Foreword

The current financial and economic crisis came as no surprise to those who had been warning of the likely repercussions for international finance and the world economy of the bursting of the US housing market bubble and the unsustainability of the massive global imbalances of recent times. In a world of weakly regulated, but closely interconnected financial markets and persistent global macroeconomic imbalances, the resulting adjustments have undermined growth, and continue to damage development prospects in the world economy, especially in developing countries and transition economies which have all become much more integrated into the world economy.

The US current account deficit has been the most widely discussed indicator of the global imbalances. Growing reliance on the greenback as the world's reserve currency is one reason for these imbalances. For the five years preceding the crisis, the US was absorbing more than two billion dollars of other countries' savings daily. The growing US deficits were financed by increasing trade surpluses—in China and other developing countries besides countries like Japan and Germany—used to buy dollar-denominated assets including US Treasury bonds.

The Crisis and the Developing World

Before the current crisis, the world economy had boomed on the basis of strong consumer demand in the US, stimulated by easy credit and soaring house prices, especially on the coasts. In aggregate, US households were spending more than they were earning, made possible by the easy availability of domestic credit on an unprecedented scale. Such borrowing was especially attractive as asset (house and equity) prices kept rising, interest rates remained low, and each new generation of financial innovators persuaded investors that they had mastered risk and overcome the laws of financial gravity. Thus, further lending, even against already over-valued collateral, was successfully presented as signaling more good times ahead.

Warnings about irrational exuberance were largely ignored, especially as US consumer spending helped fuel strong growth performances across the global economy. Robust exports from Japan and Europe supported economic recovery and steadied investor confidence, providing, in turn, further export opportunities for newly industrializing countries, most notably China, as well as primary commodity, especially mineral, exporters.

Meanwhile, greater international competition helped contain inflation, while interest rates remained low, further boosting consumer spending as part of what seemed like a virtuous circle of sustainable growth. At long last, many of the poorest countries seemed to be benefiting, achieving strong growth with rising mineral prices, more foreign mining investments and rising fiscal revenues.

Increasing financial deregulation made it easy to move capital around the world and helped keep the cost of borrowing low. Strong economic performance during the middle of the decade diverted attention away from the unsustainable bases of the seemingly widespread growth. The growing need to correct the global imbalances was ignored by influential market pundits and policy makers who ignored the need to reconsider what seemed to be a winning formula.

Meanwhile, of course, a financial crisis of unprecedented proportions was unfolding. Since late 2007, several major financial institutions in the United States and Europe have failed, as stock market and commodity prices became highly volatile before collapsing. Although far less involved than the mature economies in the most vulnerable financial institutions and instruments, emerging markets have been hit much harder in general, as stock markets and commodity prices collapsed much more than economic growth or even international trade. Not surprisingly, the most financially integrated of the emerging markets, often the transition economies which opted for shock transitions, have been hit hardest. Most businesses, of various sizes and in different activities, have found it much more difficult and costly to obtain credit as banks and other financial institutions became much more reluctant to lend.

All recent forecasts predict a significant slowdown in world economic growth during 2009 while opinions about the future continue to remain sharply divided. Sharp downturns in the United States, Europe and Japan have already slowed growth in developing countries and transition economies. This comes on top of the high food and energy prices from which billions, especially the poorest amongst them, suffered in early and mid-2008 as speculation shifted from stock to mercantile exchanges and Western bio-fuel incentives raised staple food prices. Slower growth, lower commodity prices, reduced employment, higher food prices and other adverse consequences of the crises will undoubtedly set back efforts to achieve the internationally agreed development goals, including the Millennium Development Goals.

The fate of the world—especially of those in developing countries, which have become much more open and economically integrated internationally—clearly depends on international responses to the financial instability and the still spreading economic crisis. The collapse of both property and stock markets has already dampened US household borrowing and demand, triggering a downward spiral well beyond its borders. And if trade protectionism continues to spread, then, the knock-on effects could have even more devastating consequences for all. Other forms of protectionism, affecting international finance as well as migration, are also exacerbating problems, especially in developing countries.

While the ongoing global financial and economic crisis unquestionably has its origins in the West, its consequences have undoubtedly been no less severe for the rest of the world. Discussions of "decoupling" or "de-linking"—so popular in some large developing country capitals during much of 2008—have been relegated to the dustbin of history, even in the economies seemingly least adversely affected by the crisis. Economies in transition, which hastily liberalized their financial systems in the 1990s, have been among the worst hit by the crisis. Many emerging market economies, especially those most financially integrated with the rest of the world, have also been hard hit. Many other developing countries not sufficiently integrated into international financial markets have not been much hit directly by the financial crisis, but most, if not all, have been very adversely affected by the general economic crisis it has precipitated.

Stock markets in emerging market economies plunged by about 50 percent on average, some by more than 60 percent (China and Russia, for example)—much more than the average drop of about 30 percent in rich countries. With the global financial crisis and uncertainty, international investors (pension funds, mutual funds, hedge funds, etc.) became much more risk averse, reducing their exposure to emerging markets, considered riskier than other investments. Some international institutional investors were forced to withdraw by "margin calls" at home, as their losses in developed country markets forced them to withdraw some of their investments from emerging markets. Also, the global financial crisis has seriously weakened growth worldwide, including in emerging markets. As a consequence, earnings in emerging markets will fall, further reducing investor interest in emerging market stock.

FDI inflows to emerging markets were expected to be more stable than short-term equity investments and other portfolio flows. Nonetheless, the global financial crisis has also affected FDI inflows negatively. With total funding available in developed countries tightening, financial crisis and global recession has reduced investments, including investments abroad. To make matters worse, there is considerable evidence of excess economic capacity, exacerbated by the earlier easy availability of cheap credit. With the slowdown, FDI will slow further in 2009, and investment recovery, like job recovery, is expected to lag considerably behind, even after output recovery takes place, owing to the huge overhang of underutilized capacity.

Shrinking economies, especially falling consumption in the United States and other rich countries, have already reduced export opportunities for developing countries, also undermining the strategies favored by conventional wisdom and promoted by the major international financial institutions. Fifty percent of US imports are from developing countries. So, shrinking demand in rich countries will adversely impact developing countries' exports, and consequently, growth prospects. The slowdown in exports of developing countries adversely affects industrial production and overall output growth, especially in the major export-oriented newly industrializing countries, particularly in Asia. In Latin America and Africa, export growth, mainly driven by primary commodities, has also been adversely affected, after half a decade of growth propelled by higher raw material, especially mineral prices.[1] These high commodity prices began to fall sharply from the second half of 2008.

In the short run, developing countries should stimulate domestic demand, so as to offset weakening foreign demand, as China has been doing. But for the poorer countries, the scope for doing so is more limited; they typically need more foreign aid to cope with the drops in export earnings because of weakening commodity prices. In the long run, however, they need to engage in active investment and technology policies to diversify their economies and to reduce their dependence on a few primary commodity exports.

Immediate policy responses are needed to stabilize financial markets and international capital flows, halt economic decline and initiate as well as sustain recovery. Many emerging market economies have also adopted measures to ease credit conditions and stimulate private spending to counter the deflationary impact of the crisis. However, most developing countries face resource constraints in mounting countercyclical policies. More effective policy responses depend critically on adequate international liquidity on appropriate terms and conditions through multilateral financial institutions.

To be sure, finance ministers and central bankers have already injected trillions of dollars into the financial system, lowered interest rates at which they lend to private banks, and embarked on some reflationary policies despite ominous inflationary warnings, especially by market fundamentalists. But while such actions have undoubtedly helped to stabilize financial markets, at least temporarily, they certainly will not be enough to redress the more fundamental problems giving rise to the recent financial turmoil and the ongoing global spread of recession. In today's interdependent world, a coordinated strategy is needed to check and reverse this recessionary dive, to restore lasting stability to financial markets and to create conditions for sustainable development.

Various national rescue packages have sought to calm financial markets and to induce banks to start lending again. Governments have also bailed out several major financial institutions, while new liquidity injections have sought to resume short-term lending to stave off more bank and even corporate failures as well as economic recession. Most measures taken to date have sought to keep international finance—and presumably, the world economy—afloat. The failure of the international community to contain the economic fallout from the financial crisis highlights the lack of real progress since the Asian crisis over a decade ago despite the promise then of a new international financial architecture.

Instead, as the late Robert Triffin observed in the 1970s, since the end of the Bretton Woods system in 1971, we have had a "non-system" instead. Various financial innovations and financial market liberalization, especially across borders, have combined with inadequate and inappropriate financial regulation, including the fiction of self-regulation, to enhance financial rents in recent decades. Financial lobbies have successfully promoted national and international reforms to this end, with national regulation in such circumstances opening new opportunities for regulatory and other arbitrage. Monetary and financial stability have been the victim, with the frequency and severity of financial crises growing in the wake of financial liberalization and globalization.

Developing Countries and the Post-Crisis Reform Agenda

The crisis has also broadened support for fundamental reform of the international financial system to ensure greater stability and to prevent disruptive crises with global ramifications, though it is unclear whether this will result in the kind of changes needed. Developing countries have a much greater stake in such reform due to the much greater damage caused to them by international financial instability. For developing countries, the reforms must address IMF governance and operations, while ensuring adequate policy space in managing the financial system, financial globalization as well as exchange rates.

It is now time to search for solutions, and this obviously requires an understanding of the deeper causes of the present crisis, due to global imbalances and financial deregulation carried too far. While there has been some modest progress on harmonizing standards and extending surveillance, there has been little attention to systemic problems related to unregulated private capital flows. As the problems are global and systemic, the solutions should be likewise to be effective. The present system of global economic governance has proven inadequate to prevent financial instability precipitating the current crisis. In this crisis, as with others in recent decades, there has been little else but *ad hoc* fixes, instead of developing a truly multilateral system for policy coordination and reserve management.

Efforts to safeguard global economic stability have been undermined by the vastly greater resources of private finance little constrained by national boundaries, uncoordinated national and regional policy responses, as well as the domination of multilateral financial institutions by the rich and powerful. The marginalization of the Bretton Woods institutions in run up to the current crisis has been further aggravated by their reduced legitimacy due, in part, to their biased governance arrangements, lending conditionalities and policy advice.

With global recession in 2009, global imbalances are declining for the wrong reasons, with the collapse of international trade. With the urgent need for stronger, multilaterally coordinated reflationary measures, austerity measures should not be recommended at this time to correct global imbalances. Rather, the US needs to export much more in order to achieve balance, while surplus countries should have less reason to accumulate reserves. Also, more productive investments are needed in most developing countries, especially the poorest countries, to resume economic development. Policy makers need the required policy—especially fiscal and monetary—space to move in this direction. Institutionalizing inclusive international economic surveillance and policy coordination will be important in the longer-term, but much more needs to be done soon to rebalance global demand and improve exchange rate management.

A well coordinated response will need to address immediate short-term problems and develop medium-term solutions while accelerating recovery from the world economic recession. Only appropriate financial system reforms can provide a lasting solution to the global imbalances and address the threats posed by unfettered international finance. Making progress will require all governments to act through inclusive multilateral organizations and arrangements. Despite the IMF's skewed governance and policy record, which has undermined its legitimacy and credibility in the developing world, there is no other inclusive multilateral monetary and financial organization available for the time being. Strengthening IMF resources, without reforming the institution adequately, risks exacerbating the inequities of the international monetary and financial system, and its limited existing multilateral governance arrangements.

The international monetary and financial system was reformed at Bretton Woods in 1944 due to a series of deliberate political decisions. After all, with its entry into the war, the US economy had surged very strongly from a decade of uncertainty; the recovery following President Franklin Delano Roosevelt's New Deal during his first term (1933-1937) had given way to pressures to balance the budget which, in turn, undermined the recovery of the mid-1930s. The need to reform the international monetary system was hardly a compelling priority in the middle of the war while the UK, under Churchill, preferred a bilateral agreement with the US without involving the rest of the world.

Although the United Nations Organization only formally came into being in San Francisco in 1945, the United Nations Conference on Monetary and Financial Affairs was held for almost a month at the foot of Mount Washington in New Hampshire in the preceding year. Forty four countries were represented, including 28, mainly from Latin America, which would be deemed developing countries today. The Bretton Woods conference envisaged a system of post-war international economic governance as part of the nascent post-war United Nations system of inclusive multilateralism involving a post-colonial world. Besides seeking to ensure international monetary and financial stability, post-war international economic governance would also seek to ensure the conditions for sustained economic growth and employment generation as well as post-war reconstruction and post-colonial economic development. All these systemic reform objectives continue to remain relevant six and a half decades later, not only for developing countries, but also in the interests of maintaining the conditions for sustainable development, global justice, world peace and inclusive multilateral cooperation on a variety of fronts such as climate change.

This Book: The Crisis, Developing Countries and Reform Priorities

This volume has been prepared by the G24 research program in order to enhance common understanding of the origins, consequences and policy implications of the ongoing global financial and economic crisis from the perspectives of the broad range of developing countries. As important as they are, it does not seek to directly address the current debates on the origins of the financial crisis in the rich western economies as well as the appropriate policy responses except in so far as these have a direct bearing on the broad range of developing countries.

Hence, for instance, it is important to favorably consider the significance of the United Nations' (2009) plea for global macroeconomic policy coordination, especially in so far as available simulations suggest that all economies—developed and developing, economies in transition as well as the least developed countries—will be better off with such a coordinated response. A well coordinated multilateral response promises to yield more than the mere sum of its parts in the form of uncoordinated national responses. The case for multilateral macroeconomic coordination also serves as a compelling argument against "beggar thy neighbor", "go it alone" protectionist policies likely to further proliferate as the crisis becomes more protracted.

As the world experiences its worst financial crisis since the 1930s, policy makers are increasingly calling for a new Bretton Woods conference. To claim the mantle of the historic 1944 conference, Eric Helleiner's opening chapter argues for more creative and ambitious thinking about international financial reform than has been the case so far. The global financial crisis of the early 1930s generated bold thinking about the need to assert more public authority in international finance. Thus, Bretton Woods involved genuine innovations in global financial governance designed to better regulate international financial markets, address global imbalances, and promote international development. Policy makers today should minimally address all the major issues identified at Bretton Woods, but the reform agenda put forward so far by the G20 leaders has fallen well short of the Bretton Woods precedent. Helleiner reminds us that some long-forgotten proposals from the Bretton Woods negotiations—such as those relating to debt restructuring, heterodox financial and macroeconomic policy advice for developing countries, and the role of international cooperation in controlling capital movements—should also be revisited.

New reforms, more appropriate to contemporary circumstances, should also be considered. A contemporary agenda to regulate international financial markets must, of course, assess new mechanisms and address a broader range of topics than in 1944. The management of global imbalances needs to address the reserve currency status of the greenback as well as regional cooperation options. The requirements of sustainable development must also consider contemporary international prudential regulatory initiatives. A broader governance agenda should also seek to make international financial institutions—including, but not only the

Bretton Woods institutions—more inclusive and open to the principles of subsidiarity and regionalism.

C.P. Chandrasekhar reviews some implications of recent trends in global liquidity and financial flows to emerging markets before the current financial and economic crisis in the second chapter, emphasizing the robust revival in capital flows to developing countries after the slump following the 1997-1998 East Asian financial crisis. He argues that following financial liberalization, supply-side factors better explain the resurgence in cross-border flows, rather than the financing requirements of recipient countries. Increasingly, the investment decisions of key individuals in a few major financial institutions determine the exposure and vulnerability of the global financial system as cross-border capital flows are largely intermediated by these institutions. This has exacerbated the concentration of risk and vulnerability to financial crisis in markets to which these flows gravitate.

Chapter three reviews the origins and impact of the worst world recession since the 1930s, due to an unsustainable growth pattern, related global imbalances as well as weaknesses in the global financial and economic system. Despite some signs of recovery, its strength and sustainability remain in doubt. The crisis did not originate in developing countries, which have nevertheless been severely hit by commodity price collapses, tighter global credit conditions, lower remittances and new forms of protectionism. Poverty and hunger are increasing, and major reversals in hard-won progress towards the internationally agreed development goals, including the Millennium Development Goals (MDGs) are likely. Many of the most vulnerable have been hit hardest, while there is increased risk of accelerated environmental degradation and greater social tensions. The severity and extent of the crisis also provides an opportunity to respond by ambitiously reforming the international financial and economic system, including international economic governance, in order to address the crisis in an integrated fashion by creating the international institutional arrangements conducive to equitable and sustainable development.

In chapter four, Jayati Ghosh explains the dramatic world food price spikes in 2007-2008 as largely due to greater speculative activity in global commodity markets, enabled by earlier financial deregulation and the flight of capital from Wall Street following the bursting of the housing bubble with the sub-prime mortgage market crisis. Despite the subsequent fall in agricultural prices, food prices remain higher than before 2007, and remain volatile in many developing countries. Of course, the neglect of public investments in food agriculture since the 1980s with the abandonment of food security commitments as well as the recent advent of Western biofuel subsidies have also exacerbated the situation. Meanwhile, the financial crisis has worsened food insecurity by constraining public investment in agriculture, limiting food imports in balance of payments constrained developing countries, causing exchange rate devaluation due to the reversal of capital inflows, and adversely affecting employment and incomes, thereby reducing the ability to buy food.

Yılmaz Akyüz reviews major immediate and medium term proposals for policy responses to the global financial crisis by developing countries in chapter five. He discusses deficiencies in the global institutional arrangements for crisis management as well as the international initiatives undertaken thus far. Akyüz critically assesses the constraints developing countries face in trying to respond more adequately and appropriately to the crisis. This is followed by a discussion of crisis prevention as well as crisis management, before reviewing other significant reform and major policy proposals from the perspective of developing countries.

Jane D'Arista and Stephany Griffith-Jones suggest, in chapter six, that the agenda and criteria for financial regulatory reform has to be carefully considered in view of the differing circumstances, experiences, capacities and capabilities of various economies in the global financial system. They argue that liberalization of financial markets, not accompanied by appropriate regulation, has been a major cause of costly crises, especially in the last two decades. In recent decades, a shadow banking system has emerged, which remains opaque and unregulated. D'Arista and Griffith-Jones argue that regulatory reform needs to be comprehensive in order to avoid regulatory arbitrage. Such reform should also strive to be countercyclical to try to compensate for the inherently pro-cyclical behavior of financial markets. Their chapter proposes some key criteria for financial regulatory reform involving capital provisions and liquidity requirements, bearing in mind the perspectives and needs of developing countries.

In chapter seven, Andrew Cornford examines the ongoing revisions to Basel II, the international standards for bank regulation developed by the Basel Committee on Banking Supervision (BCBS) to replace the 1988 Basel Capital Accord (Basel I). The 2006 text of Basel II, following a protracted drafting process, had been considered closed before the current crisis began in mid-2007. The crisis has shown up major shortcomings in the regulatory framework for financial institutions now also the subject of wide-ranging reform efforts. The ongoing emphasis on capital adequacy actually shaped the crisis by encouraging regulatory arbitrage The introduction of Basel II is already proceeding, or about to proceed, in a large number of emerging-market and other developing countries. Cornford argues that the Basel II rules may engender new problems in the future. In the absence of appropriate controls, banks may be exposed to risks associated with cross-border asset-backed investments as well as investments linked to operations in their own financial markets.

As the international financial crisis spread, most governments began searching for means to protect themselves, with some resorting to "unconventional tools" of monetary and financial policy, alongside more "conventional" ones. In chapter eight, Gerald Epstein argues that policies to better manage international capital flows should be part of the government "toolkits" in facing these difficult challenges. After describing the economic arguments for and against using capital controls, prudential regulations and other "capital management techniques" to manage international financial flows, he reviews empirical evidence on their impacts and the variety of policies countries have successfully implemented to achieve macroeconomic and financial stability, enhance policy space, and achieve other national development goals.

In chapter nine, Chakravarthi Raghavan examines the critical role of the World Trade Organization (WTO) in promoting the liberalization and globalization of financial services, and considers its implications for global financial reform efforts. A reformed global financial regime will not be compatible with further liberalization of the trade in financial services and capital movements. However, the ongoing global financial crisis and the systemic reform processes being initiated in various forums seem likely to lead to some governance reforms, better regulation and stricter enforcement in the public interest. However, these are unlikely to succeed unless they consider and involve the WTO and its ongoing Doha Round, and its negotiations for the further liberalization of services, particularly the "trade in financial services". Raghavan also shows that these trade negotiations have not been informed by reliable data.

David Spencer makes the case, in chapter ten, for significantly enhanced international tax cooperation, not only to enhance economic justice, but also to enhance fiscal space, especially in developing countries. Developments contributing to cross-border tax evasion are reviewed, set within a broader discussion of the need for more effective supervisory and regulatory regimes. He notes the systemic risks posed by regulatory arbitrage, including encouraging tax evasion, and emphasizes the need for cooperation among a larger group of countries in crafting a new Bretton Woods-type agreement to address such issues. A discernible change in public attitudes to tax evasion has become more apparent recently. Spencer concludes by calling for the automatic exchange of tax information.

In another chapter, C.P. Chandrasekhar argues that the crisis is encouraging serious consideration of a new global banking model as banking crises cannot be resolved without sufficient capital infusions tantamount to nationalization. Deregulation had been brought about by earlier regulation which did not adequately compensate the private owners of finance. But deregulation also triggered processes leading to crisis which, in turn, require nationalization as the solution. Chandrasekhar's chapter eleven urges developing countries to *reverse* the movement from public to private ownership of banks, and to consider the advantages of public ownership, especially to ensure more equitable and broad-based growth. Public ownership would also allow bank profits to be low in order to be able to direct credit to sectors and groups at "subsidized" interest rates in order to garner higher social returns from more equitable, inclusive and sustainable development supported by appropriate financial, investment, technology and employment policies.

In chapter twelve, Jan Kregel provides the economic rationale for the proposals to reform the international monetary and financial system made by the United Nations 63rd President of the General Assembly's Commission of Experts chaired by Joseph Stiglitz. Divided into six chapters, its final report considers both macroeconomic and financial regulatory failures leading to the global financial and economic crisis as well as challenges of international economic governance and systemic reforms. Clarifying the rationale for the reform proposals facilitates understanding the systemic reasons for the report's seeming recommendation of institutional proliferation. In the spirit of Bretton Woods, the proposals are not only concerned with macro-financial reforms for greater financial risk mitigation and monetary stability, but also with creating the conditions for more equitable and sustainable development in light of contemporary conditions.

Finally, in chapter thirteen, José Antonio Ocampo urges reforming the global reserve system in light of three fundamental problems of the *status quo*. First, it has a deflationary bias as the burden of adjustment falls on deficit countries. Second, it has inherent sources of instability associated with the use of a national currency as the major reserve asset and the high demand for foreign exchange reserves by developing countries, due to the pro-cyclical nature of cross-border capital flows and the inadequate availability of "collective insurance". Third, it exacerbates inequities by transferring resources to reserve currency issuing countries. Instead, Ocampo argues for a system based on the countercyclical issue of Special Drawing Rights (SDRs) to finance IMF facilities, and suggests the "development" potential of SDR allocations. For Ocampo, the dollar fiduciary standard overcame Keynes' deflationary dilemma, but like Akyuz, he favours a non-national fiduciary standard, seeing no need for a commodity reserve alternative.

Note

1. Various issues of the United Nations' *World Economic and Social Survey* and *World Economic Situation and Prospects* as well as UNCTAD's *Trade and Development Report* have reiterated the risks of heavy dependence on primary commodity exports which do not have strong linkages with the domestic economy. Such economies tend to be very vulnerable to external shocks.

Reforming the
International Financial System for Development