

TWN

Briefing Paper

www.twinside.org.sg

Published by
Third World Network

September 2010

Achieving the Millennium Development Goals (MDGs) Requires Fundamental Reforms in the International Financial Architecture

Development-oriented macroeconomic policies, debt mechanisms and innovative financing measures are critical to achieve the MDGs

United Nations General Assembly hearings on the Millennium Development Goals
June 15, 2010, New York

In the last few years, as the world economy has experienced both a financial and an economic crisis of magnitude proportions, the predominant arrangements and assumptions of the model for economic development and global finance has also come into a fundamental crisis of its own. As the shock waves of the global financial crisis rippled over the developed world, painful repercussions were generated for developing countries, which are still reeling from the deep contraction in world demand and the consequent decreases in export earnings, FDI and private capital flows, and remittances, despite news headlines and official reports that say the world is now in a ‘post-crisis mode.’ These effects not only exacerbate the already existing challenges in achieving the MDGs, but also point to systemic flaws and gaps in the economic development model pursued by most developing countries, such as macroeconomic policies, debt measures and financial liberalization.

National development strategies are critical for achieving the MDGs

The MDG strategies, through the framework of the 8th goal to “develop a global partnership for development,” should strive to reinforce the importance of national development strategies which build the productive capacities and social and economic infrastructure of developing countries through pro-active and strategic policies. Only then can the massive scaling up of public spending and investments necessary to achieve the MDGs take place.

Such an emphasis can be further strengthened and elaborated in **Paragraph 30 in the Draft Outcome Document for the MDGs, under the heading “The Way Forward – An Action Agenda for Achieving the MDGs by 2015,”** which states, *“We reaffirm our commitment to adopt and implement comprehensive national development strategies to achieve the internationally agreed goals, including the Millennium Development Goals. We call on the United Nations system to support the design and strengthened implementation of these strategies, at the request of Member States.”*

The successful development lessons of history clearly illustrate that the achievement of comprehensive advances in human development has been a result of economic development models characterized by economic diversification, job creation, and technological upgrading driven by concerted public spending and investments and national policy space for selective trade protections, financial caution, and industrial policy tools, among other flexibilities.¹

However, many developing countries have not had the national policy space, market and technology access, and symmetry of rules required in the international economic architecture to be able to pursue a development-oriented national strategy. **In this sense, there is a fundamental mismatch between the ambitious framework of the MDG targets and the predominant economic model in many developing countries, including the least developed countries (LDCs).**² This economic model is characterized by an agenda of financial and trade liberalization which results in a serious lack of public

investments and spending that scale up productive capacities through strategic economic diversification and employment-creation, and through the development of public social services in health, education, and housing.

This disjuncture highlights the underlying need to lay out a conceptual and analytical basis for new MDG-based national development strategies, not just indicators, for post-2015. **A central challenge in creating this basis is not the lack of explicitly economic goals in the MDG framework, but rather the challenge of formulating a policy strategy, in the context of an imbalanced global financial and trade system, that would back up the human-development ambitions of the MDG framework.**

We call for urgent efforts to enhance the policy coherence, governance and consistency of the international monetary, financial and trading systems order to foster a supportive and enabling international environment for development and achievement of the Millennium Development Goals. In this regard we stress the pressing need for substantive and comprehensive reform of the international economic and financial system and architecture to better enable it to respond to and prevent financial and economic emergencies, effectively promote development and equitably serve the needs of Member States.

MDG Goal 8: To build a global partnership for development

Goal 8 of the MDG framework, the goal to build a global partnership for development, is meant to reflect the efforts of the international community in supporting developing countries to achieve their economic and social development goals. **MDG #8 can also be understood as a fundamental precondition for the achievement of the first seven goals.**

It incorporates six main targets: (a) develop further an open, rule-based, predictable, non-discriminatory trading and financial system; (b) address the special needs of the LDCs; (c) address the special needs of LDCs and SIDS; (d) deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term; (e) provide, in cooperation with pharmaceutical companies, access to affordable essential drugs in developing countries; and (f) make available, in cooperation with the private sector, the benefits of new technologies, especially information and communications.

Three key areas in the international financial architecture impeding the MDGs

There are three key areas in the international economic and financial architecture that impede the realization of MDG #8, and thereby the realistic achievement of the MDGs, by blocking the ability of developing countries to implement policies that prioritize domestic revenue creation, public spending, and investments for broad-based and equitable development.

The first is that of the pro-cyclical and deflationary macroeconomic framework that has dominated policymaking both globally and nationally. This framework, institutionalized and promoted by the International Monetary Fund (IMF), capital markets, and many aid agencies, has obliged policymakers to focus on macro-stability. IMF loans to crisis-stricken countries across the world still, as in the past, carry fiscal and monetary conditions for fiscal austerity, monetary policy tightening, and a prioritization on debt repayment and maintaining open capital accounts.

This macro-stability focus predominantly serves creditors, investors, and markets, often at the expense of development-oriented macroeconomic policies that allow for consistent and scaled-up public spending, access to credit, and long-term investments in public services and production sectors across agriculture, industry, and services.

It is through such concerted spending and investment that the creation of domestic revenue, wage growth, skills- and capacity-based employment, as well as education and health advances can take place. **This relates to Paragraph 20 in the Draft Outcome Document for the MDGs,** which states that “successful policies and approaches from countries that could be replicated and scaled-up,” include that of “forward-looking macro-economic policies that lead to sustained, inclusive and equitable growth.”

The second constraint to scaling up investments for national development strategies that can achieve the MDGs is that of debt sustainability in developing countries and the palpable absence of an international debt resolution mechanism able to guarantee a speedy and fair solution to sovereign debt crises.

While the recent crisis has created soaring debt burdens across the developing world, the ‘debt overhang’ in most countries has persisted over many decades as result of the liberalization- and deregulation-led economic model that promotes borrowing as a source for capital. The consequence

of debt burdens for public revenue in developing countries is critical, as foreign exchange earnings are funneled into external debt servicing obligations rather than to the current account for key imports payments necessary for building the domestic economy or to public investments vital to strengthen the health and education sectors.

The United Nations has proposed the creation of a sovereign debt resolution mechanism for a number of years, also echoed by academics and policymakers in the wake of the current crisis. The Stiglitz Commission (2009), the South Centre (2009), and the Group of 77 (G77) proposal to the UN Conference on the World Financial and Economic Crisis in June 2009, all stress the need for an independent and fair debt arbitration court that can provide a single statutory framework for debt relief by ensuring that both creditors and debtors cooperate to restructure sovereign debt, with respect to a country's unique economic conditions.³

A third impediment to development in the international financial architecture is that of capital account, or financial, liberalization which allows for the free cross-border mobility of capital, and the liberalization of financial services. Numerous voices have argued that the intense unpredictability and volatility of capital movements resulting from the concerted surge in financial liberalization around the world is one of the key drivers of recurring financial and currency crises. Financial liberalization enables speculative trading, capital inflow surges, and 'panic exits' of capital, which are some of the root causes behind financial crises.

Financial liberalization has been internalized across many developing countries "...as part of the stabilization and adjustment policies which marked the 1980s and 1990s," and while the rhetoric that promoted financial liberalization promised greater growth and stability through more efficient allocation of capital, the track record has demonstrated repeated negative effects for growth, stability, equality, and policy space in the world economy.⁴

The IMF has long espoused the liberalization of the capital account in its economic surveillance and loan provision, and in many emerging market economies and middle-income countries that the Fund has provided loans to, the maintenance of an open capital account has often been financed by the loan money.

Furthermore, North-South free trade agreements (FTAs), bilateral investment treaties (BITs) and World Trade Organization (WTO) commitments often contain provisions that tie the

hands of developing countries to regulate their capital account and their financial services sectors. Trade agreements can thus increase the likelihood of a financial crisis and make it more difficult to take the necessary measures to deal with one once it occurs.

1. Macroeconomic policy framework

In an effort to respond to the global financial crisis, the G20 grouping of major economies dramatically strengthened the role of the International Monetary Fund (IMF) in developing countries, including in low-income countries (LICs), by tripling the Fund's resource base from US\$250 billion to US\$750 billion.⁵ The IMF's concessional lending capacity to LICs will be ten times higher in 2014 than before the crisis.

The IMF has announced that it has drawn lessons from the East Asian crisis of 1997-98, when its emergency lending was tied to pro-cyclical policies, such as fiscal austerity measures and higher interest rates, which led borrowing countries into even deeper crisis, causing massive job losses and an economic recession that could have been avoided. The Fund's official position now is that it has reformed its programs and provided greater flexibility for LICs to adopt expansionary policies.⁶

The IMF is still prescribing pro-cyclical policies that constrain public spending

Despite pledges to address the crisis in flexible and innovative ways, the IMF's key objective in crisis loans remains "macroeconomic stability" through the "tightening of monetary and fiscal policies."

Since the onset of the financial crisis in 2008, IMF crisis loans have required policies such as:

- lowering fiscal deficits and inflation levels;
- buffering international reserves (as they fell to dismal levels from the impact of the trade shock in this financial crisis);
- reducing or restraining public spending (through public sector wage freezes and pension freezes, cutting minimum wages, eliminating subsidies to fuel, gas and power, and hiking utility tariffs and tax reforms);
- increasing official interest rates or restraining the growth of the money supply;
- preventing currency depreciation; and,
- providing financial sector liquidity where needed.

Instead of increasing government expenditure and boosting domestic demand, local employment

and economic activity to overcome the recession, the IMF is cutting spending and increasing tariffs and taxes in already contracting economies for the express purpose of maintaining low inflation and fiscal deficit rates, flexible exchange rates, and trade and financial liberalization. The burdens of these questionable policies, intended to maintain investor confidence, access to external capital and sustainable debt situations, fall squarely on the shoulders of local taxpayers and consumers.

The impacts of the recent financial crisis has threatens key elements of the progress made by LICs over the past several decades. For LICs as a whole, economic growth decelerated to 7.2 percent in 2008, in which industry and manufacturing took the brunt of the contraction in world demand. Exports and imports were hit by the trade shock, falling to 25 and 36 percent of GDP, respectively. Workers' remittances decreased to 5.1 percent of GDP in 2008 from 5.7% in 2007. Perhaps the largest decline was seen in the decline of foreign exchange reserves in LICs, which plummeted to 4.1 months of import payments in 2008, from a previous high of 6.2 months in 2002.

A study by academics at the School of Oriental and African Studies (SOAS) finds that in 13 LICs with IMF programs, pro-cyclical fiscal and monetary policies are still being imposed. During the brunt of the food and fuel price crisis of 2008, and the financial crisis of 2009, marginally higher deficits were permitted. However, the fiscal flexibility of the IMF proved to be short-lived, as the Fund has already begun advocating tighter fiscal policies starting this year (2010).

Ghana is a key example of a country that has had to shrink its fiscal deficits dramatically, with the IMF saying that the country's fiscal policies need to "carry the brunt of the adjustment."⁷ In countries such as Benin, Malawi and Zambia, the Fund has also prescribed wage and hiring freezes for public-sector workers. Latest IMF projections for the countries assessed show that the fiscal expansion projected for 2009 amounts to only 1.5 percent of GDP on average, and a fiscal tightening of 0.5 percent of GDP is projected for 2010. Eight of the 13 countries are facing tighter fiscal constraints in 2010 than in 2009. While this suggests greater flexibility compared to the Fund's pre-crisis targets for lowering fiscal deficits, it is not a significant revision of the IMF's framework, and cannot be equated to a genuine provision of fiscal policy space for LICs.

An alternative macroeconomic framework that would allow for policy space would incorporate the judgment that fiscal policy has to play a central role in driving the development process, and thus has to

take the form of expansionary, public-investment-led fiscal policies. However, the IMF only assesses fiscal policy in terms of the costs of financing a fiscal deficit, while failing to factor in the costs of foregone growth and poverty reduction if the widening of the deficit were not allowed. The IMF also fails to assess dynamically the budgetary position of LICs, based on the potential for mobilizing additional domestic revenue, or for creating greater fiscal space with additional debt relief initiatives or further grant assistance.

On monetary policy, the IMF has continued to push for tightening in countries such as Ethiopia, Ghana, Sierra Leone and Zambia, despite the fact that inflationary pressures are due to the external shocks caused by the food crisis, rather than to rising internal demand. Inflation targets for 2008 and 2009 remained firmly within the 'single-digit' range. And the Fund's inflation targets for 2010 have continued on a downward trend. In many countries, this only served to intensify recessionary trends.

A study by the United Nations Children's Fund (UNICEF) on 86 recent IMF country reports in low- and middle-income developing countries has also concluded that the Fund advises governments to withdraw fiscal stimulus or cut public spending. In two-thirds of the 86 countries reviewed, the IMF recommends cutting total public expenditures in 2010. In all but a few countries, the Fund recommends further fiscal adjustment in 2011. Furthermore, the IMF calls for curtailing wage bills, removing subsidies, especially those for fuel, and reforming and further targeting social programs. UNICEF states that fiscal austerity measures, particularly in a context where economic recovery has yet to gain traction, entails serious human and economic costs that undermine efforts towards achieving the Millennium Development Goals (MDGs).

The traditional biases of the IMF continue to support macroeconomic frameworks where private interests supersede public interests and the role of the state, where the financial sector takes priority over the productive sector, and where foreign investor and corporate interests override those of domestic actors.

The United Nations (UN) has also critiqued the Fund's contractionary policies in its flagship annual report, the World Economic Situation and Prospects 2010. The report stated: "*Despite pronounced intentions, many recent IMF country programs contain pro-cyclical conditions that can unnecessarily exacerbate an economic downturn in a number of developing countries. Indeed, amid sharply falling global demand, the Fund has been*

advocating belt-tightening for many developing program countries. At the same time, it has been praising advanced economies for their unprecedented efforts in borrowing and spending their way out of recession. The IMF should expand the use of its resources to help support counter-cyclical measures in those developing countries that have sustainable public finances in the medium-term but are impeded in this effort by adverse market conditions.”⁸

Towards growth- and development-oriented fiscal and monetary policies

A more development-oriented macro-economic policy stance is necessary in order to generate the quantum leap in resources that LICs need to finance large-scale new investments in economic and social infrastructure, which includes the specific MDG goals in the health and education sectors, and job creation. Progress on poverty reduction and basic human development has historically required, and continues to require, such a critical degree of spending and investment in the domestic economy. The experience of the ‘Great Recession’ of 2007-2009 has altered the terms of the debate on macroeconomic policies. However, the current debate has been mostly limited to advocacy for expansionary (i.e., counter-cyclical) policies without any real debate about the need to emphasize the role of deficit-financing.

Previously, the strategic framework of the MDGs helped redirect the international debate on macroeconomic policies. By calling for substantial scaling-up of external and domestic resources to meet the MDGs, it highlighted the need for more expansionary public-investment-led fiscal policies. **The social outcomes represented by the MDGs need to be made explicit and taken into account as part of the macroeconomic policy-making process; otherwise, the MDG development agenda will continue to collide with the stability-focused macroeconomic policies that dominated policymaking in the period before the global financial crisis.**

Furthermore, while the Fund has recommended and included social safety net spending in most of its loan programs, the presence of **social protection systems should not become an effort to merely compensate for the social dislocations generated by a pro-cyclical and deflationary macroeconomic policy framework.** Instead, social protection systems should be complementary and supplementary to an expansionary macroeconomic framework that prioritizes social spending, even at

the expense of higher inflation rates and deficit levels, until the domestic social infrastructure has built a healthy level of capacity and resources.

In order to support the achievement of MDGs, IMF policies need to change:

- The IMF should not only permit, but also support, the active use of fiscal policy to support public investments and public spending to build essential economic and social infrastructures, on which private investment too inevitably relies. Future revenues expected from the investment should pay off the debt that the government initially incurred;

- The IMF should encourage more expansionary monetary options that better enable domestic firms and consumers to access affordable credit for expanding production, employment, and increased contributions to the domestic tax base. Monetary policy should thus maintain low real interest rates, rather than ineffectively trying to keep inflation low with high interest rates which dampen aggregate demand and growth prospects;

- The IMF should support exchange rate management in its developing-country member states in order to foster broad-based export competitiveness that can lead to greater structural diversification of the domestic economy; and,

- The IMF should permit the regulation of the capital account to confront the continuous inflow, as well as outflow, of private capital from national economies, i.e. ‘capital flight.’

2. Debt sustainability and debt resolution mechanism

According to a UN study, the total value of external debt in developing and transition economies increased by \$176 billion in 2008, surpassing \$3.6 trillion at the end of the year.⁹

Debt composition rapidly changed from public to private debt – in the first half of the current decade, the total long-term external debt in developing countries owed to private creditors increased from 60% to 75% (ranging from 33% in sub-Saharan Africa to 93% in the transition economies of East Europe and Central Asia).

According to the World Bank, 18 countries have foreign reserves that cover less than 4 months of imports and 16 countries have consumed 20% or more of their reserves since September 2008.¹⁰ Heavily Indebted Poor Countries (HIPC) who have reached their completion-points (to attain debt cancellation) confront an average current account deficit of 8% of Gross National

Income (GNI); while the average current account deficit of decision point and pre-decision point countries (countries that have not yet achieved their completion-points) exceeds 10% of GNI. **These figures highlight the urgent need for highly concessional or grant-based external financing for all HIPC countries.**

The IMF's 2010 report on debt problems in low-income countries affirms that recent debt sustainability analyses (DSAs) show increases in debt vulnerabilities, and financing requirements, as fallout from the crisis. The ability to repay debt is expected to be "permanently lower," and on average, debt ratios are therefore expected to deteriorate in the near term, particularly for public debt.¹¹

Measures promoted for addressing debt problems as a result of the crisis

The Conference on the World Financial and Economic Crisis and Its Impact on Development, held at United Nations Headquarters in New York from 24-26 June 2009, underlined the legitimate right of developing countries, as a last resort, to negotiate agreements on debt standstills to help mitigate the adverse effects of the crisis. Paragraph 34 of the Outcome Document stated: "We will also explore enhanced approaches to the restructuring of sovereign debt based on existing frameworks and principles, broad creditors' and debtors' participation and comparable burden-sharing among creditors. We will also explore the need and feasibility of a more structured framework for international cooperation in this area."¹²

The G77 group of developing countries in the UN called for a strategically broad range of measures to respond to the threat of a new debt crisis in developing countries in the fallout of the crisis. In the negotiations for the draft outcome document, the G77 stated support for "...increased flexibility of the Debt Sustainability Framework and in eligibility for debt relief; the provision of increased funds for debt rollover; innovative debt swap criteria; increased concessionality, and call on states to accelerate previous commitments regarding debt relief."

The UN emphasized that particularly in this period of crisis, there is an "...underlying international consensus that servicing external debt should not take precedence over the effort to achieve the MDGs. The international community should therefore avail itself of the opportunity presented by the crisis to address long-neglected deficiencies in external debt arrangements, including the resolution of sovereign debt, as part of the global effort to strengthen the international financial system."¹³

UNCTAD calls for a debt moratorium

In April 2009 UNCTAD Secretary-General Supachai called for a temporary moratorium or standstill on the official debt servicing of heavily indebted developing countries, stating that, "In the current global crisis situation, both debtor and creditor countries would probably be better served if scarcer foreign exchange earnings in the debtor economies were used for the purchase of imports rather than for debt servicing."¹⁴

Relative to the size of the stimulus package for developed countries, the total amount of a temporary debt moratorium is miniscule at about \$26 billion for 49 low-income countries for 2009 and 2010 combined. **Such a moratorium could act as a countercyclical policy measure, boosting national stability and demand in recipient economies and thus playing a role in sustaining global demand.** It would also help offset some of the negative effects of contracting export revenue and financial inflows, providing developing countries with much-needed breathing space.

Low-income countries with high debt levels urgently need alternative financing opportunities for MDG achievement. **A debt moratorium or standstill would immediately and unconditionally liberate resources and give countries the fiscal space to respond to the circumstances they are facing.** A moratorium could be seen as part of a multifaceted approach to mitigating the impact of the crisis and reduce build-up of unsustainable debt in vulnerable economies.

Accordingly, the **Debt Sustainability Framework** should be revised and expanded to include both domestic and foreign debt and control for debt structure by giving different weights to different types of debt. For example, all other things being equal, long-term debt denominated in domestic currency generates less vulnerabilities than short-term debt denominated in foreign currency.

The need for an international debt resolution mechanism

Several forward-looking documents and reports have emerged from within the United Nations system itself, articulating how an international debt solution would work and what it would like. The Outcome Document of the UN Financial Crisis Conference pledged, in Paragraph 34, to "...explore enhanced approaches to the restructuring of sovereign debt based on existing frameworks and principles, broad creditors' and debtors' participation and comparable burden-sharing among creditors. We will also explore the need and feasibility of a more

structured framework for international cooperation in this area.”

Support was also voiced by the Commission of Experts of the President of the UN General Assembly, whose report has a detailed section on “An International Debt Restructuring Court.” The report states: “A single statutory framework for debt relief is needed to ensure that creditors and debtors restructure the debt to provide a fresh start based on a country’s unique economic conditions. The debt workout regime should be efficient, equitable, transparent, and timely in handling debt problems ex post (as problems become apparent, especially after default) while promoting efficiency ex ante (when the borrowing takes place).....It should give debtors the opportunity to default through a structured process. The principles of human-centered development, of sustainability, and of equity in the treatment of debtors and their creditors and among creditors should apply equally to all sovereign debt crises resolved through the international system...”¹⁵

In support of the creation of an “International Debt Restructuring Court,” the Commission of Experts states: “Achieving these objectives requires a more structured framework for international cooperation in this area.....This entails the creation of an International Debt Restructuring Court....This court would ensure that agreed international principles regarding the priority of claims, necessary overall write-downs, and sharing of “haircuts” are followed. It could differentiate between distinct debt categories....It could also determine what debts can be considered ‘odious,’ and it would be able to grant potential private or public creditors authority to extend “debtor in possession” financing, as in corporate restructurings. National courts would have to recognize the legitimacy of the international court, and both creditors and debtors will therefore follow its rulings.”

The South Centre, in a 2009 paper titled, “Policy Response to the Global Financial Crisis: Key Issues for Developing Countries,” stated that **multilateral arrangements for orderly workouts for sovereign debt should be efficient** in that they should seek to contain the damage inflicted by debt servicing difficulties on the debtor and allow rapid recovery and growth, as in national bankruptcy procedures in many advanced economies, **such as Chapter 11 of the United States Bankruptcy Code.**

Sovereign debt workouts should also be fair in the distribution of the burden, making creditors bear the full consequences of the risks they have taken – risks which have already been compensated by handsome premiums. To the extent possible, debt

restructuring including rollovers and write-offs should be based on negotiations between the debtor and creditors, and facilitated by the introduction of automatic rollover and CACs in debt contracts. **However, impartial arbitration is needed to settle disputes in the case of failure to reach agreement over the terms of restructuring.**¹⁶

Existing procedures for official debt workouts also need a fundamental change. Decisions on restructuring such debt are currently left to a club of creditors – the Paris Club – and are tied to IMF structural adjustment programs and sustainability assessments. Sustainability is often judged on the basis of how much debt and debt servicing a country can tolerate without adequate attention to its implications for development and poverty. Furthermore, political considerations often dominate debt-relief outcomes. It might be highly desirable to delink official debt restructuring from the IMF, and leave debt sustainability analysis to an independent body of experts, appointed with the consent of the debtors. The Fund, the Bank and United Nations agencies could provide inputs to this process in their respective areas of work. Debtor countries should also be allowed to submit their own analyses of sustainability. **Consideration should also be given to establishing impartial arbitration for official debt disputes along the lines of Chapter 9 of the United States Bankruptcy Code which deals with public debtors and applies the same principles as Chapter 11.**

The United Nations proposed the following structure for a debt resolution mechanism:

“Serious consideration should be given to the idea of creating a mechanism aimed at guaranteeing a speedy resolution of debt crises. **For example, an independent international body could be mandated by both debtors and creditors – guaranteeing fair burden-sharing – to evaluate the debt situation of all countries faced with external debt problems and to propose the level and form of debt relief that needs to be provided.**”¹⁷

3. Financial liberalization

Several IMF loan documents, such as those of Serbia and Pakistan, allude to the overarching goal of averting capital flight. In response to the ongoing capital outflow in developing countries, the Fund’s motive is primarily to restore investor confidence through pro-cyclical fiscal and monetary policies that generate a stable environment for the free flow of external capital. However, the IMF’s loan documents rarely mention possibilities for structural measures

for generating such an environment: capital account regulations or capital controls. In fact, Pakistan's loan document openly opposes them.¹⁸

Recently, Brazil imposed a tax on some types of foreign inflows in order to address the volatility inherent in financial liberalization, or in other words, the free flow of capital into and out of national borders. Two economists from the Institute for International Economics (IIE) in Washington, D.C. – Arvind Subramanian and John Williamson (the originator of the term “Washington Consensus”) – wrote in the Financial Times that Brazil's tax on foreign capital, “is of great importance, substantive and symbolic. The symbolic value lies in signaling an end to an era in which emerging markets were enamored with foreign finance, and in expressing willingness to take action to moderate inflows of foreign finance. Substantively, it is important in increasing the arsenal of weapons that countries can deploy to moderate over-heating of their economies. It is a good illustration of the type of measure policy-makers can use to arrest incipient asset price overheating.”¹⁹

Not surprisingly, perhaps, the IMF was unresponsive. A senior official said that, “governments should not be tempted to postpone other more fundamental adjustments.” The same official argued the difficulty of implementing such taxes: since governments apply the taxes to every possible financial instrument, they have proven to be “porous” over time in a number of countries. Clearly, as the IIE writers noted, such a response demonstrates how little has changed in the IMF's intellectual approach to financial globalization, where preserving foreign flows is still “considered sacrosanct.”

More recently, the IMF has published a staff position paper where it considers the use of taxes and other capital control techniques to address the problem of capital volatility.²⁰ Although this is a step forward, it is an extremely tentative one. It only considers such instruments in very exceptional and occasional circumstances, rather than as a policy option that should be regularly available for developing country decision-makers.

Joseph Stiglitz asserts that the dangers associated with capital market liberalization are one of the most important lessons of the Asian crisis. He points out, “it was not an accident that the only two major developing countries to be spared a crisis were India and China. Both had resisted capital market liberalization.”²¹

The Malaysian experience during the Asian crisis shows that developing countries that have

liberalized their financial sector can still manage their capital flows through certain policy tools. These tools include selective capital controls or regulations to discourage or prevent speculation.²²

The financial crisis of 2008-09 may not have had the same root causes as the Asian financial crisis. But the Fund's continued policy and signaling role with respect to capital account liberalization, and its pro-cyclical macroeconomic policies, have done little to help developing countries respond to the crisis or protect themselves against future crises.

Free trade agreements strengthen the force of financial liberalization

North-South free trade agreements (FTAs), bilateral investment treaties (BITs) and World Trade Organization (WTO) commitments often contain a number of provisions that can increase the likelihood of a financial crisis and make it more difficult to take the necessary measures to deal with one once it occurs. These include the goods, intellectual property, competition, government procurement, services and movement of capital provisions. The September 2009 Report of the Commission of Experts on Reforms of the International Monetary and Financial System convened by the United Nations General Assembly President confirms these concerns.

These trade and investment agreements can explicitly prevent governments who have signed them from taking the measures widely recommended to prevent future financial crises such as:

- preventing banks from becoming too big to fail,
- banning risky financial activities such as those that caused the current crisis
- firewalls to separate deposits from risky investment banking (such as the Glass-Steagall Act used to do in the USA)
- re-regulating the financial services sector
- regulating capital inflows and outflows

There may be a prudential defense available in some of these agreements that would allow some of the measure above, however lawyers disagree on what government measures the prudential defense protects.

Past experience shows that investors are willing to use treaties such as BITs to sue governments who take measures to deal with financial crises for billions of dollars (Argentina is potentially liable for more than US\$17bn as a result of steps it took to deal with its 2001 financial crisis).

Key recommendations on the impact of trade agreements on finance

- There should be a careful **review** of relevant **existing** FTAs, BITs and WTO provisions to see which provisions of these rules are now inappropriate given the new understanding we now have on financial liberalisation. In such a review, recommendations should be made to adjust these existing agreements to make them in line with the new understanding and realities.

- During this review process, the implementation of the parts of the **existing** FTAs that are linked to the new understanding about the downside of financial liberalisation should be **suspended** until the review and possible revisions are completed.

- All current FTA **negotiations** including economic partnership agreements (EPAs) should be **frozen** until a **review** is completed about their appropriateness in light of the current crisis conditions.

- With respect to the WTO, the financial services **negotiations** at the WTO should be **discontinued** for the duration of the Doha Round.

- Furthermore, reviews should be made as to the appropriateness of existing financial services commitments and offers by developing countries at the WTO, since they were made when the knowledge and awareness of the nature of financial markets was inadequate, and with the new understanding of these markets, they should be allowed to revise their commitments and offers without compensation. Developed countries wishing to revise their commitments should have to provide compensation.

4. Innovative Financing Mechanisms: Special Drawing Rights and Financial Transactions Taxes

The recent global financial and economic crisis has wreaked havoc on developing countries' financing needs and gaps, as capital inflows has incurred a precipitous plunge overall. The World Bank's Global Development Finance (2009) report states that external financing needs in developing countries as a whole is estimated at \$1 trillion, \$600 billion higher than in 2003 at constant 2009 prices. This is a result of myriad factors ranging from the trade shock and consequent plunge in export revenues, to commodity price volatility, speculative capital flows, and the sharp decline in total private inflows to developing countries, which is projected to decline from more than \$1 trillion in 2007 to just \$360 billion in 2009. **Consequently, the external financing gap of developing countries has**

increased to between \$350 billion to \$635 billion in 2009.

In this context, innovative financing mechanisms such as Special Drawing Rights are a possibility to mobilize urgently needed resources for development finance. SDRs are created by the Executive Board of the IMF. They are backed essentially by the consensus of the world's governments; there is no material cost to their creation. The allocation of SDRs is free, and they can be held as assets in reserves at no net cost. They can also be converted into hard currency to be used as governments determine: in sharp contrast to IMF loan financing, there are no conditions on SDRs.²³

The cost of converting and using SDRs is usually small. Indeed, for LICs, SDRs are probably the most convenient, least expensive source of liquidity short of outright grants. **Unlike most resources from donors and lenders, the unconditioned funds derived from SDR conversions can be used for counter-cyclical public spending that can help counter domestic recessions.**

The recourse of the G20 in April 2009 to a call for a general allocation of Special Drawing Rights (SDRs) by the IMF – the first in a generation – persuaded many government officials in developing countries, as well as advocates for development, that SDRs can be an effective tool not only for building national reserves, but also for financing development and meeting urgent liquidity needs in the wake of the current crisis.

SDRs are a valuable boost for developing countries, but their potential impact has been compromised by the fact that general allocations are done according to the “quotas” which determine voting power at the IMF and are based on the economic size of member countries. Most of the SDRs, then, go to the wealthy countries which have the biggest quotas and largely control the IMF. For example, of the \$250 billion in SDRs being allocated, less than five percent – about \$11 billion – will go to the most vulnerable countries in sub-Saharan Africa. It is a particularly blatant example of the rich being required to get richer before others can get some lesser benefits.

Issues to take into consideration for using SDRs as an innovative financing mechanism:

Greater amounts of SDRs should be provided to developing countries, and the costs of converting them should be reduced or eliminated, particularly for low-income countries.

The use of SDRs for a range of purposes, including for medium- or long-term public investments, should be asserted; and, the IMF, which has no mandate to involve itself in the management of SDRs, cannot attach any economic conditions to the issuance of SDRs.

SDR allocations should be made on the basis of need rather than on the basis of IMF quotas. Criteria could be based on macroeconomic indicators such as the external financing gap and in countries. This assessment would focus particularly on the shortfall in foreign exchange reserves, out of which import payments and debt servicing are made. Other criteria that can be included are development indicators and relative poverty levels, for example.

Because rich countries are accorded the majority of SDRs in any general allocation, there have been proposals for facilitating their transfer to the developing countries that need them more. Unfortunately, recent moves by donor countries indicate that transfers will be made to the IMF rather than on a bilateral basis between countries. This means that SDRs, which provide unconditioned, cheap resources, will be turned into debt-creating loans with the typically pro-cyclical IMF conditions.²⁴

The Global Call for a Financial Transactions Tax

The political argument for the FTT is that it is an important, appropriate and just instrument to ensure that part of the enormous cost of the crisis is recovered from the very place that caused it: the financial institutions that engaged in speculative transactions. The significant amount of revenue generated from the tax would provide governments the ability to finance the national fiscal gap caused by expensive crisis responses as well as the urgent need for development financing and liquidity in developing countries.

The FTT would be a relatively small tax of about 0.05% that would be levied on all financial market transactions. This would cover any financial transaction traded through stock exchanges, futures exchanges, and transactions traded on off-exchanges (or “over-the-counter”). Specifically, the FTT would be levied on trading in stocks, bonds, foreign exchange and derivatives, such as futures and options related to stocks, currencies and commodities. The FTT would be limited to transactions between financial market actors. Ordinary consumer transactions such as payments for goods, paychecks and cross-border remittances would not be subject

to the FTT; and short-term inter-bank lending and central bank operations would also be excluded from the FTT.

The technical argument for the FTT is that it will address excessive speculation by making short-term speculative transactions more expensive. Many experts argue that a transaction tax will curb the amount of speculative trading taking place and will have a stabilizing effect on asset prices. Over the long-term, proponents of the FTT say it will reduce the overall size of the financial sector relative to the real economy. In 2008, the trading of financial transactions had soared to about 74 times higher than nominal global gross domestic product; whereas in 1990, it was only 15 times higher. Similarly, the trading of derivatives and foreign exchanges has far surpassed global trade. The ‘casino economy,’ in which money is the traded commodity, rather than goods and services, has segregated the real economy of jobs, production and income growth, from the financial economy, where speculation has led to the chronic occurrence of ‘credit bubbles.’

National political parties, and state leaders, have come forward in support of the FTT, calling for the tax to be introduced internationally, or across all major international financial markets. The majority of political support is coming from European leaders such as French President Nicholas Sarkozy, German Chancellor Angela Merkel and UK Prime Minister Gordon Brown. The European Union parliament in Brussels has stated in its resolution on the effects of the global financial and economic crisis on developing countries, on March 25, 2010:

“The EU Parliament firmly believes that taxing the banking system would be a fair contribution from the financial sector to global social justice; calls also for an international levy on financial transactions to make the overall tax system more equitable and to generate additional resources for financing development and global public goods, including adaptation of developing countries to cope with and mitigate climate change and its impact;”

President Barack Obama has stressed, *“We should institute a Financial Stability Fee on the entire financial services industry to repay any losses to the American people and make sure we are never asked to foot the bill for Wall Street’s mistakes again.”*

The Chairman of the British Financial Services Authority, Lord Turner, has said that he is “happy to consider taxes on financial transactions” if increased capital requirements are insufficient to help shrink a swollen financial sector. And well-known academics such as Joseph Stiglitz, Paul Krugman, Dani Rodrik,

Jeff Sachs and Paul Volcker have also recently voiced explicit support for the FTT, as have influential financiers such as George Soros and Warren Buffet.

An official statement by the German Bundestag, the lower house of the German parliament, said that:

“There is a massive loss of trust in the financial market. It will also result in a loss of trust in the government if politicians fail to make those who caused the crisis share the liability and to demand and enforce a greater responsibility on the part of the financial sector for the common good and society as a whole. Never before was there such a window of opportunity as today to finally arrive at an international agreement and to introduce a general tax on financial transactions.”

Estimates for how much revenue the FTT tax will be able to generate range from between \$200 to \$900 billion annually, depending on the particular formula, the rates and any exemptions, such as basic personal exemptions or transactions by pension funds, that some have proposed. **The Austrian Institute of Economic Research has estimated that a global transactions tax of 0.05% could yield between \$47 billion and \$1022 billion a year**, even assuming a drastic reduction in market activity by 65%, at the extreme.

5. The Role of the United Nations in Global Economic Governance

The role of the United Nations in global economic governance has been undermined in recent decades by the rise of the Bretton Woods Institutions in key economic policymaking processes in the world economy. However, the United Nations Conference on the World Financial and Economic Crisis and its Impact on Development, held in New York in June 2009, recognized the need for securing greater coherence of the global economic system and for strengthening the “coordinating role” of the UN.

The Outcome Document of the Conference states that *“While recognizing the decisions taken by the G20, we are resolved to strengthen the role of the United Nations and its Member States in economic and financial affairs, including its coordinating role.”* Emphasis was also placed on the UN’s development system and specialized agencies, which can advance *“consistency and coherence in support of consensus-building around policies related to the world financial and economic crisis and its impact on development.”*

With regard to Paragraph 12 in the Draft Outcome Document for the MDGS, the MDG framework needs to incorporate the role of the UN in a much more assertive and detailed manner, with reference to specific proposals that can be taken to strengthen the voice and the impact of the UN system and the vast development expertise it holds within its agencies on global economic governance.

One such proposal for how the UN could create a new structure to play a greater role in the world economy is offered by the South Centre, an inter-governmental organization based in Geneva: *“...the task is to reform the UN system by setting up appropriate bodies and mechanisms. One option could be to create a UN body at the level of the General Assembly and the Security Council with authority to take binding decisions in areas of activity of specialized multilateral agencies and to secure consistency, compliance and accountability.”*

Endnotes

- 1 See, for example, Reinert, Erik S., *How Rich Countries Got Rich ... and Why Poor Countries Stay Poor*, 2007, London: Constable Press.
- 2 United Nations Conference on Trade and Development (UNCTAD), “Reconnection the Millennium Development Goals to the development agenda: an UNCTAD perspective,” Note by the UNCTAD secretariat, Trade and Development Board, Forty-ninth executive session, Geneva:8-9 June, http://www.unctad.org/en/docs/tdbex49d3_en.pdf.
- 3 Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, 21 September 2009, Report, http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf.
- 4 UN Non-Governmental Liaison Service, “Decent Work and Fair Globalization: A guide to policy dialogue,” 2010, United Nations: New York and Geneva.
- 5 Group of 20 (G20), “The Global Plan for Recovery and Reform,” London Summit Communiqué, April 2, 2010, <http://www.g20.org/Documents/final-communicue.pdf>.
- 6 International Monetary Fund, “IMF Overhauls Lending Framework,” Press Release No. 09/85, March 24, 2009, <http://www.imf.org/external/np/sec/pr/2009/pr0985.htm>.
- 7 Eurodad and Third World Network, “Standing in the way of development? A critical survey of the IMF’s crisis response in low income countries,” written by Elisa Van Waeyenberge, Hannah Bargawi and Terry

- McKinley, The School of Oriental and African Studies (SOAS), London, April 2010, [http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Standing%20in%20the%20way%20of%20development\(1\).pdf?n=3573](http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Standing%20in%20the%20way%20of%20development(1).pdf?n=3573).
- 8 United Nations, World Economic Situation and Prospects 2010, December 2009, <http://www.un.org/esa/policy/wess/wesp2010files/wesp2010.pdf>.
 - 9 United Nations Conference on Trade and Development (UNCTAD), "Responding to the Challenges Posed by the Global Economic Crisis to Debt and Development Finance," March 2010, Geneva, http://www.unctad.org/en/docs/gdsddf20091_en.pdf.
 - 10 World Bank, Global Development Finance 2009: Charting a global recovery," 2009, Washington, D.C., <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/EXTGDF/EXTGDF2009/0,,menuPK:5924239~pagePK:64168427~piPK:64168435~theSitePK:5924232,00.html>.
 - 11 International Monetary Fund (IMF), "Preserving Debt Sustainability in Low-Income Countries in the Wake of the Global Crisis," 2010, Washington, D.C., <http://www.imf.org/external/np/pp/eng/2010/040110.pdf>.
 - 12 United Nations, "Outcome of the Conference on the World Financial and Economic Crisis and Its Impact on Development," Resolution adopted by the General Assembly, July 9, 2009, New York, http://www.un.org/ga/search/view_doc.asp?symbol=A/RES/63/303&Lang=E.
 - 13 United Nations, World Economic Situation and Prospects 2010, December 2009, <http://www.un.org/esa/policy/wess/wesp2010files/wesp2010.pdf>.
 - 14 United Nations Conference on Trade and Development (UNCTAD), "Temporary debt moratorium needed for some poor nations, says UNCTAD Secretary-General," April 30, 2009, <http://www.unctad.org/templates/Page.asp?intItemID=4819&lang=1>.
 - 15 Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, 21 September 2009, Report, http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf.
 - 16 South Centre, "Policy Response to the Global Financial Crisis: Key Issues for Developing Countries," Research Paper 24, May 2009, Geneva, http://www.southcentre.org/index.php?option=com_content&task=view&id=1016&Itemid=1.
 - 17 United Nations Conference on Trade and Development (UNCTAD), "Responding to the Challenges Posed by the Global Economic Crisis to Debt and Development Finance," March 2010, Geneva, http://www.unctad.org/en/docs/gdsddf20091_en.pdf.
 - 18 International Monetary Fund, "Pakistan: Second Review and Request for the Augmentation of Access Under the Stand-By Arrangement - Staff Report," August 21, 2009, <http://www.imf.org/external/pubs/cat/longres.cfm?sk=23211.0>.
 - 19 Arvind Subramanian and John Williamson, "The Fund should help Brazil to tackle inflows," Financial Times, October 26, 2009, <http://www.ft.com/cms/s/0/0fb77bf6-c1cf-11de-b86b-00144feab49a.html>.
 - 20 Ostry, Jonathan, et.al.: "Capital inflows: the role of controls," IMF Staff Position Note, February 2010.
 - 21 See Joseph Stiglitz, "Global financial system in need of reform," Financial Times, July 2, 2007.
 - 22 Martin Khor, The Malaysian Experience in Financial-Economic Crisis Management: An Alternative to the IMF-Style Approach, Third World Network, 2005, Penang, Malaysia, www.twinside.org.sg/title2/ge/ge06.pdf.
 - 23 International Monetary Fund, June 9, 2009, "Proposal for a General Allocation of SDRs," <http://www.imf.org/external/np/pp/eng/2009/060909.pdf>.
 - 24 ActionAid International and Third World Network, "Fruits of the Crisis: Leveraging the Financial & Economic Crisis of 2008-2009 to Secure New Resources for Development and Reform the Global Reserve System," January 2010, www.actionaid.org.