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Globalization

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# The global crisis, speculative capital and innovative financing for development

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One of the characteristics of globalization has been the marked volatility of financial flows. The realization that this was affecting growth and equity induced the International Conference on Financing for Development, held in Monterrey in 2002, to adopt a global commitment to deal with the issue of development financing. Since then there has been a mixture of progress, backsliding and inaction. This article conducts a brief review of financial globalization and the current global crisis. It then examines the Monterrey Consensus, the evaluations by the United Nations Secretariat of compliance with the commitments accepted, and the financial system reforms needed to make globalization more equitable. It then proceeds to a stocktaking of the progress made under a North-South collaboration initiative, Action against Hunger and Poverty, in applying “innovative financing mechanisms” that can contribute to attainment of the Millennium Development Goals and help developing countries cope with critical situations like the current global recession. It concludes with proposals for dealing with the challenges that remain.

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# I

## Introduction

Of all the remarkable features of the current globalization process, one of the most striking has been the huge boom in international financial flows, of which volatility is a marked characteristic. These are not harmless fluctuations but great swings that translate into powerful economic cycles, extending over long periods of time and qualitatively affecting resource allocation and equity, thereby sowing the seeds of growing imbalances until they trigger costly recessions in the real economy. Time and again, Latin America has been among the first to fall victim to shocks of this kind. The epicentre of today's crisis in the international financial markets was to be found, however, in the world's leading economy, a promoter of liberalized markets. Today, most of the world has been dragged down into a situation that originated in the globalization of financial volatility. Its severe worldwide consequences ought, at long last, to spur an urgently needed correction in the international financial architecture.

Following this introduction, section II offers a brief review of financial globalization and the current global crisis. Section III examines the main international effort made in recent decades to correct

the severe shortcomings of financial markets and reorient them towards development financing, namely the International Conference on Financing for Development held in Monterrey in March 2002. It then goes on to evaluate the increasingly urgent warnings of the United Nations Secretariat about the need to step up compliance with the Monterrey Consensus commitments that came out of the Conference and to make further corrections to bring about the kind of development financing needed if globalization is to benefit developing countries. Section IV summarizes the activities and advances of the Action against Hunger and Poverty Initiative, led by the heads of government of Brazil, Chile and France and the United Nations Secretary-General; particularly, the proposals for "innovative financing mechanisms" that can contribute to more equitable development and help combat financial volatility, while supporting developing countries in their efforts to deal with critical situations such as the current global recession. Lastly, section V describes the challenges that need to be met during this crisis if the foundations for sustained development are to be strengthened.

# II

## The globalization of financial volatility and the present crisis

The seeds of the current global crisis were sown gradually over the years and decades that preceded it. The main trigger were developments in the financial markets, with their strongly short-termist and speculative bias. Following the disastrous collapse of the 1930s, the international capital markets began to expand significantly in the mid-1960s (Díaz-

Alejandro, 1985; Devlin, 1989; Eichengreen, 2003). The process has gathered pace in recent years as rapid diversification has led to the introduction of a growing number of opaque and speculation-prone segments.

In part, the increase in financial flows undoubtedly reflects the growth of the world economy, rising international trade and the globalization of production. However, it is also due to factors of a financial nature whose influence has been increasing far more rapidly, particularly since the 1990s. The ever-growing presence of offshore international financial centres, combined with light or non-existent

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regulation, stimulated capital movements by making it possible to circumvent national financial regulations and capital controls and taxes. This phenomenon, together with revolutionary innovations in information and communication technologies, and the use of increasingly sophisticated financial techniques (many of them employing off-balance sheet operations to create excessive leverage), contributed structurally to the remarkable boom in international capital flows. Procyclical macroeconomic policies were the other factor that set the scene for imbalances which were to become increasingly explosive, given the scale of the resources involved and the volatility characterizing them.

Using information from the Bank for International Settlements, the Organisation for Economic Co-operation and Development (OECD) and the World Bank, it can be estimated that about US\$ 40 are traded in the currency markets for every dollar of international trade in goods and services. This uneven proportion indicates that the same funds are traded several times a day, usually without connection to any actual international trade. This may benefit those who wish to operate in a market where prices are quoted daily and where it is always easy to buy and sell, but it represents a problem for the macroeconomic environment in the rest of the economy, which is where the overwhelming majority of firms and workers operate. The fast-expanding financial markets are subject to frequent “mood swings” that affect expectations of the price of the dollar, for example, so that funds which were flowing into a particular geographical market may suddenly emigrate to another.<sup>1</sup> Decisions of this type in the financial and currency markets have very powerful effects on the real economy, i.e., on output, employment, profits and tax revenues.

Generally speaking, the financial boom took place in a context of flexible or fragmented regulation and oversight and was characterized by a procyclical bias (Ocampo, 2007; United Nations, 1999). The lack

of regulation was not uniform. Banking systems, for example, continued to be closely regulated, especially in the developed economies.<sup>2</sup> Nonetheless, as already mentioned, supervision had a procyclical bias, and this was heightened after the second agreement of the Basel Committee on Banking Supervision (Basel II) (Griffith-Jones and Persaud, 2005; Stallings and Studart, 2006).

In any event, the main difficulties arose because of three very marked features of financial activities. First, regulation of expanding segments (such as stock markets) or new ones (international investment funds, hedge funds and derivatives markets), which had come to make up the bulk of financial markets, was weak or non-existent. Consequently, these financial “innovations” meant a profound lack of transparency. In a context where these markets were constantly expanding, it became more and more difficult to grasp the risks involved, including the frauds that would be detected subsequently. Secondly, agents in markets of this sort usually take a short-termist approach when allocating the funds they manage, a bias heightened by prevailing incentive systems (Williamson, 2003a). They also operate with liquid resources and internationally, creating huge macroeconomic volatility in individual countries. A third characteristic is the predominance of a markedly procyclical neoliberal macroeconomic approach (Ffrench-Davis, 2005, chapter V; Ocampo, 2007), with sharp currency and monetary cycles. Two manifestations of this were the giant external deficit of the United States and the real exchange-rate appreciation experienced in Latin America from 2004.

The costs of the “financieristic” approach have been seen repeatedly in emerging economies, as demonstrated by the so-called tequila crisis, the subsequent crisis in East Asia and the 1998-2003 recession in Latin America. The current crisis, which originated in the United States before spreading to much of the planet and which has also centred on the financial markets, has some specific ingredients in common with our own recent experiences.

It is hard to predict exactly when crises will break out, but what is increasingly feasible is to identify when the ground is being prepared for them. We have often seen massive capital inflows pushing emerging

<sup>1</sup> Greenfield (production-oriented) foreign direct investment (FDI) is usually channelled into fixed assets that are “irreversible” in the short run, meaning that funds cannot be pulled out from one day to the next. Conversely, resources of a financial nature can depart in a matter of seconds. This is why financial investment and greenfield FDI are treated differently in economic research and in the policy approaches of a number of countries that have behaved more responsibly. This was what happened in Chile during the first half of the 1990s, for example, when a reserve requirement was introduced to prevent excessive financial inflows without discouraging FDI (see Ffrench-Davis, 2008, chapter IX).

<sup>2</sup> In the Latin American economies, on the other hand, bank privatization was accompanied by loose regulations, giving rise to a series of banking crises that were very costly for national States.

economies into situations of vulnerability, including the following: (i) substantial current-account deficits, (ii) large external liabilities that exceed international reserves and have a significant liquid component, (iii) real exchange-rate appreciation and currency misalignment, (iv) high prices for local assets (shares, bonds, real estate), (v) high levels of household borrowing relative to wages and profits and (vi) falling interest rates with substantial increases in the money supply. The longer the run-up and the deeper the economy goes into these areas of vulnerability, the more severe will be the potential “financieristic” trap for the authorities and the less the chances of escaping from it without experiencing an economically and socially ruinous shock.

Different combinations of the variables referred to were present in the Latin American crises of 1982, 1995 and 1999. In emerging economies, external shocks associated with capital flows or the terms of trade have tended to be long drawn-out processes characterized by gradually mounting vulnerabilities. Since these processes have gone with steadily rising asset prices, however, financial operators have reaped growing profits despite burgeoning macroeconomic imbalances.

The current crisis, originating in the United States, shares a number of these sources of vulnerability with emerging economies, such as excessively low interest rates, property price bubbles, risky incentives to lending because of the high level of liquidity, high levels of leverage and procyclical risk ratings. However, there are substantial differences in that the United States is the issuer of the leading international currency and it was its markets that first created the channels of expansion, involving a profusion of financial engineering mechanisms, which were then exported. These channels, we repeat, were characterized by a great lack of risk transparency and by very high levels of leverage.

Subprime mortgage lending was the trigger for the crisis but not the main source of vulnerability, since otherwise its effects would have been confined to that segment of the United States economy. The sector clearly underwent an unsustainable boom based on the faulty perception that high prices would continue to rise indefinitely (a feature reminiscent of many of the situations that have led to shocks in Latin America and the Caribbean), but at the same time many other imbalances of financial origin were in the making in the United States in particular and the Anglo-Saxon world in general.

- (i) First, mortgage market bubbles spread around the globe,<sup>3</sup> although always with essentially “micro” implications, as they were not sufficient in themselves to unleash a crisis in a world whose GDP was in excess of US\$ 60 trillion.
- (ii) Financial innovation had gone worldwide; it paved the way for massive frauds with repercussions in the real economy, but it also had very procyclical effects on expectations.
- (iii) Many investors were operating with extremely high levels of leverage. This might be justifiable in the case of legitimate producers and users of products who have the backing of real activities, but not in that of speculators operating with minimal capital.
- (iv) Stock markets surged to heights incompatible with real growth in net profits, which are what ultimately underpin share prices.

At the macroeconomic level, the United States economy ran a growing current-account deficit from the early 1990s onward (see figure 1). In an initial stage lasting until 2000, the increase in the external deficit was due to private-sector activities. Although this deficit adjusted after the 2001 recession, the government began a process of increasing the fiscal deficit which lasted until 2003, peaking at almost 5% of GDP. Between 2003 and 2006, the public sector began to adjust again, but private-sector exuberance caused the already large current-account deficit to widen, and by 2006 it stood at 6% of GDP.

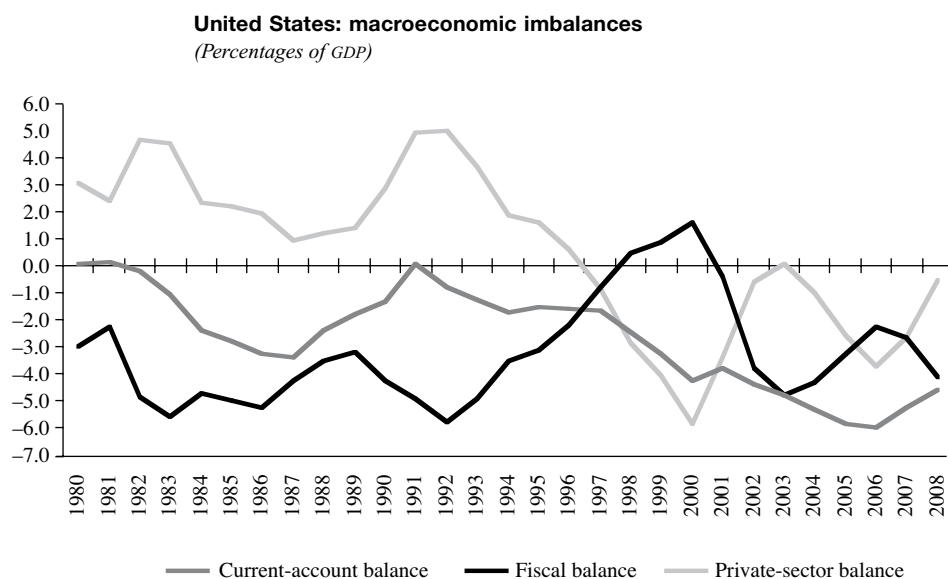
In parallel, long-term interest rates in the United States fell for several years until they reached historic lows (which have been shown to be even lower than the equilibrium rate), a trend that intensified from 2002 as demand for United States Treasury securities rose strongly (see figure 2).

A similar trend was followed by real estate assets, whose prices almost trebled (191% increase) between 1996 and the peak of mid-2006 (see figure 3); housing prices grew at double-digit annual rates for 80 consecutive months, from late 1999 to mid-2006 (see table 1).

As already noted, stock markets were central to the bubble in many countries, as they also displayed an unsustainable upward trend (see figure 4). Natural resource prices, meanwhile, rose exorbitantly; with time it became clear that speculators had progressively been dominating the derivatives markets for these

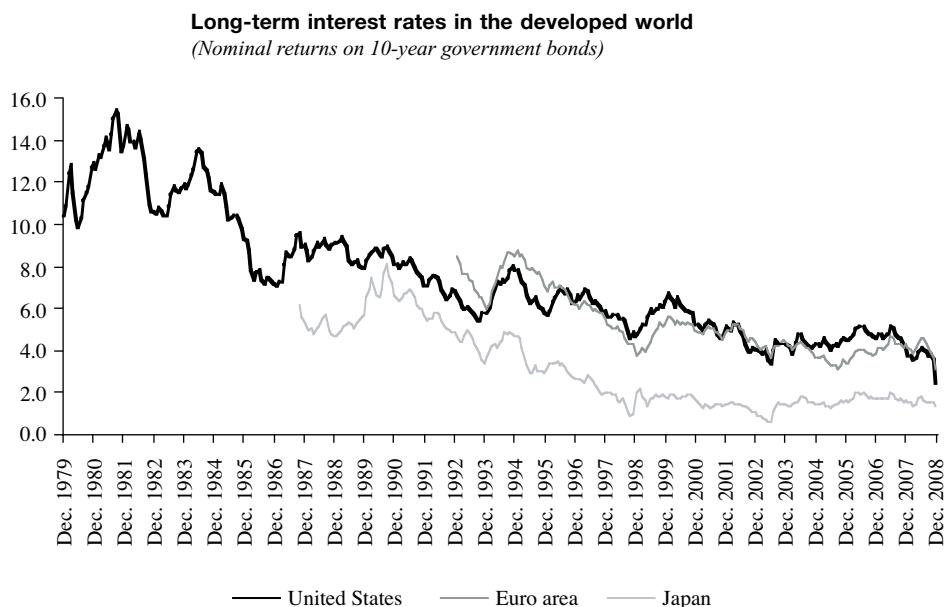
<sup>3</sup> There were also real-estate price booms in many countries.

FIGURE 1



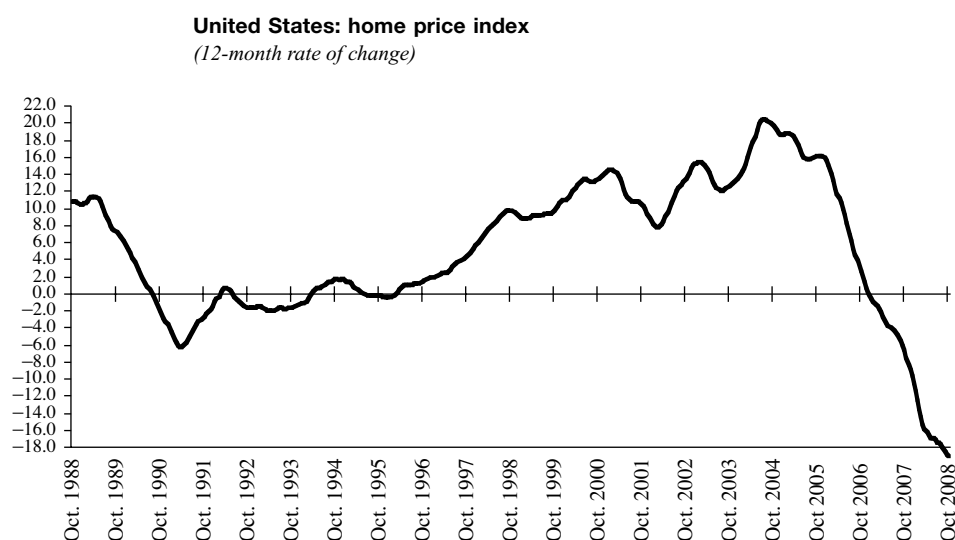
Source: prepared by the author on the basis of International Monetary Fund data.

FIGURE 2



Source: prepared by the author on the basis of data from the Federal Reserve Bank of New York, the European Central Bank, the Bank of Japan and the Bloomberg financial information channel.

FIGURE 3



Source: prepared by the author on the basis of data from the S&P/Case-Shiller index.

commodities, and this was borne out by the rapid fall in prices when the cycle turned downward (see figure 5 and table 2).<sup>4</sup> There were obvious symptoms of bubble behaviour, not only in the United States real estate sector but in a range of activities around the world. Furthermore, the procyclical behaviour of the risk rating agencies worsened the imbalances by inflating financial agents' expectations.

It is striking that, in general, evaluations by the risk rating agencies, which ought to be contributing to the sustainability and transparency of agents and markets, actually made the imbalances worse. They continued to be highly procyclical, just as they were in the run-up to the Asian crisis (Reisen, 2003).

The world is now faced with the urgent need to resolve the greatest crisis since the 1930s, whose effects on the real economy were only beginning to be discerned in late 2008. Looking beyond the corrections already made and the numerous downward revisions to economic growth forecasts that will be seen in the different countries, this is an opportunity for reforms to change the speculative and untransparent bias of financial activities. Without question, the globalization process as it

<sup>4</sup> As a top executive in a mining company put it, the expansion of the copper derivatives market was increasingly driven by operators who had no connection or familiarity with the product. Thus, the price rose from 60 cents in 2002 to 400 cents in 2008, before falling back to 130 cents in the latter part of that year.

now stands is characterized by a severe deficiency of macroeconomic and financial regulation and a striking imbalance between the voices, opinions and interests that are taken into account in designing and implementing public policies.

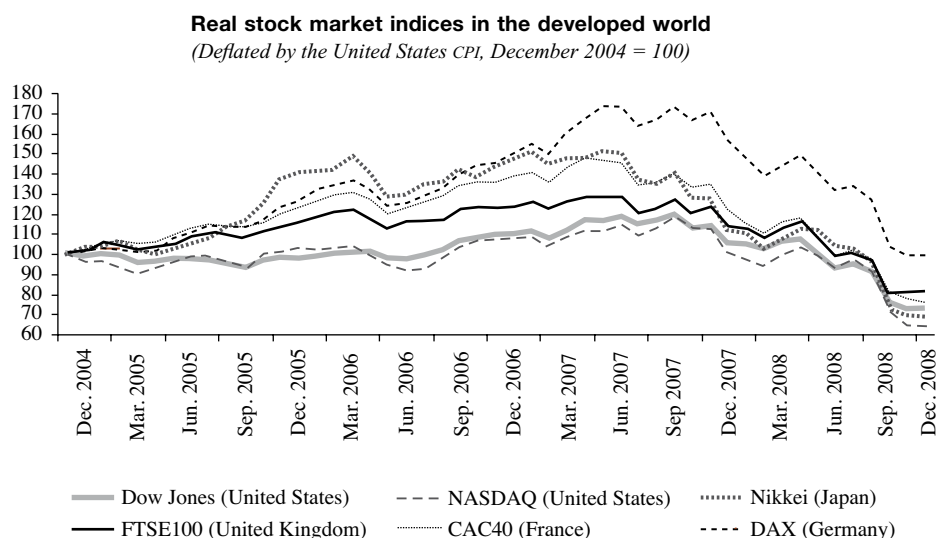
TABLE 1

**United States: home price index**

	Level (Jan. 2000=100)	Dec.-Dec. change (%)	Annual average change (%)
1989	81	6.1	0.0
1990	82	-3.6	0.8
1991	78	-1.8	-4.2
1992	78	-1.7	-0.7
1993	76	-1.3	-1.7
1994	77	1.7	0.7
1995	77	-0.4	0.2
1996	78	1.9	0.9
1997	80	5.4	3.4
1998	87	9.1	8.4
1999	95	10.8	9.4
2000	107	14.1	12.9
2001	120	8.9	11.8
2002	133	15.0	11.1
2003	151	13.4	13.5
2004	179	18.7	18.3
2005	209	15.9	16.9
2006	225	0.2	7.4
2007	215	-9.7	-4.4
2008	182	-19.1	-15.4

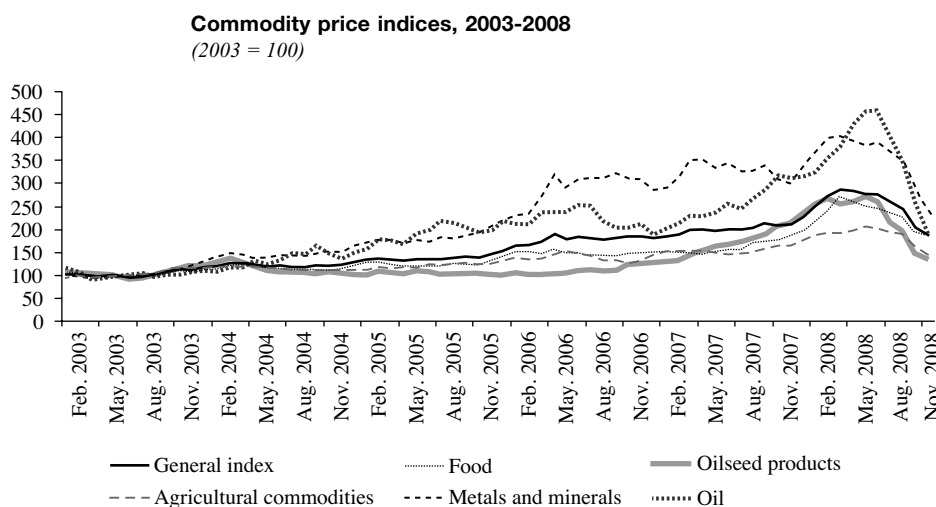
Source: prepared by the author on the basis of data from the S&P/Case-Shiller index.

FIGURE 4



Source: prepared by the author on the basis of financial information from Bloomberg.

FIGURE 5



Source: prepared by the author on the basis of data from the United Nations Conference on Trade and Development (UNCTAD).

TABLE 2

**Commodity price indices**  
(2003 = 100)

	2003	2004	2005	2006	2007	2008
General index	100	120	134	175	197	250
Food	100	114	122	145	158	228
Oilseed products	100	113	102	108	165	225
Agricultural commodities	100	113	118	136	151	185
Metals and minerals	100	141	178	285	321	352
Oil	100	131	185	222	246	353

Source: prepared by the author on the basis of data from the United Nations Conference on Trade and Development (UNCTAD).

As President Obama rightly said, it is time to hear the voices of Main Street instead of the voices of Wall Street. As we have repeatedly argued in relation to economic policy, “productivism” has

to replace “financierism” (Ffrench-Davis, 2006) if the market is to serve the needs of development financing and growth with equity, an issue that is examined in section III.

### III

## Development financing and the Monterrey Consensus

In 2002, the international community held a summit whose purpose was to agree on the measures needed to correct the path of financial globalization. Critics of that path had argued that what was occurring was the globalization of volatility and that the large increase in financial flows had contributed little and poorly to the financing of development (Ffrench-Davis and Ocampo, 2001). Trends at the time indicated that the world was moving too slowly to attain the Millennium Development Goals (MDGs).

The Monterrey Consensus of the United Nations International Conference on Financing for Development represented a major step forward, as it recognized the biases and failures in the international financial system that were obstructing or discouraging development (growth and equity alike) and drew up a set of relevant and sensible proposals which the representatives of the signatory countries undertook to implement gradually. Since then there have been some excellent evaluations of progress and setbacks in their application, particularly those prepared by the United Nations Secretariat.

This section will first review some of the aspects encompassed by the Monterrey Consensus and the progress made since the agreement was signed, including certain issues that arose after the development financing summit, and will then briefly examine the amended Declaration of the Follow-up International Conference on Financing for Development held in Doha, Qatar, in late 2008 to review application of the Monterrey Consensus.<sup>5</sup>

<sup>5</sup> The principal documents considered were: (i) Monterrey Consensus of the International Conference on Financing for Development (United Nations, 2002), (ii) Follow-up to and Implementation of the Outcome of the International Conference on Financing for Development: Report of the Secretary-General (United Nations, 2007a), (iii) Summary by the President of the General Assembly of

#### 1. The Monterrey Consensus: evaluation and follow-up

##### (a) *A selective evaluation*

The Monterrey Consensus represented a substantive step forward in the international development agenda. It complemented the international agreements on the subject, including the Millennium Development Goals, since the attainment of these goals is closely bound up not only with official development assistance and domestic social policies but also with the economic performance of developing countries.

The Monterrey Consensus recognized the crucial role of investment and its financing for economic growth, at a time when there was a strong fashion in economics for across-the-board liberalization, including more liquid financial flows. The fashion had taken as given that physical capital did not count for much in development and that financial flows, then being increasingly liberalized, contributed to macroeconomic stability and development.

The agreement signed at Monterrey marked a shift towards a pragmatic approach. It stressed the need to maintain “adequate” levels of productive investment, which actually needed to become much higher in most developing economies for their living standards to converge with those of richer countries. Increased productive investment required comprehensive financial development, including

the High-Level Dialogue on Financing for Development (United Nations, 2007b), (iv) Report on the Tenth Session of the Committee for Development Policy of the United Nations (United Nations, 2008a) and (v) Doha Declaration on Financing for Development (United Nations, 2008b). Use has also been made of material prepared by the author for the Financing for Development Office of the United Nations Department of Economic and Social Affairs, in preparation for the 2008 Doha Conference.



a significant strengthening of long-term segments of capital markets and the creation or completion in domestic capital markets of segments geared towards small and medium-sized firms (SMES) and other excluded sectors. In fact, in its concern for equity (and fulfilment of the MDGs), in several paragraphs the Monterrey Consensus repeatedly underlines the essential role belonging to the creation or completion of SME financing mechanisms (paragraphs 17, 18 and 24, for instance). This point represents a crucial link between economic growth and equity, since middle- and low-income agents are major providers of productive employment and such mechanisms are needed to give them more effective market access.

This comprehensive pro-development approach includes the issue of migrant remittances. Besides the traditional proposal of reducing remittance costs, the Monterrey Consensus (paragraph 18) advances the innovative view that remittances could serve to “securitize” loans for development-oriented investments by recipient families. This is one of the measures that would permit a significant expansion of microcredit.

Consequently, the countries signing the Monterrey Consensus “invite banks and other financial institutions, in developing countries as well as developed countries, to foster innovative development financing approaches” (paragraph 23). Similarly, they undertake to “support new public/private sector financing mechanisms” (paragraph 24).

The document, with laudable foresight, recognizes the importance of “sound macroeconomic policies”, but again with a pragmatic approach (paragraph 14). Along with due concern for price stability and fiscal balances, it stresses that their goals should also include full employment, poverty eradication and sustainable external balances, the latter requiring “an appropriate exchange rate regime”. When it comes to maintaining “adequate levels of productive investment” (paragraph 10), the Monterrey Consensus identifies a need for consistent macroeconomic policies. Evidently, “consistency and soundness” must be understood in the sense highlighted in this paragraph.

Several paragraphs are devoted to discussing financial crises. The Monterrey Consensus gives “priority to the identification and prevention of potential crises (...) with particular attention to short-term capital flows and their impact” (paragraph 55). It is recognized that domestic macroeconomic

balances can be destroyed by depressed export revenues (paragraph 37) and by contagion from financial crises. It then “underlines the need to ensure that the international financial institutions, including the International Monetary Fund, have a suitable array of financial facilities and resources to respond in a timely and appropriate way” (paragraph 59) to situations of this type, before adding that “the need for special drawing rights allocations should be kept under review”.

The document recognizes the International Monetary Fund (IMF) Compensatory Financing Facility and Contingent Credit Line as renewed and valid safeguards, but adds that the signatory nations mean to “continue to assess its effectiveness” (paragraph 37). It is further stated that even if burden-sharing can be made fair and unsustainable debts restructured in a timely and efficient manner, “such a mechanism should not preclude emergency financing in times of crisis” (paragraph 60). More precisely, it is argued that there is a need for compensatory financing to prevent crises from worsening or at least to mitigate the deterioration.

Lastly, mention should be made of another innovative source of financing, which is the agreement to strengthen international tax cooperation and efforts to combat tax evasion, money laundering, flows of illicit funds, terrorism financing and corruption (paragraphs 64 and 65). The implication is that transparency and cooperation contribute to enhanced public expenditure efficiency in developing nations and to increased tax revenues that can be used to finance domestic development and meet the Millennium Development Goals.

#### (b) *Follow-up and implementation*

There have been substantive annual follow-up reports by the Secretary-General of the United Nations, covering each of the six chapters of this global agreement on financing for development. In addition, the General Assembly has held High-level Dialogues on Financing for Development culminating in the Follow-up International Conference on Financing for Development tasked with reviewing the application of the Monterrey Consensus, which was held in Doha in late 2008, in the midst of the global financial crisis. Here we examine some aspects that merit particular attention in the Report of the Secretary-General of the United Nations on Follow-up to and Implementation of the Outcome of the International Conference on Financing for Development (United Nations, 2007a)

and in the Summary of the High-level Dialogue on Financing for Development presented by the President of the General Assembly (United Nations, 2007b). A selective review will be undertaken as an input for the discussion of innovative financing sources which will be the focus of section IV.

The follow-up report by the Secretary-General notes “considerable advances in some areas and modest progress, stagnation or retrogression in others”, in a general context of “widespread concerns that the fruits of development and growth are not fairly distributed and (...) a growing trend towards a higher concentration of income and wealth” (United Nations, 2007a).

The Report makes use of new financial market research and knowledge that has become available since 2002 on the issues covered by the Monterrey Consensus. In particular, it expands on many aspects of that document, complementing it with a proposal for a consistent approach to the development of policies oriented towards the goals laid down by the signatory countries. The progress made on the understanding of macroeconomic matters in this sixth follow-up report is of great importance, as it moves decisively in the direction of a macroeconomic approach aimed at stimulating both local and foreign productive investment in developing countries (paragraphs 17-20).<sup>6</sup> It stresses the necessity of “employment-oriented macroeconomic policy” in relation to both labour and capital, i.e., the effort to narrow the gap between actual output and potential GDP, following a development macroeconomics approach.

In a notably clear statement, the document argues: “Countries should seek to expand their tools for sound macroeconomic policy, including effective capital flow management (...) and macroprudential mechanisms, the establishment of countercyclical funds (...) and the enhanced use of their tax systems to manage booms and busts.” This paragraph (number 18) represents outstandingly pragmatic, down-to-earth progress towards a policy-oriented approach informed by the most recent research on the procyclical evolution of international financial

markets and the shortcomings of the macroeconomic approaches more in fashion (Ocampo, 2007).

The Report of the Secretary-General stresses the need “to provide stronger oversight of financial market activities”, arguing that “perhaps most urgently, international and national authorities should collaborate to strengthen the transparency and regulation of hedge funds and derivative instruments” (paragraph 56). The stress laid on this in the report long predates the eruption of the subprime crisis and the intensification of the speculative component in the climbing price trend of several commodities.

Mention is also made of “countries internationally perceived as successful globalizers”, for which “managing the boom periods of capital flows is critical. In this respect, countercyclical regulations and instruments should be given utmost consideration” (paragraph 54). The document considers several issues related to the international financial architecture and the slow progress or setbacks in this area by comparison with other forces of globalization.<sup>7</sup> One of them is the fact that “the international community has not yet succeeded in developing some broadly acceptable form of contingent liquidity (...) to provide financial support to countries with market access that may face potential capital account crises” (paragraph 119). Just a few lines before (paragraph 118), mention had been made of the need for “a comprehensive reform of the international monetary system”, particularly with respect to international reserve currencies.

A sharp distinction is made in the report between short-term financial flows and long-term investments, since it has become increasingly evident that the latter tend to be more closely associated with productive activity than the former. It is emphasized that the effects of capital inflows on economic growth also depend on the quality of domestic intermediation and exchange-rate policy. These two factors are mentioned several times (in paragraph 104, for instance). This reiteration is welcome, since the currently fashionable approaches have failed dramatically: intermediaries have not channelled the increased financial funds into investment projects but into consumption and existing assets, which became

<sup>6</sup> These proposals converge with the arguments we have repeatedly put forward about the need to correct the macroeconomic approach prevailing in Latin America. This is characterized by a neoliberal or “financieristic” bias, as compared to a macroeconomy geared towards sustained development. See Ffrench-Davis (2006, chapter III) for an analysis of “financieristic” and “productivistic” macroeconomic approaches.

<sup>7</sup> The report underlines several other issues, such as environmental taxes that could help mitigate the destruction of the environment and provide financing for research and adaptation, and resource-use taxes or royalties.

overpriced as a result, while at the same time capital inflows in general have tended to lead to outlier exchange-rates. Consequently, developing economies ought to implement active exchange-rate policies that are consistent with the evolution of domestic productivity, while focusing financial reforms on the development of long-term and non-traditional segments of domestic capital markets.

As already mentioned, the Monterrey Consensus introduced the issue of illicit flows and tax evasion. The Secretary-General's report goes further with a discussion on "expanding fiscal space" and fighting tax evasion. In fact, a fairly standard characteristic of developing countries is a strikingly low tax burden. As a consequence, they exhibit a limited capacity to finance infrastructure and human capital investment and to ensure the efficiency of public expenditure. Several well-argued paragraphs are devoted to tax and budgetary matters (paragraphs 26-36) and this issue is returned to at the end of the report, which features substantive proposals (paragraphs 124-126) focused on the role that could be played by the new (or reformed) United Nations Committee of Experts on International Cooperation in Tax Matters.

It should be stressed that the report explicitly mentions "innovative sources of finance [that have been] largely brought into the mainstream" (paragraphs 93-96). It will be recalled below that at the 2005 High-level Plenary Meeting of the sixtieth session of the General Assembly, or World Summit,

79 heads of State and government subscribed to a Declaration acknowledging the value of promoting innovative development financing.

Approval of the Doha Declaration on Financing for Development was beset by great difficulties because of opposition to the Secretariat proposal that was led by the delegation of the outgoing United States government. For all that, the final text, even after being watered down in intensive negotiations, did reiterate the positions of the Monterrey Consensus and the determination to step up compliance with the commitments entered into when that document was signed.

The following steps forward may be mentioned. First, the agreement to convene a conference at the highest level in 2009 on the world financial and economic crisis and its effects on development. This implies acceptance that the United Nations and its Member States are entitled to a say on an issue that some countries want confined within the exclusive remit of the IMF and World Bank. Second, the recognition that the architecture of the international economic system also requires corrections if it is to meet the needs of middle-income countries. Third, the explicit reference, following protracted debate between the delegations, to the importance of "innovative financing sources", with special recognition for the Action against Hunger and Poverty Initiative. Section IV briefly details some of the progress made in this field.

## IV

### Review of progress and emerging issues

Several innovative forms of financing have been proposed to help countries implement equitable social and economic policies in the effort to bring about "globalization with a human face". There is a growing determination to move from words to fulfilment of commitments and effective action, particularly as regards attainment of the Millennium Development Goals. For this to happen, it will be essential to thoroughly overhaul the workings of the financial markets. This is far more obvious now, given the deep crisis the world is going through, than in 2002 when the Monterrey Consensus was approved. In recent years, concrete measures have been adopted in an

encouraging number of cases, while in others there are now solid technical foundations that will eventually help to generate political support for future action. In particular, we wish to highlight the progress made in the field of what is known as innovative financing.

The developing world needs more resources for productive and social development, plus international commitments to ensure that people gain from the potential benefits of globalization rather than being mere passive victims of its negative features. Efforts are needed to ensure that a growing number of people become "winners" in terms of social and economic well-being.

## 1. Action against Hunger and Poverty

In 2004, determined to contribute to the fulfilment of the internationally agreed Millennium Development Goals and the Monterrey Consensus, the representatives of a group of countries from North and South launched a partnership for development and solidarity geared towards identifying innovative sources of funding to help promote public goods, boost economic development and combat public “bads” such as hunger and poverty.

Action against Hunger and Poverty was created by the presidents of Brazil, Chile and France, with the support of the Secretary-General of the United Nations; the group was subsequently joined by the heads of State of Spain, Germany, Algeria and South Africa. Funding raised by means of innovative financing mechanisms would be used to set up projects to facilitate the attainment of the Millennium Development Goals. As part of this North-South partnership, which was strongly supported by the United Nations, the heads of State of the member countries of the initiative appointed a technical working group to study possible mechanisms for financing the fight against hunger and poverty. Its proposals are summarized in box 1.

BOX 1

### **Innovative sources of financing for action against hunger and poverty**

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Solidarity levies on air travel  
 Reduction of tax evasion, particularly via tax havens  
 Increasing the benefits of migrant remittances (linking with microcredit)  
 Currency transaction tax (CTT)  
 Taxation of arms trade  
 Creation of International Financial Facility (IFF)  
 Issuance of special drawing rights (SDRs) for countercyclical financing of development  
 Voluntary contributions through credit cards  
 Socially responsible investing or “ethical funds”  
 Solidarity lotteries

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*Source:* Action against Hunger and Poverty proposals, presented to the United Nations General Assembly in New York in September 2004 and 2005.

These proposals were presented at the United Nations in September 2004 and were supported by the representatives of numerous countries. They called for work to continue and for the results of the activities carried out to be presented at the World Summit of September 2005 in which progress

towards the 2015 Millennium Development Goals was to be reviewed. The 2005 New York Declaration on Innovative Sources of Financing for Development was prepared by Action against Hunger and Poverty with the idea of steering globalization away from its more dehumanizing and procyclical aspects, raising awareness of the issues and ensuring that speeches made at international summits were followed up with tangible action. Prepared by the technical working group, the Declaration was endorsed by 79 heads of State. Concrete action was also announced during the Summit, as summarized further on.

As part of the Action against Hunger and Poverty Initiative, the Pilot Group on Solidarity Contributions for Development was set up in 2006. Including the seven countries named above, this group comprises 55 countries from both North and South with very different levels of development. The representatives of all these countries have expressed a willingness to identify and apply pro-development levies and to contribute by generating specific funding to the struggle against “public bads” such as tax evasion and financial crises.<sup>8</sup>

These two groups of nations share a comprehensive approach that pursues the globalization of solidarity, i.e., globalization with a human face that brings the benefits of development to all countries and all their middle- and low-income inhabitants. The approach is pro-growth and pro-equity as regards both sources of funding and the uses it is put to.

The group has made tangible progress, and this was reflected in the proposals presented at the World Summit of September 2005, which included a levy on airline tickets. The pilot project for the international air-ticket solidarity contribution was officially started in 2006, with proceeds to go to the fight against hiv/aids, tuberculosis and malaria. Chile and France (since March and July 2006, respectively) were the first countries to introduce airport fees earmarked for this solidarity initiative.

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<sup>8</sup> The Pilot Group on Solidarity Contributions for Development has addressed several issues besides those covered by the Action against Hunger and Poverty Initiative. They include reviewing the solidarity levy on air travel, issuing special drawing rights as a countercyclical financing mechanism to deal with financial and trade instability in developing countries, introducing a modest tax on financial or currency transactions, repatriating illicit capital outflows, enhancing the potential role of the carbon market, linking migrant workers’ remittances to microcredit in recipient households, stepping up efforts to combat tax fraud and tax evasion, implementing a digital solidarity contribution and promoting the Digital Solidarity Fund.

The project designed to deal with the three pandemics mentioned, the International Drug Purchase Facility (UNITAID), was set up by the governments of Brazil, Chile, France, Norway and the United Kingdom and is supported by the Clinton Foundation and the Bill & Melinda Gates Foundation. Thirty-four countries are currently members of UNITAID and are contributing to the financing of its activities, while several others are considering applying such a levy or using other sources of sustainable financing for this purpose.

To avoid bureaucracy and duplication in administrative costs, UNITAID operates through the World Health Organization. This is a key feature of the Facility and one that ought to be foremost in the design and identification of sources and uses of financing, given how many funds and institutions experience a shortage of financing.

HIV/AIDS, tuberculosis and malaria are major causes of hunger and poverty in the households they affect. All three are critical factors in the progress and setbacks of the development process. In addition to fighting these diseases directly, UNITAID also aims to improve the functioning of markets for therapeutic drugs in order to lower their cost and raise their quality, not only for the direct beneficiaries but also for the health systems of developing countries in general. From this perspective, it benefits poor and middle-income countries alike.

This innovative source of financing has the following advantages: (i) air passenger transport is an activity that has benefited greatly from globalization; (ii) generally speaking, air travel is a comparatively undertaxed sector (in respect of fuel and VAT, for instance); (iii) the air transport levy is progressive, as air travellers usually belong to the upper-income brackets and are thus quite well placed to share the benefits of their position with the rest of the world; (iv) it is an easy-to-collect national levy, involving negligible bureaucracy in cases where airport fees or ticket taxes are already in force.

The International Finance Facility (IFF) proposed by the United Kingdom opened the way to another pilot programme. In November 2006, the International Finance Facility for Immunisation (IFFIm) was founded under the leadership of the United Kingdom with financial backing from eight countries (Brazil, France, Italy, Norway, South Africa, Spain, Sweden, United Kingdom). IFFIm is to fund child immunization programmes and strengthen health systems in the world's 70 poorest

countries. Future legally binding grants from participating donor countries constitute the financial basis for an IFFIm bond issuance programme that will take place over 10 years.

In February 2007, a pilot advance market commitment (AMC) for pneumococcal vaccines was launched at the instigation of Italy and with financial backing from five countries (Canada, Italy, Norway, Russian Federation and United Kingdom) and the Bill & Melinda Gates Foundation. This AMC aims to accelerate the development of new pneumococcal vaccines, specifically for developing countries, by guaranteeing to subsidize their future purchase, if they are successfully developed.

Several concrete initiatives have been undertaken to develop more accurate data on migrant remittances and promote the sharing of information and best practices to reduce transfer costs. They also aim to "securitize" such remittances, in an effort to foster development by promoting recipient families' access to local financial and banking institutions. Cooperative efforts are being made by migrant communities, local and central governments in origin and destination countries, banks, transfer operators and civil society.<sup>9</sup>

## 2. Two ongoing initiatives

We shall now turn our attention to two specific issues. Progress has been made on both of them in technical design, and both have pro-development attributes, while recent events have given them a renewed urgency.

### (a) *Fighting tax evasion internationally*

Hunger and poverty are also associated with weak tax systems, not least because of tax evasion by means of tax havens. Consequently, efforts to combat tax evasion could become a major source of innovative financing for development. The issue has aroused renewed interest now that a number of emblematic cases have come to light in developed economies. Although evasion and flows of illegally acquired funds are a global concern, they affect developing countries with particular severity because they deprive them of essential resources that could be used to finance public services and investment.

<sup>9</sup> For many developing countries, migrants' remittances became the main source of capital from abroad. Unlike loans, furthermore, which flow out of the recipient country upon repayment, these funds are irreversible once they have been transferred. These financial flows fell substantially, however, when the current crisis began.

The Pilot Group on Solidarity Contributions for Development has established a task force, led by Norway, to develop proposals and plans of action for combating flows of illicit funds. In the more specific field of tax evasion, the Follow-up International Conference on Financing for Development held in Doha to review implementation of the Monterrey Consensus was used as an opportunity to launch an initiative, orchestrated by the Government of Germany with support from Chile, Norway and Uganda, to develop concrete projects in this area and coordinate their work with international organizations and civil society.

It is a matter of serious concern that a large share of the profits from the financial flows and capital gains of globalization are untaxed or undertaxed because of tax avoidance or evasion. Tax havens are one of the means by which this inequity is perpetuated. Tax evasion, furthermore, is bound up with money laundering, corruption and terrorism financing: three pervasive “public bads”.

Tax evasion has an ethical dimension, as it penalizes legitimate, transparent, unsecretive investors who duly pay their taxes, while benefiting those who engage in tax avoidance and other activities funded with money from illegal practices or allowed by tax loopholes or policy failures. Furthermore, tax evasion is very unfair to honest taxpayers. Permissive policies in the face of booming financial flows, together with weak or non-existent oversight, have allowed this flaw in globalization to develop further. It is well known that a substantial portion of the resources which leak out of the tax systems of countries in both North and South are sheltered in tax havens.

Given the weaknesses of tax systems in developing countries, it is essential to strengthen their ability to raise public revenue by adopting measures to prevent evasion perpetrated through tax havens. The United Nations Committee of Experts on International Cooperation in Tax Matters can play an important role here. The Organisation for Economic Co-operation and Development has also been working on the issue of tax evasion and tax havens, though any progress achieved would be limited to its member countries. Collaboration between the two institutions could help in concrete decision-making to combat international tax evasion and improve the tax systems of developing countries.

Effective solutions to this problem require collective measures. There are several initiatives that could be explored, such as a mandate for the United

Nations Committee of Experts on International Cooperation in Tax Matters to address international tax evasion and the preparation of a code of conduct on this issue. A strengthened Committee secretariat would be required, with full political support and the resources needed to develop its technical proposals.

(b) *Countercyclical mechanisms in the world economic slowdown*

The volume of financial flows has grown with remarkable speed in the past couple of decades. The magnitude of purely financial flows overshadows all other international transactions, including official development assistance, greenfield foreign direct investment, trade credit and migrant remittances.

The financial markets are currently experiencing frequent “mood swings” affecting, for example, stock market price expectations and exchange rates, so that funds flowing towards a particular geographical market can suddenly be switched to another. Consequently, a developing economy can move overnight from a situation in which there is an oversupply of foreign currency to one of a severe drought. Such “mood swings” in financial and currency markets are felt very strongly in the real economy, i.e., in output, employment, profits and tax revenues. In fact, recessive macroeconomic disequilibria in emerging economies can strongly affect developing countries, as happened with the East Asian crisis.

Crises triggered by external shocks affect the situation of businesses, which experience sudden falls in the demand for their products. This in turn affects employment: as a result of contagion from the East Asian crisis, for example, the average unemployment rate in Latin America rose by 3 to 4 percentage points from 1997 to 1999-2003. Thus, crises weaken the producers of wealth – businesses and workers – and depress the economy. An output gap usually opens up between potential GDP and actual GDP, implying a drop in actual total factor productivity, permanently foregone GDP and a recessionary dynamic that deters investment in physical and human capital. In other words, the present situation and future prospects deteriorate while development is undermined and, with it, the prospects of attaining the Millennium Development Goals.

The Asian crisis and its far-reaching contagion effects spurred fruitful analytical and empirical work, whose results are reflected in the contents of the documents referred to. In the particular case of

Latin America, it led to recessionary effects lasting all of six years. Between 1998 and 2003, the region's GDP increased by just 1.4% a year, which was less than the rate of population increase. Forfeiting growth in jobs, wages and profits for six years exacted an enormous cost. There could hardly be a more wasteful use of resources than to allocate them to unemployment. To rectify the situation, national macroeconomic policy design and the international architecture need a thorough overhaul.

Action against Hunger and Poverty and the Pilot Group on Solidarity Contributions for Development have developed proposals for strengthening countercyclical mechanisms and financing them through issues of special drawing rights (SDRs) by the International Monetary Fund. The United Nations Committee for Development Policy made convergent proposals in its Report on the Tenth Session (United Nations, 2008a). The analysis that follows is based mainly on the latter.

External shocks, transmitted through the trade and capital accounts, usually have large negative economic and social effects on developing economies. The initial effects on key macroeconomic and social variables can spread to the entire economy in the form of reduced government spending and private investment, lower wages, higher unemployment and thus greater poverty. Installed economic capacity is underused and some resources are foregone for ever. Therefore, economic shocks can impede or delay progress towards the Millennium Development Goals.

There is consequently a need for a development-friendly international financial architecture, including deeply reformed countercyclical official credit facilities for low- and middle-income economies when they are adversely affected by external shocks such as trade and financial crises or by worsening natural disasters associated with climate change.

As studies by the International Monetary Fund and its Independent Evaluation Office report, there is an urgent need to improve existing compensatory financing mechanisms and design new ones where gaps exist. This urgency arises, first, because the global economic outlook for 2008-2009 has turned gloomy and developing countries are likely to be highly vulnerable to a slowdown in developed economies. Second, the need for action has been made even more pressing by large increases in oil and food prices, which have severely affected countries that are net importers of these

commodities and provoked a great deal of social discontent in several countries.

In recent years, some countries have built up large cushions of reserves and fiscal resources as a buffer or "self-insurance" against external shocks. However, high levels of reserves entail large costs, mainly in terms of the opportunity costs of productive investment foregone and direct financial losses stemming from relatively low interest earnings on reserve assets. The depreciation of the United States dollar has further added to the financial costs of holding reserves, as many countries hold them in dollar-denominated assets.

Official compensatory flows can play a crucial role in sparing developing countries the unnecessary costs entailed by holding such high levels of international reserves and, most importantly, in helping them to avoid contractions in economic activity and productive investment that go beyond what is required to restore real macroeconomic equilibria.<sup>10</sup> Economic contractions have been quite frequent and have resulted in underutilization of present potential GDP and the loss of prospective growth. In this regard, improved compensatory flows can potentially be a very effective mechanism for protecting economic growth and the incomes of poorer people in the affected countries, both now and in the near future.

There are currently a number of major compensatory financing mechanisms, but either they are limited in coverage and volume or too narrowly defined, or funding is released too late or is subject to conditionality that is inappropriate given the nature of external shocks.

In view of the worsening global economic outlook, its implications for developing countries and the inadequacy of existing compensatory finance instruments, there is an urgent need for a reformed compensatory financing architecture so that official liquidity and assistance can be provided to developing countries suffering the negative impact

<sup>10</sup> A crucial condition of macroeconomic equilibrium is for potential or installed GDP to be actually used; for this to be sustainable, the "right macro-prices" are needed. It must be stressed that these remarks apply to real economies that are "well-behaved" or have already corrected their main imbalances. Evidently, economies with extremely appreciated exchange rates and large external and fiscal deficits (after duly counting international solidarity revenues) will need to engineer significant drops in aggregate demand and large devaluations. We recall that, recently, for five or six years, several Latin American countries recorded large output gaps (with actual GDP well below potential GDP) and experienced major imbalances in the real macroeconomy during that prolonged period.

of external shocks. To be effective, liquidity must be adequate and have the attributes of “speedy disbursement, scale proportionate to the shock and low conditionality” (United Nations, 2008a).

To finance a significant improvement in the volume and quality of compensatory financing, bearing in mind the arguments in favour of a gradual move towards a global reserve currency, issuance of special drawing rights (SDRs) should be reinstated. A new reform would allow the IMF to use them to finance a significant increase in the availability of compensatory financing. The current prospect of downward adjustments in economic activity and financial turmoil represents an appropriate context for a new allocation of SDRs with a countercyclical

role, with a view to progressing cautiously and gradually towards a true international reserve currency. Furthermore, the allocation of 22 billion SDRs approved by IMF member countries in 1997 and since ratified by 133 of them (but still awaiting ratification by other countries to reach the requisite threshold of 85% of Fund quotas) should be completed without delay.

The existing compensatory financing mechanisms of the IMF should be significantly simplified, as current schemes are too numerous and complex. All compensatory facilities should have the attributes referred to of speedy disbursement, scale fully proportionate to the external shock and low conditionality to maximize the beneficial impact on recipient countries.<sup>11</sup>

## V

### Conclusions

Capital flows have great potential to contribute to economic development. However, the transitory nature of financial transactions and the incomplete state of existing instruments and institutions have helped make financial markets some of the worse-functioning in the whole market economy system. Financial flows tend to exhibit wild swings, spells of excessive optimism or pessimism and prolonged periods of outlying domestic prices and ratios (Rodrik, 1998; Stiglitz, 2000); these have been characteristics of exchange rates, stock and real-estate prices, and interest rates. Consequently, better information, regulation of the financial sector and comprehensive but prudent macroeconomic management of financial flows are desirable public goods. This is why governments have a responsibility for the behaviour of supply (in the case of industrialized countries) and demand (in the case of developing countries), both coordinated where necessary by international organizations. Inaction can carry a heavy cost, as was demonstrated during the debt crisis, the 1994 Mexico crisis, the Asian crisis of 1997 and the prolonged stagnation of the countries of Latin America in 1998-2003 (Ffrench-Davis, 2006, chapter VIII).

Given the growing imbalances produced by globalization, there is a pressing need to restructure the international financial architecture in response to profound shifts in the global economy. As the Report

of the Secretary-General of the United Nations on Follow-up to and Implementation of the Outcome of the International Conference on Financing for Development (United Nations, 2007a) emphasizes, and as the Summary of the High-level Dialogue on Financing for Development presented by the President of the General Assembly (United Nations, 2007b) reaffirms, instability is a pernicious feature of today's system. The voices of developing countries must be heard and serious measures taken to prevent and respond to financial crises (including the proposal for reformed countercyclical mechanisms).

A tougher challenge is actually to generate the right conditions for redirecting potential savings towards development. The following observations need to be made. First, international finance has generally become undertaxed at the expense of the real economy, which is forced to cover the revenue shortfall or lack of public investment for productive development. This is particularly prejudicial to less mobile factors of production (small businesses

<sup>11</sup> In late 2008 the IMF approved a new mechanism similar to the one proposed in detail by Action against Hunger and Poverty at least since January 2007. This is the Short-Term Liquidity Facility (SLF). The arrival of the new Managing Director, Dominique Strauss-Kahn, has brought a welcome shift towards pragmatism and away from the extreme neoliberalism of earlier years.



and low-skilled labour). The currency transaction tax could improve financial equity and generate substantial resources to stimulate growth with equity (Williamson, 2006). Second, the fashionable approaches favouring across-the-board opening of the capital accounts exhibit a strong bias towards high-income producers, but also towards short-termist speculative agents. The latter are the new rent-seeking actors. As the Report of the Secretary-General quoted earlier points out, there is a need to reform rules and institutions so that financing can be redirected to sectors that are usually excluded, such as small and medium-sized enterprises and micro producers. Third, there is growing evidence that

greenfield foreign direct investment flows contribute to productive investment and foster development while, conversely, short-term financial flows exhibit a weak link with capital formation during booms, are a common source of busts and act as a deterrent to productive investment. In the present financial turmoil, the call by the Monterrey Consensus and the Report of the United Nations Secretary-General for greater stability in financial flows is more relevant than ever.

A development-friendly reform of the financial system is unquestionably needed, as today's architecture is far from meeting that description.

(Original: Spanish)

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