

## The 2007 financial crisis and its impact on global financial governance\*

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## **Abstract**

This paper focuses on analyzing the importance of global governance in managing the impact of the financial crisis which began in 2007. The financial crisis began when banks became overleveraged after giving loans to home buyers who had difficulties repaying these loans, thereby causing investors lose confidence in American assets and mortgage-based securities. This crisis then deepened further with a global reach that has affected a wide range of economic, financial and institutional activities in both developed and developing nations. This paper aims to identify and analyze some of the causes that contributed to the persistence of the global financial crisis. The significance of this research is that it identifies and analyses strategies that can be followed by transnational actors through political interactions and financial governance reforms to reduce the impact of debt crises.

**Keywords:** Financial Crisis, Greek Debt Crisis, Financial Governance, Systemic Risk, Financial Regulation

## **I. Introduction**

Despite several warnings, in the first decade of the 21<sup>st</sup> Century the world was not concerned that there could be a financial crisis such as that in the 1930s. Global financial institutions as well as the global market should have been well prepared; they ought to have put in place the necessary measures to curb an economic meltdown. But the system failed dramatically, leading to the 2007-2009 economic crisis.

The current study seeks to develop a clearer understanding of the overall phenomenon, the rationale behind the rapid development of this meltdown and reflect on developments resulting from the crisis since 2009. It will consider instances from the Greece fiscal crisis, systemic crises, global financial institutions and their governance.

This paper highlights the need to reassert public authority in the global financial realm. Leaders have come together and put forth sound ideas, but endorse cautious principles. This stance lead to greater economic meltdowns by avoiding difficult decisions at the risk of undermining the global economy and finance.

Therefore, the need for reforms is critical, and the political and economic circumstances at the epicenter of economic breakdown should be considered. The agenda for responses to these circumstances should be premised on more stringent regulation of the international financial markets. This must be done on a platform of subsisting factors, which have changed from the first economic crises (Bradlow, 2010: 67-93).

The financial crisis exposed the weaknesses the policies of global financial institutions to systemic risk, thereby challenging the governance of these institutions. Fiscal administration in many cases is not well equipped to handle the innovations and complexities of global finance,

and as a result the international economy was seriously damaged (Hunter et al., 2006: 58). Clearly, more structural changes are required and regulatory reforms should be instituted.

The financial crisis questioned many of the assumptions about global financial institutions and their governance, and over the last decades the financial service sector has been transformed and reorganized. As a result, global institutions which promulgate the international standards and rules have amassed enormous benefits for their role in exposing others to risks. Assumptions had developed that despite of market fluctuations, the market was technically under control since the global financial institutions understood its role and functions. Moreover, an institution of such magnitude should have put in place adequate measures and controls to counter any problems. However, after the 2007-2009 financial crises, such assumptions were proven wrong. The banking industry advanced credit to borrowers without sufficient backing, so that the risks involved were not adequately handled. Instead of expediting the capital flow, these banks caused it to freeze up. Market capitalizations fell and the stock markets experienced the most severe turmoil since the Great Depression. Even before the crisis, the need to better understand and control the connections between systemic risks, global financial governance and financial governance had been foreseen (UN, 2001).

There have been many benefits in recent decades due to globalization and economic growth. However, such growth and development has led greatly increased interdependency and complexity, thereby leading to the emergence of systemic risks that had not been effectively considered by global financial governance. The 2007-2009 financial crises manifested a systematic crisis. They was a clear demonstration of how the technical innovations needed to manage the changes thereby increased the connectivity between financial institutions and government, leading to fragility of the global financial institution. Although it is now more robust, further shortcomings have been exposed. Inadequacies have been revealed



such as inadequate response speeds to crises. Overall, the global financial system and its governance continue to present the threat of catastrophic failure due to a lack of understanding of the underlying systemic risks.

The advent of globalization has seen increased integration of global financial systems, a fact that has made apparent the issue of global governance of financial systems. Global governance of financial systems simply refers to the interconnectivity of global financial activities subject to globalization of investment activities. The outcome of any investment has two components: expected returns and unexpected returns, the latter of which may also be referred to as risk returns. The risk returns are further subdivided into two major divisions: systematic and non-systematic risk returns. Non-systematic risk is risk that is attached to a particular asset and is sometimes referred to as idiosyncratic risk. This kind of risk can be diversified by simply increasing the range of assets and thereby diversifying the risks accrued. Conversely, systemic risk can never be diversified since its occurrence affects returns on all assets that are sensitive to it.

Failure in financial governance has been interpreted in many ways, and to date it has no standard definition. Nonetheless, in its application through the International Political Economy (IPE) its limitations are evident. The world system today has no effective global governance. However, it is characterized by trans-state issues that require reforms to accommodate the interests of individual states and some non-state actors. Thus there is a dire need for immediate authority (Payne, 2010: 729-740).

International governance has been understood in terms of bundles of formal and informal principles, roles and relationships, all of which are central to the definition of international practices. In the process, non-state players and the state actors have their roles constrained. Nonetheless, there is a global state currently emerging from the accretion of previously discrete regimes. Therefore, the role of accountability, transparency and efficiency in global financial governance is necessary, forming a

cornerstone in the need for stringent measures in the oversight of the financial institutions.

The present global financial systems are an integration of the financial systems of individual countries and states. As a result of this integration and interconnection, financial activities undertaken by any one sector of the globalized financial system will affect the overall system positively or negatively, depending on the nature of the business practice and consequent outcomes. This paper seeks to determine the extent to which systemic risk occurs in the context of the global governance of financial systems, and how global governance of financial system could prevent global financial crises (Saunders et al., 2006: 140). Therefore, this research is significant since it seeks to establish the relationship between the global financial governance, systemic risks and financial crises. In addition, it reveals shortcomings in global financial institutions and their governance, thus prompting further research and the evolution of global governance.

## **II. Systematic risk and global financial governance**

It is obvious that the financial crises witnessed in 2007-2009 challenged many of the assumptions regarding financial institutions. As a result, many reorganization and transformation of the financial services sector have occurred over the last decade (see Table 1 for regulatory reforms in four countries and the effect for each reform).

It is fair to assume that, despite the tumultuous financial atmosphere at that time, investors were not overly alarmed since they believed that the management of government and financial institutions were aware of those events (Tucker, 2010).

**Table 1: regulatory reforms and their expected effects**

Reform	Country	Major elements	Expected effect on equity returns	Stronger effect on ...		Expected effect on CDS spreads	Stronger effect on ...	
				Investment banks	Systemic banks		Investment banks	Systemic banks
Dodd-Frank Act	United States	Prohibition of activities, enhanced regulation of systemic institutions, resolution procedures	↓	yes	yes	↑	yes	yes
Vickers Report	United Kingdom	Ring-fencing approach, resolution procedures	↓	yes	yes	↑	yes	yes
Restructuring Law	Germany	Resolution procedures, bank tax	↓		yes	↑		yes
TBTF Regulation	Switzerland	Enhanced capital requirements for systemic banks	↓		yes	↑		yes

Source: (Schäfer et al., 2016: 84).

In addition, in case of any emergency, the management had already established what if believed were proper and adequate risk management systems, that there was a procedure in place which would be followed, and the markets would return to normal conditions. However, the emergence of the crises demonstrated a reality that was contrary to these beliefs. The financial sector is an institution which supplies the global economy. Banks were consistently issuing credit insufficiently stable investors and failed to effectively handle the risks involved. As a result, the financial sector froze the flow of capital to industry instead of expediting that flow. As the market capitalization of financial institutions fell, the stock markets were at the point of collapse. To date the aftereffects are still felt.

As the world is still in the process of recovering from the effects of the worst economic recession since the 1930s, there has been sentiment for proposing bold innovations to curtail the occurrence of similar conditions in the future. Apart from the Basel II, many economists are calling for a Bretton Woods II. This would be an attempt similar to the 1944 conference that set out the postwar international fiscal order. Some

leaders of the G20 summit, in November 2008, agitated for setting up for benchmarks, drawing lessons from the former crises, for formulating fresh agendas for global financial reform (Kern et al., 2006: 20-32). It is noteworthy that the many of the agendas endorsed in the meeting were not included in the proposals. Thus, if there is really a desire to shield the world from future economic collapses, it would be safe to think more carefully if the Bretton Woods approach would be effective at this time.

Policy makers now are seeking goals similar to those at the time of Bretton Woods, and there is a need to assert public authority over financial institutions due to the consequences from the economic meltdown. The Bretton Woods conference sought to achieve this goal through three means. First, one organization was designated to oversee the international markets more closely; second, one organization was designed to implement and address the global economic imbalance; third, one body was responsible for the promotion of international development (Kaufman and Scott, 2003: 371-391).

These goals should be employed as the basis for a turning point in addressing the problems current situation. Although Basel II was informed by Basel I, the world has changed greatly. Hence, Breton Woods II should not simply mirror Breton Woods. New mechanisms should be considered that can effectively address today's more dynamic conditions.

Emphasis should be placed on the preservation of the current status of the dollar, the rationale informing the borrowing of the developing countries, wealth funds emanating from the sovereign funds, as well as the critical role played by organizations of regional cooperation. The promotion of international development should tackle issues resulting from the contemporary international regulatory initiatives. Therefore, these areas should inform the new requirements for international financial institutions and the desire for subsidiarity as well as regionalism.

The 2007 financial economic crises have led to a significant backlash with respect to the absence of accountability for the private sector players in international fiscal markets. Since they have been left to act largely on their own initiatives, the global financial institutions as well as international markets have been led to point of a global breakdown. There is thus an urgent need to understand the underlying elements that have led to this economic collapse (Caruana, 2005: 1-32).

### **A. Understanding systemic risk**

Before the financial crisis, the systemic risk was insufficiently understood or appreciated. Amidst the shock at seeing the collapse of large financial institutions, despite the common belief that their finances were strong in terms of both risk management and leadership, there were calls to take systemic risks more seriously. Systemic risk is pivotal since under that type of risk, which has emerged, risks for the overall financial system dwarf the financial risks faced by individuals, products or the markets.

Systemic risk is defined as the risk of disturbance in the financial services occasioned by the impairment of all or portions of the fiscal systems and is a risk that has the potential to transmit serious negative repercussions to the overall economy. If a financial institution loses money due to a risky investment, that risk cannot be considered as systemic. However, if there is a failure of the institution there can be a rapid increase in the cost of investing in financial services, a failure of the market, or even a breakdown of the infrastructure. Any of these aspects can have tremendous implications to all market participants. Therefore, there is a systemic dimension. Its negative externalities as well as the essential spillovers to the true economy are the foundation of systemic risk and combined, they make a solid case for policy intervention (Caruana, 2010).

Systemic risks are two-pronged: section dimension and time dimension.

With regard to the section dimension, the framework of the financial system influences how it responds to, and probably amplifies shocks to the market. Spillover effects can arise from common exposures and those across institutions, while some are derived from common exposure to all institutions and sometimes from network interconnections. The problem arises of determining how to deal with such exposure, as well as inter-linkages in financial institutions. In the time dimension, the risk accumulates over time, thereby affecting the macroeconomic cycle. The problem occasioned here is how to curb procyclicality of the financial system (Colander et al., 2009: 249-267).

The formulation of financial regulatory policies is a fundamental part of the solution. However, regulatory policies alone will not suffice to resolve systemic risk in all its complexity. Other policies, monetary and fiscal policy, also have significant roles to play. In addition, coordination of the proposed policies is essential. International ramifications of these policies are also critical. Nonetheless, basic issues such as market discipline, transparency, governance, incentives, consumer protection and supporting confidence are essential for fostering the financial markets.

The current study analyzes and determines the relationships that exist between global financial crises, systematic risk and global financial governance. The research is also aimed at indicating the causes and effects of financial crisis and the ways of limiting them. Proper methods of financial governance and the risks involved in the enactment and facilitation of finance are also key features of this research. The impact caused on the economy by the 2007-2009 financial crises was so intense that some negative effects remain on the financial status of many firms. The risks that are were usually in line with financial governance were previously underrated, leading to the occurrence of the crises. The lack of understanding for the expansion of different states and governments resulted in increased inter-state reliance and increased the levels of interdependency arising from the effects of globalization.

The level of failure following the global crisis was so high since it affected both small and large industries since they all depend on the line of business concentration. The lack of proper strategic methods for deterring the crises from taking place forced most global firms, organizations and institutions to incur high losses, and others were fenced-off from the market. The establishment of financial institutions intended to develop measures to be applied for ensuring that financial crises do not reoccur was made possible to facilitate future risk absorption plans.

### **B. Demystifying global governance**

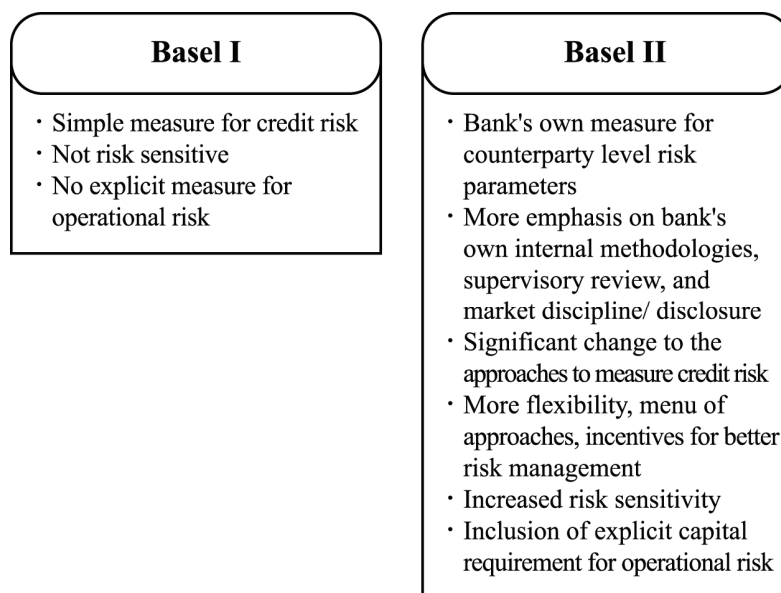
The manner in which financial crises have arisen has clarified the position that the global economy is governed poorly, and this has led to need to better understand the level of global governance. Although scholars have yet to reach a consensus on an understanding of what constitutes global governance, there is general agreement that it refers to the mode and manner by which rules are made, and power is exercised on a global basis (Wolf, 2009). However, this is done without centralized authority, mainly in the management of strategic interactions between many entities for the realization of collective goals. This notion is underpinned by the normative understanding that any form of global governance having legitimate rules is based on government and that this government conforms to a widely set of values and norms.

### **C. Basel I and II**

The general purpose of the Basel I Capital Accord was twofold: to strengthen stability of the international banking system and to formulate and implement a fair and consistent international banking system in order to decrease competitive inequality among international banks. Its main achievement was the definition of bank capital and the capital ratio (Acharya, 2009: 224-255). It was also important to establish a minimum risk-based capital adequacy that applied to all banking institutions as well

as democratic governments. Thus, there was a need to develop a definition of capital.

Despite the enthusiasm that accompanied Basel I, it had its shortcomings, and the aforementioned drawbacks led to the creation of the Basel II Capital Accord (see Figure 1 for the differences between Basel I and Basel II).



**Figure 1: differences between Basel I and Basel II**

Source: [https://www.princeton.edu/~markus/teaching/Eco467/10Lecture/Basel2\\_last.pdf](https://www.princeton.edu/~markus/teaching/Eco467/10Lecture/Basel2_last.pdf)

Basel II added operational risk and set new calculations of credit risk. It also defined operational risk as the risk of loss occasioned by human error or failure on the part of management. Following the implementation of Basel II in 2007 the frameworks introduced in Basel I were greatly expanded (Abdelal, 2007: 8-10). This second agreement covered new



approaches to credit risk, and it adapted to the securitization of bank assets, cover markets as well as operational and interest rate risks. It incorporated market-based surveillance as well as proper regulation. In summary, as the first international market that assessed the importance of risk in relation to capital, it will remain a major milestone in finance as well as the banking industry.

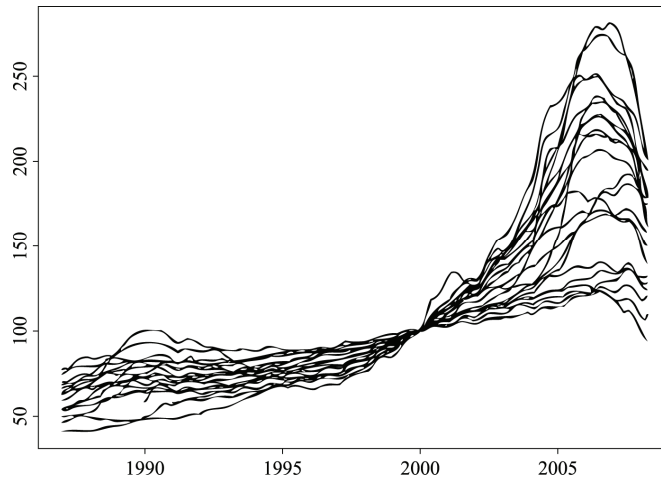
### **III. Causes of the Crisis and Risks**

There were three main causes to the global financial crises and systemic risks.

First, the developed nations had been affected by unprecedented real-estate recessions. What was initially viewed as a catastrophe of financial instruments in fact has an economic background. The massive boom witnessed in the real estate market across Europe and the United States between 2000 and 2006 was suddenly followed by a rapid fall in values (see Figure 2.).

In August of 2008, house prices had plummeted to 15% lower than their prices in the previous year. Price stabilization was not foreseeable. Similarly, several major debtors were unable to cover the capital on their mortgage payments, let alone the interest.

Second, all the innovations premised on fiscal developments within the last twenty years were considered to provide an avenue for transferring the risks associated with mortgage credits (see Figure 3.). A good percentage of these risks were transferred through securitization and later sold to investors dealing on a global scale.



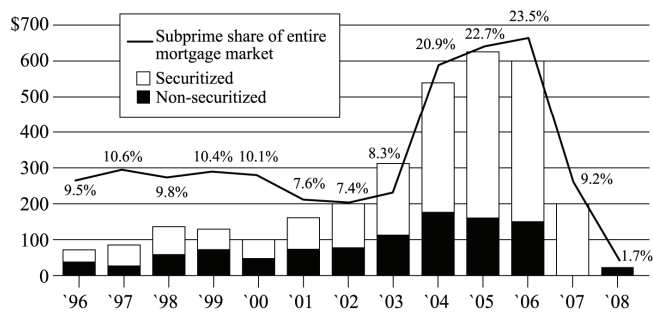
**Figure 2: Case-Shiller monthly Repeat-Sales indices for 20 major U.S. housing markets**

Source: (Goetzmann et al., 2012: 43).

### Subprime Mortgage Originations

*In 2006, \$600 billion of subprime loans were originated, most of which were securitized. That year, subprime lending accounted for 23.5% of all mortgage originations.*

IN BILLIONS OF DOLLARS



NOTE: Percent securitized is defined as subprime securities issued divided by originations in a given year.  
In 2007, securities issued exceeded originations.  
SOURCE: Inside Mortgage Finance

**Figure 3: subprime mortgage lending increased dramatically during the 2004-2006 period preceding the crisis**

Source: (Financial Crisis Inquiry Commission, 2011: 70).

Theoretically, the act of spreading risks on a broad scale stabilizes the system. However, in opposition to previous global crises, banks were not required to bear all the losses alone. Thus, the broad spreading of financial risks altered the market dynamics. Two decades ago, credit risks were mainly evaluated by a handful of established experts. Today, that has changed as it is the participants who are used to analyze the market.

At that time, there were already serious doubts related to both the rating quality and price formation. In the summer of 2007, there was a sudden exit of investors from the market, accompanied by unprecedented price falls and the total loss of liquidity in the market. The ensuing uncertainty led to a crisis that was then transmitted to other segments of the market. Since the positions of transactions are deemed as either fair value or net recovery value, many banks recorded immense losses. These tensions could only be kept under control if the central banks of the affected nations intervened (Reinhart and Rogoff, 2008: 339-344).

Third, the growth and development off systemic risk and risk management was not in proportion to the rapid expansion of financial innovation. It is well known that both the financial and banking sectors have struggled over the last couple of years to fully implement the Basel II Agreement (see Table 2.), which was centered on assets related to their investment portfolios. Numerous innovatively structured products that had been included in their portfolios were affected during the crises. Furthering the magnitude of this crisis, these investments were originally intended to be resold. However, the demand for these products was dropping dramatically, along with their prices. As a result, risk management departments of banks were not prepared for the resulting repercussions, and financial institutions lacked credit derivatives which were required for their transaction portfolios. Suddenly, banks were confronted with the need to adjust their balance sheet entries in accordance with their actual values (Principles Consultative Group, 2008).

**Table 2: implementation of Basel II in the U.S. lagged two years behind**

International		US
EU Capital Directive	2006	
Parallel run	2007	
1st transition floor (90%)	2008	Parallel run
2nd transition floor (80%)	2009	1st transition floor (95%)
Full implementation	2010	2nd transition floor (90%)
	2011	3rd transition floor (85%)
	2012	Full implementation with permission of primary supervisor

Source: (Herring, 2007: 423).

In Greece, the issuers of Collateralized Debt Obligations had preserved the least risky positions, which led to their record heavy losses in the financial market. The complex nature presented by the Basel II Accord documents led to difficulties in their assessment of liquidity in the market. This liquidity was markedly decreased as the correlation risk was stemmed to the Collateralized Debt Obligations financial market. As a result, several European governments had to be rescued during the recession. Similarly, some banks presented great difficulties to their respective governments when the banks required bailouts.

Securitization provides means to manipulate data in one way or another. However, after the ban of securitization in 2004, new and dynamic creative accounting techniques were developed, such as the use of currency swaps. In 2009, the newly elected government of Greece made the shocking announcement that the previous government was guilty of manipulating the nation's economic data. Consequently, the real deficit as well as the debt was higher than the previously stated estimation. Since that revelation, the Greek economy has been the subject of much debate and that point was seen as the commencement of Greece's financial crisis.

According to Chaffin et al (2010), April 2010 marked the point at which the situation in Greece had been exacerbated beyond expectations, and the country experienced great difficulty obtaining funds from the money market. As a result, the Eurozone decided to lend 30 billion Euros to rescue Greece's economy. The loan was pegged with a 5% interest rate, according to both the IMF lending rate and the market rate. The rescue plan was offered in tandem with Greece's announcement that it had formulated a 24 billion Euro austerity plan meant to lower its public deficit ratio by 10 percentage points within of three years. This would help it to be in line with the SGP criteria (Acharya, 2009: 224-255).

The estimated savings for Greece's government were to be obtained from layoffs and freezing wages in the public sector. Additionally, there was to be a suspension of two months' wages from the public sector. Taxes were increased and new taxes were included. The pension amount was reduced and the pension age was increased to 65 years. As a result countrywide demonstrations of protest occurred after these announcements.

The debit crisis spread to other debt driven developed countries in a rapid speed, especially those European countries such as Spain and Sweden. In Fact, the pre-crisis Spanish debt to income ratio was low, and there has been no nationalization of the Spanish banks. During and after the crisis, Spain received enormous EU support, and the non-banking sector has been hit harder than that in the other countries which have also experienced a major systemic crisis. With the inception of the debt crisis, the instability of the Eurozone has also occurred since then. The crisis is a failure of regulation, especially the change towards market forms of regulation. Before the crisis, the preferred mode of regulation was that signaled on internal risk control and management as set out in the Basle II capital measurement and capital management standards. Large financial institutions were trusted to price and judge risk in a self-interested manner that would avoid bringing disaster to itself or to the rest of the financial system. The failure call for a critical investigation of the geography of

financial regulation and, in particular, the attempt to combine national solutions into an effective transnational policy response (The Economist, 2009: 75-77).

## **IV. Measures and Reforms**

### **A. Measures to restore the financial services industry**

The nature of the global markets requires oversight as well as proper regulation to take place in various local and national jurisdictions. Regulation should be complemented by international regulation whose purpose is to ensure oversight that is both holistic and transparent. This will help prevent the possibility of regulatory arbitrage and the loopholes in the regulatory coverage found between the home and the host jurisdictions (Bordo and James, 2008). The international level is in need of oversight and regulation bodies. In addition, it should have an all-inclusive, universally consistent regulatory framework that can ensure clear accountability for all regulators in the entire industry. A structural problem that has been identified as the cause of the financial system breakdowns, was the emergence of new financial institutions over the previous two decades. These new institutions were either unregulated or less strictly supervised than the previous financial institutions.

A good example of less regulation is the divorce from the distribution of assets as well as funds, which were endemic in the pre-crisis banking institutions. This has led to the massive decrease in transparency in the overall financial services sector. Shadow banking, as it has come to be known, had many spin-offs, such as hedge funds, private equity firms, and special purpose vehicles. In addition, many institutions held trillions of dollars in asset-backed commercial conduits, tender option bonds, and rate demand notes that were variable, tri-party repurchase agreements, together and many more assets. There is a clear need to re-evaluate and adjust the

roles and responsibilities of the central banks and finance ministries, together with their regulators. This is to ensure that the areas of accountability and other pertinent areas in the finance industry are clearly defined (Cutler, 1999: 59-81).

It is common knowledge that a good percentage of the banking industry relied heavily on the rating agencies, which have also been subject to scanty oversight. In order to effectively assess systemic risk, the framework responsible for governance will need to have clear oversight for institutions being established in the various positions throughout the financial markets. This is not limited to the conventional government financial institutions (Grant, 1997: 319-336).

Stability of the financial system could be increased in an environment where there was control over the many types of risks flowing from financial institutions, since those institutions are have the greatest management ability in the advent of credit risk. However, when credit risks emerge, current regulations instead require financial institutions to set more money for risky ventures. This is done more than the nonfinancial institutions. So banks are encouraged to focus their assignment of credit risks to individuals and institutions in order to obtain a higher yield. However, the banks have very limited ability to construct these types of risks.

## **B. Specific role of regulations**

Due to the wide variety of proposals on the legislations and regulations being made at both national and supranational levels, it is clear that fundamental changes in the financial services regulations will take place in the future. The final mixture of both national and international entities should provide a platform for a globally consistent and transparent governance structure. The framework must be complementary in nature, and it should ensure that regulatory arbitrage is minimized as much as possible (Helleiner, 2001: 243-263).

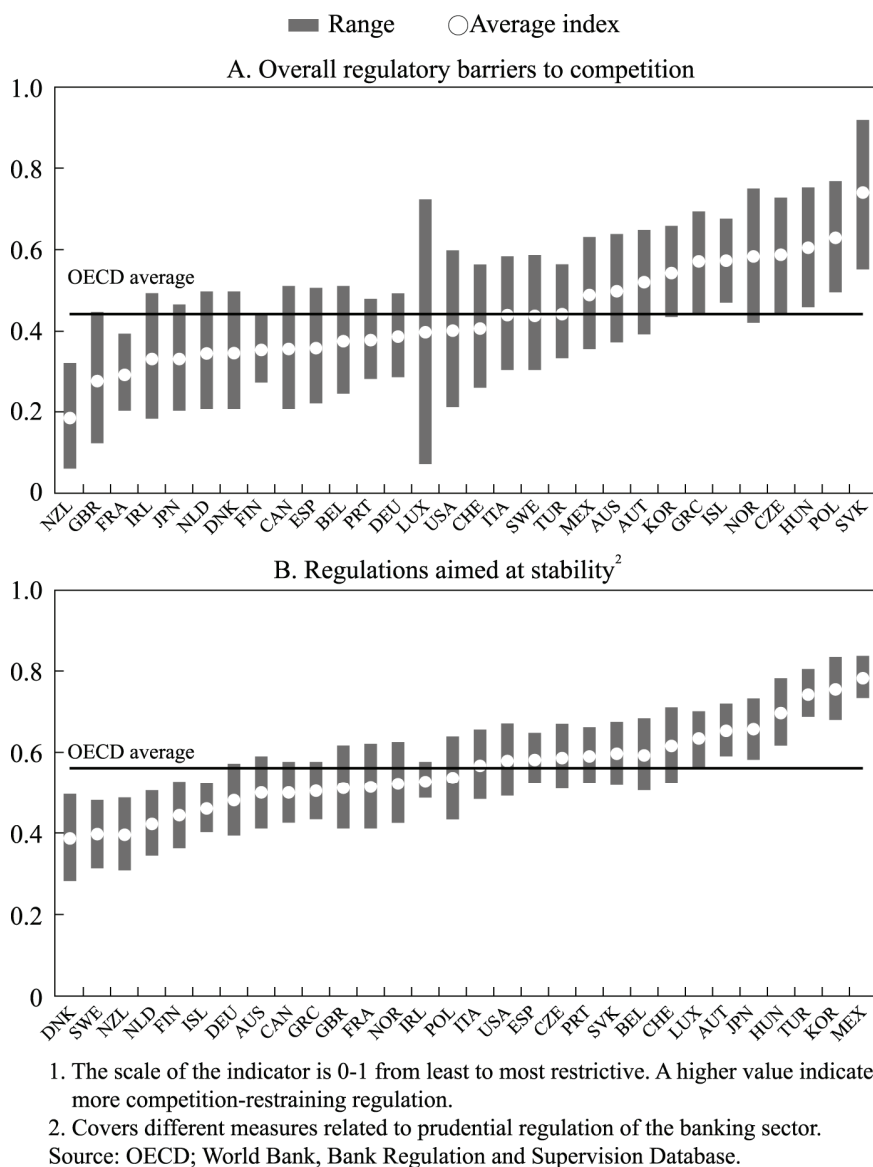
Nonetheless, the search for a level playing field must consider that regulatory approaches vary from country to country. These approaches include views on the degree to which the public sector should participate in the private sector and sometimes in demand and supply side regulations. It is possible that national governments can become more parochial, and some have already begun to protect their sovereignty by revising their foreign investment policies. For example some are encouraging financial institutions to provide domestic loans if they are required to take deposits (Prasad et al., 2003: 37-45).

But a counterbalance at the international level is needed in order to ensure consistency as well as holistic coverage in the regulation frameworks on a global platform. These frameworks can have adverse effects on the entire financial industry, as well as the global community and the overall economy. It is thus essential to have a proper grasp of the desired approach, including its role and regulation on a global basis.

Effective regulation and governance is based on the ability to supervise the overall stability of global financial institutions. This is pertinent for determining the entire health of the system as well as assessing the responses that are responsible for reducing the risk of chain reactions and accompanying system-wide failures. The risks that have been identified so far need to be mitigated in an efficient and effective manner with regard to all the affected players and their jurisdictions (Staples, 2006: 52).

It is common knowledge that the financial services have the most regulations of any economic sector. Furthermore, there are more regulations being considered in this sector in order to serve and protect interests of the economy. Too much regulation can negatively impact innovations in structures that are dependent on the financial services sector. Lessons learned from other industries, in terms of both successful and unsuccessful policies, should be used as guides in understanding and appreciating the need for transparency worldwide (South Centre, 2008).





**Figure 4: banking regulation indices, 2003<sup>1</sup>**

Source: (De Serres et al., 2006: 86).

Levels of regulation as well as oversight should guarantee the overall macroeconomic stability of global financial markets. This should be carefully done to avoid an overly restrictive system which inhibits the innovations that are economically useful. Figure 4 shows constructed regulatory indicators appropriate for the broad categories of competition and stability. It can be derived that the financial and economic history are responsible for triggering incentives that have reproduced effective behaviors and are hence are better for managing risky ventures than pure regulation. At least the incentives should complement regulation where possible.

### **C. Changes within the global financial institutions**

There is no regulatory framework that can achieve the desired stability in financial services, especially in the absence of a strong culture of risk control or where organizational practices for the guidance and information of proper behaviors is lacking. Nonetheless, the financial industry should be incentivized from its highest levels of management for establishing the correct vision. This can help align performance targets as well as incentive metrics designed to motivate organizations towards constructive goals and targets (Rodrik, 2002).

It is commonly considered that banks should be the leaders in providing capital for credit, market, liquidity, operational risk and investment. Generally they should be prepared for any type of risk. Nonetheless, increasing the overall capital baskets does not constitute a panacea for the problems that occasioned the fiscal crises over the past decade. This is because capital requirements do not take into account the different types of risks involved as well as the differences between financial institutions (Paul, 1995: 607-617).

Capital requirements need to be in tandem with the business model as well as the risks inherent with the particular business, taking into account

both national and local requirements. Moreover, they need to be assessed on the grounds of who would come to the rescue of the financial institution if that were to become necessary. Most countries see that the risks involved in global institutions are increasing, and these risks are threatening sovereignty default.

The Basel Principles are the most succinct and influential, albeit misconstrued and misunderstood, covenants in matters central to international finance. Drafted in 1988 and 2004, Basel I and II rejuvenated the entire banking industry. Both accords have been at the center of harmonization with respect to bank supervision. They applied both quantitative and qualitative benchmarks which have been predominantly applied in the eleven nations comprising the Basel Group. They have also set the trend for capital adequacy standards in emerging economies across the world.

But these accords are largely misunderstood because their strength, both technical and quantitative focus, limits their grasp of the agreements found within policy circles. Consequently, misunderstanding ensues and misuse of the accords follows. Thus, regardless of where the Basel records have been applied fully and comprehensively, neither of the agreements have provided a platform for long term stability within a nation's banking sector. It is therefore pertinent to understand the strengths and shortcomings of Basel I and II in order to appreciate their technical assessment.

The nexus between the global financial governance, systemic risks and the financial crisis needs to be investigated and addressed. The issues of distorted incentives, weaknesses in the global financial governance systems, limitations in risk management, official oversight, mis-pricing of credit risks and the global macroeconomic imbalance are analyzed and discussed below. A fundamental lesson from the global fiscal crises was that there is a dire need of oversight in the financial markets. The financial institutions, which pride themselves in being enshrined in democracy,

should put in place necessary measures to guarantee transparency and accountability. Since the rules governing all financial institutions as well as international trade are formulated by a small cluster of nations and institutions, there is only minimal opportunity for participation from the players who are primarily affected by the decisions emanating from these select bodies. As a result, international trade and financial institutions are unresponsive to the unevenness of economic globalization (Stephan, 1999: 1555-1588).

Resultantly, the need to infuse democracy into these institutions that hold the fiscal element in the fabric of life has become. Efforts to reform the financial system should be supported in an effort to ensure transparency, efficiency and accountability with regard to the delivery of financial security. Thus, there is a need to formulate and implement substitute governance structures, which will make a substantial contribution towards inculcating fresh and dynamic voices in the global public dialogue. Alliances can then be developed to ensure that the institutions are fostered to ensure public welfare.

This study is centered on the relationship between global financial governance, systemic risk and the global financial crises, and numerous proposals have been advanced in order to address the credit crises witnessed between 2007 and 2009. The current paper advances three proposals: for businesses to improve their self-regulation, for interventions to stem mortgage failures, and for addressing the reduced liquidity and increased regulation in the financial sector.

The crises served as an opportunity for global financial organizations to rise up and demonstrate leadership, seeing the crises as a justification for improved internal oversight systems. The lack of accountability, responsibility and autonomy could be addressed through self-regulation, and the financiers, not the regulators, should be better placed to amend their actions and come up with a well-functioning system. This was the

idea that the participants could themselves better ensure that the system had accountability, transparency and responsibility.

However, the turmoil witnessed in the financial markets spread at an alarming rate, facilitated by the fact that many banks, brokering societies and other financial institutions lacked effective risk management plans. Many firms had heavily invested in assets, and some had sold credits to special investment vehicles although they were not bound by contract so to do. Very few companies and firms had predicted the possibility of a liquidity deficit on their balance sheets.

## **V. The Way Forward**

The 2007-2009 economic crises caught many democracies unawares, and as a result many countries are still trying to recover. Giant financial institutions have fallen, some have been forced to merge while others had no alternative but to close. The G7 was exposed as an outdated forum that is not effective for the governance of global financial institutions. In an attempt to fortify their credentials, the G7 expanded to the G20. This was enshrined in the rationale that instead of viewing the global fiscal structure as embodying the views of finance ministers and central bankers, the world would be more comfortable if heads of state were also involved (Helleiner, 2009a: 189-211).

Arguably, the G20 has positioned itself as the most pivotal international forum in the issue of global economic governance. The paradigm shift in power away from G7 should not be over focused. It is noteworthy that the contemporary G7 countries have accepted the takeover of power by the G20 nations; they have not released control of the core agendas informing global economic governance. The factors that underpin the existence of the G7 countries continue to form the headlines in the G20 discussions.

As a result, the shift in balance of power simply results in the fact that members of the G20 can only participate in the pertinent discussions. Save for that, they can only combine forces, thereby influencing their current prioritization, which will affect the outcome in their favor. Although the shift in power has deprived the G7 of their dominance, those countries still wield a significant degree of control in issuing principles and implementing policies that affect global economics.

**Table 3: convergence between the two groups (G7 and G20)  
of countries will continue in the future**

Economic profile of G20* in 2010.											
Large advanced countries/area	(1)	(2)	(3)	(4)	(5)	Large emerging market economies	(1)	(2)	(3)	(4)	(5)
United States	309	14,646	14,636	47,310	1.8	China	1,338	5,721	10,222	7,640	10.8
Japan	127	5,334	4,412	34,610	0.9	India	1,225	1,554	4,160	3,400	8.0
Germany	82	3,522	3,115	38,100	0.9	Russia	142	1,404	2,727	19,240	5.4
France	65	2,750	2,255	34,750	1.3	Brazil	195	1,830	2,145	11,000	3.7
United Kingdom	62	2,377	2,231	35,840	1.8	South Africa	50	305	520	10,360	3.9
Italy	60	2,159	1,924	31,810	0.5	BRICS (all above)	2,950	10,814	19,774	6,706	8.8
Canada	34	1,476	1,310	38,370	2.0	Korea	49	972	1,423	29,100	4.1
G7 (all the above)	739	32,264	29,883	40,369	1.4	Indonesia	240	599	1,008	4,200	5.3
Australia	22	1,030	823	36,910	3.2	Mexico	113	1,008	1,627	14,340	2.1
Euro Area (17)	332	12,794	11,400	34,360	1.3	Argentina	40	348	629	15,370	5.6
European Union (27)	502	17,361	15,904	31,681	1.5	Turkey	73	720	1,230	15,530	4.7
						Saudi Arabia	27	434	610	22,750	3.6
Advanced in G20	994	39,847	37,085	37,258	1.6	Emerging in G20	3,492	14,895	26,301	7,505	8.1
All high-income	1,127	43,683	42,073	37,317	1.8	All emerging	5,767	18,949	33,538	5,996	6.4

Source: World Bank, Databank, 2012.

\* G20 includes: the United States, Japan, Germany, France, The United Kingdom, Italy, Canada, Australia and the European Union as a whole (among advanced countries), and China, India, Russia, Brazil and South Africa (BRICS), and Korea, Indonesia, Mexico, Argentina, Turkey and Saudi Arabia.

(1)= Population in millions.

(2)= Gross National Income (GNI) in billion of U.S. dollars.

(3)= Gross National Income (GNI) at Purchasing Power Parity (PPP) in billion U.S. dollars.

(4)= Per capita GNI at PPP in dollars.

(5)= Average yearly growth of real GDP 2000–2010 in percentages.

Source: (Klein and Salvatore, 2013: 420).

There is a need to rebalance the global power. The roles played by the G7 and G20 in running of financial affairs have been converged and the trend does exist (see Table 3.). Until the imbalance has been resolved, the recurrence of another economic meltdown is inevitable. Moreover, global governance will continue to be partial, unsustainable, and unsatisfactory. Therefore, in the interim middle-level powers can exploit the minimal opportunities provided by their participation in the G20 conglomeration. Their actions should be predicated on long term visions of the governance of global financial institutions. By reflecting from the

recent global practice, the following principles should be enunciated which have also partly mentioned in Bradlow (2012), Helleiner (2009b: 89-120).

### **A. A holistic vision of development**

The governance of global financial institutions should be based on a holistic definition of development. This will require viewing all states the standpoint of developing regions that are striving to better the lives of their citizens. However, many democratic states may fail in the definition of their responsibilities and the elements of development they should prioritize. It is necessary to seek to better the well-being of individuals and their societies can be improved, doing so in light of both economic and non-economic factors. Consequently, development should be viewed as inseparable from the social, environmental, cultural and the political elements because all of them are integral to any financial institution (Oliver, 1975: 22).

### **B. Comprehensive coverage**

This means that the institutions as well as mechanisms combined to form international economic governance should be answerable to the facts informing stakeholders of the situation of the international economy. A good example is that the structures of international fiscal governance must establish operations rooted in the fiscal intermediaries involved with national and cross-border fiscal transactions, as well as the best interests of their customers. This principle is informed by three tenets:

1. The mechanisms holding the structures of international economic governance must be both flexible and sufficient. They should be designed in a manner which can respond to the diverse and ever-changing needs of diverse stakeholders.
2. The holistic aspect of international economic governance arrangements are designed to ensure that the international community receives the services it requires from a soundly functioning global economic system.

3. Arrangements in the governance structure should ensure that the decisions taken in the lower stages should be in tandem with effective and efficient decision making.

### **C. Respect for international law**

The inner workings and financial arrangements for global economic governance should be informed by international legal principles. Therefore, the bodies responsible for making all decisions in global financial institutions should be informed by international principles codified in laws. This requires attention in the following areas:

1. Respect for national sovereignty. In as much as sovereignty is not considered absolute, it should be employed to provide an avenue of independence as well as policy space. This must be in consonance with the demands of a global financial institution which is effective (Lessard and Williamson, 1987: 16).
2. The principle of non-discrimination. For many years the major players, all of which are developed nations have determined policies, many of which are discriminatory towards newer and developing nations. However, for the global financial institution to flourish, the more powerful actors should treat both state and non-state stakeholders equally. Therefore, the standards responsible for guaranteeing the treatment received by all parties should be just and reasonable.
3. The responsibility of individual states in directing the global fiscal institutions to prevent systemic risks spreading should be based on global responsibility. It should follow that foreign entities should receive treatment comparable in line with similar local situations.
4. International environmental law should be used to derive legal principles. These legal principles would be applied to establish regulators' obligations that all actors should fully appreciate both social and environmental impacts resulting from individual transactions.



#### **D. Coordinated specialization**

Without prejudice to the foregoing, the global financial institute should have their mandates limited and clearly defined (Schmidt, 2007: 20-24). Thus, two requirements are necessary:

1. There must be clear and distinct definitions for the mandate of each mechanism within the institute, and these definitions must also apply to international economic affairs.
2. The institutions put in place must consider other pertinent elements in the development process.

Thus, the mechanism that is established must be capable of facilitating the coordination between the institutions that are involved with international economic governance as well as other bodies responsible for the arrangements of global governance. The mechanism responsible for coordination should be formulated to resolve tensions arising in the different elements of international governance. It should be transparent, accountable, and predictable. This mechanism should be capable of settling disputes.

#### **E. Good administrative practice**

The primary tenets of good administrative practice in governing a global financial institution mirror those of any public institution. These tenets include transparency, accountability, well-reasoned decision-making processes, inclusive participation, and predictability. The stakeholders and actors must have formulated a plan to be adopted as an avenue for raising their grievances and resolving them. The bodies set up for resolving problems will disseminate their works in line with legal principles contained therein. Moreover, the institutions should be in a position to critically explain the logic behind their decisions to the stakeholders and other affected players (Webb, 2008).

## VI. Conclusion

Sophisticated global institutions failed miserably when confronted by the financial crisis since they were unable to manage the fundamental systemic risks. This paper illustrates how these factors are symptomatic of the failure of global institutions to address the pace of globalization. In addition, the failure of the most advanced and developed global financial system to recognize or manage susceptibilities should be addressed. Financial institutions that are weak and ineffective are responsible for failures of the fiscal decisions that led to the recent financial crises.

In the wake of these crises, the governance of financial institutions was tasked with the responsibility of formulating and approving risky strategies. These strategies were responsible for short-term profits as well as remunerations. However, it was later evident that these strategies overlooked loopholes in fiscal accountability, which led to the crises. As a result, the financial institutions were not safeguarded, and this also applied to its shareholders, customers and the global community. The entire collective of financial governance institutions failed in their responsibility for regulating the markets (Colander et al., 2009: 249-267).

A consensus on the aforementioned issues has not been reached, and so a plan to implement the healthy governance has yet to be formulated. To overcome this, new players in the G20 should embrace a pragmatic approach to the reform of global financial institutions. They should focus their energies on the formulation of short-term strategies that will support the development of tangible benefits to their countries and their citizens.

This will foster more opportunities to achieve reforms in the governance of global financial institutions. The reforms will also be consistent with established long-term objectives. The implementation of this strategy requires outlining priorities relevant in the achievement of

short term objective, priorities that will be used as the basis for developing a plan to attain long term objectives. For instance, Greece and Europe's concerns in global financial issues are related to the rescue of large corporations and reversing the effects of globalization. Thus, Greece should concentrate on assisting Europe in dealing with these issues.

Accordingly, there are two sectors in the financial arena that should provide an avenue for achieving short term objectives. First, there is a need for financial regulation. For example, Greece put in place measures to broaden reforms in its banking regulations. It should be clear that many European Countries have smaller populations and companies within facing great challenges in accessing informative financial services. Thus some form of stringent regulation should be necessary for banking institutions to develop new services and products. These must be especially designed to address the problem at hand. For example, Greece might encourage the use of cell phone banking (Reinhart and Rogoff, 2008: 339-344).

The second issue is with respect to Greece prioritizing its reform strategies in the arrangements it has made with the World Bank and the IMF. From the fiscal crises of recent years it has become evident that there is need for substantial reform in the governance of both the World Bank and the IMF. But it is also clear that such reforms cannot be expected in the near future. In addition, the most realistic, tangible and beneficial reforms are those which take place within an existing legal framework. Nonetheless, one reform that can be more easily achieved is the accountability levels of global financial institutions.

These bodies responsible for oversight and accountability must support non-state actors from being harmed by failure on the part of the same bodies to comply with their own regulations. The smaller actors must have their claims investigated by responsible personnel in the organizations. Global financial institutions, such as the IMF and World Bank, should reduce their exceptionalism and come up with a standard version for their own structures.

The regulation of financial risk is premised on the need to optimize economic efficiency. Systemic risk has been generally considered of in terms of financial institutions, rather than from the point of inefficiency of financial markets. Companies should be encouraged to develop the elimination of financial intermediaries. Through these measures, companies will be better able to access funding in the capital market, so they will not need to satisfy and navigate the numerous hurdles currently presented by banks. There must be more concentration on the connections that exist between financial institutions and financial markets.

The abrupt policy changes put in place by banks following the subprime mortgage crisis, albeit helpful, are still insufficient to prevent a future systemic collapse. This is because monetary policies impact banks, rather than financial markets, despite the fact that it is financial markets, and not financial institutions which are increasingly at risk. Policies should address the underlying problems highlighted in this paper to restore the confidence of the investors.

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# 2007年金融危機 及其對全球金融治理影響<sup>\*</sup>

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## 摘 要

本文主要討論金融危機的影響，以及針對始於2007年的全球金融危機分析全球金融監管與治理制度的重要性。這次金融危機緣於銀行過度使用槓桿借貸給還款困難的買家，導致投資者對資產和對於基於房屋貸款的美國證券失去信心。而此次危機在後續幾年不斷惡化，致使全球層面包含已開發國家和發展中國家的經濟、金融與政府的危機。本文主要為探討和分析此次危機持續存在和惡化的原因，並建議通過政治干預、金融管理改革，以及採用跨國界的管理策略來處理債務危機持續影響的狀況。

關鍵詞：金融危機、希臘債務危機、金融治理、系統性風險、金融監管

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