Policy Responses
to Unfettered Finance

The North-South Institute

response
construire
investment
mission
solution

Beyond *Band-Aid* Solutions *to the* Crisis, *Towards a* New Development Paradigm

*The North-South Institute launched the Policy Responses to Unfettered Finance (PRUF) project in late 2008 to stimulate thinking on development-friendly responses to the global economic crisis.**

Working closely with policy-makers, the private sector, civil society, researchers and international institutions, PRUF is promoting dialogue on the often overlooked and under-represented component of the crisis: its impact on the poorest and most marginalized countries.

Through workshops in Ottawa, New York and Geneva, commissioned papers and policy engagement, the project documents key policy messages that are crucial to preventing future crises and mitigating the effects of the present one.

Understanding the Crisis: What Failed and Why

Conventional accounts of the crisis emphasize the role of lax financial and housing sector regulation, as well as prolonged expansionary monetary policy in the United States and other advanced economies. A more complete reading also emphasizes global macroeconomic imbalances between persistent deficit and surplus-saving economies.

External imbalances are further reflected in domestic imbalances. Consider two indicators: at the onset of this crisis, the income share of the top 1 per cent (richest) Americans was higher than at any point since the onset of the Great Depression. Meanwhile, in 2008, US household debt increased to levels not seen since 1929. In fact, income disparities have increased almost universally. These red flags point to deep structural issues.

In surplus-saving economies – from China and other Asian countries to the oil-exporting Gulf countries – the accumulation of surpluses is

This Policy Brief:

- Moves beyond mainstream analyses of the global economic crisis
- Assesses major risks to recovery scenarios
- Focuses on the interests of low-income and developing countries
- Articulates a New Development Paradigm that emphasizes inclusion

* This project was made possible by the generous support of the Ford Foundation, as well as continued support of our core funders the Canadian International Development Agency and the International Development Research Centre.

At its core [the crisis] is the failure of a model that relies too heavily on the ability of overextended households in a handful of advanced economies contributing to global aggregate demand.

partly explained by precautionary motives such as insurance against speculative currency attacks and sudden capital flight. However, since reserves are primarily held in US Treasury Bills, this represents a major South-North capital flow. Accumulation of large reserves indicates these countries would pursue expensive self-insurance rather than go to the International Monetary Fund (IMF) and other international financial institutions (IFI) for financing. This is a major flaw of the global governance institutions, which should act as a stabilizing force against crises.

The current crisis represents the failure of the narrow Washington Consensus development paradigm. It demonstrates the limits of an excessive reliance on the private sector to serve the essential social functions of risk management and diversification. At its core it is the failure of a model that relies too heavily on the ability of overextended households in a handful of advanced economies contributing to global aggregate demand.

Deeper issues lie behind the simultaneous freezing of credit markets, frenzied deleveraging, and the speed with which these were transmitted to the global economy and international trade. Part of the reason for this is an over reliance on the US dollar as the main store of purchasing power as well as unrestricted private capital mobility as the main counterweight to structural imbalances.

However, a global economy, underpinned by an incoherent international monetary and currency system, did not emerge overnight. The IMF and Bank for International Settlements (BIS) have been sounding alarm bells for years. Unfortunately the ability of IFIs to preempt crises is constrained by the fact that they are only able to influence the policies of countries that are forced to borrow from them, not the policies of their largest shareholders — the advanced economies at the epicentre of this crisis. This is a serious flaw.

Green Shoots Here, Yellow Weeds There

While signs of recovery may be appearing in stock markets and credit spreads, these developments are dependent on costly government intervention. Even in advanced economies threats to this optimistic scenario remain: the possibility of debt crises sparked by unprecedented public debt levels; new asset-price bubbles should stimulus cause unproductive speculation in equity, housing, commodities or derivatives markets; and currency crises if there is a sudden loss of faith in a major currency like the US dollar, or, alternatively, an excessive flight to safety to the US dollar.

Furthermore, recovery in advanced economies does not necessarily imply recovery in poor countries. The forecast for poor economies, especially low-income countries (LIC) in sub-Saharan Africa, is of a prolonged recession even if others bounce back faster and sharper. The crisis is having a lagged effect on LICs and is causing sharp increases in unemployment and precarious employment. This is worrisome given the demographic trend of fast-growing youth populations and potential for social and political unrest as increasing numbers of young people enter the workforce at a time when employers are cutting back on hiring.

In poorer countries, trade contraction, declining remittances and other capital flows, and the impact they are having on state capacity to respond to the crisis are eroding recent gains, pushing many who fought their way out of poverty back into it. Expenditures on health, education and basic services in many sub-Saharan African countries were the first casualties of the crisis. A return to high prices for basic commodities like food and fuel is a major threat

to recovery in poor countries. If the global recovery turns out to be primarily a function of emerging economy demand for commodities, this could worsen the prospects for many poor countries.

Why Development is at the Centre

In all likelihood the Millennium Development Goals will not be attained by 2015. Notwithstanding recent aid pledges, past crises demonstrate that aid levels come under pressure during tough times in donor countries.

Even before the current crisis, poor countries were suffering major food and fuel price crises which received very little attention because these countries are sorely marginalized if not completely unrepresented in key global institutions. As a workshop participant put it, "If you are not at the table, you are on the menu."

The global economy is increasingly interconnected. Low-income and developing countries encouraged by donors and IFIs to liberalize and globalize according to the Washington Consensus are now more exposed to external crises. For instance, the export-to-GDP ratio for least developed countries (LDC) is 45% today compared to 17% in 1995. Strikingly, the contribution of exports to GDP even in landlocked developing countries increased from 23% in 1995 to 58% in 2008.

This crisis has exposed major structural flaws that built up over years if not decades which the current global policy and institutional framework cannot deal with adequately. At the heart of the problem is a failed paradigm that overemphasized the benefits of development through globalization without appreciating the risks. It is now clear that the global economy is truly global, if not in sharing the benefits than certainly in sharing risks. An equitable response to the crisis requires participation of all nations, and the United Nations is best placed to coordinate this, in collaboration with other IFIs as well as the G20.

Components of a New Development Paradigm

At the London Summit G-20 leaders acknowledged the need for a new vision of sustainable economic activity.[†] It is now time to articulate that vision, which must include the following components.

More inclusive global financial governance and a more enabling international environment

Immediate IFI reforms: The IMF and World Bank must urgently address the lack of representation of the poorest and most vulnerable at the global level. Policy-makers must not only expedite this process but also recognize that beyond operational and technical issues it is time to change the intellectual framework in IFIs. The first point of change should be the conditionality framework. Clear indication of such change would increase the credibility of ongoing reform processes.

Strengthening cross-border regulation: Financial governance has clearly not kept pace with the speed of financial globalization. It is time to move beyond rhetoric on tax havens and hedge funds. Until regulation, transparency and monitoring at the cross-border level become much more comprehensive, the attractiveness of unproductive financial innovation to get around new rules in novel ways will be impossible to restrain.

[†] G20 London Communiqué, point 21.

"Even before the current crisis, poor countries were suffering major food and fuel price crises which received very little attention because these countries are sorely marginalized… As a workshop participant put it, "If you are not at the table, you are on the menu.""

Focus on growth with equity: The pursuit of economic growth must be balanced with much greater attention to equity and distributional concerns. An enabling international environment would appreciate that different countries will pursue a different balance between domestic and external orientation, pace and need for liberalization, and desired level of financial sector sophistication.

Coherent monetary adjustment mechanism and stable currency system: Coherent proposals in this area include the recommendations made by the United Nations Expert Commission. A stable currency system is a concern for all countries. Initiatives in this direction must be inclusive and the UN is well placed to play an effective coordinating role with the technical support of the IMF, BIS, Financial Stability Board and others. The special drawing rights (SDR) expansion proposed at the London Summit is a step in this direction and policy-makers have an opportunity to institutionalize SDRs as a crisis response. Such a move would be consistent with a shift to a more stable and multilaterally governed international currency and reserve system.

Quick-disbursing anti-shock facility for LICs: During crises large resource gaps can develop very rapidly in the poorest countries. They need a permanent global provision for countercyclical financing. A new facility would offer rapid financing on either grant or very concessional terms, and aim to contain the spread of crises to the poorest countries.

Acknowledgement of a greater state role in development

State as stabilizing actor: Countries which view government as part of the solution rather than as an impediment tend to work through crises better (e.g., Canada, China, France and India). A greater state role in the financial sector (e.g. through public sector banks) can have a stabilizing effect during crisis particularly in LIC contexts. Getting governance right is crucial.

Countercyclical policies: Macroeconomic policy must play a more active role to even out boom and bust cycles. This entails taking a broader view of monetary policy, going beyond inflation targets to real measures such as employment creation and targeting asset-price bubbles. In large emerging economies with vast foreign reserves, major investments in social safety nets and programs aimed at the poorest people should be undertaken. Such actions are further consistent with resolving structural imbalances and would help bring about the structural transformation necessary to harness underlying productive capacity in the developing world. The policy framework in poorer countries must be reoriented to stimulate domestic demand.

Getting financial efficiency right: There can be several interpretations of financial efficiency. From the perspective of national regulators the objective of regulatory reform must not be to stunt financial innovation but rather weed out financial instruments that increase risk but have no social return. Much greater caution should be exercised in proceeding with liberalization and deregulation, particularly in the financial sector.

Protection vs. protectionism: The foremost lesson for poor countries is the need to protect themselves from the negative effects of external crises. There is a fundamental difference between protection, or shielding the most vulnerable people from volatility, and protectionism, or unfair practices to secure advantage over competitors. This is clear from the direct intervention by governments across advanced economies to protect the integrity of their financial systems. In developing countries measures to protect systemic integrity could include restrictions on capital mobility as necessary.

Sustainable economic activity must be the baseline of a new development paradigm. The paradigm shift should enable a diversification of the sources of global demand, away from overextended households in advanced economies, and towards harnessing productive capacities in developing economies in a just, equitable and environmentally sustainable manner. Such reform will lead to lasting changes that will help prevent future crises.

For more information on NSI's work regarding the crisis, visit the project page at www.nsi-ins.ca/english/research/progress/61.asp, or contact: abhushan@nsi-ins.ca.

The North-South Institute, 55 Murray, Suite 200, Ottawa, Ontario, Canada K1N 5M3
Tel: 613.241.3535 Fax: 613.241.7435 e-mail: nsi@nsi-ins.ca Web: www.nsi-ins.ca