Fifteen years is enough

What's changed in the international financial system and its institutions, what hasn't and what needs to

Edited by the
Halifax Initiative Coalition

Fifteen years is enough

What's changed in the international financial system and its institutions, what hasn't and what needs to

About the Halifax Initiative

Canadian NGOs formed the Halifax Initiative in December 1994 to ensure that fundamental reform of the international financial institutions (IFIs), namely the World Bank and International Monetary Fund, was high on the agenda of the Group of Seven's (G7) Halifax Summit. Today the Halifax Initiative is a coalition of 17 development, environment, faith-based, human rights and labour groups, and the Canadian presence for public interest advocacy and education on the IFIs.

Our members comprise:

Canadian Catholic Organization for Development and Peace
Canadian Conference of Catholic Bishops, Social Affairs Office
Canadian Council for International Cooperation
Canadian Friends of Burma
Canadian Labour Congress
CAW-Canada Social Justice Fund
Falls Brook Centre
KAIROS: Canadian Ecumenical Justice Initiatives
MiningWatch Canada
North-South Institute
Oxfam Canada
Oxfam Québec
RESULTS Canada
Rights & Democracy
Social Justice Committee
Steelworkers Humanity Fund
World Interaction Mondiale

Halifax Initiative Coalition
153 Chapel Street, Suite 104
Ottawa, ON K1N 1H5
CANADA

Tel.: +1 613 789-4447
Fax: +1 613 241-4170

www.halifaxinitiative.org

Acknowledgements

The Halifax Initiative Coalition commissioned and edited this publication. It extends sincere thanks to all the contributors whose efforts, energy and time made this publication possible:

- Soren Ambrose, ActionAid International;
- Dereje Alemayehu, Tax Justice Network-Africa;
- John Christensen, Tax Justice Network.
- Gail Hurley, formerly Eurodad;
- David McNair, Christian Aid;
- Nuria Molina, Eurodad;
- Bhumika Muchhala, Third World Network;
- Lidy Nacpil, Freedom from Debt Movement;
- Arnaud Zacharie, Centre National de Coopération au Développement – *11.11.11*.

Readers and commentators on some early drafts include the following: Aniket Bhushan, The North-South Institute; John Dillon, KAIROS – Canadian Ecumenical Justice Initiatives; and Peter Gillespie, Inter Pares. Particular thanks go to Soren Ambrose who provided comments and helped edit a number of the chapters.

Financial Support
The Halifax Initiative Coalition wishes to thank the Canadian Labour Congress, Charles Stewart Mott Foundation, the International Development Research Centre, RESULTS Canada, the UN Millennium Campaign, and coalition members, whose financial support made this publication possible.

Imprint
Fifteen years is enough - What's changed in the international financial system and its institutions, what hasn't and what needs to

Published by the Halifax Initiative Coalition

Initial draft chapters were edited by Fraser Reilly-King, with the final editing conducted by Mark Foss in collaboration with the chapter authors.

Front cover design, layout and printing: Bonanza Printing & Copying Centre Inc.

Ottawa, March 2010

* * *

Parts of this publication are also available in French.

Table of Contents

List of Acronyms

ALBA	Bolivarian Alternative for the Americas
ASEAN	Association of South East Asian Nations
AU	African Union
BOP	Balance of payments
BWIs	Bretton Woods Institutions (the World Bank and International Monetary Fund)
CIDA	Canadian International Development Agency
ECAs	Export Credit Agencies
ECB	European Central Bank
EU	European Union
FCL	Flexible Credit Line
FCO	Foreign and Commonwealth Office
FDI	Foreign Direct Investment
FfD	Financing for Development
FSF	Financial Stability Forum (formerly the Financial Stability Board or FSB)
G7	Group of Seven
G8	Group of Eight
G20	Group of Twenty
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Countries
IASB	International Accounting Standards Board
ICC	International Currency Certificate
IDB	Inter-American Development Bank
IFIs	International Financial Institutions
IIE	Institute for International Economics
IMF	International Monetary Fund
LDC	Least Developed Country
LICs	Low-income countries
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MNCs	Multinational Corporations
OECD	Organization for Economic Co-operation and Development
PRSPs	Poverty Reduction Strategy Papers
SBA	Stand-by Arrangement
SDRs	Special Drawing Rights
SME	Small- and medium-sized enterprises
SSA	Sub-Saharan Africa
TIEAs	Tax Information Exchange Agreements
UN	United Nations
UNASUR	Union of South American Nations
UNCTAD	United Nations Conference on Trade and Development

Executive Summary

Back in 1995, the G7 met in Halifax during a "time of change and opportunity." The meeting took place in a context of mounting deficits and debt crises in countries in the South; in the wake of economic collapse in Mexico; and amid strong global criticism from civil society, the media and governments about the World Bank and International Monetary Fund's (IMF) austere neo-liberal structural adjustment policies.

A lot has changed since then, partly in response to the Halifax G7 Summit and subsequent G7 and G8 meetings. Too many of these improvements, however, exist only on paper. Beyond the surface, the neo-liberal, market-oriented bias that guides the Bank and Fund's agenda and thinking has not altered.

The 2010 G8 Summit in Toronto in 2010 takes place during another "time of change and opportunity." The financial crisis has spurred many civil society organizations (CSOs) to insist on far-reaching changes to the global financial system and its institutions. Clearly, as this publication will illustrate, 15 years of refusing to deal with the manifest shortcomings of the global economic system is enough.

This publication looks at several interrelated issues:

- The place of the dollar in the global economy, and the move towards a new global reserve system;
- The challenge to conditionality in the context of policy prescriptions that exacerbate the impact of the crisis;
- Truly sustainable responses to debt, in the context of a looming debt crisis; and
- Tax justice in development, in the wake of a growing global movement challenging tax havens.

The need for transformation
Chapter 1 by Fraser Reilly-King sets the broader context for the publication by looking at the issue of global governance, as well as new and innovative sources of financing for development and climate change.

The G20 remains an exclusive club that does not represent the interests of low-income countries and that lacks mechanisms to ensure transparency and accountability. To achieve the broader goal of democratic governance, a global leaders' forum must include the effective participation of low-income countries. It must respect democratic principles, providing avenues for citizens' voices. In the medium term, such a forum cannot replace the need for a democratic and global leaders' summit process within the framework of the United Nations.

Despite their minor role in causing the global financial crisis, developing countries have been deeply affected by it. Not surprisingly, the economic crisis is threatening to undo progress towards achieving the Millennium Development Goals (MDGs). Additional emergency funding is needed urgently to address their massive funding shortfalls. The chapter argues that low-income countries could benefit from targeted allocations of Special Drawing Rights (SDRs) — the "currency" set aside by the International Monetary Fund in an international reserve. In addition, a global tax should be imposed on all financial transactions with at least half of the generated funds allocated to developing countries to help achieve the MDGs and for climate change mitigation and adaptation.

Towards a new global reserve system
Financial crises have been a recurring characteristic of the international financial system over the past two centuries, but have become more pronounced and far-reaching with the advent of financial and capital account liberalization.[1] The gold standard and the Bretton Woods system had ushered in two decades of relative global prosperity and monetary stability,

but their collapse in the early 1970s triggered what economist Robert Triffin has called a "non system… anchored primarily on a national, paper reserve currency, that is, the dollar."[2]

In the absence of more far-reaching reforms, countries that have survived previous crises have pursued their own *ad hoc* measures, building up substantial hard currency reserves to buffer themselves against future crises and speculative attacks. For example, in 2000, the 10 countries of the Association of South East Nations (ASEAN) plus China, Japan and South Korea launched the Chiang Mai Initiative. This initiative is now a $120 billion multilateral "currency swap" arrangement to offset sudden outflows of foreign currency in order to avoid abrupt destabilization of national economies.

But building up vast currency reserves has an opportunity cost: it diverts resources that could otherwise be used for productive investments in the real economy, exerts deflationary pressures on economies and generates monetary instability.[3] This may be a price that countries are willing to pay, opting for regional initiatives in the absence of more systemic global solutions that work for them. As the past three decades have demonstrated, however, crises are intrinsic to a globalized economy, not exceptions to be treated on an *ad hoc* basis.[4]

At the heart of the problem is the US dollar-dominated international currency reserve-system. The accumulation of extensive foreign exchange reserves by some emerging market economies (China in particular) and excessive consumption by others (the United States in particular) are responsible for large and unsustainable global imbalances.[5]

This unbalanced situation has intensified recent calls for a new global reserve system. **Chapter 2** by Arnaud Zacharie with Soren Ambrose looks at the need for a new system that would accomplish two goals: reducing the reliance of the global economy on a single currency — the US dollar; and addressing the inequitable nature of the current reserve system that places the burden of adjustment solely on deficit countries instead of mitigating the difficulties caused by asymmetrical adjustments.

A new reserve currency and system would bring greater stability to the financial system, avoid the build up or global imbalances and preclude the need for countries to dedicate much-needed resources towards massive national hard currency reserves. The chapter considers the feasibility of creating a new global reserve system and some proposals for doing so.

<u>*Challenging conditionality*</u>

At the G20 summit in London in April 2009, world leaders committed an additional US$1.1 trillion in emergency financing — with US$750 billion pledged (although not yet fully committed) to the IMF. Some US$250 billion has already been issued to all IMF member countries (although not yet converted) in the form of SDRs,[6] the IMF's reserve asset. For the remainder, industrialized and reserve-rich governments are lending the IMF up to $500 billion for loans at market interest rates to countries in need.

Of the $1.1 trillion committed, only US$240 billion is expected to go to developing countries and $50 billion to low-income countries.[7] This is a paltry amount relative to what G20 countries have dedicated to boost their own economies, and woefully inadequate given the shortfalls in financing that both the IMF and World Bank anticipate. Furthermore, many of these loans are attached to new conditions and to countries without recent IMF programs, such as Ghana and Ethiopia.

In response to the crisis, the IMF changed a number of its conditions. It eliminated structural conditions[8] in many programs; it created a new Flexible Credit Line (FCL) that provides liquidity for building up foreign reserves without attaching "any conditions;" and it is allowing countries to incur slightly higher deficits compared to historic IMF positions.

Despite these changes, structural benchmarks (which are not legally binding but that still force policy change in countries that accept IMF finance) will continue to be used, as well as traditional quantitative targets.[9] As it stands, only "countries meeting pre-set qualification criteria" of "very strong fundamentals, policies, and track records of policy implementation" are eligible for the FCL.[10] Consequently, only three countries — Mexico, Poland and Colombia —have benefited so far.

Such "fiscal loosening" is also only a temporary measure;[11] the emphasis on social protection still sits firmly within a context of shrinking government budgets.[12] Finally, research on the conditions attached to new crisis loans for Eastern Europe and many middle-income countries clearly underscores the IMF's ongoing obsession with "tightening monetary and fiscal policy."[13] In other words, the conditions may have changed in name and form, but they are still alive and well.

As **Chapter 3** by Bhumika Muchhala and Nuria Molina notes, these new conditions have forced governments to cut expenditures on key essential public services, such as health care, education, public transit, water, sanitation and access to fuel and electricity; to privatize many of these services; to cut subsidies; and to introduce user fees.[14] Unnecessarily restrictive deficit-reduction and inflation-reduction targets prevent developing countries from growing their economies by expanding public spending.

These restrictions, in turn, have undermined the ability of country governments to meet their own human rights' obligations. This chapter underscores the need for substantial (unconditional) resources to be dedicated to countries to enable them to pursue counter-cyclical policies during times of crisis; for policies that promote greater domestic resource mobilization; and for macroeconomic analysis and assessment that is more objective, flexible and country-driven —and independent of the IMF — that helps governments foster economic growth, as well as protect and promote the rights of their citizens.

Next steps on debt

The Heavily Indebted Poor Country (HIPC) Initiative in 1996, Enhanced HIPC in 1999, and the Multilateral Debt Relief Initiative (MDRI) in 2005 have all helped move debt cancellation forward. There is a danger, however, that new loans to developing countries, especially if disbursed at commercial rates, will lead to a new debt crisis in the South. The World Bank has already increased its lending activities by 54 percent over the previous year, reaching an unprecedented US$58 billion in fiscal year 2009. Meanwhile, the IMF has committed an additional US$170 billion since the crisis broke out.[15]

This expansion in lending could create significant debt problems in the near future: the debt-to-GDP ratio of 28 countries is already above what the IMF considers a sustainable threshold at more than 60 percent.[16] Similarly, in its 2009 Least Developed Country (LDC) Report, UNCTAD points to serious concerns over the unsustainably high debt burden of 49 LDCs.[17] Therefore, it is important that appropriate measures mitigate the negative effects of the crisis on the indebtedness of developing countries and ensure that lending is sovereign, democratic and responsible, an issue currently under discussion at UNCTAD.[18]

In **Chapter 4,** Lidy Nacpil and Gail Hurley describe a number of ideas currently under discussion internationally that could help avoid a new debt crisis. A two-year moratorium on all external debt service payments of developing countries, for example, would free up additional resources in the amount of US$30.5 billion annually for 64 of the world's most indebted countries. This would be an effective way to release extra funds for critical social investment, while ensuring no additional debt would be incurred.[19]

Much of the debt burden of developing countries has arisen through irresponsible lending practices. In the context of the current crisis, countries are in debt due to a crisis they didn't cause — and there is an urgent need to assess and cancel these odious debts. Indeed, governments and civil society organizations are conducting audits to identify these debts. In the longer term, a renewed debt cancellation initiative should ensure future lending is responsible and transparent, and establish a fair, transparent and sovereign debt restructuring mechanism.

Promoting tax justice

Over $600 billion, or nearly three times the current levels of external debt of sub-Saharan Africa, has leaked from the continent in illicit financial flows since 1975.[20] Global Financial Integrity estimates that globally US$500-800 billion of illicit flows exit developing and transitional economies every year.[21] The Tax Justice Network has estimated that wealthy individuals hold $11.5 trillion offshore in secrecy jurisdictions.[22] Furthermore, Christian Aid estimates that developing countries lose around $160 billion each year in tax revenue as a result of secrecy jurisdictions[23] — more than 30 percent higher than the amount of aid given by northern donors in 2008.

While the G20 has begun to address the issue of tax havens, the UN Commission of Experts on the Financial and Monetary System has noted the G20's approach through the Organization for Economic Co-operation and Development (OECD) has led to, "discriminatory targeting of small international financial centres in developing countries while a blind eye is turned to lax rules in developed economies." In fact, the Commission notes that, "the principal sources of tax evasion, tax secrecy, money laundering, and regulatory arbitrage [are] located in developed countries' on-shore banking systems….",[24] such as Delaware in the United States and the City of London.

Chapter 5 by David McNair, John Christensen and Dereje Alemayehu traces the ties between mobilizing domestic resources through taxes and pro-poor economic growth, good governance and stability. It considers how those who use secrecy jurisdictions to evade taxes undermine the "tax culture" in many countries. It then presents the mechanisms, scale and impact of capital flight and tax arbitrage; assesses the current approach by the G20 to addressing the issue of secrecy jurisdictions; and considers why and how this approach falls short of tackling the issue.
Finally, it summarizes a number of policy measures for international tax cooperation that address capital flight, including the following:

- adopting automatic information exchange procedures along the model adopted by the European Union;
- promoting country-by-country reporting on accounts by multinational companies;
- ensuring alternative sustainable development paths for jurisdictions that have become dependent on financial secrecy; and
- giving countries the space to set their own domestic fiscal policy and supporting stronger tax authorities in developing countries.

Endnotes

1 Interestingly, between the late 1940s and the early 1970s, there was a striking period of calm, atypical of either the 50 years that preceded it or the thirty years that followed. Reinhart and Rogoff attribute this to booming world growth, repression of domestic financial markets, heavy-handed use of capital controls and the existence of the Bretton Woods system of fixed exchange rates. See Reinhart and Rogoff, "Banking Crises: an Equal Opportunity Menace," pp. 7-8, American Economic Association, December 2008. http://www.aeaweb.org/annual_mtg_papers/2009/retrieve.php?pdfid=245

2 Triffin proposed instead basing the system on a truly international reserve asset held with the IMF – special drawing rights – and not on the dollar or any other single national or reserve currency. Cited in "Why should we have listened better to Robert Triffin?" Speech by Jan Joost Teunissen at conference, "The economic and financial crisis of 2008-09," Louvain-la-Neuve, May 7-8, 2009. http://www.uclouvain.be/cps/ucl/doc/gehec/documents/web_Why_should_we_have_listened_better_to_Robert_Triffin.pdf.

3 See Halifax Initiative, "Issue Brief: The Chiang Mai Initiative – One step closer to an Asian Monetary Fund? - April 2009." http://halifaxinitiative.org/content/issue-brief-chiang-mai-initiative.

4 Noble prize laureate Joseph Stiglitz has forcefully demonstrated that there have been countless financial crises since the beginning of financial deregulation in the early 1980s, mostly in developing countries, and that financial deregulation has made the global financial system much more unstable and imbalanced. See Stiglitz, J.E. (2002). "Capital Market Liberalization, Economic Growth, and Instability," *World Development*, vol.28, no.6 (June 2000), pp. 1075-1086.

5 Academic and economist Robert Triffin in 1985 (and earlier) anticipated that a non-system anchored in a single reserve currency, the US dollar, would have three negative consequences: produce "inflationary proclivities, leading to [massive] world reserves," create global imbalances rendering "the poorer and less capitalized countries of the Third World the main reserve lenders, and the richer and more capitalized industrial countries the main reserve borrowers of the system" and make the world's economies more crisis prone. Cited in "Why should we have listened better to Robert Triffin?" Speech by Jan Joost Teunissen at conference, "The economic and financial crisis of 2008-09," Louvain-la-Neuve, May 7-8, 2009, http://www.uclouvain.be/cps/ucl/doc/gehec/documents/web_Why_should_we_have_listened_better_to_Robert_Triffin.pdf.

6 SDRs, an international reserve asset and the IMF's "currency," automatically increase central banks' foreign exchange reserves, but also come without any of the conditions typically associated with the IMF. Allocated relative to a country's IMF quota, the largest share of the US$250 billion will go to the U.S. (US$42.6 billion), with developing countries expected to get around US$90 billion. Low-income countries will get US$18 billion and sub-Saharan Africa will get US$10 billion.

7 The $1.1 trillion and $50 billion figures are from the April 2 Communiqué. The $240 billion is calculated in Oxfam GB, "What Happened at the G20? Initial Analysis of the London Summit", April 2009, http://www.oxfam.org.uk/resources/policy/economic_crisis/downloads/bn_what_happened_at_g20.pdf.

8 Structural conditions, to be implemented during the course of a loan, seek to change the structures of institutions and incentives in borrowing countries. They require trade and financial liberalization, tax reforms, banking sector overhauls and privatization of state enterprises.

9 The Fund attaches two different types of policy conditions to their loans in poor countries. Quantitative conditions impose a set of macroeconomic targets on poor country governments determining, for example, the level of fiscal deficit a government is allowed to go into or the level of domestic credit allowed. Structural conditions push for institutional and legislative policy reforms within countries. They include trade reform, price liberalization and privatization. This report focuses exclusively on the structural conditions.

10 IMF, "IMF Overhauls Lending Framework," Press Release No. 09/85, March 24, 2009, http://www.imf.org/external/np/sec/pr/2009/pr0985.htm.

11 Eurodad, "Bail out or blow out: IMF policy advice and conditions for low-income countries at a time of crisis," June 2009, http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Bail-out%20or%20blow-out.pdf.

12 Eurodad, Global Network and Solidarity: "Doing a decent job? IMF policies and decent work in times of crisis," October 2009. http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Doing%20a%20decent%20job.pdf.

13 Eurodad, "IMF Emergency Loans," April 21, 2009, http://www.eurodad.org/aid/article.aspx?id=124&item=3600; Third World Network, "The IMF: Resurgent but unchanged," March 2009, http://www.twnside.org.sg/title2/resurgence/2009/225/cover1.doc; Third World Network, "The IMF's Financial Crisis Loans: No change in conditionalities," March 11, 2009, submission to the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, http://www.twnside.org.sg/title2/par/IMF.Crisis.Loans-Overview.TWN.March.2009.doc

14 Ibid

15 See Eurodad, "From London to Pittsburgh: Assessing G20 Action for Developing Countries," September 16, 2009, On-line: http://www.eurodad.org/debt/article.aspx?id=2190&item=3820.

16 Eurodad, "Debt in the Downturn," October 2009, p.2, http://www.eurodad.org/whatsnew/reports.aspx?id=3844.

17 UNCTAD, Least Developed Countries (LDC) Report 2009. http://www.unctad.org/Templates/webflyer.asp?docid=11721&intItemID=2068&lang=1.

18 UNCTAD recently launched a project on responsible sovereign lending and borrowing. For details, see http://www.uctad.org./Templates/Page.asp?intItemID=4778&lang=1.

19 See Eurodad, "Debt in the Downturn."p.5.

20 L. Ndikumana and J.K. Boyce, "New estimates of capital flight from Sub Saharan African countries: Linkages with External Borrowing and Policy Options," Working Paper Series, No. 166, Political Economy Research Institute, University of Massachusetts.

21 See R.W. Baker, *Capitalism's Achilles' Heel: Dirty Money and How to Renew the Free-Market System*, (New Jersey: Wiley, 2005).

22 Tax Justice Network, *Tax us if you can*, 2005.

23 A. Hogg et al, *Death and Taxes: the true toll of tax dodging*, Christian Aid. 2008.

24 United Nations, Report of the UN Commission of Experts on Reforms of the International Monetary and Financial System, Chapter 3, Paras 110, 112, and 115. Pages 64-65.

CHAPTER 1

Fifteen years is enough – The need for transformation

Fraser Reilly-King[i]

"The process of globalization, driven by technological change, has led to increased economic interdependence […]. The major challenge confronting us is to manage this increased interdependence while working with the grain of markets […] in the pursuit of global macroeconomic and financial stability. […]

The prevention of crisis is the preferred course of action. This is best achieved through each country pursuing sound fiscal and monetary policies. But it also requires an improved early warning system [..and i]f prevention fails […] that multilateral institutions and major economies be able to respond where appropriate in a quick and coordinated fashion. […]"

"Meeting the Challenges of the 21st Century – Strengthening the Global Economy"
Halifax G7/G8 Summit Communiqué, June 16, 1995

***

"Everyone is saying that with a crisis comes opportunity. I want an opportunity without a crisis."

Ecuadorian President Rafael Correa, speaking at a side event at the
United Nations Conference on the World Financial and Economic Crisis
and Its Impact on Development, New York, June 25, 2009

Introduction: 15 years on from Halifax – then and now

It's all too likely that the statement cited above, issued in June 1995 at the Group of Seven (G7) Summit in Halifax, Canada, will bear a striking resemblance to the communiqué that will likely be issued 15 years later at the Group of Twenty (G20) Summit in Toronto, Canada in June 2010.

Back in 1995, the G7 met in Halifax during a "time of change and opportunity." The meeting took place in a context of mounting deficits and debt crises in countries in the South; in the wake of economic collapse in Mexico; and amid strong global criticism from civil society, the media and governments about the World Bank and International Monetary Fund's (IMF) austere neo-liberal structural adjustment policies.

At that time, the concept of sustainable development was still fresh in many people's minds following the 1992 Rio Summit. As greater awareness about social and environmental impacts of development grew, civil society organizations (CSOs) and communities also pointed to the negative environmental impacts of Bank-funded projects — from large dams to mining, oil and gas facilities to pulp and paper mills.

---

i Coordinator, Halifax Initiative Coalition
Views expressed in this paper are those of the author alone and should not be otherwise attributed.

In 1994, as the two Bretton Woods Institutions (BWIs) had celebrated their 50th anniversary with lavish annual meetings in Madrid, groups around the world in both the North and the South united behind the slogan "50 years is Enough." They wanted major changes and there were signs the Halifax summit would respond to those calls.

To meet the challenges of the 21st century, Summit participants proposed a number of measures for strengthening the global economy, as noted in the quotation above. They encouraged the BWIs to put the new concept of sustainable development at the heart of their mandate by embracing several measures, including the following: taking environmental impacts into consideration when designing Bank and Fund policies; encouraging "sound" (as determined by the lenders) economic, environmental and social policies in borrowing countries; promoting an active civil society; boosting the role of the private sector; and, strengthening local infrastructure.

To address poverty, the G7 instructed the multilateral development banks to provide more concessional financing to Africa, to direct more resources to basic social programs, to develop a comprehensive approach to tackling multilateral debt problems and to help integrate the world's poorest countries into the world trading system.

Positive changes on paper…

A lot has changed since then, partly in response to the Halifax G7 Summit 15 years ago and subsequent G7 and G8 meetings:

- The World Bank Group developed policies for its different private-sector funding arms to take account of the social and environmental impacts of Bank-funded projects, building on similar safeguards for its public-sector lending arms adopted in 1995.
- In 1999, both the Bank and Fund made poverty reduction central to their mandate and lending operations. This brought about a "government-led" process for generating poverty reduction strategy papers (PRSPs), which would be the basis for all Bank and Fund lending.
- The conditions attached to Bank and Fund lending have also been successively streamlined, with the distributional impacts of such lending now also addressed through poverty and social impact assessments.
- The 1996 Heavily Indebted Poor Country (HIPC) initiative and its subsequent iterations have helped cancel portions of the debts of 26 countries.
- The Bank replenished the International Development Association, its concessional lending window, with over $42 billion for low-income countries (LICs), half of which are in Africa.
- Both the Bank and Fund have made substantial efforts to streamline and reduce the number and type of conditions attached to their loans. By the spring of 2010, the Fund had even revised its long-held rejection of the use of capital controls — anathema to its belief in financial liberalization.
- The Bank also increased its support for the "aid for trade" initiative from $10 billion in 2002 to $20 billion in 2007; this has helped LICs integrate into the world economy and boost their growth through trade.
- Both the Bank and Fund have just completed another review of their disclosure policies, making positive steps forward in terms of the level of transparency.

… But not in practice

As all the chapters in this publication demonstrate, what looks good on paper has been less good in practice. Beyond the surface, the neo-liberal, market-oriented bias that guides the Bank and Fund's agenda and thinking has not changed. As a result, many groups are pursuing alternatives:

- New initiatives, such as the Bank of the South (Banco del Sur) and the Bolivarian Alternative for the Americas (ALBA), emerged in Latin America as direct alternatives to the World Bank.
- Countries turned to new lenders — in particular China and India — instead of going to the Bank.
- In Asia, the Chiang Mai Initiative, a $120 billion fund, grew out of disenchantment with the IMF's response to the Asian financial crisis of 1997-98.

- From 2005 to 2008, the IMF saw a number of key countries repay their loans ahead of schedule and vow never to return, threatening the Fund's financial viability and forcing the Managing Director to lay off 15 percent of IMF staff.

Ironically, even before the crisis, calls were mounting from civil society, the media, the Commonwealth[1], the 2008 United Nations Financing for Development process, and even former Canadian Prime Minister and Finance Minister Paul Martin[2], to fundamentally rethink these institutions and their approach to development.

When the crisis took on global dimensions in October 2008, it was the "Group of 20" (G20) that responded. They began meeting at the level of Heads of State, producing and implementing a long list of policy commitments in the areas of global governance, emergency and trade finance, macroeconomic surveillance, regulation of the banking sector and financial assets, and reforms to address tax havens. The Financial Stability Forum (FSF), established following the Asian crisis to help stem the outbreak of future crises, was renamed and mandated again to provide an advance-warning system of future financial risks.[3] The IMF, an institution in crisis in 2008, was promised that its coffers would be filled to the tune of $750 billion. A general allocation of $250 billion in special drawing rights (SDR), the IMF's currency, has been issued to countries. And Bank and Fund shares and quotas have been adjusted to give a greater voice to emerging economies.

These efforts have tackled some of the immediate impacts of the current global financial and economic crisis. But the depth, breadth and scale of the impacts have definitively demonstrated how existing structures and institutions have been overwhelmed by the "challenges of the 21st century." The G7 meeting in Halifax was set up to anticipate and address this crisis, but today's responses by the G20 are remarkably similar to proposals issued 15 years ago.

As this publication will illustrate, many solutions proposed by the G7 (and more recently the G20) scratch at the surface, but fail to reach the root of the problem. Today, to ensure a stable and sustainable global economy in the next decade of the 21st century, CSOs are demanding more than half-hearted incremental reforms: 15 years of refusing to deal with the manifest shortcomings of the global economic system is enough.

About this publication

Since the Halifax Summit fifteen years ago, we are now at another "time of change and opportunity." The financial crisis has spurred many civil society groups to insist on far-reaching changes to the global financial system and its institutions. In this context, issues such as debt relief, governance reform, traditional forms of development finance, and tweaking existing Bank and Fund policies have fallen off the agenda, replaced by issues that can have a more transformative impact. This publication looks at a number of transformative issues that are currently capturing the attention of groups South and North, governments and international fora, including the following:

- Going beyond the G20 to a real and realistic global leaders' forum;
- Exploring new and innovative sources of financing that provide reliable sources of funding for development, and climate change adaptation and mitigation, as well as for governments to pursue expansionary economic policies;
- Rethinking the place of the dollar in the global economy, and moving towards a new global reserve system;
- Challenging conditionality in the context of policy prescriptions that exacerbate the impact of the crisis;
- Creating truly sustainable responses to debt, in the context of a looming debt crisis; and
- Promoting tax justice in development, in the wake of a growing global movement challenging tax havens.

This chapter sets the broader context for the rest of the publication by looking at the issue of global governance, as well as new and innovative sources of financing for development and climate change.

Rethinking Governance of the Global Economy

As the world's economies become more integrated, there is a commensurate need for multilateral institutions to help govern the global economy and to assess and anticipate problems before they happen. In past years, various entities have underscored the need for a new multilateral leaders' forum to help govern the global economy, highlighting the failings of existing structures. Since the mid 1970s, Ministers of Finance from the G7 have played an active role in steering the global economy. Today, in response to the global dimensions of the current crisis and the growing importance of a number of emerging economies, the G7 has been transformed into a G20, which now meets at the level of Heads of State.[4]

The move towards a G20 is a small step forward. Compared to the G7, it has a greater number and diversity of members, representing 65 percent of the world's population and 85 percent of global gross national product. But the G20 remains a self-selected body and has no mandate other than its own regarding the global economy — or any other issue. As a result, like its predecessor, its membership is more inclined to prioritize national self-interest ahead of the interests of others.

While promising to repair the global economy and build an inclusive and sustainable recovery, G20 leaders instead injected $1.1 trillion into many of the same institutions whose economic, finance and trade policies exacerbated the speed, scale and impact of the crisis. Reforms have been superficial, and any shifts to the current economic paradigm still seem temporary, rather than long term. In this context, the responses of the G20 to the crisis have been heavily criticized for failing to address the needs of those countries excluded from the table — namely low-income countries.[5]

For a leaders' group to work effectively in form, and responsibly in function, it must respect democratic principles of inclusion, representation, transparency and accountability, and must provide avenues for hearing citizens' voices. Such a forum needs to be flexible and manageable in terms of its size and membership, while also ensuring that political leadership can be brought to bear on global challenges. Its policies must promote the interests of the global community in general, while reflecting the diversity of countries in particular. Ultimately, building an international leaders' forum must also be done within the context of strengthening multilateralism more generally and the role of the United Nations in particular.

Inclusive of the world's poorest countries. The G20 is not inclusive of the needs or interests of the world's poorest countries.[6] Indeed, the vast majority of the world's countries, which are disproportionately suffering from the impacts of the crisis, are not even at the table. All told, 173 countries with seats at the UN have no voice at the G20. There is not a single low-income or least developed country in the pack or a single fragile state.

Only one country represents sub-Saharan Africa (SSA) — South Africa. Yet South Africa cannot be expected to represent the interests of the entire region, as well as its own national interests. Nor can it speak effectively to the political and economic realities of SSA's diverse range of countries. Recovery for these countries will require distinct strategies reflecting their specific realities, which include high debt loads, a narrower range of exports, a weaker industrial base, a large rural population, heavy disease burdens, greater dependence on aid, and recurrent internal conflict.

As long as these countries are not at the table, the issues and solutions being discussed will likely fall short of their needs and lack credibility. Instead, the issues being addressed and the solutions being proposed will continue to reflect the interests of players at the table, but not of the broader global community. As a first step for 2010, the African Union (AU) must be included in G20 meetings — as a participant, not an observer. Over time there must be further representation for LDCs at the table.

The G20 is not representative. A *global leaders' forum* may need to be limited in size, but to be legitimate and credible, it *must also be representative*. While the European Union (EU) is a member of the G20, no other regional body — such as the AU, the Association of South East Asian Nations (ASEAN) or the Union of South American Nations (UNASUR) — is at the table.

Different regions must be engaged through a constituency system with decision-making by consensus, similar to the practices of other international institutions — with the important difference that countries should be free to choose their own groupings. The chair of each constituency should rotate on a periodic basis. This could be addressed in the short term by including representatives at the G20 from other formal regional entities, such as ASEAN and UNASUR, or from more informal groupings, such as the G24 or G77.

In addition to the G20's lack of proper representation, the group lacks any *mechanisms to ensure transparency and accountability.* Ironically, just as the G8 made modest attempts to tackle transparency and accountability for decisions taken (through the 2008 G8 Accountability Framework),[7] the locus of power has shifted to an institution that is even less transparent and accountable. Civil society organizations, which since 2004 have been able to engage with the G8 through an (admittedly imperfect) civil G8 process, now have no opportunity for input into the G20.[8] In the absence of any comparable frameworks for transparency, accountability and civil society engagement, the G20 risks sacrificing the small steps the G8 has made on these issues.

In the short term, the G20 must do the following:

- Put in place measures to address these deficiencies by extending an Accountability Framework to all G20 commitments. "Expert groups" empowered to solicit and receive outside reports should support this Framework.
- Operate transparently by making meeting schedules, participants and expert lists, agenda and background documents for the G20 and expert groups publicly available on websites.
- Institutionalize evolving best practices of the current "Civil G8" dialogue within the G20, and encouraging the Expert groups to solicit and receive formal civil society submissions for G20 consideration.
- Make an accountability report drawing upon the work of the Expert groups publicly available 30 days prior to the G20's annual summit. G20 governments and parliaments should also explicitly commit to effective consultations with civil society ahead of, and between, summit meetings.

In the medium term (for example, the next five years), a global leaders' forum established within the framework of the UN (as noted below) will help ensure the transparency and accountability of this new global governing body to the broader UN membership, as well as ensure the engagement of civil society organizations in the process.

Democratizing the G20 must clearly be done within the broader context of *strengthening multilateralism more generally and strengthening the role of the UN in this system*. The UN itself needs urgent reform; but its role must be strengthened, not undermined, by any new global governing body.

In past years, various entities have underscored the need for a Global Council to help govern the global economy. Most recently, the UN Commission of Experts on the International Monetary and Financial System[9] has called for a Global Economic Coordinating Council within the UN. Such a Council could meet annually at the Heads of State level to assess developments and provide leadership in economic, social and ecological issues, and would help secure consistency and coherence in the policy goals of all the major international organizations.

In the medium term, a new global leaders' forum could replace the *ad hoc* measures proposed above for greater regional representation. A more permanent council of 20 to 30 formal constituencies could ensure that all continents and all major economies are properly represented. The members of regional multilateral bodies could nominate the spokesperson for each constituency, with the position rotating on a periodic basis.

A representative and inclusive group of 20 to 30 countries is not a bad idea. But for such a group to be effective in this role, it must avoid becoming an elite club of members focused only on promoting their self-interest — as is the case with the current formulation. If it is to manage the global economy, it must be more inclusive and more representative of, and accountable to, the needs, interests and views of a diverse range of countries. At the same time, it must pursue policies that put the broader public interests of people and the planet ahead of an obsession with the market.

Accordingly, global governance structures — existing or new — must go hand in hand with an economic paradigm that promotes global equity, justice and environmental sustainability. In such a paradigm, governments respect their human rights' obligations and all citizens can claim their rights. The current G20 formula rapidly risks losing credibility and legitimacy just as there is renewed need for a truly international forum to steer the global economy.

Rethinking development finance – new innovative sources of finance

Despite their minor role in causing the global financial crisis, developing countries have been deeply affected by it. Additional emergency funding is needed urgently to address their massive funding shortfalls:

- Last March, the IMF estimated that, in a worst-case scenario, between 22 and 48 countries would need between US$25-$138 billion to cover balance of payments' shortfalls just in 2009.[10]
- The World Bank estimated that external financing needs (in the form of private capital flows) of 59 countries would not be met in 2009, leaving a gap of US$352 billion.[11]
- By the end of 2009, developing countries were expected to lose incomes worth at least US$750 billion. In sub-Saharan Africa, the figure is over US$50 billion.[12]

Not surprisingly, the economic crisis is threatening to undo progress towards achieving the Millennium Development Goals (MDGs). For example, the 50 percent drop in average GDP growth in developing countries, relative to the pre-crisis rate, is expected to lead to an additional 1.4 to 2.8 million infant deaths in developing countries between 2009 and 2015 than would have otherwise been the case.[13]

As noted above, in addition to the $750 billion allocated to the IMF for new loans, the April 2009 G20 meeting announced a general allocation of special drawing rights (SDRs) to all countries. SDRs, an international reserve asset and the IMF's "currency," automatically increase central banks' foreign exchange reserves. Allocated relative to a country's IMF quota, the largest share of the $250 billion allocation went to the US ($42.6 billion), with developing countries expected to get around $90 billion. LICs will get $18 billion and sub-Saharan Africa will get only $10 billion.

Despite the small figures, the allocation is a positive development. SDRs can be converted into cash and used for savings, development projects, stimulus packages or debt payments. They also come without any of the conditions typically associated with the IMF.

SDRs are interest-free if they remain part of a country's reserves. Once converted into cash, however, countries must pay market interest rates for borrowing that hard currency (be it yen, dollars, euros or pounds) until the currency is converted back into SDRs. Current market interest rates are relatively low, but should they increase, the costs of this cash conversion could become a burden to countries.

Consequently, developing countries would benefit more from regular special, targeted allocations of SDRs related not to economic size but rather to economic need. Given concerns about the fluctuations of market interest rates, the use of SDRs by developing countries should also be subsidized; the conversion of SDRs into hard currency should be at zero rather than market interest rates. Finally, countries should also have the sovereign right to convert their SDRs into hard currency that can be used to fund development initiatives, not simply to build up hard currency reserves.[14]

Despite donor commitments to maintain aid flows to developing countries, Greece, Italy, Ireland and Canada, among others, have all cut or frozen their aid budgets. In addition, since aid flows are linked to gross national income in most donor countries, declining national revenues will mean declining net aid flows from these countries regardless of whether countries make explicit cuts.[15] This does not bode well.

In September 2009 at the Pittsburgh Summit, however, G20 leaders mandated the IMF to review "the range of options countries have adopted or are considering as to how the financial sector could make a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system."[16] By many countries, this declaration is seen as *de facto* support for establishing a financial transaction tax — a small tax of 0.05 percent on all financial transactions (for example, stocks, bonds, derivatives and currency exchange) that would both help stem speculative trading and also generate significant revenue.

Austrian economist Stephan Schulmeister has shown empirically that the cumulative effect of increasingly short-term trading of assets (for example, by speculative day traders) is destabilizing in the long run, and leads to long-term swings in the "fundamental equilibrium" (most efficient allocation of resources) of asset prices.[17]

A uniform tax per transaction makes short-term speculation more expensive. It would thus stabilize both short- and long-term asset prices, improving overall macroeconomic performance. From a revenue side, a rate 0.05 percent on all financial transactions could raise as much as US$690 billion annually, a sum six times greater than current global aid levels.[18] Of the moneys generated, at least 50 percent should be used for developing countries to achieve the MDGs and for climate change mitigation and adaptation.

This should not be an excuse, however, for donors to cut their aid budgets. Parallel to this, all donors need to commit to — and deliver on — increases to official development assistance flows on an accelerated timetable towards 2015 (and beyond) to meet the international commitment of 0.7 percent of gross national income, in Canada's case, by 2020.

Conclusion
Predictably, those most vulnerable to the crisis but least responsible for it have been the hardest hit. Regrettably, there is no "quick fix" solution. Sustained and far-reaching changes are needed to ensure a speedy and comprehensive recovery for all, sensitive to the needs of the most vulnerable peoples and to the planet; and to introduce measures that will protect against any such future crisis and ensure a more robust, inclusive, equitable and sustainable economy for all for the future. Now is not a time for complacency.

When world leaders gather for the G20 summit in Toronto in June 2010, Canadians will have an unprecedented opportunity to regain and reassert Canada's historical role as a bridge-builder —now between industrialized, emerging and low-income economies — and as a global leader. We call upon the Canadian government to go beyond its first steps already taken to address the immediate impacts of the crisis. It must move towards more far-reaching changes that fundamentally reshape the global economy, its governance and its institutions. Fifteen years ago, the G7 met during "time of change and opportunity." Today we have an opportunity to change.

Policy recommendations:
Towards a global leaders' forum - To achieve the broader goal of democratic governance, a global leaders' forum must include the effective participation of low-income countries. The immediate inclusion of the African Union, followed perhaps by other regional bodies, would be a step towards a more comprehensive constituency-based system. It must respect democratic principles of inclusion, representation, transparency and accountability, and must provide avenues for hearing citizens' voices. In the medium term, such a forum cannot replace the need for a democratic and global leaders' summit process within the framework of the United Nations.

Special allocations of SDRs - There should be regular special, targeted allocations of SDRs, allocated according to need, used by countries to pursue their own development objectives and provided free of conditions. A fund should be established to subsidize the cost of interest payments for countries that cannot afford to use their special allocation of SDRs.

Implement a global financial transaction tax - A transaction tax of 0.05 percent on all financial market transactions should be implemented at the global level. This would cover any financial transactions traded through stock exchanges, futures exchanges or any other facility established for the purpose of trading by financial market actors. Of the moneys generated, at least 50 percent should be used for developing countries to achieve the MDGs and for climate change mitigation and adaptation.

Endnotes

1 Commonwealth Secretariat, "Marlborough House Statement on Reform of International Institutions," June 11, 2008, http://www.thecommonwealth.org/document/180216/marlborough_house_statement.htm.

2 "IMF ripe for shakeup, Paul Martin says," Globe and Mail, July 21, 2008.

3 G20 Communiqué, "Global plan for recovery and reform: the Communiqué from the London Summit," April 2, 2009, http://www.londonsummit.gov.uk/en/summit-aims/summit-communique/.

4 The Group of Seven Finance Ministers is still meeting. That said, when members met in Iqaluit in February 2010, in the context of a more informal "fireside chat," Finance officials clearly attempted to think through the value added of the G7 in the context of the new G20 forum. Similarly, the Group of Eight Ministers is still meeting at the Heads of State level in June 2010 in Canada, just prior to the G20 meeting. "Canada looks for ways to keep G7 alive, sees loss of stature in new G20," Julian Beltrame, Canadian Press, January 15, 2010; "Finance officials meeting in Arctic consider whether the G7 is out in the cold," Los Angeles Times, February 7, 2010.

5 See Eurodad, "From London to Pittsburgh: Assessing the G20's Development Pledges," September 16, 2009, http://www.eurodad.org/uploadedFiles/Whats_New/News/Assessing_G20_Development_Pledges_Eurodad_Sept09.pdf?

6 The elements of this proposal are drawn from a 2004 paper drafted by the Canadian Council for International Co-operation, entitled "Jumpstarting Multilateralism: Ensuring a Leaders G20 promotes Global Equity and Democratic Global Governance."

7 In L'Aquila, Italy, in July 2009, the G8 released a "Preliminary Accountability Report," outlining individual financial commitments and disbursements on food security, water, health and education. The G8 also established "a senior level working group on accountability to share best practices for accountability and develop, in cooperation with relevant international organizations, a comprehensive and consistent methodological approach for a G8 Accountability Framework, with a particular attention to results." This report will be delivered in June 2010 at the G8 Summit in Toronto, Canada. http://www.g8italia2009.it/static/G8_Allegato/G8_Preliminary_Accountability_Report_8.7.09,0.pdf.

8 At the time of publication, the Government of Canada was considering putting in place a Civil G20 and was looking to a number of Canadian civil society organizations to help develop the process. The format of the meeting is not yet known, but the fact the government is considering doing this is warmly welcomed.

9 See the Stiglitz Commission report http://www.un.org/ga/president/63/commission/financial_commission.shtml.

10 IMF, "The Implications of the Global Financial Crisis for Low-Income Countries," March 2009, p. 35, http://www.imf.org/external/pubs/ft/books/2009/globalfin/globalfin.pdf.

11 World Bank, "Global Development Finance: Charting a Global Recovery – Review, Analysis, and Outlook," 2009, p.82. http://siteresources.worldbank.org/INTGDF2009/Resources/gdf_combined_web.pdf.

12 Overseas Development Institute, "The global financial crisis and developing countries: 10 country case studies," June 2009, http://www.odi.org.uk/resources/download/3413.pdf.

13 World Bank, "The Impact of the Finance Crisis on Progress Towards the Millennium Development Goals in Human Development," Development Economics Vice-Presidency and Human Development Network, February 2009, p. 2, http://siteresources.worldbank.org/INTPOVERTY/Resources/335642-1251230679308/Crisis_and_MDGs.pdf.

14 For further details, see Action Aid International, "Special Drawing Rights and the Global Reserve System," Factsheet, 2009, http://www.actionaid.org/assets/pdf%5CActionAid%20Factsheet-%20Special%20Drawing%20Rights%20%20the%20Global%20Reserve%20System.pdf.

15 The Organization for Economic Cooperation and Development (OECD) suggests that, "due to the crisis, the fall of GNI and reduced growth prospects will negatively affect the real value of targeted commitments." OECD, 2009 DAC Report on Aid Predictability: Survey on Donors' Forward Spending Plans 2009-2011, http://www.oecd.org/dataoecd/46/19/43161677.pdf.

16 G20, "Leaders' Statement – The Pittsburgh Summit," September 24-25, 2009, http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf

17 Stephan Schulmeister, "A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal," WIFO Working Papers No. 344, October 2009, http://www.wifo.ac.at/wwa/servlet/wwa.upload.DownloadServlet/bdoc/WP_2009_344$.pdf.

18 Stephan Schulmeister, op. cit.

CHAPTER 2

Global financial imbalances: Towards a new international reserve system?

Arnaud Zacharie[i] with input from Soren Ambrose[ii]

"We should resume negotiations for a fundamental reform of the world monetary system — or non-system — that is anchored primarily on a national, paper reserve currency, that is, the dollar."

Robert Triffin, US Congressional Summit on Exchange Rates and the Dollar, 1985

Introduction: A global financial system on the edge

The dollar-gold standard of currency valuations, founded in the wake of World War II and overseen by the International Monetary Fund (IMF), successfully addressed concerns about international imbalances from 1945 to 1971. This financial cooperation system was based on fixed exchange rates and the equilibrium of current balances. When the U.S. declared it would no longer guarantee the established gold price for dollars, it abrogated the standard, which is at the heart of the Bretton Woods system. Since the collapse of this system in August 1971, free movement of international capital has become the norm and currencies fluctuate freely around the U.S. dollar, which serves as the reference currency around the globe.

The collapse of the standard has aggravated global monetary instability and international financial imbalances. Typically, the global economy has relied on a small set of significant national economies that act as "locomotives." These economies ensure an adequate global demand by spending more than they save and importing more than they export.

This balance of international trade is constantly shifting. In recent decades, the United States has shouldered this role almost exclusively, amassing huge deficits, while emerging market countries such as China have accumulated massive surpluses.

The international financial and economic crisis in 2008-09 abruptly challenged the global growth model and the U.S. dollar's status as the international reserve currency. The crisis raised the issue of how imbalances affect the political flexibility of developing countries. Confronted with monetary instability, speculative attacks and debt crises, these countries have become resigned to accumulating currency reserves in an attempt to stabilize their exchange rates, thereby tying up mountains of capital which they, in fact, need to finance their development strategies.

This phenomenon explains the growing cry for a new international reserve system. While such a system may be politically complicated to implement, it would attack the problems of destabilizing capital flows, financial imbalances and the financial crises they trigger at their root.

---

i Secretary General, Centre National de Coopération au Développement (CNCD-11.11.11 / Belgium).
ii Development Finance Coordinator, ActionAid International.
Views expressed in this paper are those of the authors alone and should not be otherwise attributed.

This chapter explores the origins of international financial imbalances and evaluates the impact of the current crisis on global financial imbalances. It assesses the role of the dollar as the global reserve currency in the context of the current crisis, and considers a number of alternative options for bringing greater political flexibility in developing countries and renewed stability to the global financial system.

How the current international financial imbalances originated

Following the implementation of the "neo-liberal" economic policies of Margaret Thatcher in the U.K. and Ronald Reagan in the U.S. in the early 1980s, industrialized countries opened up their financial markets. This allowed international private investors to transfer massive amounts of investment capital from one market to another. The "Washington Consensus"[1] on development policies grew out of this Thatcher/Reagan policy revolution. The IMF and World Bank would extend these structural adjustment measures throughout the developing world and, in the 1990s, to the countries of the former Eastern Bloc.

In the early 1990s, the European monetary system crisis (resulting from speculative attacks on the pound sterling) and the adoption of the Maastricht criteria (implemented in 1992 to align economies in anticipation of a single currency) pushed the European countries to develop austerity plans and eliminate their deficits, generating a hundred-billion-dollar surplus by 1997. Such surpluses are impossible unless counterbalanced by deficits. Thus, the international savings transfers were absorbed by the United States, and also by developing countries with their newly liberalized markets.

Observing the return of savings transfers from North to South, proponents of the Washington Consensus believed they were witnessing a "miracle."[2] They had not grasped the fragility of the channels through which these transfers occurred. International investors had issued massive loans to developing countries, in particular to Asian banks, which had reinvested this capital in real estate and risky operations. The resulting speculative bubble eventually collapsed when the international investors abruptly withdrew private capital. After the Mexican crisis of 1994-95 came the East Asian crisis, which started in Thailand (July 1997) and reverberated in Russia (August 1998), Brazil (January 1999) and Argentina (December 2001).

As a result of these repeated crises, the IMF lost substantial credibility. Its premature promotion of financial liberalization in these developing countries had made them exceedingly vulnerable, and the effects of the crisis had been felt all the way to Wall Street. As emphasized by Joseph Stiglitz, winner of the Nobel Prize for Economics, "capital account liberalization was the most important factor leading to the crisis."[3]

Finally, through currency exchange rate devaluations and stiff reductions in their expenses and imports, the countries hit by the crisis eliminated their deficits and rebuilt surpluses. The report of the United Nations' Commission of Experts on Reforms of the International Monetary and Financial System ("The Stiglitz Commission") notes the following:

> "(A)s a result of a sequence of severe crises experienced since the breakdown of the Bretton Woods system, a number of developing countries, particularly in Asia and Latin America, have sought new instruments to protect themselves against global financial and economic instability. Coupled with the increasing unwillingness of developing countries to submit to the conditionalities associated with IMF lending, this has led to a massive accumulation of reserves over the past two decades."[4]

In the early 2000s, the Bush administration in the U.S. faced a serious over-accumulation crisis and the collapse of a stock market bubble. The U.S. reduced its key interest rate sharply, cut taxes and increased public spending to enable private actors to eliminate their debts and help the economy shake off the recession. With businesses failing to spend enough as they concentrated on restructuring their liabilities, the U.S. boosted demand and served as the locomotive for the global economy by increasing its household debt. The result: unparalleled budget and trade deficits. American households took advantage of lower interest rates to invest in real estate and engage in other types of spending, boosting the imports that fuel international growth.

Huge U.S. deficits thus counterbalanced the surpluses accumulated by Japan, by emerging nations such as China, and by the oil-producing countries, which benefited from higher oil prices. The financial balance of the world's top economic power became dependent on massive savings transfers. Thus, the United States borrowed $800 billion in 2005 and $850 billion in 2006, which amounts to $2.3 billion a day — an eightfold increase in 10 years![5]

Who lent all this money to the United States? In 2005, the oil-exporting countries chalked up a surplus of $350 billion; the emerging nations of Asia recorded $240 billion; and Japan loaned $160 billion.[6] Hence the nagging questions that have dogged the issue of global imbalances for years: how high can the United States allow its debt to go as it continues to spend more than it saves? And how long will the Asian countries and oil producers lend these huge sums to the U.S.?

So far the answer seems to be: indefinitely. Provoking a dollar crisis is not in the interest of emerging countries; they have invested a substantial percentage of their reserves in U.S. Treasury bonds and benefit from the risk transfer and their currencies' weakness relative to the dollar.

Still, geo-strategic interests may one day override financial considerations: say, for instance, that China engaged in political reprisals and cut off its loans to the U.S. In that case, though, the complex chain of international financial circuits should cushion the shock: China would lend to non-Americans who would, after some unknown number of transactions, end up lending to the U.S. The ultimate effect on financing for the American economy would, surely, be close to negligible.

It would be a different story, however, if the entire world came to doubt the payment capacity of the U.S. and every country reduced its loans to the major world economic power. And indeed, the financial crisis has had serious consequences for the United States' debt, the reputation of the U.S. dollar and international monetary instability.

The impact of the crisis on international financial imbalances

In the words of UNCTAD,

> "The present economic crisis was not a bolt from the blue; it broke out following years of huge disequilibria within and among major national economies. The most visible evidence of imbalances were the large current-account deficits in the United States, the United Kingdom, Spain and several East European economies, on the one hand, and large and growing surpluses in China, Japan, Germany and the oil-exporting countries on the other."[7]

Taking advantage of lower interest rates in the early 2000s (plummeting to one percent in 2003-04), American households invested massively in real estate and bought on credit. This strategy enabled the U.S. economy to shake off the recession caused by the collapse of a stock market bubble. Simultaneously, it provided the global economy with a powerful locomotive.

The banks, however, gradually developed riskier mortgage credits addressed to less solvent households, known as "subprime mortgages." These "subprimes" are complex, variable-interest mortgage credits with the important characteristic that the repayment charges associated with them increase over time. These credits accounted for 40 percent of new mortgage credits granted in the United States in 2006.[8]

In late 2006, with the interest rate hike (from 1 percent in mid-2004 to 5.25 percent by mid-2006), some households had trouble making payments and were forced to sell their houses even as prices fell. In early 2007, the malady had infected some 20 financial institutions that had granted these high-risk loans and been forced into bankruptcy due to insufficient repayment.

Because complex chains link financial investors worldwide, the crisis quickly spread throughout the world financial system. These chains can diffuse risks, but they can also propagate them, feeding the panic that arises when things go wrong. Indeed, the financial institutions that had granted these subprime mortgages covered themselves against the risk: they transformed these mortgages into securities that investors — attracted by their high rate of return — could buy. Greater risk has a better pay-out so the speculative "hedge funds" pounced on these subprime-backed securities; pension funds and other investors accustomed to stricter precautionary rules soon followed.

All this activity gradually led to complex securities, partially subprime-based, linking investors around the world. With the first bankruptcies, the panic spread, reaching Europe and the entire international banking system. Thus, when two hedge funds at an American investment bank, Bear Stearns, went bankrupt in July 2007, the repercussions were felt in Germany, France and the United Kingdom.

In August 2007, to stave off a paralysis of the banking system, the European Central Bank (ECB) and, to a lesser extent, the U.S. Federal Reserve and the Bank of Japan, injected hundreds of billions of dollars in liquid assets into the monetary markets. The Lehman Brothers' bankruptcy in September 2008 sparked a real financial cataclysm in October, forcing the U.S. to inject hundreds of billions of dollars to save what could still be salvaged.

The opacity of the risk chains implied the banks had lost confidence in their own sector, as if the financial institutions all suspected each other of having time bombs in their accounts. This mistrust was one reason for a considerable tightening of credit to households and businesses, plunging the industrialized world into a deep recession. The real-estate crisis and the banking crisis that followed thus turned into an economic crisis — a scenario the United States and Japan had already experienced in the crisis of the late 1980s.

U.S. households' inability to absorb any more debt has consequences for global imbalances. Indeed, falling real estate prices prompted American households to tighten their belts and save rather than buy on credit, constricting the main outlet for U.S. trade partners. Between January 2008 and January 2009, according to the WTO, the volume of international trade fell by 17 percent.[9] According to Barry Eichengreen and Kevin O'Rourke, the drop in global trade between April 2008 and April 2009 compares to the drop in trade recorded in the first two years of the Great Depression of the 1930s.[10] This has affected the level of reserves in developing countries, which began to plummet in 2008.[11]

But as IMF Managing Director Dominique Strauss-Kahn has noted,

> "The issue of new sources for growth has been raised. And this is how the crisis could help in significantly reducing the major imbalances — American deficits and Chinese surpluses in particular. In the U.S., the improvement is under way: the household savings rate, which was close to zero, is now up to 5 percent and some officials are saying they hope to see it climb to 10 percent. Excellent for deficits! But who will replace the American consumer as the locomotive for global growth? Rising consumption in the major emerging nations comes to mind, of course, but will that be enough, given that the GDP of the U.S. accounts for about 25 percent of the world GDP?"[12]

The need for a new locomotive – for better or worse

It seems the global economic system ultimately needs another locomotive — for better or worse. What would "worse" look like? One scenario is a deflationary crisis, which results when oversaving depresses demand, i.e., some economies spend less than they earn but none of the others spend more than they earn. This is precisely the kind of scenario the massive recovery plans intended to avoid. In the best scenario, countries with surpluses spend their savings wisely. How? By developing sufficiently sound internal markets, through the promotion of revenue-creating jobs and financing for a sustainable development model. That would require a stable international financial architecture, which is far from the case at present.

It seems uncertain whether the U.S. economy can continue to play the role of locomotive. Together, the Paulson plan ($700 billion) and Obama's plan ($800 billion) have radically raised U.S. public debt. The IMF predicts the budget deficit will rise from 5 percent of the GDP in 2008 to 13 percent in 2009, while public debt will shoot up from 60 percent of the GDP in the late 1990s to 80 percent in 2009 and nearly 100 percent in 2010.[13] Moreover, these forecasts assume increased business activity starting in 2010, and stable interest rates.

Anxiety about the dollar is also widespread. A simple warning from China about American monetary policy weakened the value of the dollar in March 2009. There have also been calls in Japan, the second largest holder of dollars, to avoid U.S. investments unless denominated in yen.[14]

Why so much concern? Because the financial crisis poses serious problems for the stability of the system: while recovery plans mean public administrations have a growing need for outside funding to cover their deficits (rising demand), shrinking global demand means falling export revenues for the emerging nations, and a drop in their reserves (falling supply). The deficit countries must then compete even more vigorously to attract global savings, which, in turn, raises long-term interest rates. But as rates rise, it becomes more complex to get out of debt, and external financing for the U.S. becomes even chancier. That's why the emerging nations that have invested their reserves in U.S. Treasury bonds are worried: they are running a foreign exchange risk, i.e., the dollar value of their reserves could fall.

As Jacques Adda notes, "In 2008, half of the U.S. federal debt was held by foreign investors, compared with a third in 2000. By abusing their double privilege as issuers of both the international currency and the principal global reserve asset (U.S. Treasury bonds), the United States is not only risking a bond market crash, it is endangering the status of the dollar."[15]

This situation illustrates how the existing international financial architecture cannot channel funds in a stable and effective manner that could aid international economic and social development. Some governments, primarily in developing countries, have accumulated hundreds of billions of dollars in savings. After sucking up these savings, the world's top economic power then invests part of them in overly risky operations.

Worse, the current system is headed toward self-destruction. The international reference currency (the dollar) belongs to a country (the United States) sinking deeper into debt. This means the currency tends to lose its value, as well as its attractiveness for the rest of the world.

As early as the 1960s, Belgian-American economist Robert Triffin theorized that an international monetary system based on the currency of a single country would cause problems for both the country in question and the rest of the world. In "Triffin's dilemma," a growing global demand for cash in the reserve currency encourages a current account deficit in the issuing country, potentially eroding global confidence in the value of its currency. Indeed, this dilemma triggered the collapse of the Bretton Woods system. What's more, the conditions for the dilemma appear to be gradually re-emerging, with the accumulation of dollar reserves in the emerging nations and growing deficits in the United States.

Does another currency crisis lurk around the corner?

Since the beginning of the crisis, the dollar has fluctuated dramatically. As the real-estate crisis developed into a credit crisis in the United States, the dollar plummeted virtually unchecked until September 2008, when it was worth just 63 euro-cents. The Lehman Brothers' bankruptcy that same month, alongside the ensuing world financial crisis, triggered a 20 percent rise in the dollar in October 2008, which reached 78 euro-cents in February 2009.

Thus the dollar temporarily became a safe haven for international investors, while American investors repatriated their assets on a massive scale to pay off their domestic creditors. But the impact of the crisis on the U.S. public debt soon sparked a movement in the opposite direction: the dollar went into another decline, fueling anxiety about a potential collapse of the international reserve currency. That said, in Europe, the Greek debt crisis and its soaring deficit also began to weaken the Euro at the start of 2010.

Since many past dollar crises turned out to be false alarms, it is best to be cautious in presenting worst-case scenarios. Indeed, some contend there is no threat to the dollar's status at all. For Patrick Artus, it is important to recall many countries have hooked their currencies to the U.S. dollar, including most of the OPEC nations, Hong Kong and, since June 2008, China.

Artus says that imbalances within this broad dollar zone have no impact on the dollar's exchange rate because all the parties have an interest to keep the dollar from plummeting:

> "This situation is sustainable. China — along with the other emerging nations in the region — avoids another slowdown in industrial production due to lost competitiveness like the one it suffered when its currency was rising against the dollar (summer 2005 to spring 2008); the oil-producing countries maintain the value of their petroleum revenues in their currencies; the United States can continue to finance its public and international deficits at low interest. This exchange agreement has a global stabilizing effect: it avoids the chaos (falling dollar and long-term interest rate rise) which would normally result from the policies being pursued in the United States."[16]

Given the weakness of domestic demand following the global economic crisis, all of the world's economies do indeed appear to need a weak currency to boost growth via exports. At the same time, however, the falling American dollar is stifling recovery in countries with rising currencies.

Meanwhile, as they urgently redirect their development model toward domestic demand, emerging nations like China continue to mobilize huge reserves in dollars, running a foreign exchange risk. This causes a problem for the United States since it must act as "lender of last resort" while striving to reduce its long-term debt. Consequently, as Martin Wolf states, "The arguments in favour of a new system are sound."[17]

Fears about the instability of the current system have now been expressed at the highest levels. In a speech prepared for delivery to the G20 summit in Pittsburgh in September 2009, Chinese president Hu Jintao exhorted the United States to consider the consequences of its policies for the rest of the world: "Major reserve currency issuing countries should take into account and balance the implications of their monetary policies for both their own economies and the world economy with a view to upholding (the) stability of international financial markets."[18]

For his part, U.S. Federal Reserve chairman Ben Bernanke judged in October 2009 that "the dollar's reserve currency status could be threatened in the long term if budget deficits remain high."[19]

In March 2010, French President, Nicholas Sarkozy, indicated his intent to take up the issue of a new global monetary system when France chairs the G20 in 2011.[20]

Consequently, while the financial crisis and global recession should ultimately reduce international financial imbalances, the process may not be gentle or spare the financial world further chaos.

The impact of international financial imbalances on political flexibility in developing countries

The current monetary system severely limits political flexibility in developing countries, which must face unstable exchange rates and the risk of speculative attacks on their currencies:

- Monetary speculation, attracted by interest and inflation-rate differentials, tends to result in exchange rate overvaluation, undermining international competitiveness and generating a current account deficit.
- Accumulating current account deficits generally lead to external debt crises, and then to emergency loans from the IMF.

- Conditions attached to IMF loans constrict policy space; countries are thus unable to implement counter-cyclical policies.

This cycle explains why, after the repeated financial crises of the late 1990s, developing countries accumulated foreign exchange reserves to defend their currencies against speculative attacks.

Given that developing countries need capital for their own development, it may seem absurd for them to invest so much money in the world's leading economy. Of course, these investments are highly "liquid" because the United States is an excellent payer. The rate of return on U.S. Treasury bonds, however, is below what these countries could realize elsewhere. Moreover, U.S. deficits push down the dollar's value, automatically reducing the dollar value of the reserves invested by emerging nations.

So why do the OPEC and Asian developing countries lend so much to the U.S.?

Asian countries learned from their own financial crisis and built up enormous foreign exchange reserves. Abruptly losing their faith in monetary laissez-faire (a faith that only China never had), they took steps to recover the flexibility needed to support their currencies. They invested their surpluses in dollar-based securities primarily for monetary and commercial reasons: buying dollars essentially prevents the dollar from dropping too much, thus helping keep Asian currencies weak enough to make their exports attractive and "drive" their growth.

But transferring their surplus savings to the United States also gave them a stopgap solution to their financial weaknesses. Indeed, these countries have based their development on low-wage industrial exports without developing the capacity of households to support internal demand. While an export-promotion development model that relies on external demand may enable these countries to become world leaders of international trade in certain industries (textiles, electronics, etc.), their financial institutions remain relatively undeveloped. This contradiction weighs heavy on local banking systems, whose fragility does not allow them to shoulder all the risks.

This development model cannot be applied indefinitely, however, since it results in considerable disorder and perpetuates international financial imbalances. It was no accident the governor of the Central Bank of China called — a few days before the April 2009 meeting of the G20 — for a new international reserve system based on a supranational currency not linked to any one particular country (like Special Drawing Rights [SDRs]).[21]

In June 2009, the first summit of the BRIC countries (Brazil, Russia, India, China) also addressed the idea of a new reserve system. The final declaration, however, remained vague, reflecting diverging viewpoints.[22] Whereas Russia wanted to explicitly affirm the BRICs' willingness to move away from the dollar as international reference currency, the document merely evokes the need for a "stable, more diversified international monetary system."[23] Brazil agreed with the Russian proposal, but India — and especially China — refused.

The reason is simple: China is a major holder of U.S. Treasury bonds: $755.4 billion in December 2009, up from $492.6 billion in January 2008.[24] With some $800 billion in Chinese reserves invested in U.S. Treasury bonds, short-term shakiness in the dollar would automatically eat away at the value of China's reserves. An artificial balance is thus maintained because emerging nations (like China) fear the dollar will fall and their reserves will go up in smoke.

The divergent views at the BRIC summit, however, appear to concern the short-term diplomatic approach rather than the medium-term objectives. Indeed, as stressed by Benjamin J. Cohen, "The future of reserve currencies is a matter of political economy, not economics alone."[25] The political dimension is reflected in the power a reserve currency confers on its issuing country, from both the economic and the political standpoint — even though, as Triffin demonstrated, a reserve currency can also cause problems for its issuing country if it is stockpiled in the reserves of foreign nations.

Economically speaking, a reserve-currency issuing country enjoys a right of "international seigniorage" because its currency is held and used outside its borders. Moreover, this allows it to finance its deficits in its own currency. Politically, aside from the flexibility conferred by these economic advantages, the country that wields them enjoys international prestige ("soft power") and has more room to pursue diplomatic or military initiatives internationally ("hard power").

Proposals for a new international reserve system

As *Financial Times* editorial writer Martin Wolf observed the day after the G20 meeting in London on April 2, 2009, "*The world is on the road to a non-sustainable recovery. That may be better than no recovery at all, but it is not enough.*"[26] He based this observation on the G20's failure to address the major problem of global imbalances. Indeed, only the final statement of the September 2009 G20 meeting in Pittsburgh addressed the question, and then only vaguely: the G20 committed to implementing a "framework for strong, sustainable, balanced growth," aiming to "reduce development imbalances" and modernize the "architecture for international economic cooperation."[27]

Noting that "many countries have already taken important steps to expand domestic demand, bolstering global activity and reducing imbalances," the G20 countries committed in Pittsburgh to "work together to ensure that our fiscal, monetary, trade and structural policies are collectively consistent with more sustainable and balanced trajectories of growth." This goal prompted them to launch their new growth framework based on the definition of shared objectives and a "cooperative process of mutual assessment" of national action frameworks and their implications for the global growth model.

The G20 tasked the IMF to supervise the new framework, and to develop a "forward-looking analysis of whether policies pursued by individual G20 countries are collectively consistent with more sustainable and balanced trajectories for the global economy," and to "report regularly . . . on global economic developments, patterns of growth and suggested policy adjustments."

According to Aldo Caliari, it is positive that the G20 has finally considered the problem of international financial imbalances. He also points out, however, that "the exercise of implementing the 'Framework' agreed in Pittsburgh looks dangerously similar to the 2006 'multilateral consultation on surveillance' which failed to stop the macroeconomic imbalances ultimately driving the world to the current financial and economic crisis."[28] This is why the international reserve system seems to be in need of a much more profound reform, as is being increasingly proposed.

From the bancor to the global greenback

The alternative of a new international reserve system takes its inspiration from John Maynard Keynes. In 1944, at the Bretton Woods Conference, Keynes proposed the Bretton Woods system should be based on a supranational reserve currency valued on the basis of an index of commodities (the "bancor"). Instead, the conference decided on the dollar and gold to define the post-war monetary system.

As the Stiglitz Commission stresses:

> "When Keynes revised his idea of a global currency in his proposal for an International Clearing Union, as part of the preparations for what became the Bretton Woods Conference, his major concern was the elimination of asymmetric adjustment between deficit and surplus countries leading to the tendency towards deficiency of global aggregate demand and a constraint on the policy space needed for policies in support of full employment."[29]

Such a system would create a new artificial reserve currency that all countries could exchange for a contribution worth the same amount. A country affected by a deficit or crisis could exchange this "global money" against currency and solve its problem. How would this be different from the current system? It wouldn't, except the bancor would not be linked to any particular country; thus, its value would not be vulnerable to any country's deficits. If deficits became too great, bancors could be issued to compensate.

Developing countries would be encouraged to finance their development by spending the enormous surpluses accumulated to stabilize their currencies. Joseph Stiglitz proposes that global public assets, such as drugs to fight major pandemics or investments in environmental protection, be funded in this way. He suggests basing the new international reserve system on a new reference currency that he names the global greenback.[30]

Currency planets for a multipolar world

UNCTAD developed a concrete proposal for a multilateral approach aimed at ensuring global exchange rate stability.[31] It relies on the coordination of regional monetary poles: a number of reference currencies (actual or artificial), or "planets," would reflect the primary regional poles of the new multipolar world. These "planets" would be linked through a symmetric, floating system based on exchange rates automatically adjusted according to relative price differentials. Regional blocs ("satellites") could form and be linked to a reference currency ("planet").

The UNCTAD proposal is constructed around five main principles:

- *Exchange rate stabilization*: The real exchange rate is kept constant within a group of countries (one region or more) and adjusted according to changes in nominal wages.
- *Prevention of currency speculation*: Nominal exchange rates are adjusted to changes in the interest rate levels of countries; this would avoid interest rate differentials that encourage currency speculation.
- *Enduring symmetric response*: The central banks of countries with appreciating currencies must act jointly with the country whose currency is under attack to prevent it from falling.
- *Establishment of a multilateral code of conduct*
- *Global organization of the system*: A multilateral institution (new or resulting from the reform of international financial institutions) must enforce the rules by such actions as adjusting exchange rates, taking a symmetric response to speculative attacks and distributing fairly the costs and benefits of monetary interventions.

Thus, the UNCTAD proposal would require governments to transfer the management of real exchange rates to a multilateral body; this would ensure international monetary, financial and trade stability and provide more leeway for countercyclical policies, as well as policies aimed to reinforce productive capacity and create jobs. Its underlying principle is also multipolar, although a multilateral institution must use purchasing power parity to ensure symmetry of the poles.

Two options from the Stiglitz Commission

The Stiglitz Commission built its proposal on a relatively complete inventory of the various potential forms of an international reserve system. According to the Commission,

> "The current crisis provides, in turn, an ideal opportunity to overcome the political resistance to a new global monetary system. It has brought home problems posed by global imbalances, international instability, and the current insufficiency of global aggregate demand. A global reserve system is a critical step in addressing these problems, in ensuring that as the global economy recovers it moves onto a path of strong growth without setting the stage for another crisis in the future. It is also a propitious moment because the United States may find its reserve currency status increasingly costly."[32]

Taking this observation as a starting point, the commission detailed the segments to be implemented and the ways they could be put into practice. Responsibility for managing the new system would fall to the IMF or a new institution to be called the "Global Reserve Bank." The new reserve currency would thus be the IMF's SDR or a new currency called the "International Currency Certificate" (ICC).

There are two options. One would limit the system to an exchange of various countries' currencies against the world currency; these "currency swaps" between central banks would resemble the way the IMF's SDRs already work. In the alternative solution, the Global Reserve Bank would issue ICCs directly to member countries with a commitment from the countries' central banks to accept them in exchange for their own currencies.

Whichever proposal is chosen, participating states would have to hold some reserves in the international reserve currency. This currency could pay interest at a rate attractive enough to induce the central banks to use it. Annual emissions to member states would allocate the world currency according to quotas based on their weight in the world economy or their need for exchange reserves. As an incentive to stimulate global demand and eliminate global imbalances, countries maintaining surpluses would lose all or part of their allocation. A more elaborate proposal calls for adjustment of global currency emissions in response to economic cycles; this would allow emissions to be increased when countercyclical policies are necessary.

With regard to implementation, a progressive approach is suggested. A large enough group of countries could pool a portion of their reserves in a system based on a regional reserve currency that all of them would agree to hold and exchange against their own currencies. Such a system, open to any other interested country, could gradually become an alternative to the status quo.

Like UNCTAD, then, the Stiglitz Commission believes regional initiatives could become an embedded part of the new international reserve system. Consequently, it supports the idea of a network of regional reserve funds: "Such a decentralized system would have many advantages, including the possibility of solving problems associated with crises in the smaller countries at the regional level."[33]

While regional financial cooperation may not be an end in itself, it could be a first step toward a new international financial architecture. As the commission notes, "The reform of the global reserve system could take place through a global agreement or through more evolutionary approaches, including those that could build on a series of regional initiatives."[34]

Interestingly, as noted below, Asia and Latin America have already embarked on this road, although those initiatives are still in their infancy.

Chiang Mai Initiative and beyond

In September 1997, at the height of the Asian crisis, Japan proposed the creation of a true Asian Monetary Fund, but the United States and the IMF vetoed the proposal. Joseph Stiglitz says the reason is clear: "If Japan and possibly China, likely the main financial backers for an Asian Monetary Fund, were to take this path, their voices would prevail, issuing a real challenge to the leadership — and the controlling power — of the United States."[35]

Hence, in 2000, the ASEAN countries — Japan, China and South Korea — launched the Chiang Mai Initiative. This regional reserve exchange system intended to eliminate capital outflows and defaults on payment. Each member State would increase the portion of its reserves held in the currencies of other members.

A number of problems arose, however. On the one hand, if a country wants to borrow more than 20 percent of the value of a swap, it must obey the IMF's rules. On the other, the initiative, which had initial reserves of $80 billion, proved to be undercapitalized and was never actually used. In fact, when South Korea sought to increase its reserves following the crisis, it called on the U.S. Federal Reserve because the Chiang Mai initiative's reserves were insufficient.

Given this experience, the 2008 financial crisis prompted the ASEAN+3 countries to beef up the Chiang Mai Initiative. Meeting in Bangkok in February 2009 and again in June, they increased the initiative's reserve pool from $80 billion to $120 billion and moved from bilateral swaps to a multilateral exchange system. Moreover, they decided to operationalize the Chiang Mai Initiative in 2009 and establish an independent regional surveillance unit.[36] The Asian countries thus appear to be moving towards a genuine Asian Monetary Fund in all but name, although they must still take several concrete steps to accomplish this.[37]

In Latin America, a Bank of the South was established to finance the continent's integration and development. In addition, Latin American countries are considering setting up a regional monetary fund and, ultimately, adopting a single regional currency. Such an initiative would be comparable to the Chiang Mai Initiative, and would constitute an intermediate step on the path toward multilateral financial and monetary stabilization.

In 1978, seven Latin American countries[38] created the Andean Reserve Fund to use a regional reserve currency, the "Andean peso," for intraregional exchanges. The debt crisis of the 1980s struck, however, and the system was never used. The idea, in conjunction with the creation of the Bank of the South, would be to reform and expand this fund to make it a true Latin American Reserve Fund, and use a regional reserve currency for trade within the region.

In 2008, Brazil and Argentina replaced the dollar by their own currencies for trade transactions between the two countries. In July 2009, to unhook their currencies from the dollar for regional trade, they broadened the system to include the Mercosur countries. This initiative is a first step toward stabilizing regional trade, disrupted by the monetary disturbances of recent decades.[39]

Finally, in October 2009, at the seventh summit of ALBA (the "Bolivarian" integration initiative launched by Venezuela's president Hugo Chavez)[40] held in Cochabamba, Bolivia, the nine member countries announced a unified regional payment compensation system (the *Sucre*) to replace the dollar.[41]

Conclusion

Clearly, if we want to emerge from the "bubble economy" with sustainable solutions, eliminating international financial imbalances and achieving international currency stabilization is a major challenge. While more and more voices are proposing changes to the system, rallying around variations of Keynes's original proposals, the path still appears long and the obstacles numerous. Moreover, implementation of such a system should be coupled with financial regulation measures such as control over international capital movements, dismantling of tax havens or regulation of derivatives markets. Only a multilateral mechanism of this kind can guarantee enduring stability for the international financial and monetary system.

Policy recommendations:

Special Drawing Rights (SDRs) – In the short term, regional monetary funds based on regional reserve units should be implemented. The IMF should also allocate SDRs regularly in times of financial crisis and on the basis of need rather than quota or categories, making them available to countries eligible to borrow from the Extended Credit Facility; eliminate the costs of converting SDRs for the most vulnerable developing countries or subsidize costs through the sale of IMF gold or profits from other funds; create temporary or reversible SDRs for middle-income countries; facilitate the transparent transfer of surplus SDRs from wealthy countries to those with greater need; defend the use of SDRs for multiple purposes, including medium- and long-term development.

Global currency reserve – In the medium term, the UN and other agencies should convene formal discussions on the crisis of the global reserve system and work toward consensus on reforms that would eliminate dependence on the US dollar and develop a new global reserve unit not tied to any single country.

Endnotes

1 J. Williamson, "What Washington means by policy reform in Latin American adjustment: How much has happened?," Washington Institute for International Economics, 1990. In 1990, the measures of the structural adjustment programs devised by the IMF and the World Bank and implemented in the Third World were compiled into 10 commandments, baptized the "Washington Consensus" by John Williamson. The phrase referenced a convergence of philosophies among the powerful Washington-based institutions — the IMF, the World Bank and the U.S. Treasury Department.

2 World Bank, *The East Asian Miracle*, (Oxford University Press, 1993).

3 J. Stiglitz, *La grande désillussion* 2002, p. 138.

4 United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development, *Report of the Commission of Experts of the President of the General Assembly on Reforms of the International Monetary and Financial System*, United Nations, September 21, 2009, pp. 109-110.

5 Bank for International Settlements, *Annual Report 2006*, BIS, 2006, http://www.bis.org.

6 A. Brender and F. Pisani, *Les déséquilibres financiers internationaux*, La Découverte, Coll. Repères, 2007, p. 40.

7 UNCTAD, *Trade and Development Report 2009*, United Nations, Overview, 2009, pp. 4-5.

8 *Alternatives Economiques*, no. 273, October 2008.

9 WTO, *Report to the Trade Policy Review Body from the Director-General on the Financial and Economic Crisis and Trade-related Developments*, WTO, March 26, 2009, p. 3.

10 B. Eichengreen and K. O'Rourke, "A tale of two depressions," June 2009, http:// www.voxeu.org.

11 World Bank, *Global Development Finance*, World Bank, 2009, http://www.worldbank.org.

12 D. Strauss-Kahn, "Qui remplacera le consommateur américain pour tirer la croissance?", *Le Monde*, September 12, 2009.

13 IMF, "The state of public finances: Outlook and medium-term policies after the 2008 crisis", March 6, 2009.

14 *Alternatives Economiques*, no. 282, July-August 2009.

15 J. Adda, "Marché obligataire : le prochain krach ?", *Alternatives Economiques*, no. 282, July-August 2009.

16 P. Artus, "Le roi dollar," *Alternatives Economiques*, no. 283, September 2009, p. 18.

17 M. Wolf, "Le dollar, ce poison utile," *Le Monde Economie*, October 20, 2009.

18 *La Libre Belgique*, September 26-27, 2009, http://www.reuters.com, http://www.china-un.org/eng/hyyfy/t608103.htm.

19 *Le Soir*, October 3-4, 2009.

20 *Wall Street Journal*, March 5, 2010, "Sarkozy: Will Propose New Global Monetary System As G20 Head."

21 Special Drawing Rights (SDRs), created in 1969 as a global reserve asset, are the "currency" of the IMF, i.e., a unit of account specific to the IMF that represents a financial claim on member country currencies, and whose value corresponds to the sum of the four reference currencies (dollar, euro, pound and yen), calculated daily.

22 ICTSD, "Emerging economies push for global influence for first-ever BRIC summit," *Bridge Weekly Trade News Digest*, vol. 13, no. 22, June 17, 2009.

23 ICTSD, *op. cit*., June 17, 2009.

24 *http://www.federalreserve.gov/*.

25 B. J. Cohen, "The future of reserve currencies," *Finance & Development*, September 2009, p. 27.

26 M. Wolf, "Pékin a ouvert le vrai débat," *Le Monde Economie*, April 15, 2009.

27 G20, "Leaders' Statement - The Pittsburgh Summit," September 24-25, 2009, http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

28 A. Caliari, "Can the G20 have it both ways?", *Center of Concern*, September 2009.

29 United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development, *op. cit*., June 24-26, 2009, p. 100.

30 J. Stiglitz, *Un autre monde. Contre le fanatisme du marché*, Fayard, 2006, pp. 335-364.

31 UNCTAD, *op. cit*., 2009, pp. 51-53.

32 United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development, *op. cit*., June 24-26, 2009, p. 97.

33 United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development, *op. cit*., June 24-26, 2009, p. 103.

34 United Nations Conference on the World Financial and Economic Crisis and Its Impact on Development, *op. cit*., June 24-26, 2009, p. 101.

35 J. Stiglitz, *op. cit*., 2002, p. 154.

36 "Joint press statement on ASEAN+3 cooperation in response to the global economic and financial crisis," Bangkok, June 3, 2009.

37 Halifax Initiative, "The Chiang Mai Initiative: One step closer to an Asian Monetary Fund?", Issue Brief, April 2009.

38 Bolivia, Colombia, Costa Rica, Ecuador, Peru, Uruguay and Venezuela.

39 ICTSD, "Mercosur leaders urge shift away from US dollar, call for patent-free flu drugs," *Bridges Weekly Trade News Digest*, no. 28, July 29, 2009.

40 D. Azzi and D. E. Harris, "Alternative bolivarienne pour les Amériques (ALBA) : modèle ou chimère ?", in F. Polet, *Coalitions d'Etats du Sud. Retour de l'esprit de Bandung ?,* Alternatives Sud, volume 14/2007/3, 2007, pp. 105-143.

41 "Un sucre dans ce monde de brutes," *Le Soir*, October 19, 2009.

CHAPTER 3

Strings attached: how the IMF's economic conditions foil development-oriented policies for loan-borrowing countries

Nuria Molina-Gallart[i] and Bhumika Muchhala[ii]

"The IMF or any other institution must not be the ones telling us how to run the money that we borrow from them; but they do because they think they are infallible."

Gregory Gondwe, Malawian columnist

"It was tempting for macroeconomists and policy-makers alike to take much of the credit for the steady decrease in cyclical fluctuations from the early 1980s on and to conclude that we know how to conduct macroeconomic policy. We did not resist the temptation."

Olivier Blanchard, IMF Chief Economist, "Rethinking macroeconomic policy," January 2010

Introduction: A crisis in legitimacy for the international financial institutions

In the past two decades, the economic policy conditions attached to the loans of the Washington-based international financial institutions (IFIs) have become an important vehicle through which orthodox and market-oriented economic policies are carried out in developing and low-income countries. These economic policies, which are designed by the International Monetary Fund (IMF) and the World Bank and integrated into their loans and grants, have been widely criticized by the international community, including academics, civil society and social movements, as well as other international organizations and Southern governments.[1] Critics concur that conditions required by the IFIs often undermine national policy autonomy and economic development and growth in developing countries. In fact, even the World Bank and IMF have found that conditionality has failed to create the right incentives for development-oriented policy reform.[2]

In recent years, this sentiment has had an impact on the Fund's lending practices. When the IMF's recommendations during the Asian financial crisis of 1997-98 exacerbated the financial meltdown in many Asian and Latin American countries, these emerging market economies decided to repay their debts to the Fund ahead of schedule and resolved to avoid new IMF programs. By accumulating foreign exchange reserves, they indemnified themselves from having to borrow from the Fund.

But now, for the first time in almost a decade — due to the recent financial and economic crisis — the Fund is again signing loan agreements with middle-income countries, particularly in Eastern Europe. In 2007, at the end of its fiscal year, the IMF had about $11 billion in outstanding loans; since the crisis began, the IMF has committed $165 billion in

i Director, European Network on Debt and Development
ii Policy Analyst, Finance and Development Programme, Third World Network
Views expressed in this paper are those of the authors alone and should not be otherwise attributed.

new loans. In April 2009, the Group of Twenty (G20) re-established the IMF's place on the world stage by committing $1.1 trillion towards the financial crisis with the lion's share, $750 billion, channeled through the IMF. Some $250 billion has already been issued to all IMF member countries in the form of special drawing rights[3] (SDRs), the IMF's reserve asset. For the remainder, industrialized and reserve-rich governments are lending the IMF up to $500 billion for middle-income countries in need of financial assistance at market interest rates.

But while the IMF is back in business, back at the negotiating table, and back on the world economic stage, is it fit for the task? The G20 has placed the IMF centre-stage in the crisis both politically and financially, but will the IMF rise to the challenge of fundamentally rethinking the monetary and fiscal policies it recommends to developing countries or will it re-enact its pro-cyclical economic policies as it did during the Asian financial crisis? In other words, will the Fund's loan policies be an obstacle or a conduit for fundamental changes in the economic paradigm that has resulted in recurring financial crises?

This chapter first looks at some long-standing critiques of the impacts of the IMF's policy prescriptions, its influence over global economic policy and the flaws in its prescriptions. It then considers the IMF's response to both these critiques and its new role in the context of the global financial crisis. Then, in analyzing the Fund's present role and lending activities, it explores whether these changes mark a radical shift in IMF policy, or represent old policies dressed up in new clothes. After considering the implications for borrowing countries, it recommends several fundamental changes that would leave countries space to determine the orientation of their own, nationally driven economic policies.

The pervasive influence of the IMF and its macroeconomic conditions

Over the years, the scope of conditionality has gone beyond the types of policies countries are expected to follow to guarantee loan repayment and stable macroeconomic indicators. Conditionality now reflects a whole range of indirect, often tacit, policy requirements that ultimately have a more pervasive and intrusive impact on national policy space.

Lender of last resort – few options for low-income countries

Nowhere are the IMF's influence and the negative, anti-developmental impacts of its policy prescriptions more evident, than in low-income countries (LICs). Unlike advanced and emerging market economies, LICs[4] cannot access finance in private capital markets and adjust their balance of payments disequilibria by manoeuvring their exchange rates. Indeed, the IMF is often the most accessible, or even the only, source of external finance for low-income countries. When LICs were confronted with the food and fuel price increases of 2008, or the financial crisis of 2008-09, they had very little choice but to borrow from the Fund to redress balance of payments problems; this widened current account deficits, dwindled foreign exchange reserves and added to mounting debt.

Despite IMF attempts to reform the way it does business with low-income countries (both in 1999 by taking into account the national Poverty Reduction Strategy Papers and in the aftermath of the current global crisis), the fundamentals have not changed — the key problems associated with implementing a pro-cyclical macroeconomic framework still remain.

Long-term pain for a short-term gain?

Critics argue the IMF's involvement has overstepped its mandate as an international lender for balance of payments' problems as it does not have the expertise or mandate to fill that role.[5] At the heart of this problem is the fundamental mismatch between the long-term nature of LIC economic problems and development needs, and the short-term nature of the Fund's policy advice.

The Fund seeks to address short-term balance of payments' problems (e.g. within two to three years). Its macroeconomic framework thus focuses on low inflation, budget deficits and public debt levels. These strategies are designed to reassure foreign investors and institutions and project an image of macroeconomic stability to international financial markets. In this way, they help LICs gain access to foreign capital and investment.

In the short term, these policies may help restore investor confidence. Applied consistently over the long term, however, contractionary fiscal and monetary policies have a more pernicious impact, including the following:

- long-term economic growth is undermined;
- public investments for national development and for public services, such as health and education, are inhibited;
- the development of local industries is constrained, particularly by high interest rates; and,
- the mobilization of domestic revenue is neglected, as disproportionate attention is placed on securing external capital flows;

In the education sector, ActionAid's International Education Team demonstrated the chronic and severe shortage of teachers stems largely from IMF policies. Its research in Malawi, Mozambique and Sierra Leone revealed the IMF critically influences the setting of annual ceilings on public budget expenditures.[6] As these countries reduce the public wage bill to meet the ceiling set by IMF loan conditions, the governments freeze or reduce the recruitment and salaries of teachers.

In 2007, a study by the Center for Global Development assessed criticisms that the Fund's fiscal policies challenge the delivery and capacity of the health sector in low-income countries. Based on in-depth case studies from Mozambique, Rwanda and Zambia, the report found the IMF has often been too "conservative or risk-averse," and had not adequately explored "more expansionary, but still feasible, options for higher public spending."[7] The report also demonstrated through empirical evidence that the Fund's monetary policy of targeting low inflation rates, usually in the range of five to seven percent, is not justified. It called on the IMF to "help countries explore a broader range of feasible options," and with "less emphasis on negotiating short-term program conditionality."

The IMF as "policy trend-setter" and "financial gatekeeper"

Despite these impacts, the Bank and the Fund have become "trend setters" since the 1990s, advising other bilateral and multilateral donors on economic policy conditions for their developing-country clients. For example, donors, through their own bilateral budget-support and program-based approaches, still rely on IMF conditions to establish the agenda of the broader policy discussions related to poverty reduction strategies. This is the case of the Canadian International Development Agency (CIDA), and most European donors, including the European Commission, which require recipient countries to have "stable and sound macroeconomic frameworks." In practice, this policy ends up giving the IMF the power of signalling whether the country deserves aid, or not.[8] The IMF may not always be at the table in a multiple donor budget-support program with developing-country partners, but it is always preparing the menu in the kitchen.[9]

So why, despite the demonstrated damage of IMF economic conditions, do borrowing countries adhere to such conditions? At stake is not just the next tranche of IMF money, but access to financing from other sources, including bilateral donors, capital markets and other regional development banks. The IMF's advice, and the extent to which recipient countries are "on-track" with their IMF programs or the Fund's policy prescriptions, sends signals to bilateral and multilateral donors, as well as private investors: it tells them whether to offer or continue grants and loans, or to cut them short.

In 2007, for example, Sierra Leone's foreign aid suddenly dried up because of a negative IMF assessment.[10] Similarly, Ghana and Malawi apparently suspended financing for HIV/AIDS treatment because the governments diverted aid towards international reserves to fulfil an IMF requirement.[11] In 2005, the IMF's declaration that Nicaragua's program had gone off-track led to the suspension of aid and grants from the IDB, the World Bank, the European Commission, the United States and Sweden.[12]

The wrong prescription for the illness – domestic vs. external shocks

Promoting macroeconomic stability, which is at the heart of the IMF's mandate, is, of course, desirable. But IMF macroeconomic policy advice, strongly influenced by the U.S. Treasury and key European Finance Ministries, such as the German, is wrong-footed. It follows the theory that balance of payments' (BOP) deficits result from domestic policies —

policies that over-stimulate the economy and increase the country's perceived absorption capacity beyond its actual potential output.

In other words, the IMF does not give sufficient consideration to external factors and shocks that arise from the widely acknowledged volatile nature of the global economy. And yet for most of the IMF's developing-country loan borrowers, external factors such as shifts in demand for trade and volatility of capital flows, have significant impacts on the national economy's health. For example, capital flow volatility can directly affect a country's exchange rate; subsequently, any movement in exchange rates affects its trade competitiveness.

Instead of pursuing an internationally coordinated solution to redress balance of payments' problems among countries (see Chapter 2 for details), the IMF assumes that domestic policy reforms can redress global imbalances. The Fund advises its developing-country members to correct their deficits through two mechanisms:

- contractionary fiscal policies that limit government spending; and
- monetary policies that limit growth of domestic money supply and raise interest rates on government bonds.

The logic is that lowering demand and economic activity in the domestic economy will restore equilibrium to balance of payments. But this rationale ignores the external origin of the large supply shocks, which include the oil price hikes of the 1970s; the debt crisis that hit Latin America — followed by many developing countries — in the 1980s; and most recently, the food and fuel price hikes of 2008, to name just a few. Most external shocks are neither domestically induced nor temporary in nature. Ironically, IMF policies that recommend liberalizing domestic economies undermine the ability of domestic policy-makers to guard their economies from external shocks.

The financial crisis of 2008-09 – same medicine, different bottle?
The impacts of the current financial crisis on developing countries have been severe, including the following:

- export revenues have plunged;
- foreign reserve levels have shrunk to dangerously low levels;
- capital flows have switched from robust net positive inflows to net outflows;
- investments and spending have stagnated;
- remittances have dropped; and
- growth and output have ground to a halt.

As currencies began to devalue, many developing countries and transitional economies in Eastern Europe were severely impacted by the financial meltdown, precipitated by the U.S. sub-prime mortgage loans. Eastern European countries, which had rapidly liberalized their economies in the context of a lending and credit boom from Western European investors and banks, were deeply exposed to the toxic assets of international banks and firms.[13] Many of them could only turn to the IMF for help with their balance of payments' crisis and soaring debt burdens.

As a result of the crisis, as well as in response to heavy criticism from civil society and academia, the IMF has attempted to streamline its conditions. It has eliminated one type of structural condition[14] in many programs: structural performance criteria. While this is positive, its absence will likely just translate into more "prior actions" — laying on conditions to be fulfilled prior to getting a loan.

Structural benchmarks, which are not legally binding but still force policy change, will continue to be used, as well as traditional quantitative targets.[15] Structural benchmarks are long-term performance criteria required for changes in a country's economic policy or the structure of its economy or institutions. Quantitative targets measure a country's economic targets while in receipt of a loan. Not meeting these targets may halt the IMF's loan disbursements.[16]

In March 2009, the IMF also introduced the Flexible Credit Line (FCL), which provides liquidity to build foreign reserves without attaching any conditions. A country can draw from the FCL as needed and on a precautionary basis. According to the Fund, however, FCLs are only approved for "countries meeting pre-set qualification criteria," which involves "very strong fundamentals, policies, and track records of policy implementation."[17] Thus far, the FCL has only been disbursed to three countries — Mexico, Poland and Colombia — even though most developing countries negatively affected by the crisis urgently need such a facility.

The Fund now also allows countries to incur slightly higher deficits compared to historic IMF positions. It has factored in higher national deficits and spending to its loans for 2009 and 2010, and loosened fiscal targets in close to 80 percent (18 out of 23) of African countries that have an active IMF program.[18] As always, the devil is in the details, and the limited resources available in these countries have effectively constrained the governments' opportunities to adopt more growth-oriented counter-cyclical fiscal policies.

Moreover, the IMF has stated that fiscal loosening is only a temporary measure.[19] It hopes former levels of global economic growth will resume in 2010-11. This would allow countries to return to strict fiscal balances and very low levels of inflation, and a growth pattern heavily reliant on exports, foreign direct investment and international capital.

The Fund seems to have learned from past mistakes: current lending increasingly emphasizes the protection of social spending. Due to budget cuts forced on many countries, however, social protection spending and creation of decent jobs are dramatically limited.[20] IMF programs are not assessing the long-term costs of cutting today's expenditure. Fiscal tightening can condemn a whole generation of children to malnutrition as a result of the crisis.

The crisis loans of 2008-09: The proof is in the pudding

Beginning in September 2008, countries started to sign Stand-By Arrangement (SBA) loans with the IMF for the largest financial amounts yet disbursed in the Fund's lending history. The significant expansion in the size and scope of the IMF's loans can be attributed to internal changes to double access limits for LIC loans, increase available resources for loans and provide faster, simplified loan procedures. The Fund's expansion also came from the G20's decision in April 2009 to triple the Fund's lending coffers from $250 billion to $750 billion, and to politically empower it with the central institutional role in the crisis.

Analysis of the SBA loan documents by the Center for Economic and Policy Research, the European Network on Debt and Development and Third World Network is revealing. 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."

Stand-By Arrangements

During times of financial crisis, the IMF uses the Stand-by Arrangement (SBA) loan, viewed as "the Fund's workhorse lending instrument for crisis resolution."[21] SBAs, which are non-concessional and based on market interest-rates, compose the bulk of the Fund's lending portfolio. They are designed to address problems with balance of payments in developing- and emerging-market countries. The SBA was originally conceived to guarantee a country's right to access IMF funds.

In practice, crisis loans mean the following:

- 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.

In so doing, the Fund's policies reassure both the IMF's creditors and investors that the borrowing country will repay the loan and honour foreign debts.

In the core areas of pro-cyclical fiscal policies, the Fund continues to impose more of the same. In fact, in programs for countries like Latvia, Serbia and Ukraine, the Fund delayed or halted loan installments by adding requirements for deeper reductions or reforms in fiscal policy, primarily in public expenditures and tax reforms.[22]

One notable exception: as the economic recession became more severe than the IMF had forecast, the Fund increased the allowable fiscal deficit (as a percentage of GDP), and in some cases, increased it significantly. This was a positive move, but these increased fiscal deficit targets are largely temporary, and generally projected to decrease again in 2010.[23] As for the relaxed deficit levels, the IMF's apparent generosity may simply be recognition that harder limits would lead each client country "off track."[24]

With respect to monetary policy, the IMF believes reducing domestic demand for capital is the way to lower wage and price inflation. But high interest rates increase the cost of borrowing and reduce the availability of local money and credit at a time when capital inflows, national revenue sources and consumer demand have decreased significantly.

In Pakistan, for example, the IMF advised raising interest rates to 15 percent, and increasing them as necessary. In Latvia, the IMF advised raising the official interest rate by six percent in 2008.[25] Prohibitively high interest rates deny Pakistani and Latvian consumer and business borrowers access to financing and credit, and push existing borrowers to default on existing loans.

Expenditures have been cut in a number of ways. Hungary has frozen public sector wages, while eliminating a salary bonus for public servants. The Fund has also advised Hungary to cap its pension payments, postpone social benefits and trim the resources of government ministries. In Hungary's second loan review, the IMF recommends further expenditure cuts. These include funding for public transport, as well as "tightened and rationalized" transfer schemes at the local government level. "Mandatory expenditures" such as unemployment benefits and sick pay are to be retained.[26]

The Fund also asked Hungary to cancel plans to cut taxes in 2009, and instead increase its value-added tax and income tax.[27] Hungary's explicitly pro-cyclical fiscal and monetary policies leave very little room to stimulate a recessionary economy through public spending. Tax burdens have increased, and yet a low fiscal-deficit target restricts the prospect of public investment and social expenditures — funding that could boost domestic economic activity, including consumer demand.

The story is similar in other countries:
- In Ukraine, the IMF recommended freezing public wages, pensions and social transfers, postponing increases to the minimum wage for two years, and eliminating consumer subsidies for imported gas.
- In Iceland, the income policy agreement between unions and the public and private sector aimed to cut wages across the board.
- Latvia reduced its fiscal deficit by two-thirds (with one-quarter coming from cuts in public sector wages and bonuses in 2009) by placing a ceiling on its public sector wage bill.
- In Serbia, wage growth was tightly restricted, while Belarus had to reduce public sector wages to achieve a zero fiscal deficit.[28]

- In Serbia and El Salvador, gas subsidies were to be gradually phased out.
- Pakistan's second loan review involves tax and electricity tariff increases and a continuation of tight monetary policy to ensure low inflation levels.[29] In the national context of losses in export revenue and capital outflows, electricity tariffs and new tax increases recommended by the Fund places undue financial burdens on taxpayers and consumers.

The Fund's fiscal and monetary macroeconomic targets vary little from its pre-crisis policy —and this poses a serious dilemma of development policy. Such pro-cyclical economic policies are exacerbating the economic downturn in affected countries at a time when rich countries are increasing spending and credit supply to promote recovery.

The United Nations (UN) has also critiqued the Fund's contractionary policies in its flagship annual report, the *World Economic Situation and Prospects 2010*, released in December 2009. 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."[30]

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. 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.

Breaking the Monopoly – what needs to change

Counter-cyclical and nationally-driven policies

The IMF's macroeconomic analysis and assessment provided to its developing-country members needs to be more objective, flexible and country-driven for developing countries. Economic policies recommended by the Fund should be a vehicle for the effective use of aid and should allow for the national policy space to pursue pro-active development policies; they should not simply act as a traffic light to international capital.

Instead, the Fund's pro-cyclical macroeconomic advice to its developing-country borrowers is designed with the explicit objective of contracting domestic demand, reducing economic activity and shrinking government spending. The Fund's macroeconomic frameworks have no targets for achieving higher GDP growth, increasing productive investment, increasing employment and diversifying the economy. Consequently, IMF programs still prioritize financial stability (through tight fiscal and monetary policies) over job creation and growth in productive sectors of the economy. These objectives differ sharply from initiatives adopted by developed countries such as boosting domestic demand, spurring economic activity, facilitating access to credit and enabling employment increases in public sectors that employ the vast bulk of the economy's workers.

Employment expansion supported by job retention and creation programs would strengthen domestic demand and stimulate economic activity and output. Such counter-cyclical policies are intended to minimize the harmful loss of employment and economic output despite the possible increase in fiscal or current account deficits. Much-needed public spending increases in developing countries, through temporary deficits, can help spur the longer-term objective of growth and development.

Clearly, a broader heterodoxy of economic policies linked to nationally driven priorities and policy choices is needed. A 2008 civil society report points out that alternative sources and content of economic assessment would,

> "create competition in the market for macroeconomic assessment, increase the breadth of such assessments, and ensure the use of good practice development principles, such as country ownership and stakeholder participation, which are currently lacking in the Fund. This can improve the information available to both donors and domestic policy-makers while also strengthening the capacity of institutions in the South."[31]

Finally, it is also not just a narrow question of opting for one policy over another. More flexible macroeconomic policies geared towards job-creating growth can be combined with microeconomic interventions to increase the resilience of these countries to external shocks. This can occur through investment in social protection systems and enhancing access to credit by small- and medium-sized enterprises, capital controls or more progressive taxation systems.[32]

A financial paradigm fixated on the free flow of capital

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.[33]

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 enamoured 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."[34]

Not surprisingly, perhaps, the IMF was unsupportive. 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.[35] 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."[36]

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.[37]

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.

Policy recommendations:
The IMF's economic conditions need to make a fundamental departure from the pro-cyclical orientation of fiscal and monetary policy advice. They should leave countries to determine the orientation of their own, nationally driven economic policies.

Support counter-cyclical spending and investment in countries
The IMF should support counter-cyclical measures through Fund loan programs in developing countries affected by the financial and economic crisis. Priority should be given to countries that are experiencing difficulties accessing the financial resources to pursue counter-cyclical policies due to adverse market conditions.

Provide substantial and unconditional emergency resources to countries that need them
The IMF should issue and allocate Special Drawing Rights (SDRs) at a fixed interest rate, convert them using a flat user fee, and subsidize conversion charges with available funds — for example, using proceeds from the Fund's gold sales. It should stop allocating SDR resources according to quotas, which result in rich countries obtaining the overwhelming share of SDRs. Instead, as Chapters 1 and 2 note, the Fund should allocate SDRs on the basis of need and urgency, which an independent mechanism can assess for the Fund.[38]

Macroeconomic policies should foster equitable growth
Macroeconomic policies are not neutral. They have distributional impacts in different sectors of the economy; in addition, they can be narrowly focused on macroeconomic stability or also focus on equitable growth. The IMF must give countries adequate policy space to focus on the latter, and make significant and long-term investments in employment-creation and local growth, as well as social protection for the most vulnerable in society. Such policies would prioritize active labour market and industrial policies. These policies could enhance economic diversity by building capacity for value-added production and services to stimulate both domestic and external demand.

Put in place institutions to ensure macroeconomic policy advice meets basic human rights obligations - In the short term, the IMF could work with other UN agencies such as the ILO to help ensure its advice and conditions do not hinder governments from protecting and promoting basic economic, social and cultural rights. As the IMF lacks a development mandate, however, it will be necessary to empower or create alternative bodies or institutions. Such bodies should be mandated to conduct assessment and provide advice on a macroeconomic level that respects the particular development needs of low-income and developing countries. The responsibility for these institutions lies with the IMF, national authorities and social partners. Each should play a part to ensure that agreements reached between the IMF and governments are progressive and in line with international human rights obligations.

Addressing the Fund's monopoly in developing country assessment and policy advice
The IMF should not be the sole international organization shaping macroeconomic policies in developing countries. Other agencies should be urged to help assess macroeconomic policy in developing countries, and to

help formulate policy recommendations. This would break the Fund's monopoly in these areas and give others the opportunity to "signal" the stability and suitability of governments' economic policies to the international financial community.

Promote an environment conducive to domestic resource mobilization - Highly indebted countries with limited access to external finance need greater resource mobilization alongside counter-cyclical fiscal policies. Both the effectiveness and efficiency of domestic resource mobilization would be enhanced if institutions with true expertise and authority over development finance could provide policy guidance to developing countries. (See Chapter 5 on tax and capital flight).

Endnotes

1 For perhaps one of the most comprehensive and inclusive assessments of the Fund's economic policies, see "The Structural Adjustment Policy Review Initiative", launched by the World Bank in 1997 with civil society, governments and the Bank. The final report was released in 2004. http://www.saprin.org/global_rpt.htm.

2 For further arguments on the ineffectiveness of conditionality, see World Bank (2005) "The theory and Practice of Conditionality: A Literature Review."

3 SDRs, an international reserve asset and the IMF's "currency," automatically increase central banks' foreign exchange reserves, but also come without any of the conditions typically associated with the IMF. Allocated relative to a country's IMF quota, through this issuance of $250 billion, the largest share will go to the U.S. ($42.6 billion), with developing countries expected to get around $90 billion. Low-income countries will get $18 billion and sub-Saharan Africa will get $10 billion.

4 Most commonly, the term low-income countries refers to a classification created by the World Bank, which defines those countries with a gross national income per capita of $975 or less as low income. The World Bank divides middle-income countries into two sub-categories: lower-middle income, $976 - $3,855 and upper-middle income, $3,856 - $11,905. There are currently 43 LICs.

5 Bretton Woods Project, Christian Aid, Save the Children and Action Aid International, "Reforming the role of the IMF in low-income countries: Questioning the IMF's current involvement," February 2008.

6 ActionAid International, "Confronting the Contradictions: The IMF, wage bill caps and the case for teachers," April 2007, http://www.actionaid.org/assets/pdf/1%20%20CONFRONTING%20THE%20CONTRADICTIONS%20E-VERSION.pdf.

7 Center for Global Development, "Does the IMF Constrain Health Spending in Poor Countries? Evidence and an Agenda for Action," November 2007, http://www.cgdev.org/doc/IMF/IMF_Report.pdf.

8 Eurodad: "Outcome based conditionality: too good to be true?" February 2008, http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Outcome_based_conditionality.pdf .

9 Canadian Council for International Co-operation, Halifax Initiative Coalition, "At the Table or in the Kitchen? CIDA's new aid strategies, developing country ownership and donor conditionality," September 2004, http://www.halifaxinitiative.org/updir/at_the_table_brief_final_eng.pdf .

10 Eurodad, "Turning the Tables: Aid and accountability under the Paris framework," Eurodad, (2008), Old Habits Die Hard, Aid and Accountability in Sierra Leone, http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Turning_the_Tables.pdf.

11 Afrodad (2007) "The Macroeconomic Framework & the Fight Against HIV/AIDS in Africa," http://www.afrodad.org/downloads/HIV%20Policy%20Brief%202007.pdf. The full case studies are available at http://www.afrodad.org/downloads/publications/FINAL%20HIV%20Malawi.pdf and http://www.afrodad.org/downloads/publications/FINAL%20HIV%20Ghana.pdf.

12 Forum Syd (2005) "International Monetary Fund Conditionality in Nicaragua: Good, Bad or Ugly?", http://attac.se/file_download/621.

13 Christoph Rosenberg, "Foreign Currency Borrowing More Risky for Eastern Europe," International Monetary Fund Survey Magazine, October 28, 2008, http://www.imf.org/external/pubs/ft/survey/so/2008/car102808a.htm.

14 Structural conditions, to be implemented during the course of a loan, seek to change the structures of institutions and incentives in borrowing countries. They required trade and financial liberalization, tax reforms, banking sector overhauls and privatization of state enterprises.

15 The Fund attaches two different types of policy conditions to their loans in poor countries. Quantitative conditions impose a set of macroeconomic targets on poor-country governments determining, for example, permissible levels of fiscal deficit and domestic credit. Structural conditions push for institutional and legislative policy reforms within countries. They include, for example, trade reform, price liberalization and privatization.

16 Global Transparency Initiative, "Transparency at the IMF: A guide for civil society on getting access to information by the IMF," September 2008, http://www.globaltransparencyinitiative.org.

17 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.

18 “A Changing IMF: Responding to the Crisis - A Factsheet,” International Monetary Fund, Washington DC, May 2009, http://www.imf.org/external/np/exr/ facts/changing.htm.

19 Eurodad: “Bail out or blow out: IMF policy advice and conditions for low-income countries at a time of crisis,” June 2009, http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Bail-out%20or%20blow-out.pdf.

20 Eurodad, Global Network and SOLIDAR: “Doing a decent job? IMF policies and decent work in times of crisis,” October 2009, http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Doing%20a%20decent%20job.pdf.

21 International Monetary Fund, “IMF Implements Major Lending Policy Improvements,” March 24, 2009, http://www.imf.org/external/np/pdr/fac/2009/pdf/032409.pdf.

22 Forthcoming, Third World Network (TWN), “The IMF’s Crisis Response Loans: Have the initial pro-cyclical conditionalities changed, or do they remain the same?” October 1, 2009.

23 Mark Weisbrot et al, “IMF-Supported Macroeconomic Policies and the World Recession: A Look at Forty-One Borrowing Countries,” Center for Economic and Policy Research, October 2009, http://www.cepr.net/index.php/publications/reports/imf-supported-macroeconomic-policies-and-the-world-recession/.

24 Jose Antonio Cordero, “The IMF’s Stand-by Arrangements and the Economic Downturn in Eastern Europe: The cases of Hungary, Latvia, and Ukraine,” Center for Economic and Policy Research, September 2009, http://www.cepr.net/index.php/publications/reports/imf-hungary-latvia-ukraine/.

25 Third World Network, “IMF Crisis Loans: Do the loan reviews alter the initial pro-cyclical fiscal conditions? The cases of Latvia, Ukraine, Pakistan, Hungary, and Serbia,” October 1, 2009, www.twnside.org.sg.

26 Ibid.

27 International Monetary Fund, “Hungary: Second Review Under the Stand-By Arrangement,” June 30, 2009, http://www.imf.org/external/pubs/cat/longres.cfm?sk=23049.0.

28 Third World Network (TWN), “The IMF’s Financial Crisis Loans: No Change in Conditionalities,” March 11, 2009, http://www.twnside.org.sg/title2/par/IMF.Crisis.Loans-Overview.TWN.March.2009.doc.

29 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.

30 United Nations, *World Economic Situation and Prospects 2010*, December 2009, http://www.un.org/esa/policy/wess/wesp2010files/wesp2010.pdf.

31 Bretton Woods Project, Christian Aid, Save the Children and Action Aid International, “Reforming the role of the IMF in low-income countries: Questioning the IMF’s current involvement,” February 2008.

32 Stiglitz, Ocampo, Spiegel, French-Davis and Nayyar, *Stability with Growth: Macroeconomics, Liberalization, and Development*. 2006 (Oxford University Press: New York). p.70.

33 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.

34 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.

35 Ostry, Jonathan, et.al.: “Capital inflows: the role of controls,” IMF Staff Position Note, February 2010.

36 See Joseph Stiglitz, “Global financial system in need of reform,” Financial Times, July 2, 2007.

37 Martin Khor, *The Malaysian Experience in Financial-Economic Crisis Management: An Alternative to the IMF-Style Approach* (Penang, Malaysia: Third World Network, 2005).

38 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.

CHAPTER 4

Where next on debt? Forward-looking measures to address a new debt crisis

Lidy Nacpil[i] and Gail Hurley[ii]

"Don't owe; won't pay"

Jubilee 2000 slogan

Introduction: 15 years of progress on debt

In 1995, the Halifax Group of Seven (G7) meeting represented the first steps taken by Heads of State and Government officials to address the debt of low-income countries. At the meeting, G7 leaders promised to "encourage the Bretton Woods institutions to develop a comprehensive approach to assist countries with multilateral debt problems."[1] This promise led directly to the 1996 Heavily Indebted Poor Countries (HIPC) Initiative, which promised to extend multilateral debt cancellation to 42 eligible countries that met conditions imposed by the International Financial Institutions (IFIs). The Enhanced HIPC Initiative followed in 1999.

These initiatives were partly in response to citizens' campaigns around the world that called for comprehensive debt cancellation for developing countries. Under the simple message of "drop the debt," these campaigns mobilized aid agencies, trade unions, churches, celebrities and ordinary citizens to pressure world leaders to take action.

In 2005, the advocacy strategy worked again. The G8 Summit in Gleneagles extended existing HIPC agreements to a more comprehensive Multilateral Debt Relief Initiative (MDRI). Leaders agreed to cancel a further US$55 billion in debt owed to the World Bank, International Monetary Fund (IMF) and African Development Fund.[2] The Inter-American Development Bank (IDB) later agreed to participate in the initiative and cancelled US$4.4 billion in debts owed by five Latin American HIPCs.

Since the G7 Summit in Canada in 1995, US$92.78 billion in multilateral debt has been provided as relief or has been cancelled through HIPC and MDRI for the 26 countries that have graduated from the process.[3] Meanwhile, the Paris Club of 19 creditor countries has rescheduled or cancelled a total of US$539 billion in bilateral debt for 86 countries.[4]

At first glance, these headline figures sound impressive. For example, between 1995 and 2008, sub-Saharan Africa's debt-to-GNI ratio fell from 76 percent to an average of 25 percent.[5] The World Bank also reports the HIPC Initiative has helped countries increase their anti-poverty expenditures from an average of 42 percent of government revenue to 49 percent between 1999 and 2008.[6]

Clearly, some debt has been cancelled, and the external debt ratios of several developing countries have improved since 1995. But the initiatives reveal flaws and severe shortcomings both in terms of the imposition of conditions and the

i Secretary General, Freedom from Debt Movement, Philippines.

ii Formerly Policy and Advocacy Officer, European Network on Debt and Development

Views expressed in this paper are those of the authors alone and should not be otherwise attributed.

austere nature of conditions required for debt relief and cancellation (see Chapter 3), as well as the framework countries are expected to follow to maintain "sustainable" levels of debt. In fact, in many cases, the initiatives have not guaranteed external debt sustainability, as originally hoped.

Haiti is a recent case in point. The HIPC and MDRI Initiatives cancelled $1.2 billion of its debt stock. But since then, Haiti has accumulated new debt not covered by the Initiatives. As of January 2010, Haiti still owed multilateral and bilateral creditors $1.1 billion, including $441 million to the Inter-American Development Bank.

Other countries show a similar trajectory. For example, Guyana has the same debt in nominal terms now as it did before the HIPC Initiative. (In contrast to Haiti, however, Guyana's economy has grown). Countries have borrowed all over again and find themselves once again in unsustainable debt situations (or at risk of unsustainable debt).

Moreover, in the past two years, the global financial crisis and new lending to address additional financing shortfalls have seriously undermined debt cancellation. In fact, in 2009, the World Bank more than doubled its lending activities over the previous year to an unprecedented US$58 billion. Meanwhile, since the crisis broke out, the IMF has committed an additional US$170 billion.[7]

While emergency financing is essential, this expansion in lending could create significant debt problems in the near future. Consider that the debt-to-GDP ratio of 28 low-income countries is already above 60 percent — the level considered by the IMF to be a sustainable threshold.[8] UNCTAD has recently pointed to concerns over unsustainable debt in at least 42 least developed countries. In fact, the extension of new loans to developing countries, especially if disbursed at commercial rates, may well lead to a new debt crisis in the South.

According to the World Bank's Global Development Finance Report 2010, developing- country debt ratios have not increased as dramatically as was initially feared and IMF/World Bank officials do not fear new rounds of unsustainable debt in developing countries; they are more concerned about debt in high-income countries.

The debt-to-GNI ratios of many countries have indeed improved over the past 10 years. But this improvement hides important variations between countries. It also ignores the fiscal stimulus plans implemented by many governments in the context of the crisis; these were mostly funded via the issuance of debt on local bond markets and domestic debt typically carries higher interest rates. So while external debt ratios may have declined, domestic debt ratios will undoubtedly have risen in the course of the crisis.

This chapter identifies the shortfalls in current debt initiatives and the threat of a new debt crisis. It explores the various measures required to mitigate the negative effects of the crisis on developing country indebtedness; emerging mechanisms to address past wrongs; and policies needed to ensure that future sovereign lending follows responsible and sustainable practices.[9] In the current climate, we need to address today's debt crisis, and ensure we don't create a new one for tomorrow.

Shortfalls in current debt initiatives

<u>*The imposition of external conditions*</u>

International debt relief schemes are flawed because they are designed and led by lenders, not borrowers. Lenders alone decide who will benefit from debt cancellation and on what terms and conditions. Since the programs are primarily driven by, and serve, lender interests, debt relief has fostered faster economic recovery. It has not, however, guaranteed external debt sustainability in the longer term for countries.

As noted in Chapter 3, many debt movements from both South and North have denounced the HIPC Initiative for the onerous and controversial conditions that are an intrinsic part of borrowing from the World Bank and International Monetary Fund. Before debt is cancelled, beneficiary countries must spend, on average, six to seven years implementing a macroeconomic reform program supervised by the IMF and World Bank.[10] Many macroeconomic conditions were strongly opposed by governments, parliaments and civil society organizations, and also proved disastrous for national economies."

Politically motivated decisions

In 2003, the Paris Club re-wrote its own rules so it could extend debt cancellation on a case-by-case basis.[11] Far from broadening criteria and coverage to enable more countries to benefit from debt cancellation, the new rules opened the door to decisions based on geopolitical interests. For example, in 2004, middle-income Iraq secured a write-down of over 80 percent of its debt, while low-income Nigeria obtained just 67 percent a year later.

The limits of measuring debt sustainability

In 2006, the Word Bank launched its "debt sustainability framework for low-income countries."[12] Some hailed the analytical tool as the "magic bullet" for avoiding new rounds of over-indebtedness by poor countries. On the basis of an economic assessment by the World Bank and IMF, countries are stamped with a red, amber or green light to signal a high, moderate or low risk of debt distress. Lenders could then respond by extending only extremely concessional finance (or no finance at all) to "red light countries." Lender governments around the world signed up to this new tool enthusiastically.

At best, lenders' efforts have eased the pressure of debt payments. But they have not significantly reduced debt stocks (in the case of payments rescheduling, debt moratorium, securitization deals) or addressed the structural causes of debt accumulation. Thus new debts are now replacing old ones. More importantly, the problem of illegitimate debt was not addressed.

The current financial crisis – deepening vulnerabilities and a new sovereign debt crisis

Since the agreement in 2005 to expand multilateral debt cancellation, global policy-makers have portrayed developing-country debt as a "done deal." But the economic and political climate has changed substantially over the past year. The outbreak of the global financial crisis in September 2008 has left virtually no country — rich or poor — unaffected.

Multiple and simultaneous external shocks have hit developing countries hard. These include a sharp contraction in global demand, volatile world commodity prices, lower levels of migrant remittances, uncertain levels of official development assistance, increased spreads on sovereign bonds, lower levels of affordably priced capital and a fall in foreign direct investment.

Combined, these pressures have significantly worsened the budgetary position of many governments. In 2009 alone, the shortfall in external financing was estimated at between US$350 and US$635 billion.[13] By the end of 2009, developing countries were expected to lose incomes worth at least US$750 billion. In sub-Saharan Africa, the figure is over US$50 billion.[14]

Given these issues, many analysts warn of a new sovereign debt crisis. In 2007, before the outbreak of the global financial crisis, 12 low-income countries registered debt-to-GDP ratios of over 60 percent.[15] By March 2009, the IMF reported that debt-to-GDP ratios of 28 low-income countries had already exceeded 60 percent, which signaled high levels of debt distress.[16]

The IMF also had another warning: should Official Development Assistance and Foreign Direct Investment inflows decline by 30 percent relative to 2008 levels, and should low-income countries replace this shortfall by external borrowing at non-concessional or commercial rates, debt burdens would increase by another 4 percent of GDP over just one year. Thus, if the effects of the global recession are drawn out over a number of years, as some analysts predict, impoverished countries' vulnerabilities will be at a heightened risk of debt distress.[17] Indeed, the World Bank noted in September 2009 that, "a number of low-income countries are at high or moderate risk of debt distress."[18]

In its 2009 *Least Developed Countries (LDC) Report*, UNCTAD points to serious concerns over the unsustainably high debt burden in 49 LDCs.[19] Consider that, even before the crisis, several developing countries held extremely high (and climbing) debt-to-GDP ratios, including Grenada (with a debt-to-GDP ratio of 116 percent), Jamaica (108 percent), Kazakhstan (103 percent), Lebanon (101 percent), Samoa (223 percent) and the Seychelles (190 percent). In November, UNCTAD reiterated its concern, noting that developing countries' debt burdens would increase by 17 percent in the coming years.[20]

The international response – new loans

In response to these challenges, the international community has thrown new loans at developing countries, and given the IFIs a central role in delivering this money.

In April 2009, as noted elsewhere in this publication, the G20 agreed to funnel an additional US$500 billion in resources to the IMF. Between September 30, 2008, and December 31, 2009, 28 countries reached agreements with the IMF for a total of SDR$107.9 billion in new loans.[21] This follows five years in which repayments to the institution exceeded new disbursements.

Money is also flowing from other sources as well:

- In 2009, the World Bank announced US$58.8 billion to help countries cope with global recession, a 54 percent increase over the previous year and a record high for the global development institution.[22]
- The Asian Development Bank plans to increase lending assistance by more than US$10 billion in 2009-10.[23]
- The G20 announced an additional US$250 billion in support for trade finance over the next two years.
- In May 2009, the European Commission reported that Governments in 10 EU Member States had provided their export-credit guarantee agencies (ECAs) with increased insurance capacity to the magnitude of €36 billion (an average increase of 35 percent).[24]

To enable them to throw more loans at the problem, the G20 has pushed through substantial reforms to the debt sustainability framework. Essentially, the reforms re-write the rules on sustainable and unsustainable debt. Countries can now take-on and service more debt than Bank/Fund analysts previously calculated.

This is due to several factors: despite severe data difficulties, the G20 will now take into account migrant remittances when assessing countries' capacities to repay. The publicly guaranteed debts of some state-owned enterprises will also be excluded from calculations of countries' overall levels of indebtedness.[25]

Thus, the poorest countries' credit limits have essentially been expanded to accommodate the new loans.

Where next on debt?

Four key ideas currently under discussion internationally could help avoid a new debt crisis:

- placing a moratorium on all external debt service payments of developing countries;
- conducting debt audits;
- establishing a fair and transparent mechanism for the arbitration of sovereign debt; and
- developing a new framework to guide responsible lending.

Some of these proposals stem from the notion that many debts held by Southern countries are historically illegal or illegitimate. Mechanisms are needed both to evaluate the poor practices that have led to today's debts, and to ensure countries avoid future debts.

The concept of illegitimate debt

The concept of illegitimate debt emerged during the global debt crisis in the 1980s, although other terms were also used such as onerous, fraudulent, odious, criminal, immoral or unjust debts. The concept captures debts that by their nature have unacceptable, irregular, inappropriate, dubious and unjust features; cause harm to people, communities, the environment and economies; and violate widely accepted legal, political, financial, economic, environmental and ethical standards and principles. Due to all these factors, they therefore cannot legitimately be considered as debts of the people in whose name and interest they were contracted.[26]

The roots of the concept of illegitimate debt can partly be traced back to the notion of "odious debt," a concept in international law outlined in 1927 by Alexander Sacks in *The Effects of State Transformations on Their Public Debts and Other Financial Obligations.* Sacks wrote, "If a despotic power incurs a debt not for the needs or in the interest of the State, but to strengthen its despotic regime, to repress the population that fights against it, etc., this debt is odious for the population of all the State. This debt is not an obligation for the nation; it is a regime's debt, a personal debt of the power that has incurred it, consequently it falls with the fall of this power."[27] Today, illegitimate debt carries with it a much broader range of sub-categories, of which the concept of odious debt is just one.[28]

Precise and detailed consensus on the meaning and definition of illegitimate debt is still being developed.[29] Broader perspectives capture the specific and immediate circumstances, nature and consequences, and historical and systemic analysis of the debts, while narrower definitions focus on legal definitions of illegitimate debt.[30]

In recent years, important achievements have compelled governments and international institutions to recognize the issue of illegitimate debt and lay the grounds for official policy and action.

In 2006, the Government of Norway took an historic and unprecedented decision to cancel US$80 million claimed from five countries — Ecuador, Egypt, Jamaica, Peru and Sierra Leone. The debts were first incurred between 1976 and 1980, when the Norwegian government sold 156 cargo ships to the five countries. The sale was not intended to promote development needs, but to bolster Norway's shipping industry. Norway provided export credits to companies in the recipient countries to facilitate the purchase. In the Ecuadorian case, Quito assumed the company's debt when the Ecuadorian Banana Fleet folded in 1987. By 2002, although the purchased ships have never been located, Ecuador owed $50 million on an initial loan of $13.5 million.[31] While the Norwegian government used the words "failed development policy," the rationale for cancelling the debt refers to issues covered by the concept of illegitimate debt. The Norwegian government also acknowledged "creditor responsibility" for the "failed development policy," which no other government had previously done. Since then, the Norwegian government has promoted recognition of the issue in the processes and structures of the United Nations, including in the World Bank, at UNCTAD, and at the 2008 UN Financing for Development High Level Conference.

In 2007, as a result of Norway's advocacy, the World Bank released a paper on odious and illegitimate debt.[52] While the paper pointed to several problems with the concept, it did not deny its validity and relevance. It later took up the issue in two subsequent events — A Roundtable Discussion on Odious and Illegitimate Debt with governments, experts and representatives from civil society organizations in April 2008; and a World Bank Conference on Debt in October 2008 that devoted one session to illegitimate debt and responsible finance. The Bank also devoted three chapters of its most recent publication on debt — Debt Relief and Beyond — to the issue of odious debt, although the institution remains unconvinced that illegitimate debt is a priority issue.

UNCTAD also released a study on illegitimate debt in 2007 entitled "The Concept of Odious Debt in Public International Law" by Professor Robert Howse of the University of Michigan Law School.[33] The paper is much more positive than the World Bank's study with respect to the validity of the concept and the possible arenas and prospects for raising the issue. UNCTAD has since embarked on a three-year project (2009-2011) aimed at "promoting responsible lending and borrowing, including developing criteria for and assessing the legitimacy of sovereign debt." As its central feature, the project created an "Experts Group" to propose principles for responsible lending and borrowing, criteria for defining illegitimate debt and possible models for an independent mechanism to work-out debt. The Experts Group includes some representatives of debt campaigns and civil society groups.

At a national level, in 2008 and then again in 2009, the Philippine Congress decided to suspend payments for 19 debt cases on grounds covered by the concept of illegitimate debt. Unfortunately, Philippine president Gloria Arroyo vetoed the Congress decision in both instances. Nevertheless, these decisions of the Philippine Congress for two consecutive years represent important victories in asserting the issue of illegitimate debt.

Moratorium on debt payments

Some developing-country governments, international organizations and civil society groups have called for a moratorium on external debt service payments by the poorest countries as an immediate response to the problem. In April 2009, UNCTAD Secretary-General Supachai Panitchpakdi said, "debt-ridden developing countries already struggling with the economic crisis will be particularly hard hit if they do not receive some form of debt relief in the immediate future."[34] He called for a two-year debt moratorium for 49 low-income countries, which according to their calculations would release about US$26 billion in 2009 and 2010 combined.

That same month, 13 HIPC Finance Ministers declared their support for the "provision of further debt relief for the duration of the crisis financed through the sale of IMF gold reserves."[35] The final consensus outcome document of the July UN Conference on the World Financial and Economic Crisis and Its Impact on Development highlights the importance of "[d]eveloping countries facing an acute and severe shortage of foreign reserves because of the fallout of the crisis, […being able to] negotiate agreements on temporary debt standstills between debtors and creditors, in order to help mitigate the adverse impacts of the crisis and stabilize macroeconomic developments."[36]

Eurodad has calculated that a two-year moratorium on external debt service payments for the 64 Poverty Reduction Growth Facility/International Development Association-only countries (i.e. countries too poor to receive credits at commercial rates) would release over US$30.5 billion in extra finance in 2010 and 2011 combined.[37] Such an initiative would provide countries with predictable, efficient and condition-free extra resources to meet growing demand for social services and infrastructure development. But most importantly, it would not create new debt.

In late 2009, the IMF announced it would offer all low-income countries a moratorium on interest payments due on all concessional loans from July 2009 until December 2011. Foregone interest payments will amount to just US$60-70 million over two years. While this is a drop in the ocean, it does suggest that policy-makers and governments believe this sort of initiative can help safeguard critical expenditures in difficult economic times. This moratorium should be made available on demand to all those countries currently off-track to achieving the Millennium Development Goals by the target date of 2015.

A coordinated international agreement at the United Nations General Assembly would help to ensure broad buy-in. But if progress is too slow for some more progressive lenders, they should not hesitate to act unilaterally and to offer this measure to borrowers which are keen to safeguard — and increase — critical social expenditures.

A moratorium, however, can only be a temporary measure. It will not address concerns over illegitimate debt or generalized repayment difficulties.

Debt audits

In 2007, the Government of Ecuador under President Rafael Correa launched the first official comprehensive debt audit. As one of its central aims, the audit was to assess the legitimacy of debts claimed from Ecuador. The Comprehensive Public Audit Commission fully involved civil society organizations and revealed multiple instances of coercion, over-charging, corruption and lack of independent advice in the loan negotiation process. The Audit was completed in late 2008.

The Commission said it uncovered clear signs of "illegality and illegitimacy" in Ecuador's "foreign obligations."[38] This led the government to suspend payments on certain government bonds and to initiate discussions with some bilateral lenders over certain claims.[39] This process is still ongoing. Following this trend, official debt audits have begun in Paraguay, Brazil and Zimbabwe, and citizens' audits have begun in Brazil and in the Philippines.

Jubilee South, a global movement of debt campaigns and peoples' organizations from the South, are among many groups calling for comprehensive debt audits since 2001. Such audits, in their view, don't just serve a financial accounting purpose, but allow countries and citizens to do the following:

- conduct an historical and structural review of the debt problem;
- take stock of outstanding debt claims, in particular those deemed to be illegitimate;
- rigorously examine the specific circumstances in which the debts were incurred and evaluate the processes involved (including compliance with national laws and policies, adherence to democratic process, conditions and purpose of the loans and the policies and practices of lenders); and
- evaluate how the funds were spent and the subsequent impacts of the loans and on borrowing countries and peoples, including on financial markets.

Different groups have developed resource materials that provide guidelines and ideas for carrying out debt audits in a systematic and comprehensive manner.[40]

The debt audits are important not only for surfacing the issues of legitimacy or illegitimacy of the debts, but also for understanding their root causes. Neither lenders nor borrowers have fully acknowledged the structural and policy causes of the debt problem. Debt audits are needed for comprehensive and lasting solutions.

International Debt Work-out Mechanisms

Southern countries were not responsible for the current global recession. Yet they are forced to increase their debt burdens to meet rising demand for social spending. This strategy is unsustainable. Many Southern country governments want a new approach to debt that alleviates immediate pressures on government budgets in a way that does not create new debt.

The international system currently has three mechanisms for addressing developing country debt.

- creditor forums like the Paris Club created in the 1950s to address official bilateral debts;
- the London Club formed in the 1970s to address commercial bank debt; and,
- the HIPC and MDRI Initiatives that establish "debt work-outs" for multilateral debts incurred through multilateral lending agencies

Initiatives designed and led by creditors, however, lack impartiality and credibility. They offer no permanent solution to a recurrent phenomenon. Problems with bondholders are addressed through "collective action clauses" in the contracts for sovereign bonds, but these typically only remedy one kind of asset owed by borrowers (bonds). Currently, no international judicial body exists with competence to resolve issues between sovereign borrowers and their lenders.

A developing country facing general repayment difficulties — or with allegations of illegitimate debt — has no single forum to which it can turn for a fair, impartial and transparent assessment of the problem. And it is here that current international debt relief measures have fallen far short.

There is a growing call for fair and transparent international debt-workout procedures to deal with both unsustainable and illegitimate debt. Given the rising number of countries facing high debt burdens as a consequence of the current economic crisis, international discussions on such mechanisms are urgently needed.

Numerous proposals have been made with respect to establishing such a mechanism:

- In 1990, Kunibert Raffer of the University of Vienna proposed internationalizing Chapter 9 of the U.S. bankruptcy code.[41]
- In 1998, UNCTAD called for an international bankruptcy court.[42]
- In 2002, the IMF proposed a comprehensive sovereign debt-restructuring mechanism, which it would administer.[43]
- In 2003, Latin American economists, Alberto Acosta and Oscar Ugarteche, tabled the idea of a permanent "Sovereign Debt Arbitration Tribunal" (TIADS) under the United Nations.[44]
- In 2005, African Finance and Economics Ministers called for a new mechanism outside the Paris and London Club frameworks for dealing with Africa's debt problem.[45] This was echoed at the 2002 UN Conference on Financing for Development in Monterrey, the follow-up review conference in Doha in 2008 and at the 2009 Conference on the World Financial and Economic Crisis and Its Impact on Development.
- Finally, in December 2009, Eurodad released a set of 10 principles to help guide the development of a fair and transparent debt work-out procedure.[46]

If policy-makers genuinely fear renewed sovereign debt difficulties, it would appear especially urgent to re-open international discussions over a fair and transparent debt work-out procedure at the international level. There is certainly ample consensus. In addition to agreement in principle at successive UN Financing for Development summits, UNCTAD also took up the idea in a three-year project on responsible lending and borrowing.[47] As well, the Dutch Government recently tabled a proposal for an "independent and authoritative international organization" to arbitrate on debts contracted between sovereign states; this would be based at the Permanent Court of Arbitration in the Hague and would deal particularly with alleged cases of illegitimate debt.

As noted by the UN's Independent Expert on debt, Cephas Lumina,

> "an international independent debt arbitration mechanism under the auspices of a neutral, non-lending institution with sufficient global legitimacy — ideally, the United Nations — can help resolve unsustainable debt situations. Based on the principles of equity, transparency, inclusion and participation, the mechanism would help resolve debt repayment difficulties and disputes fairly and efficiently. [...] The establishment of such a mechanism would address a critical gap in the international financial system."[48]

Sovereign Democratic and Responsible Lending

As noted above, governments around the world are stepping-up the amount of loans to poor countries. During a crisis, emergency finance is extremely important, but it is even more essential to ensure that all new lending — whether in the context of the global financial crisis or not — does not generate new rounds of debt, illegitimate or not. This would be a double injustice: firstly, because countries were forced to take-on the debt due to a crisis for which they were not responsible; and secondly because the new debts financed activities that did not benefit the people. Governments have a particular responsibility to ensure that lending and borrowing is delivered in a responsible, democratic and transparent manner.

The issue of "responsible lending" by both official and private creditors has been rapidly gaining ground in international discourses on debt and aid. The Norwegian government's acknowledgement of creditor co-responsibility in lending to sovereign states (as noted above) has further fuelled the discussion.

CSOs have been demanding changes in loan contracts issued to sovereign states. These measures aim to provide guidance, fairness and certainties to borrower states and lenders, as well as protect the citizens and environments of developing nations. The proposal moves away from institutional or sector-specific approaches to dealing with concerns over "responsible lending" and "fair resolution of debt crises" towards internationally recognized legal standards for responsible financing.

CSOs have elaborated a clear set of steps for lenders and borrowers to ensure legitimate loan transactions. These are laid-out in documents such as the South-North Platform on Sovereign, Democratic and Responsible Finance and Eurodad Charter on Responsible Financing.[49]

Eurodad's charter outlines the essential components of a responsible loan:

- fair terms and conditions;
- transparent loan contraction process;
- respect for human rights and environments of recipient nations; and
- fair and efficient resolution of repayment difficulties or disputes.

Many of these charter provisions are drawn from international treaties and conventions to which lender and borrower nations are signatories.

The South-North Platform on Sovereign, Democratic and Responsible Finance articulates broad principles and demands for changes in the financial system and elaborates specific standards and rules not only on lending, but also on borrowing and on financial transactions in financial markets.

New finance needs to be extended in a responsible, transparent and pro-development manner. Governments have particular responsibilities and must adopt the principles outlined in documents such as the South-North Charter on Sovereign, Democratic and Responsible Finance and Eurodad's Charter on Responsible Financing. This will ensure that future illegitimate debts are not generated.

Conclusion

Despite claims by global policy-makers to the contrary, debt remains a major obstacle to equitable and sustainable development of South countries and the economic empowerment of the peoples of the South.

Most South countries continue to be burdened by significant external debts and debt service payments. Even the World Bank acknowledges that debt continues to be a major problem and threat to developing countries. By end-2010, as a result of the global financial crisis, 89 million more people are expected to be living in extreme poverty (defined as less than US$1.25 per day).[50] And, while countries are increasingly dedicating more money towards fighting poverty, less than half of the countries that have graduated from HIPC are on track to achieve the Millennium Development Goals.[51]

At the same time, external debt service obligations remain in place and developing countries as a whole are projected to reimburse over US$806 billion to lenders in 2009 and 2010 combined.[52] These include payments to illegitimate and unjust debt.

A new debt crisis is looming. And now, more than ever, there is an opportunity to resolve this issue for the longer term through the introduction of sovereign, democratic and responsible lending practices; support of national official and civil society audit processes; the recognition of the problem of illegitimate debt; and the establishment of a fair, transparent and independent debt work-out mechanism.

Policy recommendations:

Debt moratorium - In the immediate term, world leaders should promote a moratorium on all external debt-service payments of developing countries for a minimum of two years, or until those countries' economies have recovered. This moratorium should be made available on demand to all those countries that are currently off-track to achieving the MDGs by the target date of 2015.

Definition and recognition of illegitimate debts – World leaders should acknowledge the notion of illegitimate debt, and develop its definition and corresponding guidelines and criteria for assessing the legitimacy of sovereign debt, incorporating a human rights perspective. UNCTAD has taken an important step by forming an Experts Group to assist governments in this work. This would be in keeping with a recommendation by the UN independent expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights.

Auditing of illegitimate debts – World leaders should support comprehensive international and national debt-audit processes that will lead to the identification and immediate cancelation of all illegitimate and odious debt of developing countries. The international process should be established and executed by a United Nations body.

Framework for responsible and democratic finance – World leaders should also work to ensure that new finance is extended in a responsible, democratic and transparent manner that supports development.

Establishment of a fair, transparent sovereign debt restructuring mechanism - In the long term, governments South and North should support a process to establish, within a specified time, a Fair and Transparent Debt Workout Procedure at the international level that is part of the UN system. The discussions should be inclusive and fully involve CSOs as key stakeholders.

Endnotes

1 See G7 Halifax Summit Communiqué, June 16, 1995, http://www.g8.utoronto.ca/summit/1995halifax/communique/index.html#development

2 G8 Finance Minister's Final Communique, June 10-11, 2005, http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTDEBTDEPT/0,,contentMDK:20634752~menuPK:64166739~pagePK:64166689~piPK:64166646~theSitePK:469043~isCURL:Y,00.html.

3 See World Bank, HIPC At A Glance Guide – September 2009, http://siteresources.worldbank.org/INTDEBTDEPT/Resources/468980-1240603491481/HIPCFall2009_ENG.pdf. The 26 countries that have benefited from HIPC are Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Central African Republic, Ethiopia, Gambia, Ghana, Guyana, Haiti, Honduras, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, São Tomé and Príncipé, Senegal, Sierra Leone, Tanzania, Uganda and Zambia.

4 While welcome, this has required countries to renegotiate and reschedule their debts more than 410 times. The Paris Club itself has modified its own rules many times over to cancel or reschedule these bilateral debts. For more information on the Paris Club and its debt cancellation policies, see http://www.clubdeparis.org/sections/types-traitement/reechelonnement/termes-de-traitements.

5 Global Development Finance 2009.

6 See World Bank, HIPC At A Glance Guide – September 2009, http://siteresources.worldbank.org/INTDEBTDEPT/Resources/468980-1240603491481/HIPCFall2009_ENG.pdf. In 1995, sub-Saharan Africa registered a debt-to-GNI ratio of 76 percent. By 2008, this had declined to on average 25 percent (Global Development Finance, 2009). For the "poorest countries with weak administrations," the IMF recommends a debt-to-GNI ratio of around 30 percent.

7 See Eurodad, "From London to Pittsburgh: Assessing G20 Action for Developing Countries," September 16, 2009, http://www.eurodad.org/debt/article.aspx?id=2190&item=3820.

8 Eurodad, "Debt in the Downturn," October 2009, p.2, http://www.eurodad.org/whatsnew/reports.aspx?id=3844.

9 UNCTAD recently launched a project on responsible sovereign lending and borrowing. See http://www.uctad.org./Templates/Page.asp?intItemID=4778&lang=1.

10 The 26 countries that have reached completion point spent on average three years, four months between being eligible for debt relief at "decision point" and then full cancellation at "completion point." This does not include the time spent making changes to policies before they reached decision point.

11 See the so-called Evian Terms.

12 Debt Sustainability Framework for Low-Income Countries, http://go.worldbank.org/SOM6UQ9ZX1

13 World Bank, Global Development Finance 2009.

14 Overseas Development Institute, The global financial crisis and developing countries: 10 country case studies, June 2009, http://www.odi.org.uk/resources/download/3413.pdf.

15 World Bank, Global Development Finance 2009.

16 IMF, The Implications of the Global Financial Crisis for Low-Income Countries, March 2009, http://www.imf.org/external/pubs/ft/books/2009/globalfin/globalfin.pdf.

17 IMF, The Implications of the Global Financial Crisis for Low-Income Countries, March 2009, http://www.imf.org/external/pubs/ft/books/2009/globalfin/globalfin.pdf.

18 World Bank, Protecting Progress: The Challenge Facing Low-Income Countries in the Global Recession, September 2009, p.14, http://siteresources.worldbank.org/NEWS/Resources/WorldBankG20PaperonLICsSept2009.pdf.

19 UNCTAD Least Developed Countries Report 2009, http://www.unctad.org/Templates/webflyer.asp?docid=11721&intItemID=2068&lang=1.

20 *Centre de l'actualités de l'ONU*, Pays en développement : Le poids croissant de la dette menace leur croissance, November 10, 200, http://www.un.org/apps/newsFr/storyF.asp?NewsID=20557&Cr=dette&Cr1=.

21 Data drawn from IMF Lending Arrangements as of December 31, 2009. This includes loans through the General Resources Account (Stand-by Arrangements, Extended Arrangements and Flexible Credit Line) and the Exogenous Shocks Facility, http://www.imf.org/external/np/fin/tad/extarr11.aspx?memberKey1=ZZZZ&date1key=2009-12-31.

22 See World Bank, http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:22233771~pagePK:34370~piPK:34424~theSitePK:4607,00.html?cid=ISG_E_WBWeeklyUpdate_NL.

23 World Bank, Global Development Finance 2009, p. 87.

24 Eurodad, "Review of the DSF: Bank & Fund Declare Countries can Borrow More", 22 September 2009, http://www.eurodad.org/aid/article.aspx?id=118&item=3830

25 For a critique of reforms of the debt sustainability framework for low-income countries, see: Eurodad, Review of the DSF: Bank & Fund Declare Countries can Borrow More, September 2009, http://www.eurodad.org/whatsnew/articles.aspx?id=3830.

26 The following is a summary of issues raised as the basis for determining the illegitimacy of debt and grounds for repudiation (Jubilee South)
   a. Harm caused to people, communities, and environment;
   b. Violation of human rights;
   c. Violation of international and national laws;
   d. The violation of basic notions and rules of fairness;
   e. The violation of public trust, and obligations of transparency and accountability, the principles of good governance;
   f. The violation of democratic principles; violation of the sovereignty of peoples and nations;
   g. The use of coercion, deception, misrepresentation, manipulation;
   h. The exploitation of others' vulnerability, impoverishment and misfortune;
   i. The violation of basic assumptions of Public Contracts, i.e. Debt Contracts concerning whether
      o Parties have the mandate and authority to enter into contracts on behalf of the people;
      o Parties respect common obligations to be transparent and accountable to their citizens so that agreements respect these obligations;
      o The agreement is for the benefit of the people in whose name they are contracting the agreement;
      o The agreement, and the attendant terms and obligations should be fair and not grossly disadvantageous to one party.
   j. The violation of widely held ethical, social, political, legal, economic, environmental values, principles, standards and norms — any of which are articulated in international covenants and treaties that attest to the formal consensus and commitment among states to uphold them.
   k. The responsibility of both lenders and borrowers in the above.

27 Cited from http://www.odiousdebts.org/odiousdebts/index.cfm?DSP=subcontent&AreaID=3.

28 Other subcategories of illegitimate debt include the following: illegal debts, which do not respect the basic legal norms and procedures of the debtor country; onerous debts, which are unenforceable due to their unreasonable terms; ecological debts, which have resulted from decades of resource plundering (minerals, oils, forests, and traditional knowledge), destruction of ecosystems and cultural identities; and illegitimate debts, which are the result of ill-conceived projects of a more political than development nature.

29 In August 2009, Dr. Cephas Lumina, the UN Independent Expert on Debt, released his annual report to the Human Rights Council that calls on countries to support efforts to agree on a definition for the concept of illegitimate debt, http://www2.ohchr.org/english/issues/development/debt/docs/A-64-289.doc.

30 See Latin American and Caribbean Jubilee 2000 Platform, Tegucigalpa Declaration, 27 January 1999; Khalfan et al. "Advancing the Odious Debt Doctrine. Montreal: Centre for International Sustainable Development Law, McGill University, 2002; J. Hanlon, "Defining illegitimate debt and linking its cancellation to economic justice," Milton Keynes, Open University, 2002 ; P.P. Frere, "Illegitimate debts, debt relief and citizen audits" in, *Upheaval in the Backyard: Illegitimate Debts and Human Rights: the Case of Ecuador-Norway* (2002); *New Economics Foundation, Odious Lending: Debt Relief as if Morals Mattered* (London, New Economics Foundation, 2005); AFRODAD, *The Illegitimacy of External Debts: the Case of the Democratic Republic of the Congo* (2005), pp. 11 and 12 ; World Bank, *"The concept of odious debt: some considerations,"* September 2007; R. Howse, *The Concept of Odious Debt*

in Public International Law, UNCTAD discussion paper No. 185 (Geneva, UNCTAD, 2007; Jubilee USA Network, "Recent Developments on Odious & Illegitimate Debt," Briefing Note 5, April 2008.

31 This case is documented in Centro de Derechos Economicos y Sociales, *Upheaval in the Backyard – Illegitimate debts and human rights – The Case of Ecuador-Norway,* November 2002, http://www.cetim.ch/fr/documents/dette-CDES-ang.pdf); and Éric Toussaint, et al. "Ecuador at the cross-roads," 15 August 2007, http://www.cadtm.org/Ecuador-at-the-cross-roads.

32 World Bank, *"The concept of odious debt: some considerations,"* September 2007. This was later revised with a final version produced by Vikram Nehru and Mark Thomas, May 22, 2008, http://siteresources.worldbank.org/INTDEBTDEPT/Resources/468980-1184253591417/OdiousDebtPaper.pdf.

33 R. Howse, *The Concept of Odious Debt in Public International Law,* UNCTAD discussion paper No. 185 (Geneva, UNCTAD, 2007).

34 UNCTAD, Temporary debt moratorium needed for some poor nations, UNCTAD Chief says, April 2009, http://www.unctad.org/Templates/Webflyer.asp?docID=11446&intItemID=2068&lang=1.

35 The Commonwealth, 2009 Commonwealth Ministerial Debt Sustainability Forum – Statement, http://www.thecommonwealth.org/document/211279/2009_commonwealth_ministerial_debt_sustainability.htm.

36 United Nations General Assembly, Outcome of the Conference on the World Financial and Economic Crisis and Its Impact on Development, A/RES/63/303, 13 July 2009, Para 15, http://www.un.org/ga/search/view_doc.asp?symbol=A/RES/63/303&Lang=E.

37 Author calculations based on Global Development Finance 2009 data. To obtain the data sets, please contact the author.

38 Ecuador inmediato, Presidente de Ecuador ya dispone de pruebas sobre fraude en deuda externa, 25 September 2009, http://www.ecuadorinmediato.com/noticias/especial/88196.

39 For more details, see Ecuador's Debt Default: Exposing a Gap in the Global Financial Architecture, Neil Watkins and Sarah Anderson, Foreign Policy in Focus, http://www.fpif.org/fpiftxt/5744.

40 Centre Europe-Tiers monde and Comité pour l'annulation de la dette du tiers monde (CADTM), "Let's launch an inquiry into the debt: a manual on how to organize audits on third world debt," October 2006. This manual was based on workshops held with many organizations in Jubilee South.

41 Kunibert Raffer, Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face, 18 WORLD DEV. 301 (1990).

42 UNCTAD, *Trade and Development Report,* 1998 (United Nations publication, Sales No. E.98.II.D.10).

43 See Anne O. Krueger, "A New Approach to Sovereign Debt," Washington DC: IMF, 2002. http://imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf. Also read the debate about the IMF proposal at "Towards a Fair and Orderly Resolution to Debt Crises: A Debate between IMF, UN, NGOs, Academics and Representatives from the Private Sector and Argentina on "A Sovereign Debt Restructuring Mechanism," CIDSE/Caritas Internationalis, New Rules for Global Finance and Center of Concern, http://www.new-rules.org/docs/sdrm0902.pdf.

44 Oscar Ugarteche and Alberto Acosta, A favor de un tribunal internacional de arbitraje de deuda soberana (TIADS), January 15, 2003, http://www.odg.cat/documents/enprofunditat/Alternatives_moviments/TIADS_Ugarteche_Acosta.pdf.

45 See report of the first Conference of African ministers of economy and finance, May 7, 2005, Dakar (AU/CAMEF/Rpt (1)).

46 See Eurodad, *Sovereign Debt Work-Out Procedure: 10 Civil Society Principles*, December 2009, http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Eurodad%20debt%20workout%20principles_FINAL.pdf?n=13.

47 See UNCTAD for further information, http://www.unctad.org/Templates/Page.asp?intItemID=4778&lang=1.

48 United Nations General Assembly, *Effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights*, A/64/289, August 19, 2009, http://www2.ohchr.org/english/issues/development/debt/docs/A-64-289.doc.

49 A South-North Platform: Transforming the International Financial System: Sovereign, Democratic and Responsible Financing, September 2009, http://www.cadtm.org/Transforming-the-International; Eurodad, Eurodad Charter on Responsible Financing, January 2008, http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Responsible_Financing_Charter_report.pdf.

50 World Bank, Protecting Progress: The Challenge Facing Low-Income Countries in the Global Recession, September 2009, http://siteresources.worldbank.org/NEWS/Resources/WorldBankG20PaperonLICsSept2009.pdf.

51 International Development Association and International Monetary Fund, "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Status of Implementation," September 15, 2009, http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTDEBTDEPT/0,,contentMDK:22326067~menuPK:64166739~pagePK:64166689~piPK:64166646~theSitePK:469043~isCURL:Y,00.html.

52 Author calculations based on data received from the World Bank and World Bank Global Development Finance 2009.

CHAPTER 5

Tax Matters – How to make tax systems more just and prevent capital flight

David McNair,[i] John Christensen[ii] and Dereje Alemayehu[iii]

"I like to pay taxes. With them I buy civilization."

Oliver Wendell Holmes, Jr.

Introduction: The promise of great benefits

Globalization has promised great benefits to countries both North and South through increased trade and investment. This, in turn, promises growth in the domestic economy and industry, decent work and the development of public and social infrastructure. Countries must manage the risks of globalization effectively to realize this promise, but even their best efforts may not be enough.

Economic globalization entails the closer economic integration of countries through the increased flow of goods, services, capital and labour. The global financial crisis, however, has been a stark reminder that a high level of economic integration can leave countries vulnerable to macroeconomic shocks beyond their control:

- Economic reforms enshrined in the so-called "Washington Consensus"[1] have left developing countries particularly vulnerable to global macroeconomic shocks and the contagion of financial crises;
- Trade liberalization has led to the reduction or abolishment of trade tariffs, a major source of finance for developing countries; and
- Other policies promoted by the World Bank and International Monetary Fund (IMF) have increased the dependence of developing countries on external sources of finance including debt financing, external financial flows, foreign direct investment, aid and remittance flows. At the same time, these policies have pushed the orientation of developing-country economies towards exports and a reliance on external demand. In a globalized economy, there may be a lot to win in the good times; but in the bad times, there is even more to lose.

The volatility of these pro-cyclical sources of finance has underlined the urgency of adopting measures that will increase mobilization of domestic resources. In addition to reduced revenue from trade tariffs, developing countries frequently face multiple challenges:

- weak and under-resourced revenue authorities;
- a narrow tax base due to large informal sectors;
- low income-levels; and
- growth-oriented policies to increase income levels that are not always consistent with revenue mobilization.

i Senior Economic Justice Adviser, Christian Aid
ii Director, Tax Justice Network, International Secretariat
iii Kenya Country Manager, Christian Aid, Chair, Tax Justice Network, Africa.
Views expressed in this paper are those of the authors alone and should not be otherwise attributed.

At the same time, several factors have further undermined the capacity of states to raise revenue from the economic activity occurring within their boundaries:

- the globalization of financial flows;
- the increasing complexity of multinational corporate structures and supply chains; and
- the explicit policy of some jurisdictions to attract and harbour capital by promising lax regulation and financial secrecy. This is most evident through the phenomenon of secrecy jurisdictions (widely known as tax havens).

This chapter will explore the benefits and the challenges of domestic resource mobilization in a globalized world by presenting the mechanisms, scale and impact of capital flight and tax arbitrage. It will then summarize ongoing policy processes for international tax cooperation that address capital flight.

Tax matters - taxation and development

The state plays a crucial role to help expand people's choices. Using the tax system, the state mobilizes domestic resources, redistributes wealth, provides essential services and infrastructure, and creates a stable political environment in which the interests of citizens are represented.

Indeed, taxation is an intrinsic part of state-building, democratic development and growth. Collective bargaining around tax revenue creates a "social contract" between members of society who are paying taxes and voting for political parties, and officials who are expected to raise and spend those revenues in a manner that benefits the constituents who elected them.[2]

A strong "fiscal social contract" can, in theory, legitimize elected officials and bring sustainable economic growth.[3] Effective tax administrations can contribute to pro-poor economic growth by raising revenue for investment in human capital and infrastructure, and redistributing wealth throughout society. In fact, investors often consider strong tax administrations to be a proxy for good governance and stability.[4] Conversely, states with weak tax collection capacity are more prone to conflict and poor governance.[5]

In the long term, state-building helps states become legitimate in the eyes of their citizens. When citizens regard tax authorities as competent, and see revenues spent on improving public welfare, they are willing to contribute.[6] As Angel Gurria, Secretary-General of the Organization for Economic Cooperation and Development (OECD), has noted:

> "Taxation matters for effective state-building. Bargaining between governments and taxpayers plays a central role in the emergence of democratic governance. Citizens want more responsive government. They want the state to be accountable for its actions or inaction and taxes are the vital link between governments and societies. Improved tax relationships between state, businesses and society have provided a strong underpinning for broad-based growth and state accountability."[7]

For many countries in the South, an increased reliance on mobilizing domestic resources through tax revenues has other virtues as well. It is the best route towards ending aid dependency, as well as the problems caused by the harmful policy conditions frequently attached to bilateral and multilateral aid and debt cancellation. (Some of the problems associated with aid and debt are discussed elsewhere in this publication).

The Offshore Phenomenon: the commercialization of sovereignty

The globalization of capital, trade and commerce, which has been accelerated through the development and growth of multinational corporations (MNCs), has challenged the nature of taxation, the "fiscal social contract" and the "tax morale." The "tax culture" or "tax morale" is the willingness of citizens to contribute to tax revenues and the perceived fairness of the tax system. The "tax morale" is undermined when some sectors or members of society do not contribute to society by paying tax, and yet benefit from the policy stability, infrastructure and services that a strong tax system brings. This is a particular problem in states where political and business elites do not pay tax and use secrecy jurisdictions or "tax havens" to hide money offshore.

The OECD defines a tax haven as a jurisdiction that imposes no or nominal direct taxes on financial income or other mobile services. Tax havens lack transparency; do not engage in information exchange; and facilitate the establishment of entities with no substantial activities.[8] The low taxation and financial secrecy of such jurisdictions attract investment flows from corporations and wealthy individuals who want to take advantage of tax incentives by routing transactions via affiliates created in secrecy jurisdictions.[9]

As their main attraction, secrecy jurisdictions allow MNCs to "free-ride" on public services provided by taxpayers elsewhere. Since secrecy jurisdictions simply facilitate the outflow of capital and the avoidance and evasion of tax in countries where productive economic activity occurs, free-riding undermines the capacity of states to raise revenue. This liberates capital from its social responsibility and frees it from paying a good portion of the tax otherwise owed to national governments. This, in turn, affects the "tax morale."[10]

In effect, secrecy jurisdictions use the attribute of sovereignty — the right to make laws — for commercial gain, drawing rent surpluses from income that would otherwise accrue in larger states.[11] Individuals and companies pay millions of dollars to lawyers and accountants so they can appear to reside somewhere else. Thus, alongside the "real" state, offshore financial centres create space for virtual citizenship. This commercialization of sovereignty[12] allows those who do not see taxation as moral or civic duty, reflecting the desire to participate in a social group,[13] to simply opt out.

Of course, the undermining of one state by another is nothing new. Yet by providing secrecy and hosting assets and companies with "no questions asked," secrecy jurisdictions can facilitate corrupt practices, criminality and irresponsible financial behaviour. This contributes to systemic risk within the financial system.

The phenomenon of tax competition

Nation states, investors and multilateral institutions all play a role in encouraging tax competition, a policy that often generates "a race to the bottom."

Rather than generating revenue primarily through taxation, a number of nation states are trying to attract foreign direct investment (FDI) and capital through low tax rates and tax incentives, and, in some cases, the promise of financial secrecy. This strategy enables investors to wave a stick at states that have failed to lower tax rates or deregulate enough. With the gates open, mobile yet traditionally heavily regulated sectors such as shipping, financial services and gambling can then move into the cheapest and least regulated regimes.[14]

Frequently, multilateral institutions such as the World Bank and IMF have played a role in promoting tax competition by encouraging the lowering of corporate tax rates or granting tax-deductible capital allowances for the mining industry.[15] In the past, for example, the World Bank's *Doing Business Indicators* guaranteed higher scores to states with lower corporate taxes. This in turn influenced the decisions of investors and aid donors.[16] For its part, as documented in its Article 4 consultation papers for countries in sub-Saharan Africa, IMF policy has taken a "One Size Fits All" approach to tax, often recommending policies enshrined in the Washington Consensus.[17]

Tax competition is a major concern for developing countries, few of which can resist the pressure of providing tax concessions to multinational corporations in return for investment in what UNCTAD calls a "hidden subsidy."[18] In Africa, excessive tax concessions and subsidies awarded to mining investors, along with aggressive tax avoidance strategies practised by mining companies, have cost governments billions in lost tax revenues. Between 2003 and 2008, for example, tax concessions stopped African governments benefiting from the surge in prices for metals on global markets and likely cost the governments of Tanzania, Ghana and South Africa US$30 million, US$68 million and US$359 million a year respectively.[19]

Tax competition also has more troubling social impacts since it affects the distribution of the tax burden throughout society. Fewer capital taxes mean that owners of capital pay a relatively smaller proportion of total taxes and wage earners pay more. In turn, widespread use of secrecy jurisdictions reduces the tax base, resulting in higher taxes for other sectors of society, or less revenue for investment in state services.[20] This shift of the tax incidence increases the return on capital relative to the return on labour. As capital provides increasing returns, demand for labour is reduced. The outcome: less job creation and more income inequality.

The "artful" (tax) dodger - Transfer pricing and all that

Multinational companies (MNCs) are corporate entities that have commercial operations in more than one country. For example, one entity (a parent) might own all or most of the shares or assets in a second entity (a subsidiary). Subsidiary companies will frequently be located in different countries to manage the trade of the corporate group in those different locations. These companies will therefore trade goods, services and intangibles, such as intellectual property rights, between countries but within the company group.

A set of internationally agreed principles called "transfer pricing guidelines"[21] governs the system of trade within companies. When a company trades internationally, it must observe an "arm's length principle." This means whether the companies involved in a transaction are related or not, it must pay the same price for an item.

Increasingly, companies operating internationally can structure their operations to minimize the taxable profit of subsidiaries in countries with higher tax rates. MNCs can artificially inflate or deflate the value of their custom transactions to shift capital from one country to another. This practice enables a company to declare a lower level of taxable profit in a country with a high tax rate, and then declare this profit in a low tax jurisdiction. The company pays less overall tax, but some of the countries in which the company operates lose out on tax revenue.

Examples include hair dryers exported to an African country from the U.S. for US$3800 (median price US$25) or beds exported from an African country to the U.S. for US$5 (median price US$119.99).[22] Given that 60 percent of global trade occurs *within* rather than *between* MNCs this is a significant problem.[23]

Indeed, off the record discussions with senior accounting officials have suggested that some companies create incentives for this practice by making senior executive bonuses dependent on post-tax rather than pre-tax profit.

In addition to transfer-pricing abuse on customs transactions, companies can set up subsidiary companies in a country and keep the company artificially in debt so it never declares taxable profit. Companies can locate intellectual property rights in a sister company based in a secrecy jurisdiction meaning that fees are charged to companies for the use of this intellectual property. Given the difficulties in establishing an arm's length price for intellectual property, this can be open to abuse.

Companies can also negotiate favourable tax agreements with countries that lack expertise or the political or economic power to negotiate fair agreements. They can also take advantage of tax holidays offered to new companies investing in a country; when the tax holiday expires, they simply set up a new company and take advantage of the tax holiday again.

As a consequence of these mechanisms, countries where profit-generating activity occurs frequently lose out on tax revenue.

The scale of the problem – secrecy jurisdictions and illicit financial flows

> *"There is an important issue about transparency here because it is clear that the fact that some activities were hidden away in some jurisdictions where there wasn't any transparency...that opaqueness has contributed to the severity of the problems we are seeing in the world economy at the moment."*
>
> Stephen Timms, UK Financial Secretary to the Treasury

Due to the opacity of financial transactions within secrecy jurisdictions, it's difficult to estimate the scale of illicit capital flight. Even estimates, however, shed significant light on the scale of the problem both for developing and developed countries alike. The IMF estimated in 1999 that around $4.6 trillion, or half of cross border assets, were held in offshore financial centres (secrecy jurisdictions).[24] To put this in perspective, consider the following:

- Secrecy jurisdictions account for only 1.2 percent of world population and 3 percent of GDP, but in 1994 accounted for 26 percent of assets and 31 percent of profits of American multinationals.[25]
- Over $600 billion, or nearly three times the current levels of external debt of sub-Saharan Africa, has leaked from the continent in illicit financial flows since 1975.[26]
- Raymond Baker from the organization Global Financial Integrity estimates that globally US$500-800 billion of illicit flows exit developing and transitional economies every year.[27]
- Tax Justice Network has estimated that wealthy individuals hold $11.5 trillion offshore in secrecy jurisdictions.[28]
- Christian Aid estimates that, between 2005 and 2007, abuse of the trade pricing of commodities led $1.1 trillion in capital flow from non-EU countries into the EU and U.S.[29] The lost tax revenue on this non-arm's length pricing is estimated to cost developing countries $160 billion each year[30] — more than 30 percent higher than the global aid budget in 2008.

These estimates demonstrate the gravity of the issue and the urgent need for robust policy solutions. Due to weak international accounting standards, lax international regulation and complex multinational company structures and supply chains, companies can shift capital between tax jurisdictions to declare the minimum amount of profit in jurisdictions while maximizing profits declared in low or zero tax jurisdictions (see "The artful (tax) dodger" above).

Such opportunities, which are open to companies operating in more than one country, introduce systemic bias into the tax system that favours the largest firms.[31] In developing countries, the private sector most likely exists as large international companies and smaller businesses in the informal sector.[32] Partly since the actual tax burden falls on small- and medium-sized enterprises (SMEs) in the formal sector, these businesses are disproportionately small in number. As a result, the tax base narrows and revenues are depleted. International tax dodging thus gives an unfair advantage to the largest firms, contributing to a phenomenon known as the "missing middle."

International Tax Cooperation - the end of the beginning, or the beginning of the end?

Such processes as the 2002 UN Financing for Development (FfD) conference and its 2008 review shifted the emphasis of development policy-making towards mobilizing domestic resources.[33] The Monterrey Consensus, a product of the 2002 FfD meetings, also recognizes the need for international tax cooperation to ensure countries can benefit from the profits generated within their economies.

In addition, in the wake of the global financial crisis that erupted in 2008, tax cooperation and transparency have shot up the agenda. Developed countries, keen to find new revenue streams to fill huge deficits, have heralded the "beginning of the end of tax havens."[34] Meanwhile, in April 2009, the G20 threatened sanctions against secrecy jurisdictions that do not commit to signing a minimum of 12 bilateral agreements for sharing tax information based on the OECD model Tax Information Exchange Agreements (TIEAs). The G20, however, has relied on the OECD for technical support to develop information exchange standards, and to assess compliance with the standard.

This is problematic for two reasons:

First, the OECD's benchmark for a cooperative jurisdiction — negotiating 12 bilateral information-sharing agreements — necessarily excludes the countries not party to these agreements. In reality, secrecy jurisdictions have only signed agreements under the threat of sanctions. But since many developing countries do not have the economic or political influence to impose effective sanctions, they have been excluded from the benefits of these agreements. In 2007, for example, Chile requested negotiations for information exchange agreements with a number of secrecy jurisdictions and did not receive one positive response.

Second, to prevent "fishing expeditions," authorities must set out their case for an information request in a lengthy legal document. In effect, they must already have much of the information they are seeking before their request is granted. What's more, legal technicalities provide ample opportunities to hinder and block requests for information. Ironically, information sharing is intended to provide revenue authorities with evidence of tax evasion or avoidance, thereby creating a deterrent. If companies and individuals know that information is unlikely to be exchanged, there is no deterrent.

Two international regulatory changes would provide a significant deterrent effect to those seeking to evade or avoid tax. They would also equip revenue authorities with the information needed to identify cases worthy of further investigation in a timely way. Two other measures would help address the longer-term impacts of secrecy jurisdictions both on the economies where they are located, and on countries that suffer from the impacts of such jurisdictions.

Conclusion

In the context of the global financial crisis and the volatility of external sources of finance, countries North and South must develop more robust systems to mobilize domestic resources, including effective domestic taxation of the private sector and individuals.[35] Not only would this provide a more sustainable and less volatile source of public revenues, it would also strengthen the accountability of states to their citizens, improving domestic governance. The commercialization of sovereignty within secrecy jurisdictions must be addressed to ensure that effective domestic resource mobilization benefits the poor. This is a significant political challenge given the many vested interests, including those of political and business elites who use secrecy jurisdictions.

Policy recommendations:

Automatic information exchange - The alternative to the OECD "on request" model lies with automatic information-exchange procedures along the model adopted by the European Union.[36] A multilateral process promoted by a global body such as the UN Committee of Experts on International Cooperation on Tax Matters should replace the bilateral treaty processes pursued by the OECD. Such a body could more legitimately claim to represent the interests of the global South.

Country-by-country reporting by MNCs - To address the issue of abusive transfer pricing, multinational companies should be required to file accounts on a country-by-country basis. This policy would enable revenue authorities to identify and pursue companies engaging in non-arm's length transfer pricing. The International Accounting Standards Board (IASB) can recommend policies to be made into law in over 100 countries. While the IASB has not yet recognized the benefits of such a standard, the UK government has publicly supported country-by-country reporting; and the OECD has committed to include the standard in its guidelines for Multinational Enterprises.[37]

Addressing alternative sustainable development paths for secrecy jurisdictions - Any moves to address financial secrecy must consider alternative development paths for jurisdictions dependent on financial secrecy. As inflation results in higher prices for indigenous residents, countries that have become secrecy jurisdictions have exhibited increasing inequality; this is particularly relevant for small island states.[38] In the past, the UK's Foreign and Commonwealth Office (FCO) and Ministry of Development actively encouraged its dependencies to develop offshore financial service sectors in order to reduce dependence on external aid. Yet, as a result of dependence on this harmful economic model and in the wake of the financial crisis, some secrecy jurisdictions are now facing significant financial difficulties.[39] The Cayman Islands, for example, recently requested a financial bailout from the UK government.[40] Such jurisdictions must be supported in the transition towards a more sustainable economic model.

Greater space for setting domestic policy and capacity building for tax systems - Policy- making space for setting fiscal policy (see also Chapter 4 on conditionality), and technical assistance in both tax administration and tax policy monitoring by civil society is essential. This will ensure developing countries can mobilize domestic revenue effectively; direct taxation, in particular, has been shown to have significant positive effects on governance. In this regard, bilateral aid donors and multilateral institutions should prioritize the strengthening of tax authorities in developing countries as a development goal.

Endnotes

1 The "Washington Consensus" was a term coined in 1989 by John Williamson, then economist at the World Bank and academic with the Peterson Institute. In his work "Latin American Adjustment: How Much Has Happened?" Williamson laid out 10 key macroeconomic conditions for policy-makers at the Washington-based International Financial Institution (IFIs) to put recipient countries back on the right track. The original Washington Consensus included 1) fiscal discipline; 2) modifying Public Expenditure Priorities; 3) tax reform; 4) interest rate liberalization; 5) a competitive exchange rate; 6) trade liberalization; 7) liberalization of FDI inflows; 8) privatization; 9) deregulation; and 10) securing property rights.

2 D. Brautigam, "Introduction: taxation and state-building in developing countries," *Taxation and State-Building in Developing Countries Capacity and Consent*, Edited by D. Brautigam, O. Fjeldstad and M. Moore, (Cambridge: Cambridge University Press, 2008). Many states with high levels of taxation are not democratically representative. However, Brautigam et al. explore how state-building and state-responsiveness throughout history has been inextricably linked with taxation.

3 Investors perceive a stable, transparent and even-handed tax system as signs of established "rule of law." R. Bird, J. Martinez-Vasquez, and B. Torgler, "Societal institutions and tax effort in developing countries," *The Challenge of Tax Reform in the Global Economy*, edited by J Alm and J Martinez-Vazquez (Germany: Springer-Verlag, 2006).

4 M. Everest-Phillips, Business tax as state-building in developing countries: applying governance principles in private sector development, International Journal of Regulation and Governance 8(2): 123–154, 2008.

5 Research by Hendrix shows that as taxation increases as a share of national economic output, conflict becomes less likely. The tax/GDP ratio is strongly and negatively associated with the incidence of conflict. C. Hendrix, *Leviathan in the Tropics? Environment, State Capacity, and Civil Conflict in the Developing World*, San Diego: University of California, 2007.

6 Ibid.

7 Remarks by Angel Gurría, OECD Secretary-General at the International Conference on Financing for Development, Doha, November 29, 2008, http://www.oecd.org/document/35/0,3343,en_2649_37413_41765091_1_1_1_1,00.html.

8 OECD, *Harmful Tax Competition: An Emerging Global Issue. Paris:* OECD. 1998.

9 While tax havens are often associated with small island states, the notion they are also "offshore" does not form an official part of this definition. "Offshore" is a jurisdictional status rather than a geographic location, with increasing attention also being paid to major secrecy jurisdictions, such as the City of London and the U.S. state of Delaware.

10 "Tax morale" is strongly affected by both corruption and the perceived effectiveness and efficiency of the state in spending tax revenue. *Taxation and State-Building in Developing Countries Capacity and Consent*, Edited by D. Brautigam, O. Fjeldstad and M. Moore, (Cambridge: Cambridge University Press, 2008).

11 D. Fabri and G. Baldacchino, 'The Malta Financial Services Center: A Study in Microstate Dependency Manangement?' *Offshore Financial Centres and Tax Havens*, edited by Mark Hampton and Jason Abbott. London: Macmillan.

12 R. Palan, The Offshore World: Sovereign Markets, Virtual Places, and Nomad Millionaires, (Cornell University Press, 2003).

13 Bosco and Mittone note that tax compliance is most likely in conditions where perceived levels of redistribution are high, and individual expectations of others' compliance are high. Bosco, L. and Mittone, L., "Tax evasion and moral constraints: some experimental evidence," *Kyklos* (50) pp. 297-324. 1997.

14 R. Palan, *The Offshore World: Sovereign Markets, Virtual Places, and Nomad Millionaires*, (Cornell University Press, 2003).

15 Ibid.

16 In 2008, the Independent Evaluation Group review of the *Doing Business Indicators* recommended revision of the paying taxes indicator to include only measures of administrative burden and exclude taxes and other mandatory payments to government. The 2010 edition of the Doing Business Indicators has not implemented this recommendation.

17 J. Marshall, *One Size Fits All: IMF tax policy in sub-Saharan Africa*, Christian Aid Occasional Paper, 2009.

18 UNCTAD, "Economic Development in Africa: Rethinking the Role of Foreign Direct Investment," New York/Geneva, 2005, p 46 63.

19 Christian Aid, *A wealth of development: turning Africa's mineral resources into development through mining tax reform*, Christian Aid briefing paper, 2009. In the wake of the 2003-2008 commodity price boom, many African governments have been reviewing their mining contracts to ensure higher revenues are gleaned from future price surges. At a 2007 meeting on "Managing Africa's Natural Resources for Growth and Poverty Reduction," participants asked the UN Economic Commission for Africa to lead a pan-African research process that would provide guidelines for African governments on how to turn their mineral wealth into development benefits.

20 Norwegian Commission on Capital Flight from Poor Countries, *Tax havens and development: Status, analyses and measures, 2009.*

21 The Organization for Economic Cooperation and Development (OECD) establishes and maintains transfer- pricing rules.

22 S Pak, "Estimates of Capital Movements from African Countries to the U.S. through Trade Mispricing," 2006.

23 J Neighbour, "Transfer pricing: Keeping it at arm's length" January 2002, http://www.oecdobserver.org/news/fullstory.php/aid/670/Transfer_p.

24 IMF, Offshore Financial Centres, Background paper prepared by the Monetary and Exchange Affairs Department http://www.imf.org/external/np/maw/oshore/2000/eng/back.htm, 2000.

25 J.R. Hines and E.M. Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," Quarterly Journal of Economics 1994; Oxfam, Tax Havens: Releasing the Hidden Billions for Poverty Eradication. Oxfam Policy Papers http://www.oxfam.org.uk/policy/papers/taxhvn/tax.htm, 2000.

26 L. Ndikumana and J.K. Boyce, "New estimates of capital flight from Sub Saharan African countries: Linkages with External Borrowing and Policy Options," Working Paper Series, No. 166, Political Economy Research Institute, University of Massachusetts.

27 R.W. Baker, *Capitalism's Achilles' Heel: Dirty Money and How to Renew the Free-Market System*, (New Jersey: Wiley, 2005).

28 Tax Justice Network, *Tax us if you can*, 2005.

29 D. McNair and A. Hogg, "False Profits: robbing the poor to keep the rich tax free," London: Christian Aid. 2009. This estimate does not include intangibles such as services and intellectual property rights.

30 A. Hogg et al, *Death and Taxes: the true toll of tax dodging*, Christian Aid, 2008.

31 Nancy Birdsall, 2007, *Do No Harm: Aid, Weak Institutions, and the Missing Middle in Africa*. Centre for Global Development Working Paper 113. Washington, D.C.: Centre for Global Development.

32 Ibid.

33 The UN Financing for Development process was set up following the UN General Assembly decision in 1997 that "Due consideration should be given to modalities for conducting an intergovernmental dialogue on the financing of development." In 2002, Heads of State adopted the "Monterrey Consensus" in which countries agreed to a global response to the challenges of development finance. This consensus was reviewed in 2008 at a conference in Doha, Qatar.

34 In the lead up to the G20 London Summit in April 2009, British Prime Minister Gordon Brown heralded the "Beginning of the End of Tax Havens," http://www.guardian.co.uk/business/2009/mar/13/switzerland-tax-evasion-fight.

35 Countries faring best are those with the largest share of production and domestic consumption.

36 The European Union Savings Tax Directive, implemented in 2005, has provisions for automatic exchange of information on interest income from personal savings. This is due to be reviewed and may provide for exchange of information on trusts and other financial vehicles.

37 While this is not a binding standing, it increases the pressure on MNCs to disclose this information as part of their corporate social responsibility.

38 Jersey has the highest living costs in the world. The average price of a three-bedroom house on the island is £470,000; *15 times* the average Jersey salary. These high prices effectively price homeownership beyond the reach of a large part of the population. They have also effectively "crowded-out" the tourism industry, which is relatively poorly paid. I. Johansen, "Tax Havens – Issues and Alternatives for Small Islands." Unpublished paper written for Christian Aid. M.P. Hampton, and J. Christensen, 2007, "Competing Industries in Islands: A new tourism approach," Annals of Tourism Research, vol.34, No.4 pp 998-1020.

39 R. Palan, *The Offshore World: Sovereign Markets, Virtual Places, and Nomad Millionaires,* (Cornell University Press, 2003). Notably the UK's Inland Revenue and Treasury were largely against the encouragement of Overseas Territories and Crown Dependencies adopting offshore policies.

40 http://www.guardian.co.uk/business/2009/sep/13/british-tax-havens-need-bailouts.

Halifax
INITIATIVE
d'Halifax

153 Chapel Street,
Suite 104
Ottawa, ON K1N 1H5
CANADA

Tel.: +1 613 789-4447
Fax: +1 613 241-4170
info@halifaxinitiative.org

www.halifaxinitiative.org