MODULE 3

INTRODUCTION TO GLOBAL FINANCE

JOACHIM HERZ STIFTUNG

CONTENT

AN OVERVIEW OF THE TEACHING MATERIALS

Target group	School students aged 14–18
Potential subjects	Social science subjects such as economics and politics, but the material is also well suited for language courses (especially English) and bilingual lessons.
Time requirements	Depending on the materials chosen, we suggest 2 teaching hours; exercises designed to broaden/ deepen knowledge are available on request.
Background	The materials are suitable for studies of international politics and economics, including changes and trends in these fields and the associated opportunities and challenges. The topic of financial integration and the exploration of the international financial markets can be used as an instructional example for getting to grips with the global economy.
Content	These teaching materials looks at the international economy and the financial sector as examples of globalization. Financial issues are of central significance for the work of the G20 because international financial markets play a fundamental role in the global economy as a whole. The materials cover issues such as functions and actors in the financial markets as wells as financial integration. Students can discuss options of the G20 to shape global finance.
How to use the materials	The materials offer an inside view on the G20 Finance Track. We will not provide standardized answers to the exercises. Teachers are free to select and reorganize the order of the materials for a suitable use. Any questions concerning the materials can be answered through info@global-classroom.de.
Knowledge requirements	Students should have a basic understanding of the phenomenon of globalization, including its causes, opportunities and consequences.
Usage tips	Due to the complexity of the topics covered, the source text is relatively long. We recommend having students read the source text as a homework assignment, as this allows enough time for group study and discussion in the classroom.
Objectives	Students • describe the characteristics and functions of financial markets. I • explain what is meant by the "integration of financial markets" and outline the opportunities and risks this presents for different stakeholders. II • describe the "globalization trilemma" (as defined by Dani Rodrik) (I) and explain why this appears to be a problem for financial markets in particular. II • explain which actors can develop and implement policy and regulatory frameworks for international financial markets and with what level of legitimacy. II • analyze which actors are affected by sovereign debt, how/why they are affected and what the economic implications are. II • discuss what options the G20 has to become an effective force in shaping financial markets. III The targeted skills are indicated using "operative words." These are verbs that indicate the activities the students are expected to perform when completing the exercises: Exercise category I comprises reproduction, exercise category II requires reorganization and transfer, and exercise category III asks for reflection and transfer. The numbers next to the individual skill descriptions indicate the exercise category. The skills are structured chronologically in line with the module.

MATERIAL 1

GLOBAL ECONOMY: FINANCE (AUTHOR: TIM GEMKOW)

Well-functioning financial markets play a key role in society: some people want to save for the future, whereas others need money now to build something for the future – like an entrepreneur who invests in new machinery. [...] Furthermore [...], a bank, for instance, is usually better placed than an individual saver to judge which companies will be able to pay back their loans in the future. Financial markets also make it possible to transfer risks. Take the example of a life insurance policy that covers the risk of premature death. This is possible because an insurance company with many policyholders can be sure that random differences will even themselves out.

In an ever more interconnected world, demand for all these functions also crosses borders: emerging countries, whose economies are now starting to catch up, need considerable investment, while industrial nations faced with an aging population have an interest in saving. Also, private individuals and companies alike can benefit when risks and counter-risks balance each other out across the world. Equity funds that invest globally, for example, are often less prone to fluctuations than those that invest in only a single country, as they are impacted less strongly by individual local or regional crises. Indeed, financial markets have become a byword for globalization, with stocks, bonds, currencies and commodities traded around the world and around the clock. [...] The volume of global financial transactions is almost impossible to quantify and far outstrips global trade.

This development, however, can in no way be taken for granted – and is not simply a result of the technical innovations that have made the global flow of information much faster. Nation states can still place considerable restrictions on cross-border financial transactions if they want to – and sometimes they still do. [...] Therefore, today's global financial sector is also built on political decisions fostering the integration of financial markets. [...] Moves to globalize the financial sector are, however, subject to far fewer binding safeguards than in the area of trade, for example. In the field of finance, there is no central international institution comparable to the World Trade Organization that has laid down comprehensive rules and put in place an arbitration system to ensure their enforcement. The International Monetary Fund (IMF) is charged with monitoring certain basic rules in the financial relations between its members. However, it cannot impose any guidelines on, say, the extent to which a particular country permits cross-border bank transactions. [...]

Because they play such a significant role in society, financial markets can also be a source of serious problems. If faulty policy conditions and regulatory frameworks are in place, financial markets can, for example, promote a reckless attitude toward risk (instead of risk transfers that make good sense). They can create "bubbles," where large amounts of money are invested in assets that are unable to fulfill the expectations placed in them. One example would be an excessive construction boom that goes far beyond the actual level of demand, leaving behind unfinished buildings and deserted homes. Investor protection can also fall by the wayside.

INFO

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These risks became especially apparent in the global financial crisis that escalated following the collapse of US investment bank Lehman Brothers in 2008. This led to a global economic crisis, with many countries experiencing major difficulties.

But who should make the rules in an integrated global financial market? This is where the “globalization trilemma” – formulated by US economist Dani Rodrik – comes in: global economic integration, political decisions at national level, and democratic principles all cancel each other out to some degree. If each country enacts its own rules, this harms cross-border financial markets. In addition, individual countries find themselves competing for capital inflows (which enable investment in the country concerned) and, to some degree, for jobs in the financial sector. Therefore, each country has an incentive not to adopt strict rules that might scare off financial market players. When it comes to the possibility of setting harmonized rules at the global level, however, there is currently no world parliament or world government that corresponds to our understanding of democratic governance. The trilemma is particularly acute in connection with financial markets, as capital flows can react much faster to the political decisions of individual countries and therefore restrict national decision-making scope more strongly than may be the case with trade flows, for example. Various attempts have been made, however, to put into place new and internationally harmonized regulations governing the financial markets. [...]

The Basel Committee on Banking Supervision was set up in 1975 in order to implement rules that apply to banks operating in multiple countries. [...] Membership of the Committee has gradually been expanded, and it now comprises representatives

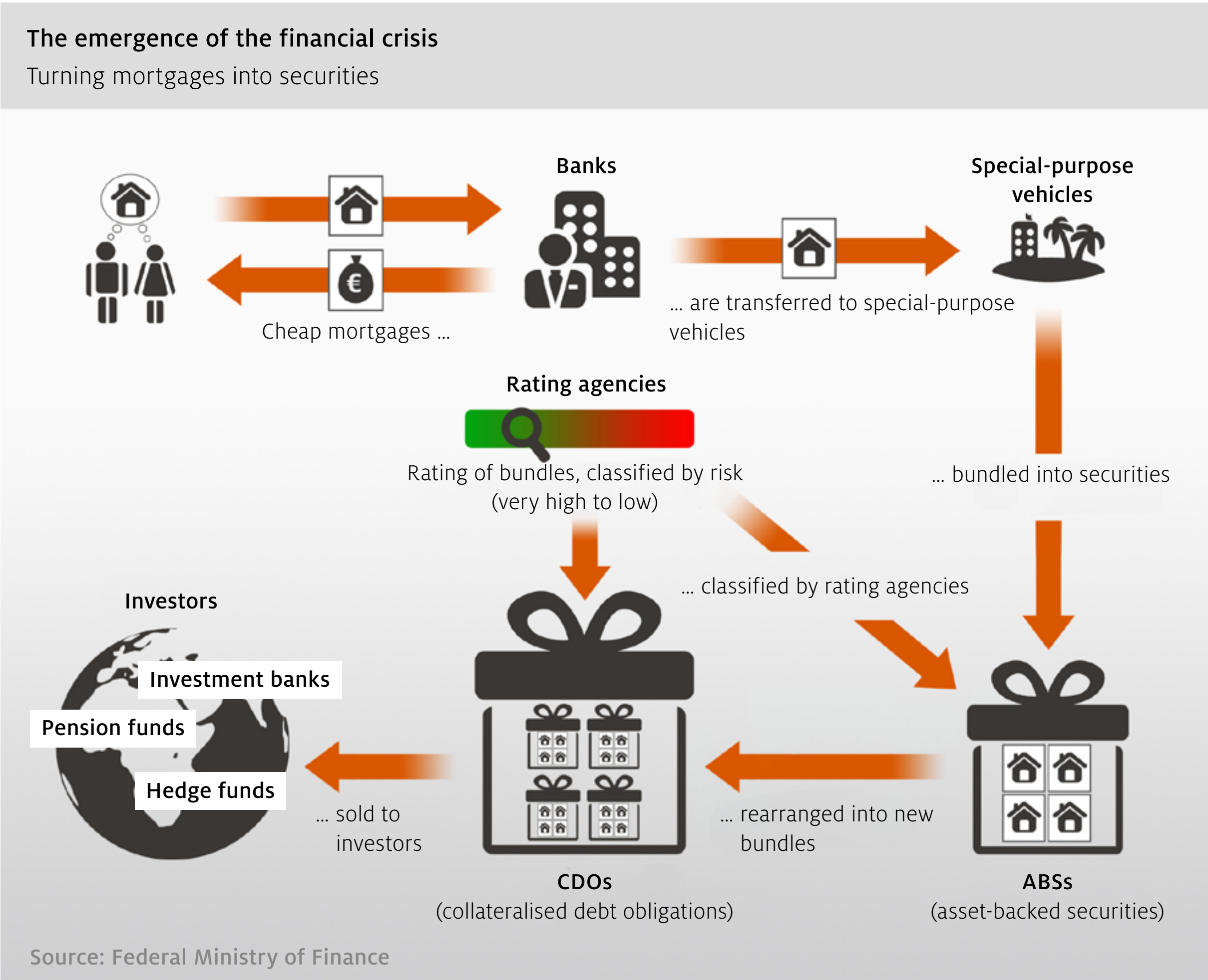

Figure 1: The emergence of the financial crisis

from 27 countries. The regulations developed in Basel are drafted by experts. [...] Many of them are therefore extremely detailed and unusually effective for informal guidelines. But the Basel standards are not legally binding. In order to take effect, they have to be enacted into the national law of each country, meaning there is always the potential for delays and discrepancies. [...] The Group of Twenty (G20) has gained special significance, particularly in light of the financial crisis. [...] But despite their considerable political weight, G20 resolutions are only declarations of intent and cannot be enforced in court, which highlights once again the low degree to which global financial regulations have actually been enacted into law. [...]

International financial market regulation is an extremely complex field. Over time, the individual rules have become more and more detailed, and the number of regulated activities and the entities involved have grown continuously. Nevertheless, the key milestones of banking regulation serve as a guide. A central issue, for example, is how much of its own capital a bank must set aside in order to be able to absorb potential losses without falling into danger of failing (known as "capital requirements" or "capital adequacy"). [...]

In the 1990s, there was a sharp rise in cross-border financial transactions, which was partly due to a scaling back of national restrictions on the international banking sector and capital markets (increasing liberalization). At the same time, there was a considerable increase in the range and complexity of financial instruments on offer. In the US, the existing separation between investment banking and commercial banking was lifted, giving commercial banks the green light to move into investment banking. As a response to these changes, a comprehensive revision of supervisory rules was adopted in 2004 under the name Basel II. Its primary objective was to capture the risks of bank transactions more accurately. For example, it sought to distinguish much more precisely between good and bad debtors, which would in

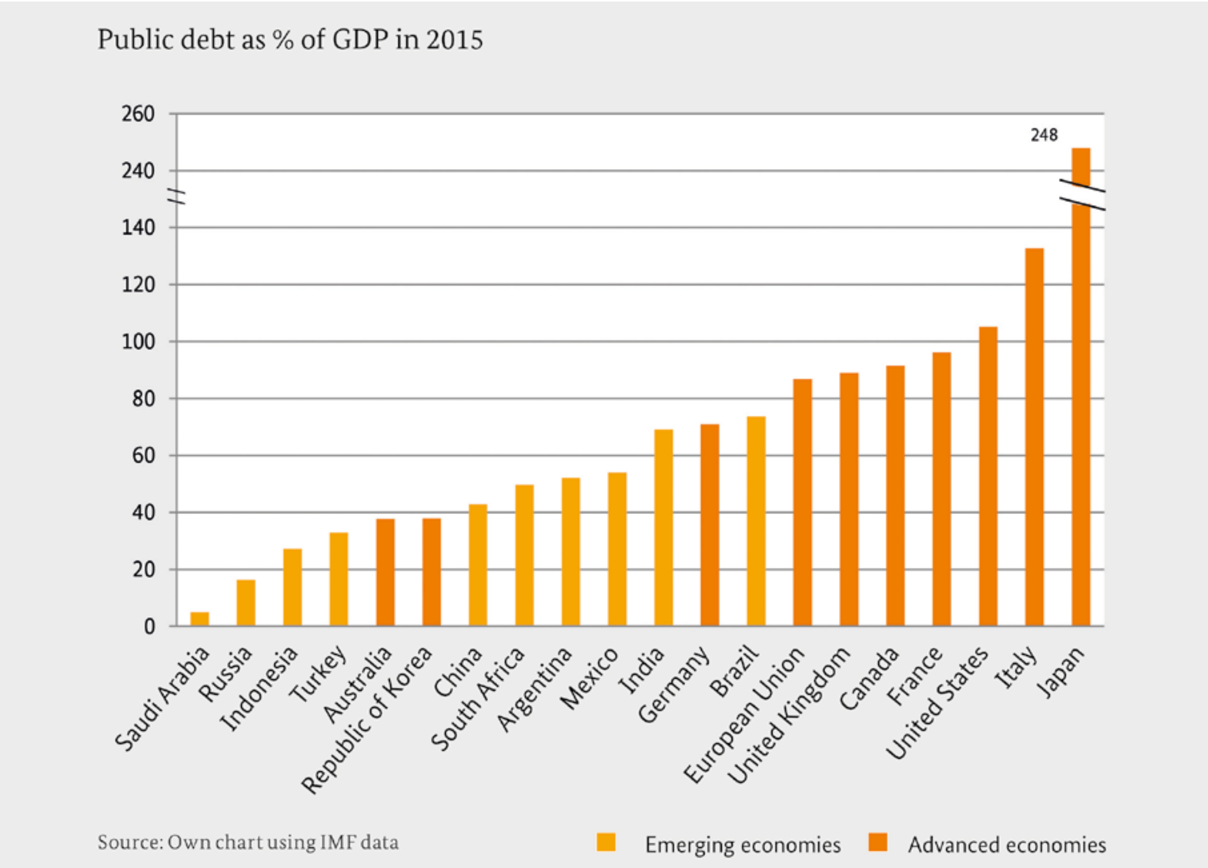

Figure 2: Public debt as % of GDP in 2015

turn require banks to make different degrees of risk provision. [...] Nevertheless, the financial crisis that started in 2008 demonstrated that the banking sector harbors considerable risk. What's more, the highly interconnected nature of the financial sector made it virtually impossible to allow a bank that had made bad business decisions to go bust in the same way as another company would. As a result, the Basel III regulatory framework was adopted in 2010 following a highly accelerated process. Equity rules were once again tightened and new regulatory categories were introduced. As a result, banks must now set aside enough cash and other liquid assets at all times and must not exceed a certain debt limit. [...] In addition, financial market regulation is increasingly widening its net to include other entities such as stock markets and trading platforms, derivatives traders (who use various complex products to hedge against, but also speculate on, unexpected exchange rate and interest rate fluctuations) and so-called "shadow banks" (e.g. money market funds). The aim is to stop risky behavior from simply moving from a regulated to a non-regulated area and instead to actually prevent it.

The internationalization of financial markets also triggered broader public demand for new regulations. Attac, a network operating in many countries, demands a global tax on financial transactions, which it believes will curb speculative behavior. Nevertheless, the rules governing financial markets are highly abstract and complex. As a result, citizens tend to mobilize much more in countries where the government is unable to pay its debts without outside help and, in return for this help, must meet a host of conditions in terms of its economic policy – conditions that impact the domestic economy and result in the loss of public sector jobs or (sometimes huge) cuts in social security benefits.

International financial markets also make it possible for nations to build up debt with foreign creditors. This can increase the availability of capital, making greater indebtedness possible in the first place or at least reducing the associated interest rates. At the same time, high foreign debt also comes with considerable risk, especially when foreign investors lose confidence in a country and remove large sums of money in a short space of time. When this happens, a country may not be able to borrow any more money – or may only be able to do so on extremely unfavorable terms. At the same time, parts of its old debt – which it cannot pay back all at once – will become due at regular intervals. Even if a country does not wish to incur any more debt, it is often dependent on new financial backers to restructure its existing debts on a regular basis. In the event of an acute crisis of confidence, there is a risk of sovereign default. [...]

There is an emergency mechanism in place by which the country concerned can receive loans from the International Monetary Fund (IMF). In return, however, the IMF demands stringent reforms of the country's economic policy in a bid to make it more competitive and regain the trust of international investors. [...] In the short term, these measures are designed to win back trust and, in the long term, to boost growth and strengthen the competitiveness of the country in order to avert a sovereign default. However, such reforms often have a huge impact on the lives of many of the country's citizens, while simultaneously lacking democratic legitimacy. This is because even if the country had already been in crisis for a long time, the decisions about specific bailout conditions are often taken by the international creditors. Cases such as this become highly politicized as ordinary citizens demand a say in decisions that have a huge effect on their lives. In the future, improved financial regulation will hopefully prevent such crises before they occur.

EXERCISES ON THE TEACHING MATERIALS

MATERIAL 1

GLOBAL ECONOMY: FINANCE

1. Outline the various markets that can be described as “financial markets” (individual markets, market types, suppliers/consumers, intensity of competition, goods traded, special characteristics, etc.) and the functions they perform.
2. Explain what is meant by “integration of financial markets” and outline the opportunities and risks this presents for different stakeholders.
3. Analyze what is meant by the “globalization trilemma” described in the text and explain why this appears to be a problem for financial markets in particular.
4. Explain which actors, and with what level of legitimacy, can develop and implement policy and regulatory frameworks for international financial markets.
5. Analyze which actors are affected by sovereign debt and how/why they are affected, and describe the possible implications of sovereign debt. Refer to the above chart showing 2015 public debt levels when preparing your answer.
6. Discuss what options the G20 has to become an effective force in shaping financial markets.

OPTIONAL EXERCISES

1. Define the criteria by which a country can be deemed bankrupt.
   Identify which countries would currently be declared bankrupt using these criteria (or which countries would have been declared bankrupt in the past 10 years).
   You can discuss your results in your own course on www.my-global-classroom.de.

2. Research the current state of play in the development of a global financial transaction tax and compare the arguments put forward by supporters and opponents of such a tax. Describe whether, to what extent, and why you would or would not be in favor of such a tax.
   You can discuss your results in your own course on www.my-global-classroom.de.

3. Global Conference Room: Using appropriate sources to help you, research the causes and consequences of the economic and financial crisis of 2008 and present your findings. You could, for example, give a presentation or design a poster.
   You can upload your work and see the work of others online in the Global Conference Room on www.my-global-classroom.de.

SOURCES

Page 1	*Fotolia: © micromaniac86*
Page 4	*Gemkow, Tim (2015): Globalisierung und Global Governance. In: Aus Politik und Zeitgeschichte (APuZ), 1/2015, S. 69-73 short version*
Page 5	*Figure 1: © Federal Ministry of Finance*
Page 6	*Figure 2: http://www.bundesfinanzministerium.de/Web/EN/Resources/Publications/Brochures/brochures.html*

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JOACHIM HERZ STIFTUNG

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GLOBAL CLASSROOM IN THE G20 FINANCE TRACK

The Global Classroom is a joined project of the German Federal Ministry of Finance and the Joachim Herz Stiftung. It provides teaching materials covering up-to-date topics of the G20 Finance Track 2017, like different aspects of economic growth and financial stability as well as the role of international organizations in global and national politics. The materials can be used in all social science classes such as economics and politics, but are also well suited for languages (especially English) and bilingual lessons.

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