

## **G-20 Infighting: Canada and the EU Clash on the Proposed Global Banking Levy**

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### ***What is it all about?***

For a brief moment it seemed that the politics of the global economy would undergo a sharp and decisive turn-around, and that the road to further liberalization and non-regulation would become a thing of the past. The deep financial and economic crisis that rapidly spread from the US to many economies around the globe triggered political crisis responses by nation-states. These reactions would have been unheard of during the period of the second wave of globalization. In order to avoid a meltdown of the global financial system, national governments and central banks had to spend hundreds of billions of US Dollars. General political parlance was about the need and political willingness to re-regulate the financial industry, big-time. Although it was conceivable that the *Keynesianism Turn* was involuntary and was not the result of deep sitting demand management convictions on the side of policy makers, the speed in which the policy climate changed and the pendulum swung back towards fiscal austerity and small-letter regulation is outstanding. The initial willingness to inject money into circulation in order to keep up effective demand and to start regulating the financial sector met fierce opposition early on. This was not only from the financial industry but more and more from political actors who were scared about the fiscal implications of their policy actions.

The most recent fiscal expansion and financial regulation are two sides of the story. It was the failure of financial market regulation in the first place that forced national governments to step in with fiscal policy in order to avoid a global meltdown. Fire sales and rapid de-leveraging required political intervention, and thus shifted losses of risky investments from the private to the public sector.<sup>1</sup> Given the slow speed of economic recovery and the still high degree of financial market fragility, it is not yet clear whether fiscal expansion

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<sup>1</sup> M. Brunnermeier (2009): Deciphering the Liquidity and Credit Crunch 2007 – 08, in: *Journal of Economic Perspectives*, 23 (1), pp. 77-100.

needs to be kept as a policy option.<sup>2</sup> However, financial markets have already made the (high) level of fiscal vulnerability of national governments the game of the day by asking high premiums for the provision of liquidity and by encouraging speculative attacks against currencies.

The fight on the adequate form of regulation is taking place on the national as well as the international level. As a rule of thumb, it turns out that national governments with national finance industries that did relatively well during the crisis are actively opposing global reforms. Meanwhile, governments whose financial industries were in deep trouble combine national reform efforts with strong attempts to create a global tool of financial market regulation. The UK, for example, went along with an ex post levy on bonus payments. France seconded this approach. Germany introduced a ban of naked sales, and the US came forward to tax certain liabilities of large financial institutions. These countries also argue in favour of a global bank levy.

The preparations for the upcoming G-8 and G-20 summits in Canada in June 2010 confirm this battle line. The IMF was asked by the G-20 Ministers to prepare a report regarding the effectiveness of various tools to make the global financial sector contribute in a fair and substantial way to the costs of financial stabilization, as well as to deal effectively with the “too-systemic-to-fail problem.” Its response was that an instrument of a global levy on financial institutions was the most effective and promising policy measure on the global level. Some European governments as well as the Obama administration signalled support early on. It was up to the Canadian minority Government of Stephen Harper to successfully organize an international rally against this plan and to get rid of the “global banking tax” from its top position in the agenda. In terms of global policy cooperation, this diplomatic endeavour can be seen as a tragic mistake, as its one-sidedness favours national policies against a coordinated homogenous global policy approach.<sup>3</sup> However, a different reading of the political postures can come to the conclusion that the efforts of the Conservative Government (and

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<sup>2</sup> Paul Krugman made this point over and over in the last months:” Penny-pinching at a time like this isn’t just cruel; it endangers the nation’s future. And it doesn’t even do much to reduce our future debt burden...So now is not the time for fiscal austerity.” – New York Times, June 20, 2010.

<sup>3</sup> The efforts by the Conservative government may put a dent into its relations with the EU and European governments. At a time when both sides negotiate a far-reaching *Comprehensive Economic and Trade Agreement (CETA)*, such a political manoeuvre may come with a price tag.

its support by key global economic actors) reflect sound politics, as it accurately reflects national policy preferences. Still, even such an interpretation needs to take into account that the Canadian action overlooks the fact of a disturbing regulatory failure on the global level.

### ***The “Too big to fail” Interpretation***

Prior to the “Great Recession”, the financial sector of the world economy had been growing at an extraordinary pace. It is estimated that in 1995, the total output of the main global financial markets was equivalent to 25 times the world’s economic output. In 2007, this figure had skyrocketed by a multiple of 70, mostly due to the growth in derivatives and in “over the counter” markets (OTC). The increased sophistication of global financial markets and the development of new financial instruments have greatly contributed to overall economic growth through an increase in liquidity and a reduction in the cost of capital. The downside of this contribution was that it favoured the proliferation of scarcely productive activities (basically speculative operations in the very short term), which tend to be pro-cyclical and conceal a strong potential to destabilize real economies. In brief, strong processes of *financialization* were at the root of the financial and economic crisis.

Beginning in the 1970s, international financial markets have been subjected to processes of liberalization and deregulation, which made them more flexible and dynamic, but which also increased the overall risk in the system. Since then, the number of financial and banking crises increased steadily. The transactional volume growth of the financial industries went hand in hand with the emergence of banks and financial institutions that are deemed “too big to fail”. This systemic feature was most expressed in the US and the UK, but also in Germany where concentration processes in the industry were strong, and eventually some of those institutions needed huge liquidity injections in order to survive. The fall of Lehman Brothers in the US spurred a development towards safeguarding individual institutions in order to secure the overall financial system. It is important to stress that governments made strong efforts to avoid legal commitments to act as liquidity providers of last resort. However, private actors learned from the episodes of this last wave of liberalization that governments are willing to exactly act in such a role. From a microeconomic view, any “too-big-to-fail” structure provides a systemic (perverse) incentive for companies to get bigger and to opt for

riskier investments. At the macro level, the state umbrella represents an “insurance policy provided by the taxpayer” to the financial sector, and thus a moral hazard that led individual actors to accept more and more risks.

The eventual *socialization of losses and failure costs* since 2008 provides the political rationale in asking the financial sector to contribute to the rescue costs of the national and global financial systems. Furthermore, in order to avoid a revival of the crisis, governments were arguing in favour of an economic policy tool that would help deal with systemic risk and the “too-big-to-fail” syndrome. Some governments (and the IMF) proposed a levy or tax on the financial industry as the best available instrument.<sup>4</sup> However, the same economic logic led other governments to argue that their financial industries avoided those pitfalls and thus would be punished by a global banking tax, as this would subsidize financial industries abroad that had acted not as prudently. While there is widespread consensus among G-20 members on the need for improved banking regulation, the group is divided over the appropriate action. The IMF, the US, the European Union (EU) and most of its member states are in favour of a global banking tax. Canada, Australia, India, Brazil and China form the alliance opposing such a measure.<sup>5</sup> Canada, as the host country of the G-8 and G-20, started a whirlwind diplomacy tour to discredit the plan for a global banking levy and to eventually remove the item from the meeting’s agenda.

### ***To tax or to regulate?***

Upon request of the G-20, the IMF proposed two levies on the banking system at the G-20 meeting in Washington, DC in April 2010. The first one, called Financial Stability Contribution (FSC), would target the excessive risks which banks take in their daily operations, with the revenues of the tax going to a fund which could be used in case of financial instability. The second proposed levy, called Financial Activities Tax (FAT), would be a charge on the so-called excessive profits and remunerations in the sector, and it has been suggested this could

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<sup>4</sup> International Monetary Fund, 2010a, *Global financial stability report*, April, <http://www.imf.org> (accessed May 17, 2010). – IMF (4/16/2010): A Fair and Substantial Contribution by the Financial Sector, Interim Report for the G-20, prepared by the Staff of the International Monetary Fund

<sup>5</sup> Le Monde, 2010c, “Le projet du FMI de taxation du secteur financier divise les membres du G20”, April 25.

help balance the national budgets of the governments collecting it.<sup>6</sup> Both taxes respectively levy, says the report, so each could be applied jointly or executed as single-handed tools.

The IMF does not consider these instruments solely as a cost recovery tax but also as insurance against “systemic financial crises”, and in particular as a tool to deal with the “too-big-to-fail” structure of modern finance.<sup>7</sup> The proposed taxes are intended to change entrenched behaviours in the sector, thus leading financial agents to operate in a less risky way by increasing its stability and its efficiency, and reducing the excessive remunerations enjoyed by banking executives.<sup>8</sup>

According to the IMF proposals, national governments would apply and collect these levies.<sup>9</sup> An amount equivalent to a 2 - 4 percent of GDP would be allocated to the newly created financial stability fund and the rest could be apportioned to the national budget.<sup>10</sup> The head of the IMF, Dominique Strauss-Kahn, also suggested that governments apply these two new taxes in combination with tighter regulation measures to reduce the risks associated to financial crises.<sup>11</sup> Finally, the IMF has suggested there should be enhanced coordination schemes between governments to avoid the risk of double taxing the financial institutions.<sup>12</sup> The funds collected through the IMF’s FSC and FAT taxes would be substantial enough to make up for the cost of initiating public plans to rescue the banking system in case of a financial crisis. If applied carefully, these instruments may help reduce the risk taken by banks in the short

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<sup>6</sup> International Monetary Fund, 2010b, *A fair and substantial contribution by the financial sector*, interim report for the G-20, April 16, <http://www.imf.org> (accessed June 1, 2010). / Le Monde, 2010a, “Le FMI propose au G20 de créer deux taxes sur toutes les institutions financières”, April 22.

<sup>7</sup> Pisani-Ferry, Nicolas J., 2010, “Taxer les banques”, *Le Monde*, April 27.

<sup>8</sup> Le Monde, 2010b, “Le FMI va proposer de taxer les banques”, April 20 / Le Monde, 2010i, “A Washington, le G20 se réunit pour évoquer les taxes sur la finance”, April 23.

<sup>9</sup> International Monetary Fund, 2010b, *A fair and substantial contribution by the financial sector*, interim report for the G-20, April 16, <http://www.imf.org> (accessed June 1, 2010). p. 20. / Le Monde, 2010c, “Le projet du FMI de taxation du secteur financier divise les membres du G20”, April 25.

<sup>10</sup> Certain governments, such as the French and the British, would like to see all the revenues collected in each country allotted to its general budget, while others, such as the German, are in favour of the IMF proposed stability fund (Le Monde, 2010h).

<sup>11</sup> The Globe and Mail, 2010a, “IMF throws weight behind bank tax”, April 22.

<sup>12</sup> International Monetary Fund, 2010b, *A fair and substantial contribution by the financial sector*, interim report for the G-20, April 16, <http://www.imf.org> (accessed June 1, 2010). / Le Monde, 2010a, “Le FMI propose au G20 de créer deux taxes sur toutes les institutions financières”, April 22.

term by making it relatively expensive to engage in certain speculative operations. As declared by some senior officials both from IMF and EU, the levies could become a true insurance against systemic financial crisis, and could help reduce the excessive remunerations in the financial sector. The effectiveness of the taxes would be strong if they were implemented at a global level, since banks could not relocate their operations in order to move to tax-free locations.

The IMF proposal relies heavily on global consensus in their enforcement. If this consensus cannot be achieved, countries moving forward with the proposal run the risk of losing financial sector business (and tax receipts). Governments that do not want their banks to lose their positions as “national champions”<sup>13</sup> opt out, as the Canadian case shows.<sup>14</sup> Other governments, like China, are not at all happy with the concept of integrating their financial institutions into a global political approach. Both the EU as well as most of its members—many of whom have some kind of financial profits or stabilization tax of their own currently in place—have supported the proposed IMF measures. Among them are France, Germany, the United Kingdom and Sweden. The US has also supported these international levies, and the European Central Bank (ECB) is also in favour, though it has recommended being very careful in choosing the moment to introduce them, for fear it could bring the international recovery to a halt.

Most of the arguments against the rationale of a global banking levy are based on the relatively vague design details, and the IMF was asked to add exactly more concrete elements to its proposal. Representatives of the German Council of Economic Experts already prepared a detailed proposal that satisfies most of the critical arguments:

“Summarizing the ...proposal, systemic risk relevance should be *charged with a levy (or “tax”)* the level of which (*or “tax rate”*) rises with the systemic relevance of an institution. The levy should be complemented by a *Systemic Risk Fund* which is endowed with *control rights*, in particular early intervention and resolution powers, to discipline systematically relevant institutions. The Systemic Risk Fund is financed by the proceeds from the levy; if the Fund reaches a certain *threshold size*, the continuing flow of distributions is *distributed to government*

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<sup>13</sup> Pisani-Ferry, Nicolas J., 2010, “Taxer les banques”, *Le Monde*, April 27.

<sup>14</sup> Notice this applies as well to the new Basel III regulations (that we should address presently, see *infra*.), whose nearly universal consensus may fracture when minimum liquidity standards threaten to affect the position of the national banks. For instance, a report published last May by Credit Suisse Group AG affirms those new standards may cut European bank profits by ten percent (see Bloomberg, 2010).

(s). Systemic Risk Funds implemented on the *global, European, and national level* will take care of *cross-border active* institutions...as well as institutions that operate within the *national range*. *All systemic institutions* should be charged. This means that also insurance firms and hedge funds can be too-systemic-to-fail ...”<sup>15</sup>

The levy approach towards systemic financial risk, either in the preliminary IMF version or in the version suggested by the representatives of the influential German Council of Economic Experts, will probably not prevent the next financial crisis. At best, and in combination with other regulatory measures, it will add an incremental cost to the industry and simultaneously create a limited fund for eventual rescue packages. Given the state of the industry, such a policy is a step in the right direction as it addresses a global systemic feature on the appropriate global level. Taxes and levies influence economic behaviour, and this will hold too for the proposed levy. It is argued that the creation of such a fund may add to the already existing moral hazard component and thus generate pro-cyclical effects by encouraging financial market actors to engage in even riskier transactions. However, such an argument is not very convincing. It only needs a punitive tax rate in order to offset the moral hazard dimension of the proposed instrument.

### ***Canadian Counter Proposal: The Plan for Embedded Contingent Capital (ECC)***

As mentioned previously, such proposals did not sit well with some G-20 governments. Canada, Australia, India, Brazil, Russia and China stated their fierce opposition to introducing new taxes on their financial systems. The most vocal among these countries has been Canada, whose government argues it would be unfair to impose new taxes on a banking system that weathered the crisis without public help.<sup>16</sup> In the words of its Finance Minister, Jim Flaherty, Canada is not “going to punish [our] banks for the fact that they have acted responsibly and

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<sup>15</sup> (Doluca/Klüh/Wagner/Weder di Mauro 2010): Reducing Risk Relevance: A Proposal, German Council of Economic Experts, Working Paper 04/2010

<sup>16</sup> The Globe and Mail, 2010c, “Canada rejects IMF bank tax plan”, April 21. The Globe and Mail, 2010d, “Canada, EU, at loggerheads over bank tax”, May 5.

maintained the appropriate leverage during the course of the financial crisis,”<sup>17</sup> and “is not going to follow the path of excessive, arbitrary or punitive regulation of its financial sector.”<sup>18</sup>

The Canadian government has been very successful in getting the support of some prominent G-20 member states to fight such a policy tool. Harper’s insistence in advocating his own model of financial regulation as an alternative to the IMF proposal showed diplomatic adroitness but no political willingness to address the systemic global problem. The self-regulation approach to the banking system, based on the Canadian capital regime, constitutes the core of the alternative proposal to deal with the risk of financial crisis advocated by Harper’s government. This approach to banking regulation can be labelled as “conservative” or even “boring.”<sup>19</sup> It has helped to shield the Canadian financial system from the turmoil endured by everyone else:

“Canada’s banks face high capital requirements and a cap on their leverage, such that their assets cannot exceed 20 times their capital (a lot less than the corresponding figure for many Wall Street firms and European banks). Canadians who take out mortgages worth more than the 80 percent of the value of the property must also take out insurance against default from a federal agency, the Canada Mortgage and Housing Corporation. The banks must insure the rest of their mortgage book with the corporation. [...] And, *mirabile dictu*, their shareholders managed to ensure that bankers’ bonuses were kept within modest bounds.”<sup>20</sup>

Paradoxically, Canada’s financial landscape itself is dominated by a strong “too-big-to-fail-structure” as only five big banks make up the bulk of the financial industry. However, those banks were acting in a different regulatory environment than many of their international peers. The refusal by the former Liberal government to grant those banks permission to merge in order to participate in global processes of *financialization*, added an ambiguous dimension to the Canadian regulatory regime as banks could not be sure to have sufficient bail out-support from the federal government in the event of a worst-case scenario.<sup>21</sup> In addition to the conservative regulation standards, this ambiguity prevented a strong participation of Canadian

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<sup>17</sup> The Globe and Mail, 2010f, “Flaherty stands firm against new bank tax”, April 16.

<sup>18</sup> Le Monde, 2010i, “A Washington, le G20 se réunit pour évoquer les taxes sur la finance”, April 23.

<sup>19</sup> The Economist, 2010b, “The goldilocks recovery”, May 6.

<sup>20</sup> The Economist, 2010c, “The charms of Canada”, May 6.

<sup>21</sup> See Ellen Russell: The Case for Constructive Ambiguity in a Regulated System: Canadian Banks and the “Too Big to Fail” Problem, PERI Working Paper Series, May 2010.

financial institutions in risky investment activities, and thus made it less crisis-prone than the industry further south.

Expanding the Canadian regulatory regime to a global template has some support, domestically as well as internationally. This experience seems to be the driving force favouring regulation against taxation. The Harper government went one step further and suggested its own plan to deal with potential financial crises. In the words of Julie Dickson, Superintendent of Financial Institutions Canada, “embedded contingent capitals is a security that converts to common equity when a bank is in serious trouble, thereby replenishing the core capital of the bank without the use of taxpayer dollars. [...] This would create a notional systemic risk fund embedded within the bank itself – a form of self-insurance pre-funded by private investors to protect the solvency of the bank.”<sup>22</sup> In other words, as soon as Banks got into trouble, they would sell debt that would convert into equity. Even though the Canadian government was so far very vague in terms of details, the plan for an ECC was criticized as too lax and even too expensive.<sup>23</sup> The conversion actually relies on the willingness of private bondholders to actually buy equity from troubled Banks. Goodhart correctly argues that those securities could only be sold at a high yield.<sup>24</sup> Given the problems of this suggestion, it may be easier and more practical to raise equity requirements directly.

Despite hard lobbying efforts on part of the Harper government, the proposal for a ECC has not (yet) met the support of other G-20 governments. So far, Canada and its *alliance* have been successful stopping a globally coordinated policy approach. The ECC may experience the same fate as the proposal for a global banking tax: national governments are free to choose from the menu.

### ***The State of Global Cooperation***

The financial crisis underlined the enormous level of interdependencies of national systems and stressed the well-established fact that financial stability is a global public

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<sup>22</sup> Dickson, Julie: Too-big-to-fail and Embedded Contingent Capital. Remarks by Superintendent Julie Dickson, Office of the Superintendent of Financial Institutions Canada (OSFI) to the Financial Services Invitational Forum, Cambridge, Ontario, May 6, 2010

<sup>23</sup> IIF, 2010,

<sup>24</sup> Charles A.E. Goodhart, 2010,: Arte Cocos from Cloud Cuckoo-Land?, Vox 10 June 2010

good. The production of such a good runs into the familiar problem of free riding, and thus, of underproduction. Despite all the rhetoric about global governance around G-8 and G-20 meetings, the reality is that global cooperation declined in the last couple of years. Indications are the halt of the multilateral Doha Round and the accompanying rise of bilateral agreements, the failure of the Copenhagen Climate Summit as well as the strong opposing views of the US on the one side and of the Eurozone economies plus Canada on the other side regarding fiscal austerity, and respectively fiscal stimuli.<sup>25</sup>

If we assume for a moment that the global banking tax is the best, or the least harmful way to contribute to financial stability, the current clash of political strategies would lead to the creation of an uneven global playing field. The EU already announced its opting for an EU-wide banking tax. If other governments stay neutral, such unilateral action would add additional costs to the European financial industry and create a comparative cost disadvantage. In this case, Canada and its allies may not even go for the ECC and still enjoy a comparative cost advantage. This distribution of comparative advantages and disadvantages may change, however, in Canada's case (and its allies) it would actually opt for the ECC. The concrete distributional outcome would be decided by the actual costs of an ECC plan.

Given the choices, non-action on the side of Canada (and its allies) would be the preferred option, as it would create a comparative cost advantage for the Canadian financial sector. However, as previously stressed, such an outcome is detrimental to all efforts creating global financial stability.

Whether the Canadian choice will negatively affect the EU-Canada negotiations on the Comprehensive Economic and Trade Agreement is an open question. It may be the case that the EU's willingness to show some flexibility in areas where Canada is economically as well as politically sensitive will be diminished. Some dark clouds already form on the horizon. In a joint letter to the host of the G-20, German Chancellor Merkel and French President

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<sup>25</sup> The most recent clash was the exchange between President Obama and German Chancellor Merkel. In his letter to the heads of state Obama made the point that the G-8 and G-20 meetings in Huntsville and Toronto should not favor fiscal austerity over long-term fiscal consolidation and that the trade surplus economies should even further stimulate domestic demand. Merkel countered this argument by referring to financial markets that see the high debt burden as crisis-trigger and by further arguing that it would be misleading to finger-point to Germany as the trade balance of the Euro zone would be the relevant indicator, and latter would be in equilibrium. –See FAZ.NET, accessed June 21, 2010.

Sarkozy pushed hard to put the issue of a global bank levy and a financial transaction tax back on the agenda of the Toronto meeting. This initiative generated quite some concerns on the side of other leaders of EU states. David Cameron from Britain as well as the political leaders of Sweden and the Czech Republic made clear that they are not in favour of bringing the topic back on the agenda so soon. As circumstances are, the Canadian Alliance will not crumble, and global policy cooperation will continue to be weak.