70% of hundred-dollar notes and nearly 60% of twenty- and fifty-dollar notes are held abroad, while two-thirds of all US banknotes have been in circulation outside the country since 1990. Additionally, dollar remains the major currency used in trade and makes up 86% of foreign exchange transactions.

In spite of the desire to diversify away from dollar assets, many Central Banks have been constrained in their asset allocation, by their exchange rate policies and a lack of alternatives for investing liquidity: the US financial markets have the depth, breadth and liquidity allowing effective management of reserves and short-term liquidity. The US dollar is currently widely accepted because the US economy is large and diversified and has financial markets with the requisite breadth, depth and liquidity. Holders of dollars expect to be able to purchase goods and services they need paying in dollars. But it is not so farfetched to think that the primacy of the dollar has been the result of unusual historical circumstances not the result of long term equilibrium. In short, the size of the dollar liquidity necessary to finance global trade and capital movements will in the foreseeable outweigh the size of the US economy: the Triffin dilemma is growing in size and risk.

In a multipolar world where the economies of China and Euroland have a size on par with that of the US, the international role of the dollar would come increasingly under strain. Furthermore, the significant role played by other countries, such as Brazil, the GCC, Korea, South Africa, (the D10) on the world stage will lead to a more decentralized network of financial centers unlikely to be revolving only around the US dollar. So it is likely that the rise of China, India and other emerging markets will lead to a multicurrency international monetary system. But even in a multipolar financial world, it would be desirable to have a global unit of account as an anchor for international transaction. The currency of a *primus inter pares* is unlikely to confer the trust necessary for the global store of wealth, especially in a period where its public finances are not in order and the temptation to inflate away its debt looms. However, some new initiatives like the ASEAN Economic Community Blueprint (to achieve integrated financial and capital markets by 2015 through financial services and capital account liberalization alongside capital market development) and East Asian Financial Integration (including the Chiang Mai Initiative – a $120bn multilateral currency swap facility designed to assist countries with short-term liquidity difficulties) are important initiatives in building an alternative monetary and financial architecture. However, to move forward to a new multi-currency international monetary system requires prominent roles for the Yen, a common GCC currency, the Euro and a major international role for the Renminbi, the 'Redback'.

[2] See "*Is the International Role of the Dollar Changing?", By Linda Goldberg, NY Fed2010.*