Reforming the International Financial System for Development

Edited by Jomo Kwame Sundaram

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The Initiative for Policy Dialogue (IPD) at Columbia University brings together academics, policy makers, and practitioners from developed and developing countries to address the most pressing issues in economic policy today. IPD is an important part of Columbia's broad program on development and globalization. The Initiative for Policy Dialogue at Columbia: Challenges in Development and Globalization presents the latest academic thinking on a wide range of development topics and lays out alternative policy options and tradeoffs. Written in a language accessible to policymakers and students alike, this series is unique in that it both shapes the academic research agenda and furthers the economic policy debate, facilitating a more democratic discussion of development policies.

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The chapter by Yılmaz Akyuz was originally written for the South Centre and is published here with its permission, while the chapter by Andrew Cornford was originally written for the DITC in Geneva and will be published under Selected Issues in International Trade, Assuring Development Gains as document UNCTAD/DITC/TNCD/2009/1. The chapter by Jayati Ghosh and the banking chapter by C.P. Chandrasekhar were previously presented at an IDEAs seminar in Beijing in April 2009. Michael Lennard helped prepare David Spencer's chapter for inclusion in this volume.

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Jomo Kwame Sundaram

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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.

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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

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