

# Making Financial Markets Work for Development

## Financial Markets, Crisis and Development

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An EED working paper for the International Follow-Up Conference  
To Review the Implementation of the Monterrey Consensus  
in Doha, Qatar, Nov 29 – Dec 1, 2008

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“Do you enjoy rising prices? The whole world is talking about commodities – with the Agriculture Euro Fund you get the chance to participate in the increase in value of the seven most important agricultural commodities.” With these words the Deutsche Bank advertised one of its Investment Funds in May 2008. At the same time, food riots had erupted in Cameroon, Haiti, and other developing countries because people could not afford basic food any more after prices had risen.

*Though the increase in food prices has several reasons, and speculation may only be one of them (see below, chapter 1), the current crisis has shed light on an issue, which many people interested in development and active in this field have for a long time perceived only peripherally: The enormous influence of the international financial markets on development.*

*Incidentally, the shockwaves of the Wall Street crash are yet to hit the entire world economy. The impact on the vulnerable economies of the South will be especially severe.*

*So, from a development perspective there are sufficient reasons to look a little closer at the interrelations between financial markets and development, and to develop expertise in order to engage in advocacy work and develop the capacity to conduct campaigns.*

*This does not mean a shift away from the “core business” of development, given that the influence of financial markets on the South at least matches that of international trade.*

*Therefore, it is only consistent when under point 8 of the MDGs it is stated: “To continue the development of an open, regulated, calculable and non-discriminating trade and financial system.” So, at the upcoming conference on the financing of development in Doha, civil society should present its own ideas for a development-friendly financial system.*

# 1. The effects of the financial crisis on developing countries

The financial crisis, which began as the Subprime Crisis in the US and then subsequently developed into an international banking and credit crisis and reaching its climax with the crash at Wall Street, is the most severe disruption of the international financial markets since the Great Depression 1928/29. In contrast to the crises of the 1990s, the current crisis has its roots not in an emerging market or some developing country, but in the centre of the global financial system. While during the Asian crisis the mainstream of the finance community had blamed poor financial markets, poor supervision and “crony capitalism”, this crisis at the centre of the system reveals that the problems have deeper-lying causes. It was the new instruments and protagonists that had been hailed as “*innovation*” for years, investment banking, credit certificates, derivatives, Hedge Funds, etc. (see below, chapter 7), that brought the system to a collapse from within.

In light of the historical significance of the crisis it is too early to predict all its consequences. What we can be sure about, though, is that the world economy in general and the developing countries in particular will suffer from it for the next future.

## 1.1 Economic Crash and global recession

The financial systems of the developing countries and emerging economies are not directly hit by the collapse on Wall Street. The casino system does not exist there, or at most embryonically. However, they must nevertheless pay the price due to the spread of the financial crisis to the real economy.

This spread of the financial crisis to the real economy is already underway.<sup>1</sup> The USA is already heading for a recession. Great Britain and the Euro zone are just entering the recession.

With view to the economic weight of the USA and the other large industrialised countries this will no doubt have a great impact on the entire world economy. Global growth rates will decline significantly (UNCTAD 2008b) and the world will see a global recession. The highly vulnerable economies of the developing countries will be hit particularly. Poverty reduction programmes and measures against the environmental crisis will suffer setbacks. The Millennium Goals for Development will not be reached.

Even more so, developing countries with close economic ties to the USA such as Mexico and other countries in Central and South America will feel the impacts the hardest (Eichengreen 2007). Their exports will strongly decline due to the drop in demand from the US. Foreign investments will decline. European markets will not be able to offer alternatives because of their own crises. Also China and India, the world’s growth engines, will not be able to compensate for this decline (Keidel 2008).

It turns out once again that a stable international financial system is a global public good, and that it’s proper functioning must be at the centre of concern for development-friendly financial politics.

## 1.2 Long-term dollar weakness and high interest rates

The gigantic rescue package the US government is providing in order to avoid a complete collapse of the financial system will send the US state deficit skyrocketing for years. This will in a long-

<sup>1</sup> September 24, 2008

term perspective result in an even weaker dollar. This does not exclude, that there might also be short periods of appreciation, for instance if during the crisis large amounts are repatriated to the US.

In the long run, however, the US economy needs an exchange rate, which supports recovering by improving its competitive position on the world market through an increase of its exports. The competition on the world market will thus become fiercer, which will hit emerging markets selling manufactured goods.

In addition to that, a weak dollar in the long term is a factor for an increase in prices for commodities. Due to the fact that commodities are mainly billed in dollars on the world market, a depreciation of the dollar results in a decline in revenues for commodity producers. In order to compensate for this decline, prices are raised. The price of crude oil, which as a strategic price influences all other prices, will be particularly affected by this. That mechanism also engulfs food prices, and thus causes an increase in poverty and an undermining of food security in developing countries dependent on imports.

Apart from the individual effects on the poor, high commodity prices also have macro-economic implications for countries dependent on imports: Their balance of payments is worsening, foreign debt will increase, and inflation will rise. (UNCTAD 2008b). After the peak in summer 2008 commodity prices have been sinking again. In particular for oil, the upcoming recession will reduce demand and lead to falling prices. However, food demand is by far not that flexible. Even after the peak in summer 2008 was over, the prices remain at a higher level than before the crisis.

However, a falling dollar exchange rate has a positive effect on debt service. But then again, an increase in US interest rates in order to attract capital into the crisis-wracked US economy is most likely, and high interest rates would only accentuate the burden of debt servicing for developing countries.

In any case will the conditions for development become more insecure, more prone to fluctuations and crises, and less predictable. Development however, requires a stable economic environment.

### 1.3 Speculation driving food and commodity prices

Furthermore, the crisis has contributed to the increase in food and commodity prices over the past two years. Thus, the prices for rice and other crops rose by 126% between late 2006 and March 2008 (FAO 2008). These increases for oil, food and other commodities are the result of a whole bundle of causes. They include long-term causes such as the growing demand in emerging economies, or with regard to food, the replacement of food by bio-fuel, as well as short-term aspects, such as crop failures or price increases by oil producers compensating for the falling dollar. However, all these factors do not explain the increases in prices, nor their sudden decline. Take for example the oil price, which after its all-time high in July 2008 fell by 30% until September, despite *Peak Oil* and long-term growing demand. To a large extent, the price increases were caused by speculation. Speculative operations have a triple effect in this context:

- a. The largest share of food commodities is traded via derivatives (derived financial products, see below), namely futures. This has been common practice for a long time. For the producers, this represents a kind of insurance. They can be sure to achieve fixed prices for their products even before production has begun, and independent of economic risks. Naturally,

<sup>2</sup> That is without including other factors contributing to price fixing, e.g. growing demand.

since derivative traders receive a risk bonus, the final prices are higher. This procedure does not go without alternative (it is possible to organise the insurance of the producers through co-operatives or the state), but under the given conditions, the use of derivatives has a stabilising effect as long as business is conducted by the appropriate specialised and experienced traders and no external disruptions of the market occur.

- b. However, the crisis has led Hedge Funds and other institutional investors to desperately search for alternative investment options due to the lack of profit opportunities on the financial markets. In this process they bet on price volatility on the oil and commodity markets, including food. This immediately boosted demand for commodity derivatives and consequently drove prices up.

Before all that, investment banks, Hedge Funds and other institutional investors had already anticipated the long-term real-economic trends, and having bet on a further increase in exchange rates, they also helped push prices up. The result both of speculation based on long term real effects and on the crisis driven speculation lead to a bubble (World Bank 2008 UNCTAD 2008a. BMZ 2008; CFTC 2008; Schulmeister 2008).

During the intensification of the financial crisis, Hedge Funds searching for new sources of profit then also bet on falling prices via Short Selling<sup>3</sup>, until this type of speculation was banned by the supervisory authorities of the USA, Great Britain, Germany and other countries.

- c. The oil price is a strategic price, that is to say it plays into the prices of all other products which require oil as fuel for production and marketing. This includes basically all globally traded goods, thus also agricultural products. For their production, tractors and other machinery, fertilisers, etc. are used that need fuel, and their transport to the consumers also requires fuel. This means that food prices are influenced by the speculation-induced increase in food futures described in a., firstly, and then, secondly, are subject to an additional price increase because of the speculation bubble with regard to oil. It is difficult to assess the exact share in price increase due to speculation. With regard to oil, experts' estimates say that about 20% of price increases result from speculation.<sup>4</sup>

Whatever the exact share of speculation may be, it is definitely not marginal. Considering the significance of food prices for the economically vulnerable groups in the developing countries, it can be concluded that tackling this problem and introducing measures against the speculation on commodities must be the starting point of any fight against poverty.

The necessity to do so becomes clearer when one realises that the factor speculation, in contrast to the increase in demand, could easily be neutralised by the industrialised countries if the political will existed. Civil society has the responsibility to build the political pressure to help eliminate this factor.

<sup>3</sup> In Short Selling, a contract on the sale of bonds or goods at a fixed price is signed, the seller actually not being in possession of the product yet. If speculation proves favourable, the product can then be bought at a lower price and sold for the fixed high price.

<sup>4</sup> This estimate was given by the expert Claudia Kemfert of the rather pro-business German Institute for Economic Research (DIW) in: faz.net, Sept 29, 2008

## 2. Financial markets – the most dynamic sector of globalisation

The crash on Wall Street represents the preliminary climax of a development that began in the 1970s and quickly accelerated during the 1990s. It was predictable, and it actually was predicted, by heterodox economists like Stiglitz, by insiders like the big speculators Soros and Buffet, as well as by some politicians and NGOs.

Up until the end of the Bretton Woods System, financial markets had three basic functions: to guarantee payment, to finance investments (credit market), and to enable trade with all kinds of bonds, securities etc. As they offered these services, financial markets always played a secondary role, serving the real economy – i.e. production and trade.

Also, in the 1970s financial markets were mainly national entities. Foreign business only involved transactions for foreign trade and foreign investments.

Furthermore, before 1973 financial markets were politically regulated by the Bretton Woods System. The essence of the system were fixed exchange rates between the main currencies, capital controls, and one reserve currency, the US-Dollar. It was run by an institution specially designed for this task: the IMF. The system immensely contributed to the stability and the relative prosperity of the post-war decades. Financial crises, such as the debt crisis of the 1980s, the Asian crisis, or the current crisis were not possible under the conditions of Bretton Woods.

After the system's collapse in 1973, the world economy was marked by a period of substantial change, the historical significance of which only became clear afterwards: The end of Bretton Woods was the “big bang” for the current wave of globalisation. Fixed exchange rates were replaced by floating rates, the international flow of capital was liberalised and de-regulated, and capital controls were lifted.

Capital became the most mobile production factor. Today, in connection with technological progress (digitalisation, communication), it only takes a simple mouse click, and within a few seconds, hundreds of billions of Dollars can be moved to any financial place on the globe. Capital thus has an enormous comparative advantage over the other production factors, and uses it correspondingly. The worldwide turnover in foreign exchange dealings per trading day went from US\$ 120 billion in 1980 to over US\$ 2 trillion in 2005 – a seventeen-fold increase. The international trade in goods, the rapid growth of which is frequently referred to as an expression of globalisation, grew only fivefold in the same period. While the annual turnover of goods amounted to US\$ 10.4 trillion in 2005 (UNCTAD 2008b), the figure for the foreign exchange markets was US\$ 400 trillion – forty-fold, by 2007. The financial markets were by far the most dynamic sector of the world economy.

Through the liberalisation and de-regulation of the national financial markets a world market was created, which the financial industry used for expansion. At the beginning they expanded mainly into other industrialised countries, but later also into developing countries and emerging economies.

This way, the financial industry was able to tap new sources for profit.

Their customers – primarily large companies, governments and other financial service providers – now had easy access to money, often at very good conditions and in large amounts. By principle, easy access to capital is crucial for the real economy, since it is the basis for investment, innova-



tion, and growth. This is especially true under the conditions prevalent in developing countries, where there is a high demand for investment and thus capital.

The liberalisation and de-regulation of the Post-Bretton-Woods-Era actually made it possible that large capital flows made their way into developing countries, tied to the hope that they would trigger development.

### 3. Growing instability and increase in the frequency of financial crises

However, it turned out quickly that private capital flows – in contrast to what the theory claimed – by no means went directly where they were needed most urgently, that is to the poorest countries, but instead they were concentrated in those spots promising the highest returns. And this was especially the case in the emerging economies. The flows of private capital sidelined the poor.

With the outbreak of the debt crisis in 1982 it also became clear that easy access to money was taking its toll: The volatility and systemic instability of the international financial system had drastically increased, and through international integration the risk of infection posed by crises had grown. The raise of interest rates in the USA and the increase in the dollar exchange rate thus were the defining economic trigger for the debt crisis. The debt trap snapped shut and what followed was a lost decade for development. The indebted countries had to carry enormous economic and social costs. Even if the emerging economies have overcome the effects of the debt crisis, for many poor and highly indebted countries they still remain a huge burden – despite some debt relief through the HIPC Initiative.

In the 1990s another wave of financial crises in the emerging economies followed. First in Mexico in 1994, then the Asian crisis in 1997/98, Brazil and Russia in 1999, Argentina in 2001. These crises overnight destroyed the development efforts of many years. Those hit hardest were always the economically most vulnerable groups of the poor. Unemployment, wage cuts, and impoverishment spread fast. The affected countries did not necessarily have to be involved in the crash directly. The crashes always drew other countries into the mess indirectly. For example, following the crisis in Thailand, the crash in Laos was even greater, since the country carries out 80% of its foreign trade with Thailand.

In total, the costs of the financial crises of the past 25 years for developing countries are estimated to lie at about one quarter of the gross national product (GNP) (Griffith-Jones 2007). This means without those crises, their economies would be around 25% larger.

### 4. Volatility of Exchange Rates hampering Development

However, even without crises the normal, everyday functioning of the new financial order is the cause for grave problems for developing countries. With regard to this, particularly the fluctuations in exchange rates of the main currencies represent a permanent stress factor. Owing to the fact that most of global trade and debt service are handled in US-Dollars, external trade prices and debt service became difficult to calculate. That is, debt service and foreign trade prices can increase – or decrease – overnight due to exchange rate fluctuations.

Moreover, liberalisation and de-regulation facilitated speculative attacks on developing countries. In the Asian crisis for example, there was much speculation on the fall of the Thai Baath.

Trying to protect their markets from the volatility of exchange rates, more and more developing countries opted to use an instrument that maintains at least a certain degree of autonomy: The use of currency reserves. These reserves usually consist of US-Dollars, though in the recent past the Euro and the Yen have also been increasingly used. By using the reserves, the central bank of a developing country is able by selectively buying or selling hard currencies to stabilise its own currency. But then again, this is very costly. To begin with, the reserves must be built up, but this in turn permanently ties resources that then are no longer available for development and poverty reduction. The financing of the reserves works via domestic state borrowing. The result of his type of exchange rate stabilisation leads to a permanent outflow of resources.

Furthermore, reserves create the pressure to raise interest rates, since the state is increasing the demand on the money market. But if a devaluation of the reserve currency occurs, losses are inevitable. And this is exactly what happens with the devaluation of the US-Dollar at present. So, currency reserves as protection against the exchange rate risk are very inefficient and represent a strain on development.

## 5. Short-termism - a threat to stability

There are however actors on the financial markets, who profit greatly from volatility and instability. The fluctuations make it possible to carry out arbitrage and speculation with hard currencies, interest rates and all kinds of bonds, stocks, securities etc. Arbitrage means exploiting known differences in exchange rates, interest rates etc. Thus, for instance, "Carry Trade" was very fashionable up to the recent crisis. A credit would be taken up, say in Japan at an interest rate of 5 %. Then the credit would be lent in Brazil, where the interest rate is at 15 %, for a few days or weeks. The 10% difference in interest rates represents the gross profit. In addition, the *Exit Option*, available at any given time and allowing for the abrupt withdrawal of all capital, heightens the systemic instability.

In contrast to arbitrage, speculation is an unsafe bet on the future. But since even minor exchange rate fluctuations of only a few basis points<sup>5</sup> allow for huge profits if large sums are at stake, this source of profit has become extremely attractive. Of the US\$ 2 trillion worth of daily currency turnover, most transactions are speculative deals. They usually run for less than seven days.

This short-termism creates instability and insecurity. And quite clearly the *Exit-Option* not only poses a threat to economic stability, but it is also an instrument of political leverage through which investors can influence governments to act in their interest. The former head of the *Deutsche Bank*, Breuer, said in this respect, "*shareholders must follow what governments offer them as investment opportunities, but rather governments must serve the interests of the shareholders.*" This in turn, sets tight limits on the policy space for developing countries, their democratic right to self determination and their right to choose the path of development that suits their own situation.

<sup>5</sup> A hundredth of one percent

## 6. Capital flight and tax evasion – the permanent outflow

Another troubling element of the international financial system for development are tax havens and Offshore Centres (OFCs). Just like vacuum cleaners, they suck the capital out of developing countries.

The name “Offshore” may seem slightly confusing, seeing that these centres must not necessarily be out at sea. “Offshore” means, that there are no, or only very reduced, forms of finance supervision, and/or no taxes, or extremely low taxes. The Offshore financial complex actually includes the City of London, Switzerland with its system of banking secrecy, or the US State of Delaware with its tax deductions for business.

OFCs are virtually free of supervision and regulation. High discretion and confidentiality in banking therefore allow for money laundering and tax evasion. It is not only the Mafia, terrorist networks, and other dubious clients that use the OFCs, but also trans-national corporations, banks and other institutional investors and of course rich individuals.

Capital flight and tax evasion lead to a permanent drain of resources. Around 50% of all assets from Latin America are invested in OFCs. In the Middle East this figure is closer to 70% (TJN 2007). The losses for developing countries due to OFCs are estimated to be at about US\$ 500 billion annually. That is about five times the total sum of Official Development Aid.

OFCs also greatly contribute to the erosion of corporate taxes, wealth taxes, and on capital both in the industrialised and developing countries. Through tax deductions and special services, such as escrow administration, tax dumping takes place. An estimated US\$ 11.5 trillion of private assets are deposited in the OFCs. That is about one third of all private capital worldwide. At least US\$ 225 billion of this amount is money that is kept from the fiscal systems of the countries of origin. And because many developing countries entertain only badly developed or poorly functioning tax regimes, the outflow of capital and tax evasion is especially severe. Due to tax dumping the offshore financial complex deprives the developing countries of resources badly needed for poverty reduction and development.

Also, beyond the financial drain, OFCs pose a threat to the stability of the system as a whole.

From an overall economic perspective, OFCs are superfluous. They only serve a small group of privileged actors, wealthy individuals, institutional investors, as well as criminal operations.

## 7. A New Economic System has emerged

The international financial markets' extra-ordinary dynamic is not only owed to the quantitative effects stemming from the international integration of the financial markets, but also to numerous qualitative changes and innovations.

It is of utmost importance in this regard, that arbitrage and speculation become crucial sources of profit. The British economist Keynes referred to such a system as *casino*. And secondly, innovations such as securitisation, the development of derivatives, as well as the emergence of new types of institutional investors like Hedge Funds and Private Equity Funds have fundamentally transformed the international financial system.

### 7.1 New Instruments

What securitisation does is transform credits into securities, which in turn can be traded on the market, i.e. they can be freely bought and sold. This shifts the credit risk to other market participants, and the original lender never again has anything to do with the borrower after the credit title is sold.

The consequences of this were felt the most by company financing, because large companies today are no longer financed by their bank, but instead through the financial markets. In the past, the bank kept the title for the credit it had granted in its books. The relationship with the borrower remained an exclusively bilateral one until the debt was fully repaid. The bank had an interest in the prosperity of the debtor and an according capacity to fulfil the debt servicing. The new form of business financing has eliminated this aspect, while simultaneously now there is a direct path for transmission of the instability of the financial markets to the real economy.

Securitisation played a central role in the US Sub prime Crisis and the subsequent crash. The defaulted mortgage credits had been turned into tradable securities (*Collateralized Debt Obligations* – CDO) sold worldwide. These papers triggered the crisis. Because not only the mortgages were certified, but also large credit sums were generally secured through so-called *Credit Default Swaps* (CDS), the credit crunch brought the whole system to a collapse.

Securities represent a variant of derivatives (Latin: derivare = (to) derive, deduce). The market for derivatives has rapidly grown. Initially serving as a kind of insurance for an underlying deal in the productive economy, derivatives have since been attached to all sorts of underlying deals, e.g. deals on course developments (ranging from exchange rates and share values to highly aggregated stock indices like the Dow Jones or the Dax) or on derivatives of derivatives. Only 10% of trade is supervised, that is when it is carried out via the stock exchange. The remaining 90% take place outside the stock exchange (over the counter – OTC) and are free of any kind of supervision. The illicitness of the trade with derivatives makes it a high risk factor for the international financial system, which was so impressively confirmed by the current crash.

### 7.2 New actors

Of the various new actors that have emerged in the financial markets, institutional investors are of central importance. They include banks, especially investment banks, pension funds, insurances, investment funds, Hedge Funds, Private Equity Funds, real estate funds, etc. These protagonists act as funds for collecting capital. Combined with their own funds they invest huge amounts in financial dealings. In contrast to individual investors, they can dispose of an enormous capital mass as well as a professional apparatus for the management of their investments, which employs

highly specialised methods to not only achieve viability, but to generate the highest possible profit. The most recent result of institutional innovation are Hedge Funds, Private Equity Funds, and real estate investment trusts (REITS). Their prime interest is simply to increase the assets of the shareholders. Because of their leveraged operations, that is the investment of far more loan capital than own capital, the use of Offshore Centres, and highly speculative deals, they represent a threat to stability. Increasingly, institutional investors are also becoming rather active in developing countries. In India for example, the total sum of investments by Private Equity Funds went from US\$ 1.1 billion in 2004 to US\$ 10.8 billion in 2007 (Singh 2007).

The profits possible in this system were high above those normally to be made in the real economy. This leads investors who dispose of sufficient liquid capital to preferably invest in the new business models. The result of this is a structural under-investment in real economy, resulting in negative consequences for growth, employment, and development.

### 7.3 Distribution effects

What goes beyond the problems of stability, is that the new financial regime is not only very unstable but also produces rather negative effects on distribution and social equity. It amplifies social polarisation, i.e. income development and wealth formation are very dynamic at the top levels whereas the lower it gets on the scale the less dynamic it gets, eventually showing stagnation or even a drop. The rich are getting richer, and the poor are getting poorer. This is equally true for both industrialised and developing countries. The economic pie continues to grow, but the piece of the pie that the rich end economically powerful are serving themselves is getting bigger, while that of the rest is getting smaller.

The development of assets in Africa is an interesting indicator of this effect. Since African elites are increasingly exploiting the possibilities of the financial markets, they take the lead in the emergence of millionaires and multi-millionaires, the so-called *High Net Worth Individuals (HNWI)*.<sup>6</sup> From 2005 to 2006 their number grew fastest compared worldwide: by 11.5%. In absolute numbers, their capital assets have grown by US\$ 51.5 billion. In comparison: In 2005, Africa received a total sum of US\$ 24.7 billion in ODA. That is only about half of the wealth increase for Africa's HNWIs.

If these assets were invested in development instead of wealth formation, or at least adequately taxed, the continent could have a few problems less. This quite clearly points out again, that poverty and wealth are not independent of one another. Who speaks of poverty cannot be silent on wealth.

### 7.4 An historic transformation

Taken together, the changes in the financial system since 1973 have brought about an historic transformation. Financial markets are no longer second in place to the real economy. With their unleashing, financial markets have not only become an independent source of accumulation, but also a superior one, while the orientation on the shareholders has become the standard in all economic sectors. Thus, the financial markets dominate the real economy. The relationship between the financial sector and the real economy has been reversed. A new system has come into being, which some call *globalisation, driven and dominated by financial markets*, while others see it as an

<sup>6</sup> HNWIs are owners of capital assets (i.e. not including real estate, luxury items etc.) of US\$ 1 million and above. Worldwide, this group includes about 8.7 million people. In most common statistics, this group does not appear because it is so small. The usually blend into the upper fifth or the top 10%.

*asset and wealth-centred economy*, and again others speak of *financial market capitalism*. Whatever one may call this shift, what is clear is that it represents a new economic model. Its emergence has also drastically transformed the conditions for development.

However, the current crash may be the beginning of the end of the new system. Just like the Bretton Woods agreement was a reaction to the Great Depression, the current crisis will most probably lead to a new financial architecture.

In any case must the development community intervene in the current disputes and point out ways to regulate financial markets in such a way that they support sustainable development. The time is right. Acceptance for market radicalism has been eroded by the financial crisis. Even bankers admit that the market is not capable of regulating itself and demand state regulation. Politicians all over the world have announced changes.

The reform debate must not be left to the banking lobby and politicians. A stable, predictable and development-friendly international financial system is a global public good that urgently needs to be provided. Without such a system progress in poverty reduction and development will come under attack again and again. Effective development policy also implies to address the economic structures of the international economy.

## 8. Alternatives and starting points for action by civil society

The crash on Wall Street also represents the bankruptcy by the dominant economic model. It has revealed that the market is not capable of regulating itself. Strict regulation is now necessary.

The complexity of the financial system makes it impossible however, to come up with a single solution for all problems. What is needed is a whole toolkit. With view to the reform proposals pouring in by the hundreds, some basic criteria from the perspective of civil society should be established:

- It is necessary to redirect the development of the financial markets. Priority cannot be given to make the casino safer for the gamblers, or even socialise the losses, while the profits continue to flow into private pockets. Rather, the dominance of the financial markets on the real economy must be ended. The casino must be shut down. Poverty reduction, development, and human rights must become the financial markets' top priorities.
- International co-operation must replace the brutal competition between national economies and the resulting *race-to-the-bottom*. A new financial architecture must be established. It must be democratic, development-friendly, allow for adequate participation of developing countries, and meet the requirements of the 21<sup>st</sup> century.
- To mitigate the consequences of the crisis for the LDCs, an international emergency fund under the administration of the UN must be established, because otherwise the MDGs can by no means be reached. With regard to the financing of this fund, the "*Speculator Pays Principle*" must come into play, just like it was accepted to a certain extent by the US Congress when it passed the US\$ 700 billion rescue package for the country's financial industry. Through an internationally coordinated and progressive special tax on capital assets those will be required to pay the costs, who in the past have benefited most from the casino.

Moreover, proposals such as the increase of capital requirements, the reinforcement of supervision, a ban on off-balance deals, the inclusion of all institutional investors – that is Hedge Funds, Private Equity Funds, etc. – into the realm of the country's supervision regime in which the investors operate, as well as a strict regulation of rating agencies<sup>7</sup> seem to be sensible short-term measures. Hedge Funds and other institutional investors that evade regulation in OFCs must be banned.

The pressure on developing countries to liberalise their economies created by the annex on financial services in the GATS<sup>8</sup> must be ended.

The privatisation of public services, and thus their financing, especially that of pensions and health insurance, via the international capital markets, has proven disastrous. Especially developing countries, when establishing such systems, should orientate along models that are based on the principle of solidarity.

In order to push back the dominance exerted by financial markets on the real economy, the structure of incentives should be fashioned in a way that makes speculation, arbitrage, and short-term operations unattractive. The best way to achieve this is through taxation instruments, such as a tax on currency transactions, as well as through a stronger (and more progressive) taxation of capital income.

Every country must have the right to impose capital controls wherever it is deemed necessary; macro-economic conditionality clauses set by the IMF and the World Bank must be stopped.

Risks created by Hedge Funds and other protagonists operating with leverage must be defused through the according capital requirements.

The entire speculatively inflated sector of credit securitisation needs to be limited to the measure required for investments in the productive economy. High risk financial products such as CDOs and other risky derivatives must be banned. The remaining derivative market has to be placed under supervision, and the OTC market must be drained.

Who actually needs the offshore financial complex? It is the institutional investors, businesses trying to escape their domestic tax regimes, wealthy individuals, as well as economic and other criminals. From a macro economic perspective, and even more so from a development point of view, OFCs are nothing but harmful. They should therefore be economically neutralised. After September 11, the US demonstrated through their measures to counter terrorist funding that effective measures can in fact be imposed, if only the political will to do so exists. Even the Swiss banking secret has been loosened, if only for US authorities.

In order to cope with the effects of the volatility of the exchange rates inhibiting development, the setting up of regional currency unions, maybe in resemblance of the Euro zone, should be pursued as a mid-term goal. As interim steps currency co-operations, managed floating, currency boards, and exchange rate corridors may be useful.

<sup>7</sup> These private institutions assess credit risks. However, these institutions have failed to perform during all the major crises over the past 15 years, the latest example being the Subprime Crisis in the US as well as the crash on Wall Street.

<sup>8</sup> The annex on financial services to the General Agreement on Trade in Services of the WTO, the GATS, is designed to push for further liberalisation in the financial industry. Implementation of this annex would lead to the expansion of banks, insurances, and other institutional investors from industrialised countries into emerging economies and developing countries. In the light of the current crisis this would have to be tied to strict state regulation and conditionality clauses with regard to development.





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The „Monterrey Consensus“ emerged from the International Conference on Development Finance in Monterrey, Mexico 2002. It paid less attention to financial markets and more to the liberalisation of financial services. The dangers of globalised financial markets for development economies were not in focus. Now the financial crisis hits. Large state and private assets run for shelter, particularly in developed economies. Foreign investments in emerging and developing economies are repatriated. The demand for commodities, resources and cheap labour becomes very volatile. Economic growth drops, the Millennium Development Goals become a distant dream.

This EED - working paper explains the effects of the crisis of the financial markets on emerging and developing economies. It refers to systemic issues, which the Finance for Development Follow Up Conference in Doha in December 2008 needs to consider. It points out alternatives and options for civil society action and ways to safeguard the MDGs.

