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The FfD challenge: Financing for development requires fundamental changes in the international financial system

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It is now clear that the world is slipping, or has already slipped, into a new economic downturn. A double-dip recession is a looming threat, in particular because of the European debt crisis and a weak US economy, and because the essential tools that helped the world recover from the 2008-09 recession — fiscal stimulus and expansionary monetary policy — are not being employed in the developed countries.

The pro-cyclical fiscal austerity measures now being implemented in the developed countries, which contract the economy by dampening demand, employment and income, pose a grave threat to growth as well as long-term development. As such, the vilification of public expenditure and investment impedes world economic recovery and forebodes a devastating downward spiral where "tightening the belt" becomes counterproductive both locally and globally.

Given that counter-cyclical policies are particularly important for combating the unemployment crisis in developed countries, the current political consensus on austerity puts the still fragile recovery from the crisis in even deeper jeopardy.

In this context, developing countries could face serious problems. They need to ensure that they are not caught as helpless victims of the new crisis. Developing countries should, among other actions, prepare themselves with policy responses to reduce the impacts of a new crisis, including a reversal in capital flows and a concomitant decline in currency values and a sharp fall in exports due to declining commodity prices and world demand for goods.

Developing countries should also review their previous development strategies to see if they are still valid or whether changes are needed to respond to the changed international situation. In particular, developing countries that have relied heavily on exports to lead their growth may now face a drop in demand, especially from the developed countries. They need to examine how to rely more on domestic demand and on regional South-South cooperation.[1]

On the global front, developing countries should take an active part in the discussions on reform of the international monetary and financial system, as well as on the coordination of macroeconomic

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policies of systemically important countries. Developing countries are adversely affected by the dysfunctional global system, and therefore have an interest in its reform. Unfortunately there is an absence of an appropriate system of global economic governance that enables all developing countries to participate, both within the Bretton Woods institutions and in the G20. Thus, calling for a democratic and inclusive governance system, while repetitive, is still urgent and necessary.

Two key areas within the international monetary system that require systemic reform are the reserve system and global imbalances. And in the international financial system, two critical policy actions are capital flow regulation and expansionary macroeconomic policies for arriving at global economic recovery.

Global imbalances and the reserve system: policy options and proposals

The absence of a global regime to prevent and mitigate financial crises and a reluctance by many developing countries to resort to the International Monetary Fund (IMF) for financial assistance, after adverse experiences with Fund loan conditions in earlier crises, has led emerging market and developing countries to accumulate vast sums of foreign reserves as an act of "self-insurance". The rationale is that when shocks such as financial crises instigate capital flight, foreign exchange stocks can be used to prevent the currency from depreciating.[2]

In the wake of the global financial crisis, this insurance incentive has been reinforced in a context of persistent uncertainty and fear in the global economy. Mounting reserve accumulation in developing countries constitutes a perverse net flow of resources from the South to the North. And it is costly, in terms of both global imbalances and social costs on a national level, as resources sit dormant in low-yielding assets, primarily US Treasury bills and bonds which currently have record-low interest rates, rather than being used for productive investments and development financing domestically.

On the basis of average historical spreads between the borrowing rate and the return earned on reserves, the annual carry cost of reserves to developing countries can be estimated at $130 billion.[3] This constitutes a net transfer of resources to reserve-issuing countries, notably the US, and exceeds total official development assistance to developing countries. This number is even higher if the opportunity cost of foregone domestic use is quantified.

Policy actions to address the insurance-based nature of the current reserve system, which creates wide global imbalances between surplus and deficit countries, would look into ways to revamp the US-dollar-based reserve system and policy options to reduce the reserve needs of developing countries.[4]

Some policy options include: (i) capital controls, particularly over short-term surges of capital, in the logic that it may be better to arrest volatile capital flows from entering the economy than to insure their potential loss with expensive reserves; (ii) fair economic surveillance of the developed countries where powerful financial markets orchestrate the size and direction of international capital flows; (iii) orderly debt workout mechanisms, including temporary debt standstills and exchange controls, in order to reduce the need for liquidity when capital flight occurs; and (iv) collectivizing reserve insurance through regional financial pools, such as the Chiang Mai Initiative, a reserve pool of $120 billion among ASEAN+3 countries (member states of the Association of South-East Asian Nations, China, Japan and South Korea) which meets their temporary liquidity needs.

Significant international debate has brewed on how the world economy should move away from the current reserve system anchored to the US dollar, to a reserve system based on multiple currencies or on a composite international currency such as the Special Drawing Right (SDR).

One proposal that has been put on the table as being the most feasible politically and institutionally is that of a greater role for SDRs in the reserve system. Supported by the Commission of Experts appointed by the 63rd President of the United Nations General Assembly in 2009 to consider international financial reforms, SDRs would distribute the benefits of reserve creation more broadly across the globe, and would not entail costs unless they are used.

This is the basis of the Chinese central bank governor's support for making the SDR more important.[5] Some initial steps could include providing greater amounts of SDRs to developing countries' reserves and, for low-income countries, reducing or eliminating the costs of converting SDRs into hard currency. The use of SDRs for a range of purposes, including for medium- or long-term public investments, should be asserted and defended on an international level.

Capital controls: the G20 consensus and the IMF's mandate

In the context of the slow recovery in developed countries and the US Federal Reserve's quantitative easing, where hundreds of billions of dollars in liquidity was created, investors across the world flocked to developing countries, and in particular emerging market economies like Brazil, South Korea, Taiwan and Indonesia. Then, in recent months, capital has suddenly fled these very same emerging countries, showing once again how volatile and dangerous such flows are.[6] Whereas capital inflows come with destabilizing pressures such as currency appreciation and asset price bubbles, outflows trigger currency depreciations and balance-of-payments and loan-servicing problems. This can lead to a global financial contagion, as seen in the Asian financial crisis of 1997-98.

Capital controls can provide a significant method for developing countries to protect themselves from a new financial crisis, while also reducing global imbalances. National policy space is strengthened when states can garner some degree of checks and balances over the volatile whims of unregulated global capital.

Effective controls can buffer economies from external shocks, free up capital for productive investment in the real economy, and subsidize the cost of foreign exchange accumulation. If applied in the form of taxes on inflows, capital controls can provide a subsidy to offset the cost of reserve accumulation. A tax on foreign purchases of bonds, equities and derivatives would reduce the amount of reserves needed in emerging markets while simultaneously funding reserve accumulation costs by the very capital flows that create the costs.

The November 2011 summit in Cannes of the G20 group of major economies offered an enormously significant victory which went largely unreported. While the G20 has not made progress in most areas, its working group on capital flows, led by Germany and Brazil, produced a report titled "G20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experiences." It concluded that "there is no one-size-fits-all approach or rigid definition of conditions for the use of capital flow management measures." In direct opposition to the IMF's verdict that controls should be a temporary last-resort measure, the G20 report stated that such measures should not be solely seen as a last resort.[7] In his final speech at Cannes, French President Nicolas Sarkozy also said that "the use of capital controls, and this is very important, is now accepted as a measure of stabilization."[8]

In contrast, the IMF asserts that capital controls should be used only after measures such as building up reserves, letting currencies appreciate and cutting budget deficits are first carried out.[9] The IMF's efforts to extend its mandate to police and harmonize regulations are inappropriate, as countries in diverse stages of development need national policy space to design measures that fit unique country circumstances, and ensure support for domestic financial systems and the real economy. The IMF and the Financial Stability Board, along with other bodies, should try to reduce the stigma attached to capital account regulations and protect countries' ability to deploy them.

Expansionary macroeconomic policies to stimulate global recovery

A fundamental reorientation of macroeconomic policy goals is urgently needed today. This includes the prioritization of employment in the mandate of central banks and a greater acceptance of higher fiscal expenditure, in the recognition that spending does not necessarily translate into an equivalent increase in the fiscal deficit if revenues in the real economy of production and income are also generated.[10]

The current leadership of the IMF has acknowledged that too much austerity is risking jobs and growth, and the Fund staff's report to the G20 suggested that developed countries "have scope to slow their current pace of consolidation, if offset by a commitment of additional tightening later."[11]

However, Fund loans and policy advice to developing countries continue to promote fiscal retrenchment. In a study released in 2011, UNICEF (UN Children's Fund) analysis confirms that the scope of austerity is severe and widening quickly, with 70 developing countries reducing total expenditures by nearly 3% of GDP on average during 2010, and 91 developing countries expected to curb spending in 2012.[12]

A reading of IMF country reports reveals that the following adjustment measures are widely recommended by the Fund: (i) cutting or capping the wage bill (in 56 countries); (ii) phasing out or removing subsidies, predominantly on fuel but also on electricity and food items (in 56 countries); (iii) reducing social protection programmes (in 34 countries); (iv) reforming pensions (in 28 countries); and (v) increasing consumption taxes (e.g., value-added taxes) on basic goods that the poor tend to consume (in 53 countries).

Policymakers should resist the prevailing political consensus on austerity and instead pursue policies that have proven to be effective in stimulating economic recovery from past recessions and crises. A menu of policy options is available for policymakers to boost social and economic investments for the recovery of the real economy. Such options, which vary in importance across different countries and their individual circumstances and needs, include expansionary macroeconomic policies, budget reallocation to social sectors, debt restructuring, taxing higher-income earners and the private sector (including a financial transactions tax), cash transfers, North-South and South-South transfers, targeting illicit financial flows and using foreign exchange reserves.

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