Overseas Development Institute

A Development Charter for the G-20

March 2009

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Overseas Development Institute

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A Development Charter for the G-20

The global financial crisis started in developed countries, but the global recession which has followed is having a wide-spread impact on developing countries. By the end of this year, developing countries are expected to lose incomes of at least US $750 billion. In sub-Saharan Africa, the figure is over US $50bn. The consequence is likely to be rising unemployment, poverty and hunger: an extra 50 million people trapped in absolute poverty, with the number expected to rise to 90 million;[1] and the total number suffering from hunger already up by 75 million to nearly a billion people, rising for the first time in nearly two decades.[2]

ODI researchers, in coordination with other developed and developing country institutes, are tracking the spread of the recession, monitoring and modelling its impacts and applying their different skills to the policy challenge of restoring growth and development in the poorest economies in the world. The G-20 cannot deliver development, but its members can aim to promote development efforts rather than hinder them. The 12 short articles in this pack do not constitute an institutional position but, taken together, they outline a Development Charter for the G-20 to help poor countries tackle the effects of the global economic recession. This includes:

- A Global Poverty Alert System:
  - to monitor the economic impact of declines in trade, financial flows, remittances and aid. Work by ODI and its partners in ten countries in Africa, Asia and Latin America show all are affected, but in very different ways.
  - to monitor the impact on people's lives of lost work, lower incomes and falling investment in health and education.
- Better financial regulation and new financial rules to increase the transparency of capital flows, curb illegal transfers, and reduce the pro-cyclicality of financial flows to developing countries, for example by adjusting capital adequacy ratios over the business cycle, or promoting capital flows to developing countries using innovative financing mechanisms.
- A significant share of the fiscal stimulus of G-20 countries to be spent in developing countries (at least $50 billion in Africa) to provide social protection, but especially to help provide the infrastructure needed to restore growth. Such a fiscal stimulus can raise welfare in the poorest countries and offset a significant part of the impact of the crisis and will also help developed countries seeking export markets.
- A trade package which does not set unrealistic expectations about a conclusion to the Doha Round, but instead concentrates on preventing 'beggar-thy-neighbour' protectionism and bringing forward funding for Aid for Trade.
- A reversal of labour protectionism, which restricts migration and hurts both sending and receiving countries.
- Support developing country efforts for building institutions, establishing crisis management focal points, and implementing home-grown 'rainbow' policies that:
  - promote policies and institutions that help developing countries to grow themselves out of the crisis;
  - support the livelihoods of the poor through greatly expanded social protection schemes;
  - invest in the technology, institutions and structures necessary to deal with climate change;
- Making sure that aid is managed to support national ownership and effective response, with fast distribution, in support of government plans, and through government budgets;
- Using the G-20 as a platform for reform of the international system, starting with the governance of the Bretton Woods system, but also launching a wider process to strengthen the effectiveness of the United Nations.

Dirk Willem te Velde
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Endnotes

1. Address by Douglas Alexander, Secretary of State DFID, Chatham House, London 2009: http://www.dfid.gov.uk/news/files/speeches/sos-wb-speech.asp
2. Address by Jacques Diouf, Director-General of the Food and Agriculture Organization, Madrid 2009: http://www.ransa2009.org/docs/docs/speech_DG_FAO_ransa2009.doc.pdf

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1. Monitoring the effects of the global financial crisis on developing countries: a Global Poverty Alert Network

By Olu Ajakaiye, Debapriya Bhattacharya, Massimiliano Calì, Tayo Fakiyesi, Amoussouga Gero Fulbert, Hossein Jalilian, Luis Jemio, Jodie Keane, Isabella Massa, Mareike Meyn, Manenga Ndulo, Mustafizur Rahman, Ira Setiati, Hadi Soesastro, Sarah Ssewanyana, Milo Vandemoortele and Dirk Willem te Velde[1]

The Overseas Development Institute (ODI) is coordinating a large study examining the effects of the global financial crisis in 10 developing countries. This links developing country research institutes, think tanks and donor agencies, with funding from the UK Department for International Development (DFID) and the Dutch Ministry of Foreign Affairs. The research is ongoing, and the following reflects the views of the authors alone, but there are already important preliminary findings. The research finds that low-income countries are being affected through different transmission mechanisms:

- declines in trade such as commodity export revenues and government budgets;
- declines in financial flows such as bank lending and foreign direct investment;
- declines in remittances; and
- possible declines in the dollar value of aid.

The G-20 will need to monitor closely the effects of the global financial crisis on development.

Asian countries such as Bangladesh, Cambodia and Indonesia have already experienced a sharp decline in manufacturing exports and industrial activity. Bangladesh recorded negative export growth for the first time in recent years. Cambodian garment exports to the US have suffered. In Indonesia, growth in manufacturing slowed in 2008, and exports have been hard hit since November 2008.

Commodity exporters such as Bolivia (hydrocarbons), Kenya (tea), Nigeria (oil), Uganda (coffee) and Zambia (copper) have seen recent declines in export revenues, which have also affected government revenues negatively. The copper price has fallen and a quarter of the mining jobs have already been lost in Zambia. In Uganda, there has been a decline in value of trade from September 2008 into 2009. In Benin, cotton accounts for a large share of exports, but prices have fallen recently. The value of Kenyan tea exports has declined by 60% since September 2008. The government budget in Bolivia is highly dependent on hydrocarbon revenues, which are falling.

Several countries are also affected through migration, remittances, financial markets and exchange rate fluctuations. The number of workers leaving Bangladesh to find work elsewhere fell by 45% in January 2009 year-on-year (y-o-y). Uganda has seen a slowdown in remittances. Some of the case study countries have also reported large effects on their financial sector. The Indonesian stock exchange dropped by half during 2008; the equity market capitalisation nearly halved during 2008. The stock market index fell by 29% in 2008 in Zambia, and 25% since July 2008 in Kenya. Some countries have also reported exchange rate depreciations.

In **Bangladesh**, export growth in the first six months of the 2008/09 financial year (July and December 2008) was robust at 19.6% (y-o-y), but exports fell by 2% in the second quarter (y-o-y). This is the first time that negative export growth has been recorded in recent years. The number of workers leaving Bangladesh to find work elsewhere fell by 45% in January 2009 (y-o-y). The impact of devaluation in Pakistan and India has rendered Bangladesh less competitive. Stimulus packages in other countries may affect Bangladesh negatively. Import duty values have decreased considerably.

Benin's exports are limited to a few products with relatively low value added. Cotton accounts for 34% of all exports. Cotton prices on the international market have fallen recently by around 37.4% y-o-y. Oil prices have fallen by 60.6% y-o-y. The US dollar has appreciated by almost 10% against the euro in the past year. This combination will most likely result in a dramatic reduction in exports.

In **Bolivia**, the mining sector is the first to have started to feel the impact of the financial crisis. From December 2007 to June 2008, there was a decline in exports. Remittances grew dramatically in 2007 but almost halved in 2008. The government budget is highly dependent on hydrocarbon revenues, which are falling.

In **Cambodia**, tourism and garments revenues are under pressure. Around 300,000 migrant workers in Thailand have been told to go back to Cambodia. Most Foreign Direct Investment (FDI) is destined for the garment and construction industries, but there have been recent factory closures and reduced investment, including some flight of investors. Most investment in construction comes from Korea. The government has responded with fiscal, monetary and financial policies.

'Low-income countries are being affected in different ways … the G-20 will need to take note of the effects of the global financial crisis on development.'

In **Indonesia**, growth in manufacturing industries slowed in 2008, with commodity prices starting to fall from June 2008 onwards; exports have been hard hit since November 2008. The non-oil and gas trade balance has worsened and experienced a larger export decline compared with imports. The Indonesian stock exchange dropped 51.17% during 2008; equity market capitalisation was down 46.4% during that year. Government policy has consisted mostly of measures to maintain financial market stability and to provide fiscal stimuli in order to keep private and government consumption (which occupies almost 65% of its gross domestic product – GDP) growth in check.

In **Kenya**, the NSE-20 Index has fallen by 25% since July 2008; portfolio flows have been adversely affected. The Kenyan stock market is still going down. The decline in the stock market index has made it more difficult to borrow from the capital market; this has affected the availability of funds. The value of Kenyan tea exports has declined by 60% since September 2008. Cut flowers may be affected. Macro imbalances could cause the Kenyan shilling to fall dramatically: it has already depreciated by 22.6% against the US dollar since September 2008. In 2007, Kenya achieved the highest growth rate in over two decades but the International Monetary Fund (IMF) predicts growth for 2009 will be only 4%. Reduced growth will affect poverty reduction efforts significantly. In terms of policy responses to the crisis, the government has reduced bank cash ratios from 6% to 5%; the Central Bank has reduced ratios from 9% to 8.5%.

In **Nigeria**, stock market capitalisation fell by some 45% in 2008 compared with 2007. There has been a dramatic reduction in the all share index. Huge capital outflows have eroded confidence. A reduction in liquidity has constrained firms' ability to raise funds. The government has increased interest rates. In addition, bad banking debt is hidden; borrowers are unable to pay back loans. Foreign reserves have declined. There has been a reduction in expenditure on capital projects. Some foreign commitments have been scaled back or withdrawn. Crude oil comprises around 85% exports and 90% of government revenue. The price of oil fell from a high of $147 per barrel in July 2008 to $47 per barrel in January 2009.

In **Uganda**, monthly trade data show a decline in value from September 2008 into 2009. Uganda's key export is coffee. At the beginning of 2008, the value of exports was high ($/kg) but this fell towards the end of 2008. The exchange rate has depreciated by 20% since October 2008. Government tax revenue has recently declined. There was a slowdown in remittances during 2008. Aid disbursements declined between 2007 and 2008 (y-o-y). There have been anecdotal reports that Barclays Bank Uganda might close. There are some reports of non-governmental organisation (NGO) activities in northern Uganda falling and operations closing. Uganda's growth projections have fallen. No concrete measures have been announced by the government on either monetary or fiscal policy.

In **Zambia**, the global financial crisis threatens recent development gains. Trade data show that, in the final period of 2008, the trade balance worsened (imports exceeded exports). Changes in the terms of trade index for Zambia suggest that the impact may be yet to come. The stock market index fell by 29% in 2008. Mining products account for around 80% of Zambia's exports. The Kwacha has depreciated against the US dollar. The copper price ($/pound) fell in 2008, from just over $3 per pound to just over $2 per pound by December 2008. Copper mines are already closing. There were around 30,000 workers in mining in 2008 but some 8,100 have lost their jobs – 27% of the total mining workforce. New projects have been put on hold; exploration projects have been affected as a result of difficulties in obtaining bank loans for financing. The government is adopting prudent fiscal policies and negotiating with mining companies for a potential suspension of windfall tax.

The monitoring of the effects of the global financial crisis on developing countries is ongoing and further results from the network will become available on ODI's website on the global financial crisis. See www.odi.org.uk/odi-on/financial-crisis/default.asp.

Endnotes

1. For affiliation of the authors, and the details of the presentations on which this note draws, please see http://www.odi.org.uk/odi-on/financial-crisis/default.asp

2. The impact of the financial crisis on poor people: what we know and what can be done

By Milo Vandemoortele and Kate Higgins

The economic impact of the crisis on low-income countries is serious and cannot be ignored. But it does, to some extent, mask the human impact.

This human impact deserves attention, particularly if we want to understand and respond to the poverty impact of the financial crisis. Specifically, in the context of the G-20, three questions need to be answered. First, will the crisis push more people into poverty? Second, will the crisis make the lives of those who are already poor even more difficult? And third, what can be done to anticipate, and mitigate, these impacts?

Poverty impact: what might happen?

The financial crisis is likely to push more people into poverty, and undermine progress towards the Millennium Development Goals. The UK Department for International Development (DFID) estimates that by December 2010, the number of people living on less than $1.25 a day will be about 90 million higher as a result of the financial crisis. The International Labour Organization (ILO) anticipates an increase of between 24 million and 52 million people unemployed worldwide, a large majority in developing countries.

The crisis will also make the lives of those who are already poor and vulnerable even more difficult. UNESCO's Education for All Global Monitoring Report team estimates that reduced growth in 2009 will cost 390 million people in sub-Saharan African living in extreme poverty around $18 million, representing 20% of the per capita income of Africa's poor. Poor people spend between 50% and 70% of their income on food – this has important human development implications. The findings also highlight wider human development impacts, including the prospect of an increase of between 200,000 and 400,000 in the number of annual infant deaths. Malnutrition levels are rising the report says. Following the 2008 food price crisis, the Food and Agriculture Organization (FAO) estimated an increase of 40 million in the number of malnourished people. What will 2009 bring?

Poverty impact: what can we anticipate and mitigate?

The poverty impacts of the crisis are hard to determine at this stage for at least two reasons. First, the impact of the crisis has not yet been fully transmitted through the real economy to poor people. Second, the availability of timely, relevant and reliable national-level and disaggregated data on income and non-income poverty trends are hard to come by on a monthly or quarterly basis.

This does not mean there should be no action. We do know how macroeconomic changes are transmitted to households. We do know how past financial crises have affected poor people. Governments and donors must take action to anticipate, and mitigate, these impacts.

Five transmission channels, shown in Figure 1, link macro and micro (or household) level shocks: taxes and transfers; prices; assets; employment and access to goods and services (OECD, 2007). The structure of a country's economy and of its political economy will determine the channels that have greatest impact on the lives of poor people.

> **'Poor people did not create this crisis, but their lives will be seriously affected by it'**

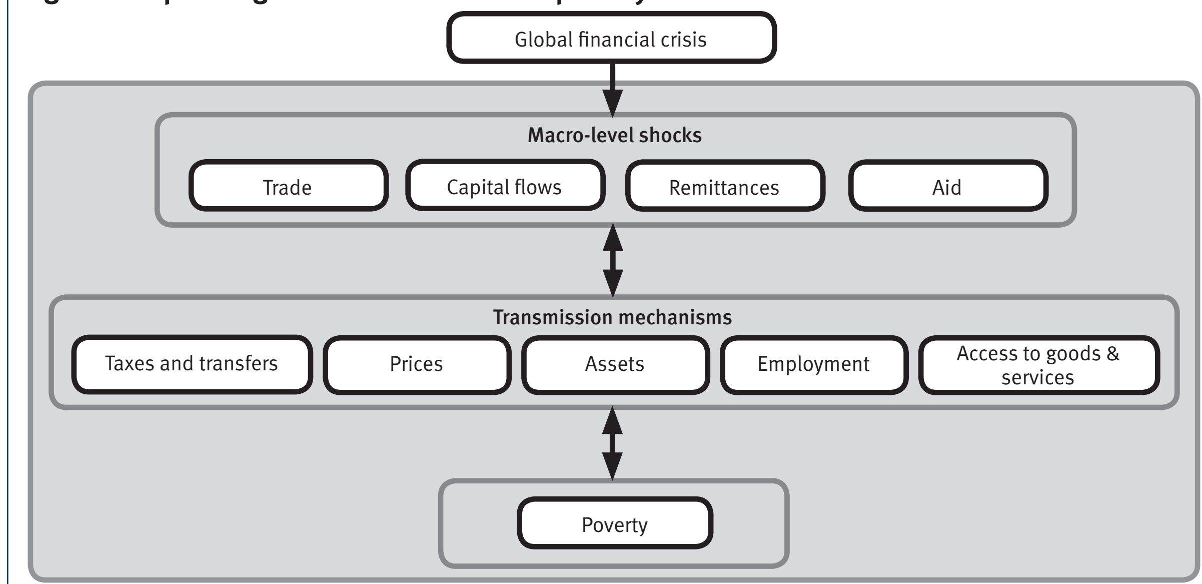
Taxes and transfers include both private and public transfers. Some countries depend heavily on remittances. In Kenya and Bangladesh, such flows have represented almost 6% and 9% of GDP in recent years (World Bank, 2008). Slowing remittance flows will affect the level of expenditure on nutrition and education, which are the most common uses of this type of transfer (Mehrotra, 2009). The potential for long-term recovery is likely to be jeopardised as the cognitive and physical capacities of people are undermined by reductions in spending on nutrition and education.

The **prices** channel includes consumption and production prices, wages, salaries and interest rates. Lower demand in global markets for commodities is pushing down prices, reducing the income of primary producers. The Asian economy is expected to experience a drop of 3%, and this will push an additional 40-50 million people below the poverty line in the Asian Pacific region alone (Bauer et al., 2009).

The reduction in **employment** (in both formal and informal sectors) associated with macroeconomic shocks will reduce income levels of individuals and households. ILO estimates that the number of females without work will rise by 16 million to reach 97 million by the end of 2009, with most of this rise taking place in developing countries. Households struggling to survive may turn to child labour and commercial sex work as a means of survival.

The ability of a household or individual to cope

Figure 1: Impact of global financial crisis on poverty



with a shock is linked to the possession of (or access to) **assets**, which may be social, physical, natural or financial. During the 1995 recession in Mexico, the poorest children dropped out of school and many never returned (Birdsall, 2007). This undermines the next generation's ability to participate productively in growth (owing to low levels of education). It may also reduce the ability of communities and households to cope with subsequent shocks.

The fifth transmission channel between macro level shocks and households is **access to goods and services**. As government revenues shrink as revenues from exports, national taxes and import levies fall, social budgets shrink as well. Thailand's public health budget was reduced by 9% and its education budget fell by 6% in 1998 (Bauer et al., 2009). This reduced the quality and quantity of social services available to the poor. Unlike European countries protecting their citizens' access to goods and services, 43 out of 48 low-income countries lack the capacity to provide a pro-poor fiscal stimulus (UNESCO, 2009).

Understanding how macroeconomic shocks are transmitted to people, and how they feed back into prolonged macroeconomic instability, is essential for the appropriate design of policies, both to mitigate poverty impacts and macroeconomic instability, and to help countries 'grow' out of poverty in an inclusive and pro-poor way.

A response that supports poor people

Poor people have had little to do with creating the financial crisis, but their lives will be seriously affected by it. Decisions made around the G-20 need to result in bold action that prevents the slide into poverty of some, and the slide into even deeper poverty of others. Its decisions, and the subsequent actions of G-20 countries, need to reflect a commitment to mitigating the adverse impact the crisis could have on the poorest.

Countries can mitigate against the poverty impacts by addressing key transmission channels. This may include strengthening the provision of health and education services and supporting social protection programmes.

There are three action points for the G-20. First, it should support the development of a Global Poverty Alert Network that links international organisations, aid agencies and research groups under a single network to provide updates on the impact of the financial crisis on poor people. Second, it must reassert the Gleneagles aid commitments and support additional commitments. For example, support Robert Zoellick's proposal that 0.7% of developed countries' stimulus packages are channelled into a vulnerability fund for the world's poorest countries. Finally, G-20 countries must maintain commitments on aid effectiveness, as expressed in the Paris Declaration and the Accra Agenda for Action.

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3. First things first: the trade priorities for the G-20

By Mareike Meyn

Developing countries need open export markets to help them mitigate the negative effects of the global financial crisis on their economies. G-20 countries have the choice of implementing short-sighted protectionist measures, thereby prolonging and aggravating the crisis, or responding with open trade policies, thus ensuring that long-term development interests prevail. The successful conclusion of the World Trade Organization (WTO) Doha Round is highly unlikely in the current economic and political environment and the G-20 should concentrate on other, more urgent, trade issues.

One important mechanism that is transmitting the crisis to developing countries is trade. For trade-dependent economies like Bangladesh, Cambodia, Mozambique and Vietnam, exports account for up to 70% of gross domestic product (GDP). Many small developing countries export to only two markets, both of which are severely impacted by the global financial crisis: the US and the European Union (EU) (WTO, 2008). Affected even more heavily are those countries hit by multiple effects of the crisis, many of them falling into the first category: low diversity and a high dependence on exports. Nigeria, for example, has been hit by tumbling oil prices and a 45% decrease in share prices, both resulting in a sharp depreciation of the local currency and worsened terms of trade.

Protectionist measures in developed countries will affect vulnerable developing economies. It is disturbing to see new protectionist measures emerging in developed countries, such as increased subsidies for agriculture, conditional bailouts for the car industry and tendencies to expand trade distorting product standards.

The crisis as a chance to conclude the WTO Doha Round?

There are two divergent views on how an economic crisis affects trade policy in developing countries. The conventional view (based on historical observations of the behaviour of countries) is that governments tend to become protectionist in times of crises, aiming to protect their own firms and employment. Reforms that are unpopular and hurt certain interest groups are undertaken in 'good times', not during recessions. However, a different view argues that policy changes that may well be unpopular, such as enhanced trade liberalisation and macroeconomic reform, are made possible in times of crises (Little et al., 1993).

Following this argument, Baldwin and Evenett (2008) suggest that the crisis offers the chance for an immediate conclusion of the WTO Doha Round, which is seen as the best insurance against the risk of increased protectionism. This view is challenged by Meyn et al. (2009), who argue that a Doha trade deal is unlikely to be reached in the current economic and political climate. It is not only the probability of concluding Doha successfully that is low, but the likely benefits of the compromise deal that could be reached. In brief, the Doha Round would not be very important, for either developing or developed countries. It is estimated that the effects of a successfully concluded WTO Round would be around $80 billion – around one-tenth of the estimated 2008/09 output losses resulting from the global financial crisis, which are estimated to be around $800 billion for developing countries (Anderson et al., 2005, Te Velde, 2009). There would be some benefits for some large developing countries, such as Argentina, Brazil, India and Thailand. A lowering of the bindings on tariffs and subsidies, even if there was no actual reduction from current levels, would reduce the risk of increased protection in response to the recession. But the benefits would not be large for most developing countries (Page et al., 2008) and would be negative for most preference-dependent countries (Meyn, 2008).

'The conclusion of the WTO Doha Round is desirable, but does not appear realistic in the current economic and political environment'

High priority trade issues

Instead of pushing for a minimalistic consensus on the Doha Round, which bears the risk of damaging the institution of the WTO, policy-makers should instead concentrate on more urgent trade issues, such as:

- Resisting domestic pressures to apply protectionist measures and opposing protectionist measures taken by any G-20 member. For instance, the Czech and German governments have set a good example by questioning French support for cars that are produced in France;
- Avoiding the introduction of new formal or informal product standards, labelling requirements and so on, intended to encourage discrimination against imports;
- Supporting the surveillance process that the WTO has put in place to track the new protection

measures applied by members and encouraging it to cover a broad range of potentially distorting measures;
- Monitoring and disciplining any trade-distorting impact of the various fiscal stimuli aimed at combating the global financial crisis;
- Bringing forward Aid for Trade allocations (without reducing other aid commitments) and addressing trade finance constraints, in order to mitigate the effects of recession on developing countries (Meyn et al., 2009).

Although the conclusion of the WTO Doha Round is desirable, it does not appear realistic in the current economic and political environment. However, the G-20 countries can still demonstrate that they are serious about complying with international trade obligations by fighting any form of new protectionism at home, and by supporting developing countries to access their markets.

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4. Restricting migration is a counterproductive way to tackle the crisis

By Massimiliano Calì

As the global financial crisis intensifies, a number of G-20 leaders have demonstrated a desire to fight protectionism in trade and finance. But none of them seem to be willing to fight another more pronounced form of protectionism that is acquiring prominence in the wake of the crisis: migration protectionism. In fact, governments across the globe are tightening their borders in an attempt to constrain migration flows. For example, the UK government has just proposed new measures, which would limit access to dependants of skilled migrants working in Britain and would restrict skilled migrants to taking jobs only in occupations with shortages. The economic stimulus, signed recently by US President Obama, limits the ability of companies receiving stimulus money to employ highly skilled foreign workers. And this tendency is not confined to developed countries. Recent reports suggest that restrictions on the employment of foreign labour are occurring in countries like India and Thailand.

It seems these days that nationalising jobs is a more popular proposition than nationalising banks. But while there may be arguments to support the latter, no economic argument in support of migration restriction can withstand close scrutiny. After all, if the impact of the economic crisis and unemployment could be addressed simply by restricting the entry of outsiders into a local labour market, why is no one calling for restriction in movement of workers from one US state to another?

Migration restrictions are a bad way to fight unemployment in times of crisis. There is no evidence that less immigration means less unemployment. In fact, the opposite seems to be true. While immigration tends in the minds of people to be linked to domestic unemployment, in reality rises in immigration have been associated with falling unemployment in all countries for which data are available. It is obvious that a booming economy attracts migrants, but it is also true that the presence of migrants helps the economy grow (in per capita terms) and creates jobs. Research has shown that immigrants play an important role in US innovation in science and technology: in periods when the number of visas granted by the US to highly skilled foreign workers (so-called H-1B visa) decreased, so did patent applications in the country. When the number of visas went up, so did patent applications (Kerr and Lincoln, 2008).

The economic literature is fairly convincing: there is no evidence of any negative effect on the domestic labour market as a result of immigration. Even one of the largest migration inflows in recent European history – that of Eastern Europeans into the UK following the enlargement of the European Union (EU) in 2004 – did not contribute to a fall in wages or a rise in claimant unemployment in the UK in the following two years (Lemos and Portes, 2008). And this does not apply only to Eastern European migrants. Recent evidence suggests that overall immigration has led to a slight increase in average real wages in the UK, with the effects being most beneficial for relatively high skilled workers (Dustmann et al., 2008).

This is not surprising as migrants tend to self-select, with the brightest and more educated people the most likely to migrate. Migration is, therefore, likely to raise the average education and skills level of the workforce in the host country, helping employers create (rather than destroy) new employment opportunities. And new migrants tend to be concentrated in the young (and most productive) age groups, raising the average productivity of the labour force. This is why immigrants are usually an important source of innovation and long-term growth for the receiving economy. In addition, migrants often act as intermediaries between their country of origin and the country of destination, effectively reducing transaction costs in trade and investment between the host and the source countries.

'No country in the world has developed by closing its borders to new immigration'

This brief review suggests that not only are there no economic arguments supporting immigration restrictions, but also that the welfare losses from restrictions in destination countries may be substantial. In times of crisis, such losses (in terms of competitiveness, innovation, trade, investment, skills, etc.) may be particularly painful.

Moreover, restricting migration is damaging for international development. As restrictions are most binding for developing countries among the sending countries, they prevent, in effect, the unleashing

of the potential beneficial impacts of migration for source (developing) countries (Calì, 2008). These include remittances, increased trade and investment linkages, knowledge transfer and incentives to accumulate human capital (see Calì and Te Velde, 2008 for a review of the evidence).

No country in the world has developed by closing its borders to new immigration, just as no country has ever developed by closing its borders to trade. As the G-20 leaders meet to find solutions to the global crisis and to renew international cooperation, they would do well to bear this in mind.

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5. Global finance and development: new global rules needed

By Nick Highton, Isabella Massa and Dirk Willem te Velde

Development depends on stable international financial resources. While the financial systems of low-income countries may not have been affected markedly by the global financial crisis to date, it is clear that they have a direct interest in global financial stability. At the April summit, leaders of the G-20 will consider new global financial rules. It is important that these consider the effects of these rules on development.

Global financial flows to developing countries are set to drop dramatically, after increasing to record highs in 2007. International financial flows include private capital flows such as foreign direct investment (FDI), portfolio flows and international lending; other official flows (OOF) and capital/current transfers; official development assistance (ODA); and remittances. Forecasts on net capital flows have become gloomier: the World Bank (2008) suggests that net capital flows to developing countries will decline from one trillion US dollars to around $550 billion in 2009. The Institute of International Finance (IIF, 2009) forecasts an 82% decline, from $929 to $165 billion.

This slowdown will be much more dramatic and faster than those experienced in the downturns of 1981-1986 and 1996-2002. The IIF suggests that inflows as a percentage of gross domestic product (GDP) may fall by 5.8 percentage points, from 7% of GDP in 2007 to around 1% of GDP in 2009, compared with falls of 3.2% of GDP from 1981-1986, and 3.7% from 1996-2002. Net portfolio flows experienced a dramatic drop in 2008, shifting to large net outflows. This is consistent with the sharp fall in equity prices globally. Initial public offerings in developing countries have dried up.

'There is consensus that most global finance flows need further regulation, but how?'

FDI will also be affected. In previous downturns (1989-1992 and 2000-2002), FDI has tended to decline by more than GDP. According to the UN Conference on Trade and Development (UNCTAD, 2009), worldwide FDI fell by 21% in 2008, with a further decrease expected in 2009, and growth in FDI flows to developing countries dropped from 20% in 2007 to 3.6% in 2008. The IIF estimates that net FDI flows to emerging markets have already declined, from $304 billion in 2007 to $263 billion in 2008, a drop of some 15%. The latest International Monetary Fund (IMF) projections show FDI inflows for 2009 falling by almost 20% from 2008 levels, compared with the over 10% growth projected in April 2008.

The IIF suggests that net bank lending fell from $410 billion in 2007 to $167 billion in 2008, and forecasts a net outflow of $61 billion in 2009. In December 2008, the Bank for International Settlements (BIS) reported signs of a slowdown in the growth in credit to emerging markets, which had quadrupled between mid-2002 and mid-2008. There is more recent anecdotal evidence of foreign banks pulling out capital to satisfy new stringent domestic requirements on capital. For 24 countries, more than two-fifths of their banking assets are held by foreign banks.

Remittances are normally considered a stable resource of external finance. IMF projections show remittances to low-income countries stagnating in the second half of 2008, and shrinking in 2009. Calì et al. (2008) observe that previous financial crises led to a 20% drop in the value of remittances, which, under some assumptions, implies a drop of around $40 billion in the current context. Remittances account for more than 15% of GDP in 12 developing countries.

ODA reached $100 billion in 2007. At the Gleneagles G-8 summit in 2005, donors committed to increasing aid to $130 billion in 2010 (at constant 2004 prices), with a target of 0.56% of GDP for the European Union (EU) in 2010. According to the Organisation for Economic Cooperation and Development (OECD), most donors would have had to make unprecedented increases to meet their 2010 targets. However, commitments are under increasing pressure. Calì et al. (2008) suggest there is no systematic relationship between economic downturns and aid because, primarily, aid is a policy and can, therefore, increase if the environment is right. However, there is a risk that the value of commitments in dollar terms will decline substantially in 2009, by several billion. For example, the devaluations of the pound against the dollar (30-40% over the past year) and the euro against the dollar (15%) may, taken together, cut the value of EU aid commitments by several billion this year. Further, commitment cuts

by Italy and Ireland may slash aid by a further $5 billion compared to the plans. Finally, where countries aim for aid/GDP ratios, aid value might decline further.

There now seems to be a clear consensus that most global financial flows need further regulation, but how? There are questions as to what new regulations need to be introduced, which regulations need to be better enforced and which are particularly important for development.

Regulations should consider new accounting rules to reduce the pro-cyclicality of international capital flows, and international bank lending in particular. There is a debate between academic thinkers, favouring a complete rewrite of the current Basel II financial principles, and practitioners and regulators, who suggest that anti-cyclical elements could be included in those principles. Capital adequacy ratios could be made to vary over the cycle and should be linked to growth in banking assets; these could be lower in bad times. There is also a need for rules on the funding of assets: the crisis has taught us that it matters whether mortgages are financed by deposits or by short-term money markets. Further, there is a need to make incentives (e.g. bonuses) in the banking system consistent with a stable international finance system that can deliver development benefits.

There are discussions on the global rules governing tax havens. It is important to separate the immediate need for transparency from a longer debate on tax policy. Transparency should cover new or better supervisory colleges or international regulators of existing international financial activities, more attention to dealing with illicit capital flight from developing countries, but also the need to put in place new ’comprehension tests’ before the introduction of the new financial products. The debate on taxes is more complex as it is a sovereign issue. It is perfectly possible for countries to engage in a ‘beauty contest’ and compete on efficient tax systems that deliver public goods, but, at the same time, they need to avoid competition leading to an undesirable and welfare-reducing race to the bottom.

Low-income countries need better rules on global finance so that they can benefit from finance while preventing their development prospects from being overruled by the cyclicality built into the current global financial system. The G-20 will need to ensure that new rules are appropriate to the needs of developing countries.

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6. Blue, green and red: A ‘rainbow’ stimulus to tackle global recession

By Dirk Willem te Velde

Political ideologies are often associated with particular colours: blue for conservatism and market forces; green for environmental sustainability; and red for state interventionism. As monetary policy becomes ineffective, with people losing faith in the banking sector, attention has shifted to fiscal stimulus as a possible lifeline. But what ‘colour’ should this stimulus be, and can it really promote development?

The crisis is putting pressure on the main sources of external revenues for developing countries: exports, remittances, foreign direct investment and equity flows. This is likely to hamper growth and efforts to reduce poverty. It is impossible to predict the precise effects, as the news gets worse every day. Growth revisions from the International Monetary Fund (IMF) over the past six months suggest losses of more than $50 billion in sub-Saharan Africa and $750 billion in developing countries as a whole in 2008-2009, and a 3.5% reduction in world output in 2009. World income per head is expected to fall. In Africa, incomes are likely to stagnate. These predictions include the effect of a fiscal stimulus equivalent to 1.5% of gross domestic product (GDP) in G-20 countries.

While developing countries have larger reserves than 10 years ago, few can afford the kind of fiscal stimulus needed to address a crisis originating in the developed world.

Some estimate that global financial flows to developing countries will tumble from $1 trillion in 2007 to $165 billion this year. Banks in developed countries are required to hold more capital at home. Trade finance is under pressure; global trade is forecast to fall by at least 2% in 2009. Exports and industrial production in China, Taiwan and South Korea were already down at the end of 2008. The International Labour Organization (ILO) suggests that up to 30 million jobs could be lost between 2007 and the end of 2009. The World Bank suggests around 100 million people will remain poor, 20 million for each percentage point of slower growth.

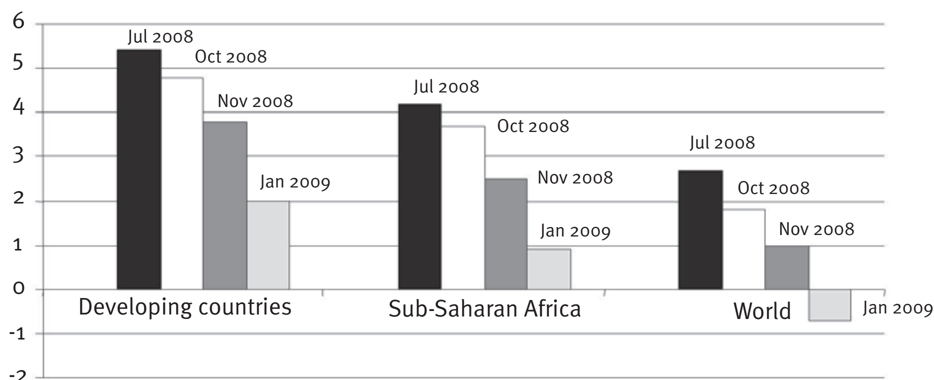
What should be done? Quite a lot. The G-20 meeting on 2 April could consider more transparent and countercyclical rules, and reform of the international financial institutions. But, above all, they could encourage a global fiscal stimulus, with a significant part for early disbursement in poor countries, where even a small proportion of a 1.5% stimulus would go a long way.

Blue, green or red?

A blue stimulus would accelerate support for the private sector on the supply side by creating an appropriate framework for investment and investing in infrastructure. The market alone, however, will not deliver desirable economic and social outcomes, so the G-20 should respond to and implement global trade rules. The G-8 has committed $4 billion to Aid for Trade but, if infrastructure is included, research suggests that $12-13 billion is needed in sub-Saharan Africa alone to meet the Millennium Development Goals.

A green stimulus would address the two biggest market failures relating to climate change. First, the price of energy does not reflect the negative costs to the environment. If it did, it would change incentives, as well as trade and growth strategies, throughout the world. Second, there are information-related market

Figure 1: Revised forecasts for GDP per capita, 2009 (annual change, %)



Source: IMF forecasts and own calculations, scaled for expected population growth.

failures linked to technical change and the adoption of green technologies. Green growth – growth that is efficient enough in its use of energy – depends on level of economic activities, sector distribution of energy use and energy efficiency at firm and household level.

Preliminary research suggests that productive firms tend to be more energy efficient, so private sector development policies that promote productivity growth can also promote greener growth. Support for the adoption of green technology can help narrow the energy efficiency gap between actual energy savings and those that are economically and socially efficient. Further stimulus could go to measures to help people adapt to the realities of climate change.

'What we need now is a 'rainbow' fiscal stimulus, bringing together the best of market, environmental and interventionist approaches'

A red stimulus would inject finance into the economy to stimulate consumption and demand and aim for short-term macroeconomic stabilisation. This would include social programmes to smooth incomes over the cycle, especially for the poorest or those affected by price rises or sudden loss of employment. It could include tax reductions or government transfers, which have little impact on growth, or public investment support for growth-oriented policies. Small and medium enterprises, which require an increase in liquidity, need additional support, as they face greater difficulties in accessing finance than larger firms. The financial crisis will make this worse, as will a lack of trade finance.

A 'rainbow' stimulus

We need a stimulus that brings together the very best of the blue, green and red. Why should developed countries support such a stimulus?

- The crisis, which could outstrip the capacities of developing countries to respond, has been caused by failures in developed countries. In addition, the benefits of higher growth in the developing world will be felt in developed countries. China has been responsible for up to 75% of recent world growth, importing large quantities of goods and services from developed countries. It is the developing world that will account for most of the world's growth this year (even if small). We also estimate that every $6 provided in non-earmarked bilateral aid to developing countries leads to at least $1 in imports from developed countries.
- Countries such as the US and UK have suffered a period of over-consumption, accumulating large debts. It may be that a fiscal stimulus will have less impact here, where additional resources may be used by households to pay back debt, and will work better in the developing world.
- If the poorest countries are unable to put in place a fiscal stimulus, while other richer countries do so, they will suffer from a kind of 'beggar-thy-neighbour' economic nationalism.

How much fiscal stimulus should be provided? The IMF suggests a stimulus of 2% of GDP. Model simulations by the National Institute of Economic and Social Research (NIESR) suggest that such a coordinated developed country stimulus could lead to a rise in GDP of around 1-1.5% in 2009 and early 2010. The smoothing of incomes would entail a cost of at least 5% of GDP for 2008-2009 alone. See a note elsewhere in this pack specifically dealing with this issue.

What mechanisms exist to do this? One channel is Aid for Trade, which urgently needs more funds. Faster budget support would also help to address balance of payments or other issues. Infrastructure spending could also be streamlined and, perhaps, brought forward through the use of development finance institutions. All of this requires improved shock facilities and finance arrangements with improved disbursement rules. These interventions need to be in tune with private sector needs as the mechanisms need to leverage in, not crowd out, other actors.

To conclude, it is clear that developing countries will be hit by a global financial crisis caused by developed countries. While the benefits of a fiscal stimulus might be greater in developing countries, developed countries could benefit through greater demand for their exports. Developed countries should provide a rainbow stimulus for developing countries, including more aid for trade, investment in infrastructure, support for green growth and improved social protection.

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7. Us or them. Them and us. We are all in it together, stupid. How a G-20 supported fiscal stimulus in sub-Saharan Africa can help the G-20 too

By Ray Barrell, Dawn Holland and Dirk Willem te Velde

The G-20 countries have announced fiscal stimuli worth around $2 trillion, to cushion the consequences of the global financial crisis. It will matter greatly for poor countries (non-G-20), such as sub-Saharan African (SSA) countries, whether part of such a stimulus is provided in poor countries or whether the entire stimulus is kept in the G-20. At the same time, exporters in G-20 countries need strong growth elsewhere. The world is linked and inter-dependent, of course, and some are now realising just how true this is.

The World Bank President, Robert Zoellick, has argued that 0.7% of the developed country stimulus, worth around $ 15 billion, should be used to finance a vulnerability fund for developing counties to spend on infrastructure, safety net and projects for small and medium size enterprises (SMEs). The International Monetary Fund (IMF, 2009) provides current baseline projections for 2009 that suggest an aggregate additional financing need for low-income countries of about $25 billion. However much larger financing needs – up to $140 billion – would result if various downside risks were to materialise. The World Bank (2009) suggests that developing countries face a financing gap of $270-$700 billion, depending on the severity of the crisis and the strength and timing of the policy responses. Birdsall (2009) discusses the financial resources for a cash injection into the world economy and suggests that one trillion US dollars could be resourced, though this is not based on needs. Te Velde (2009) uses the revisions in growth forecasts by the IMF (July 2008 to present) and suggests that the global financial crisis has already led to an estimated output loss (assuming that the revisions can be attributed only to the crisis) of $2.7 trillion in the world (around 5% of world GDP), $737 billion in developing countries and $51 billion in sub-Saharan Africa (SSA).

'... we live in an interdependent world. Economic growth in sub-Saharan Africa is good for other regions – for all of us'

ONE is arguing for a countercyclical investment in Africa commensurate with the loss of output caused by exogenous factors flowing from the global financial crisis, and commissioned this research to assess: Impact of countercyclical package commensurate with the output loss for SSA of around $50bn; Impact of countercyclical package of 1% of total global fiscal stimuli (1% of $2 trillion = $20bn); How such sums could be programmed; Benefits for Africa, and for the rest of world/donors of investing such sums.

Developed countries can support a fiscal stimulus in developing countries through increased aid (e.g. in the form of budget support or funds for Aid for Trade and infrastructure). The empirical literature suggests that productive investment in infrastructure increases growth in developing countries. Studies suggest that social rates of return are around 20% for investment in infrastructure.

Barrell et al. (2009) use a quarterly macro econometric model (NiGEM) to simulate a $20 and a $50 billion fiscal expansion in sub-Saharan Africa, financed out of the original developed country fiscal stimuli. Taken together, the developed countries' domestic fiscal stimuli and a $20 billion stimulus for sub-Saharan Africa (this region excludes South Africa and Nigeria, but includes Morocco and Tunisia) spent on current consumption would offset about half the impact of the global financial crisis on GDP growth in SSA in 2009 and 2010, raising growth in SSA by some 2 percentage points in 2009-2010. This still leaves a significant gap in GDP that could be filled by increasing the size of the stimulus package to around $50 billion.

If $50 billion goes to debt relief in SSA, the initial growth effects are small. If the stimulus is spent on consumption (income transfers, social safety nets etc.) it can smooth income losses and increase incomes by 4% in 2009 and a further 1% in 2010. If the stimulus goes to productive investment there is a similar income-smoothing effect over the short term, but in addition there is a long-run positive impact on the level of output, which remains about 1.5% higher, while other stimuli do not shift the long-run level of potential output. Additionally, the stimulus on infrastructure could have a further sustained increase in output by an additional 1%.

A stimulus in SSA of $50 billion has positive effects on global trade, and world GDP would be 0.1% higher in 2009-2010 as a result. US and Chinese exports would increase by about $1.4 billion in 2009; German exports would increase by about $1.9 billion and UK exports by $0.7 billion.

Table 1: Summary of growth projections for sub-Saharan Africa[a]

	2007 (current prices US$)	2008 (real growth %)	2009 (real growth %)	2010 (real growth %)	Long-run impact
Pre-crisis	855.8	6.5	6.5	6.5	Base
Post-crisis		5.4	2.2	1.7	Returns to base
G-20 fiscal packages			3.3	3.2	Returns to base
$20 bn debt reduction			3.3	3.3	Returns to base
$20 bn consumption			4.7	3.7	Returns to base
$20 bn investment			4.8	3.8	Increased by 0.6%
$20 bn infrastructure			4.7	3.8	Increased by 1%
$50 bn debt reduction			3.4	3.5	Returns to base
$50 bn consumption			7.2	3.9	Returns to base
$50 bn investment			7.2	4.1	Increased by 1.4%
$50 bn infrastructure			7.2	4.0	Increased by 2.5%

Note: a) Growth rates for the $20 billion and $50 billion fiscal expansions in SSA also include the spillover impact of currently agreed fiscal programmes in the G-20 economies.

Table 1 summarises the findings in terms of the growth rates of real GDP expected for SSA under the various scenarios. Under a pre-crisis scenario, real GDP in SSA could have been expected to rise by about 6.5% per annum 2008-2010. The crisis has reduced prospects significantly, with growth expected to be just 1.75-2.25% per annum 2009-2010. Announced fiscal packages in the G-20 economies will offset some of this loss, raising the prospects for growth to about 3.25% per annum in these years. On top of this a fiscal stimulus of $20 billion raises growth to average 4.2% in the two years, while a fiscal expansion of $50 billion raises growth to average 5.6% in the two years, largely offsetting the impact of the financial crisis on SSA.

Table 2 provides the costs and benefits to the financing regions, and also to the world as a whole and China, of the $50 billion simulation of investment in infrastructure in SSA, entailing productivity spillovers. Taking the UK as an example, we find that while it spends $1 billion on the SSA fiscal stimulus it gets $0.7 billion back in the form of exports.

These simulations show clearly that we live in an interdependent world. Economic growth in sub-Saharan Africa is good for other regions – for all of us. The benefits of faster growth in Africa are both non-economic: less conflict and more stability, fewer communicable diseases and so on, and economic. Part of the G-20 fiscal stimuli might, very usefully, be spent on development.

Table 2: Impact of sub-Saharan Africa fiscal expansion on financing countries in 2009

	Direct costs	Additional exports	Net impact on real GDP
US	$28.5 bn (0.20% of GDP)	$1.4 bn	+0.003%
Japan	$6 bn (0.11% of GDP)	$0.6 bn	+0.005%
Germany	$6 bn (0.18% of GDP)	$1.8 bn	+0.007%
France	$4 bn (0.15% of GDP)	$1.6 bn	+0.025%
Italy	$3 bn (0.14% of GDP)	$0.7 bn	+0.007%
Canada	$1.5 bn (0.12% of GDP)	$0.3 bn	+0.006%
UK	$1 bn (0.05% of GDP)	$0.7 bn	+0.011%
China		$1.4 bn	+0.016%
World		$20.4 bn	+0.073%

Professor Ray Barrell, Senior Research Fellow, NIESR, Dawn Holland, Senior Research Fellow, NIESR and Dirk Willem te Velde, Research Fellow and Programme Leader, ODI. This is a summary of a paper for ONE. The views expressed are those of the authors alone.

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8. Social protection: a global imperative

By Anna McCord

The contagion effects of the international financial crisis risk reversing decades of progress in developing countries. Without urgent measures to extend social protection for the most vulnerable, hundreds of millions of people will experience worsening impoverishment and destitution.

Progress towards the Millennium Development Goals (MDGs) may well be eroded. As poverty rises, so will malnutrition, ill health and mortality, while rates of school participation may well fall, leading to irreversible human capital losses among the poor, as government expenditure on basic services contracts.

In previous crises, failure to protect the poorest has had a significant and sustained negative impact on poverty and inequality as well as growth. But there is now a brief opportunity to support developing country governments to put the necessary programmes in place before it is too late. This also represents an opportunity to set up systems and ways of working that can provide ongoing social protection on a scaled-down basis once the worst effects of the crisis are over.

The current crisis confronts developing country governments with a paradox; government revenues are shrinking but there is a desperate need not only to protect health and education expenditure but also to invest in increased social protection provision for the poorest. Policies focusing on macro-economic stabilisation or growth alone will not address the current crisis of global impoverishment, or the immediate problems faced by the poorest as a result of the financial collapse.

The current focus on stabilisation may be at the expense of social protection

The international donor community and developing country governments must now work to protect the development achievements of recent decades, and address the immediate needs of the poor as a priority component of their response, alongside initiatives to promote macro-economic stabilisation and stimulate growth. The immediate response of many developing countries has been to restrict government expenditure in the face of falling revenues, and prioritise stabilisation rather than extending expenditure directed towards the poor. However, experience from previous crises highlights the importance of addressing, explicitly, the immediate needs of the poor, while promoting interventions to protect growth in the form of economic stimulus packages. Without this twin-track strategy, addressing both stabilisation and social protection provision, there is a real risk that the poor of today will pay the price for economic recovery tomorrow.

Many international funding agencies are calling on developing country governments to make significant increases in social protection provision. However, despite donor enthusiasm in recent years, and current demands to extend provision, many countries have remained reluctant to adopt comprehensive programmes, even during periods of relatively rapid growth. This reticence is partly a consequence of concerns about the fiscal implications and forward liabilities associated with implementing such large-scale programmes, and the difficulty of scaling down a system once it has been initiated. These concerns are particularly acute, given the volatility of commodity prices, and fluctuations and uncertainties associated with donor aid flows.

What should be done?

Increase funding flows on a medium-term basis. The importance of identifying modalities to address the medium- to long-term recurrent costs of large-scale programmes needs urgent recognition, by both the donor community and by developing country governments. In the current climate, the predictability of official development assistance (ODA) flows becomes all the more critical if governments are to respond to calls to develop, and take ownership of, major expansions in social protection provision. A commitment to increased financial support for affected governments must be central to the international development response, and should include multi-year ODA packages to safeguard the provision of basic health and education services, as well as the extension of social protection for the growing numbers of poor. Such a response is critical to support governments in safeguarding the interests of the vulnerable during the current crisis.

Recognise institutional constraints. Institutional constraints are significant factors that limit the development and implementation of programmes at national level. This undermines prospects for the absorption of significant additional funding flows and the development of expanded social protection provision that enjoys significant national ownership. As such, the international community needs to invest in capacity and institution building, to promote the sustainability of donor-supported interventions, national ownership and the potential to maintain

in the medium to long term instruments developed in response to the crisis. In this way, the problems characterising many internationally funded interventions in recent years, such as parallel implementation structures, can be addressed.

'Experience from previous crises highlights the importance of addressing, explicitly, the immediate needs of the poor'

Rationalise existing social protection expenditure. The current crisis offers an opportunity for national governments to rationalise current programming and expenditure, and for donors to harmonise their own activities at country level, rather than continuing to promote multiple small-scale or pilot initiatives with patchy and inequitable coverage. The rationalisation of current expenditure could result in increased and more equitable coverage, and the simplification of activity in a sector currently characterised by fragmentation and inefficiencies, which exacerbate institutional and ownership problems.

Protect social sector expenditure. There is a simultaneous imperative to protect expenditure in the health and education sectors, particularly at primary level. These sectors are often subject to cuts during periods of budgetary contraction, in the face of competing demands for resources from sectors with more influential champions. It is critical that expenditure in these sectors be protected to ensure continued access by the poor.

In short, developing country governments should:

- Protect existing budgetary allocations to health, education and social protection provision;
- Extend social protection coverage to include the growing number of people in poverty;
- Rationalise social sector spending to address priority needs within the existing resource envelope on the basis of national social protection strategies;
- (Where countries cannot finance social protection provision from their own resources), work with the donor community to establish modalities for financing the recurrent costs and forward liabilities implied by the adoption of a sustained and extended social protection programme;
- Ensure that crisis response policies take into account the immediate needs of those in poverty, as well as protecting macroeconomic stability and growth.

The international community should:

- Maintain the real value of overall international aid allocations and continue to work towards the G-8 Gleneagles commitments;
- Safeguard existing ODA allocations to the health, education and social protection sectors;
- Prioritise increased allocations for social protection provision;
- Work with developing country governments to develop national social protection strategies with extended coverage, rather than continuing to promote multiple small-scale or pilot initiatives with patchy and inequitable coverage; Promote coordination and rationalisation of donor social protection programming to increase efficiency and maximise the impact of expenditure;
- Provide technical assistance to develop appropriate policies to extend coverage;
- Commit to medium- to long-term social protection funding at national level (5 to 10 years), to facilitate developing country government planning and budgeting processes and ownership of social protection initiatives.

9. Aid architecture and the global financial crisis

By Nick Highton and Dirk Willem te Velde

The current aid architecture is not set up to deal with the possible effects of the global financial crisis. Effective shock-response architecture must provide rapid countercyclical resources. Existing modalities are ad hoc and inadequate to address problems on the scale currently being experienced. The G-20 countries need to think about mobilising new sources of financing in the short term to enable existing mechanisms to function, and putting in place a more appropriate and less fragmented architecture over the longer term – one that can both protect against system failure and provide a more flexible and better resourced response in the event of future shocks.

The role of the international financial institutions in the shock architecture

The International Monetary Fund (IMF) has taken steps to strengthen its capacity for financing in crises. For example, in 2004, the IMF introduced the Trade Integration Mechanism (TIM) to mitigate situations where World Trade Organization (WTO) agreements give rise to strictly temporary balance of payment difficulties (e.g. erosion of tariff preferences in export markets, removal of textile quotas). This works by increasing the predictability of resource availability under existing facilities rather than by providing a new mechanism. A key advantage of TIM is that it does not normally involve additional conditionality, and it also builds in possible deviations from the IMF's usual baseline scenarios, which help to provide a greater degree of certainty. In this respect, it could provide a model for dealing with trade-related shocks.

However, new mechanisms such as this are not backed by additional money, leaving a key part of the architecture facing fundamental constraints. Allowing the Fund to issue Special Drawing Rights (SDRs) would require amendments to its Articles of Agreement and could face opposition.

In the longer term, a practical way of building greater speed of response to shocks into existing IMF lending facilities is to build alternative scenarios into all Fund programmes. Thus, programmes could include provisions that lending would automatically increase, should certain levels of deterioration of terms of trade or reversals of capital flows occur while programmes are otherwise on track.

The World Bank is planning to make available crisis-related financing on International Development Association (IDA) terms for 78 of the world's poorest countries though a new Fast-Track Financial Crisis Response (FTCR) facility. FTCR will be designed to provide quick technical and budgetary financial assistance (up to $2 billion of the $42 billion IDA resources, subject to further review) to support a degree of fiscal stimulus, strengthen safety nets and maintain basic services, subject to Board approval. No additional macro conditionality is envisaged, beyond an up-to-date IMF assessment. It is hoped that the FTCR facility will help leverage parallel donor financing. The upfront analytical work to be carried out by World Bank country teams should serve as a basis for donors to make rapid assessments of the situation and help facilitate follow-up on their part. The International Finance Corporation (IFC) has facilities for $30 billion over the next three years, providing resources for a bank recapitalisation fund and distressed infrastructure programmes.

The regional development banks aim to respond to the crisis through resources, for example to provide trade credits. The African Development Bank (AfDB) is observing a worrying decline in African equities, exports and ability to access capital and trade finance, and is establishing an Emergency Liquidity Facility (ELF), tentatively set at $1.5 billion, to provide fast-disbursing liquidity. The Asian Development Bank (ADB) is supporting proposals to establish a so-called Asian New Deal to cushion the impacts of the global financial crisis through coordinated financial assistance. The ADB response is constrained by a lack of capital. The Inter-American Development Bank (IADB) might seek a capital increase from members to allow it to expand its lending.

'New mechanisms to address the crisis are not backed by additional money, leaving a key part of the architecture facing fundamental constraints'

The European Union and bilateral donors

The EU's FLEX (part of the European Development Fund – EDF) is unlikely to reach its full potential in its current format. Allocations to countries are small, and are calculated on the basis of historic vulnerability, which is inappropriate to current circumstances.

Bilateral donors cannot, typically, reorient flows quickly, although fast-disbursing budgetary aid provided by EU countries, including early disbursements of EDF (subject to relaxation of disbursement rules) and concessional financing provided by the World Bank and regional banks though similar mechanisms, could provide an opportunity if financing were brought forward for countries requiring a rapid fiscal stimulus. Such responses should have low conditionality and require no more than, for example, approved annual Art. IV consultations to ensure that acceptable macroeconomic frameworks are in place.

Can development finance institutions play a countercyclical role?

The G-20 countries are shareholders of a range of bilateral, regional and multilateral Development Finance Institutions (DFIs). The DFIs serving the private sector (e.g. IFC, EIB, DEG, FMO, CDC, EBRD, AfDB) have had long experience in using financial instruments on commercial terms (loans, equity positions and guarantees) on the basis of state-backed guarantees or loans. It is important to recognise the contribution of DFIs (worth $50 billion in 2006/07), as capital may have already become a binding constraint in many countries, and to consider whether DFIs can play a countercyclical role.

Until recently, DFIs had substantial liquid assets (e.g. cash) in their balance sheets. Capital adequacy ratios had increased dramatically. For example, the IFC reached a level of 57% in 2007, much higher than the recommended 30% (i.e. they have not been able to find enough profitable projects in recent years). This may now change, and DFIs need to ensure that they can continue to promote capital flows to developing countries in 2009 and 2010. As mentioned above, the IFC has announced a number of schemes (including dealing with trade finance); the EBRD will be increasing its exposure by 20%.

New aid, incentives and regulations would need to ensure that DFI finance is used to overcome market and coordination failures (e.g. the current herding behaviour in trade finance, or the mismatch between financial and real rates of return) and promote capital to countries and sectors that are affected by the crisis. Practically, this could involve recapitalisation of multilateral DFIs; revised investment targets for countries; incentives for investment officers inside DFIs; and new crisis funds that could be linked to DFI operations in a transparent and open way, similar to the global partnership of output-based aid (see Te Velde and Warner, 2007). A survey among European development financial institutions (EDFIs) suggested that the financial crisis had not yet hit hard by the end of 2008: they expected that the effects would become evident later in the year. EDFI members were already seeing an increase of projects in the pipeline. Promoters are increasingly turned down by commercial banks for financing of their projects or promoters are afraid that their credit facilities will be withdrawn and are therefore contacting DFIs.

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10. Beyond the numbers: combating the crisis in poor countries requires more than just cash

By Geoff Handley and Tony Killick

The forthcoming G-20 summit in London will focus on plans to address the global financial crisis, and perhaps even strike a 'grand bargain' to ensure that a crisis of this magnitude cannot happen again. Debates surrounding any such bargain will rightly involve calls for support to low-income countries suffering from the crisis.

Much of the debate about how rich countries can help has centred on building a coalition for vast and rapid additional resource flows to countries that have insufficient fiscal space to protect the poor during the crisis. This has been accompanied by numerous 'back of the envelope' calculations about what appropriate volumes might be.

The President of the World Bank, Robert Zoellick has proposed that 0.7% of rich countries' stimulus packages should be pledged to a vulnerability fund to assist the poorest developing countries. Nancy Birdsall, President of the Center for Global Development (CGD), argues that, in order to help emerging market economies as well as poor countries, $1 trillion will be required (Birdsall, 2009). World Bank Chief Economist Justin Lin has even argued for provision of $2 trillion, spread over five years. At the same time, some donors have been quietly reneging on their aid commitments and it is not clear how these competing wishes will play out.

Whether or not such additional resources are found, it is important to remember the hard learned lessons of how to deliver aid effectively and what it can achieve, realistically, in a short timeframe. Some key principles are needed to inform any additional aid spending during the crisis:

Rationalise and coordinate, rather than fragment: Creating new funds and initiatives imposes a negative externality by adding to the complexity and fragmentation of the aid non-system. We should guard ourselves against the 'innovation-itis' that assumes that each new problem needs multiple new initiatives. For example, at a conservative estimate, 18 different global climate funds for developing countries have already been set up. We also need a better coordinated response. Lessons from previous multilateral responses to crises suggest that a lack of coordination between the International Monetary Fund (IMF), World Bank and the regional banks hampered the efficacy of the response.

Take country context into account: The World Bank has suggested that countries be classified according to their exposure to the crisis and how far they are able to cope with it. In the most exposed countries, the binding constraint is often a lack of institutional capacity to deal with additional spending. The Bank suggests briefly that 'tax measures' may be a way that such states can respond to the crisis. For example, reductions in VAT or similar taxes could be a simple, quick and possibly equitable way of raising consumer purchasing power, even though tax exemptions might be difficult to reverse later and could weaken domestic accountability between tax payers and the state.

Ultimately, the capacity to spend large amounts at short notice is limited in many countries. This has implications for how aid should be delivered in a recessionary crisis. The crucial principle is that it should be capable of being spent quickly. From this standpoint, budget support is much to be preferred over time-consuming aid financing projects or special funds. It also suggests that much of the mooted 'vulnerability fund' should be provided through the IMF: as the institution designed to cope with macro crises, its assistance can be mobilised and spent more quickly. One possible option for this is the creation of additional Special Drawing Rights (SDRs), although that would only work if the Fund did not insist on strict policy conditionality.

'It is important to remember the hard learned lessons of how to deliver aid effectively and what it can achieve, realistically, in a short timeframe'

The World Bank should also play an important and complementary role in the crisis. This could be helped if, as the UK's Secretary of State for International Development, Douglas Alexander, has argued recently, the Bank is able to make money available more quickly, to relax restrictions on the amount it can lend to countries and to remove the 30% ceiling on the proportion of funding that can be provided to the poorest countries as budget support (DFID, 2009).

Be realistic about what can be achieved with aid: We must be careful to distinguish between aid flows and fiscal stimuli. Aid only enables an economy to invest and consume more by financing an increase in imports relative to exports. In such situations, extra spending capacity is matched by more imports so

there is no net addition to domestic demand (Killick and Foster, 2007). This should not detract from the case for aid to finance investment and protection for the poorest at a time when it is urgently needed, however. The new aid-financed spending may still be of much economic value but that would depend on recipient government ability to spend well or to reduce taxes (see above). This also highlights another advantage of using an SDR issue to provide finance during the crisis: it would provide genuinely expansionary resources.

To avoid waste and delay, the emphasis should be placed on the accelerated completion of ongoing or planned investment projects rather than new initiatives, which may either take too long to develop or be wastefully hurried. The same goes for expenditures aimed at providing social safety nets. One of the key lessons from the Asian financial crisis was to expand established safety net programmes rather than create new ones.

Do not forget aid quality: Principles of aid effectiveness are as important in a crisis as at any other time, and can even help point to less distortionary ways of channelling additional aid. Hard-won commitments to untying aid should remain in place, especially given the imperative for rapid disbursement. The availability of additional crisis resources should not let donors off the hook from honouring their existing aid commitments.

One improvement to aid quality donors could introduce at the stroke of a pen would be dropping their insistence on tax exemptions for projects that they finance (as the World Bank has done). The default position should be payment of taxes, with clearly defined and commonly agreed criteria for opting out. This would be equivalent to providing additional general budget support. Both budget support and payment of taxes would seem the most consistent means of rapidly delivering substantial and additional resources while maintaining aid effectiveness commitments.

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11. The G-20 and low-income countries: a growing crisis or growing out of a crisis?

By Dirk Willem te Velde

The best way for developing countries to get themselves out of the current crisis is faster and sustained economic growth. The G-20 should be a help, not a hindrance, to this process. The crisis has put pressure on all important sources of external revenues for developing countries: exports, remittances, foreign direct investment (FDI), equity flows, with significant effects on the real economy. Revisions in growth forecasts for 2009 already imply a 3.5 percentage points slower output in 2009 alone. World income per head is expected to decline and Africa's would hardly grow. Slower growth will compromise development successes based on fast growth over the past decade. A crisis of this magnitude could provide a critical juncture for growth models. The question is, which way will it go? Could developing countries engage more intensively in growth-promoting policies based on appropriate institutions? Beyond aid (Te Velde, 2009) that is well managed (Handley, 2009), how can the G-20 support developing country growth?

'Can the G-20 remain committed to supporting growth policies in low-income countries?'

Economic policies: short term

Developing countries are now in a better fiscal position to smooth the impact of the downturn than a decade ago. However, while many have built up external assets, there are concerns about countries whose current account deficits have recently ballooned owing to the food and fuel crisis, and about the flexibility of the fiscal and monetary institutions in some countries. The International Monetary Fund (IMF, 2009) estimates a balance of payments shortfall of at least $25 billion.

Few poor countries have such leveraged financial systems as in developed countries, and many do not have a large short-term foreign debt that needs financing (unlike e.g. Pakistan, Iceland and Hungary). But some do. Countries need to be able to put in place short-term monetary easing and countercyclical banking reserve requirements to counteract falling deposits (Cambodia).

The social effects are already visible in developing countries. There have already been mining job losses in Zambia following a reduction in copper prices by 40%. More than 20 million urban workers in Cambodia, China, India and Bangladesh have lost their jobs and returned to rural areas. Unchecked, short-term shocks may have long-term growth implications when productive assets depreciate faster in a crisis.

It is important that countries can respond immediately and are not constrained by externally imposed slow disbursement rules or conditionalities, which hampered the recovery process in previous crises.

Economic policies: long term

The most obvious response to the crisis is to accelerate reforms and introduce policies to attract investment and promote growth. While the constraints to growth are country specific, low-income countries also face common long-run challenges to growth and the G-20 can be a help or a hindrance.

- While openness to trade makes countries more vulnerable to downturns elsewhere, it has frequently increased growth and productivity in developing countries. No country has become rich behind protected borders. The G-20 must remain open to imports from developing countries.
- Openness to financial markets increases the risks of financial contagion, yet openness to foreign banks has over the longer term increased productivity and innovation in the financial sector. The G-20 needs to ensure that banks be better regulated but not be forced (directly or indirectly) to withdraw from low-income countries.
- Countries such as Bangladesh, Philippines and smaller countries rely on migration opportunities to G-20 countries – which are at risk of becoming protectionist, a fast way of getting deeper into recession.
- It is easier to cut spending on infrastructure and long-run capital-intensive projects in light of the current crisis, but these projects are needed for growth and human development in the long run. The G-20 could plug the financing gap for the private sector and ensure that development finance institutions are able to service increased demand from the private sector.
- With foreign resources receding, the onus is on finding domestic resources. But countries frequently have ineffective tax policies with high tax incentives in special industrial zones. The crisis could make this worse if countries engage in a race

to the bottom by slashing taxes and royalties to attract investment; instead, developing countries should ensure that they engage in a competitive but transparent tax rate, sufficient to pay for growth-enhancing public goods. Reform of revenue authorities, implementation of tax policies that fit into a development strategy and increased transparency supported by G-20 companies might help to improve tax revenues.
- Strategic industrial policy is back as confidence in the market has been lost. However, the G-20 might engage in industrial policy types that are close to economic nationalism, at the cost of developing countries. 'Buy local' campaigns need to be avoided; promoting capacity positively (targeted human resource development) is better.
- Faster adoption of green technologies is likely to help growth directly. The G-20 can support this greening process, which in essence is a process of innovation.

Some policy choices are urgent. There have already been protests in Turkey, Ireland and Iceland. Can the G-20 remain committed to supporting growth policies in low-income countries?

Institutions

To respond to the challenges of the global financial crisis and be able to make the right policy decisions, it is important that developing countries themselves set up effective country-specific taskforces to deal with the fallout. The foundations of state–business relations will be shaken; only the most institutionalised (in the formal or informal sense) can act in an effective way (Sen and Te Velde, forthcoming) to address market and co-ordination failures in development. Throughout the developed world, the public sector has taken over banks, forcing them to lend to small enterprises. There is now a shared belief that (financial) markets can fail (Te Velde and Morrissey, 2005) signalling the end of 'laissez faire'. There are also new initiatives in developing countries. Ghana, for example, has set up a commission to monitor the impact of the crisis, South Africa introduced a new sub-committee of the national body governing relationships amongst government, business and labour and Mauritius has used its already established institutions to respond flexibly. There will be an increased emphasis on the functioning of state-business relations to guide development.

Box 1: Mauritius: A pre-emptive strategy to address the global financial crisis

Mauritius has been quick to put in place new economic policies and build on an effective institutional framework for state–business relations, launching a stimulus plan in May 2008 worth 3.4% of GDP and an additional one in December 2008 worth about 3% of GDP.

The country benefits from an institutionalised setup to deal with the crisis. The Prime Minister set up two Ministerial Committees in November, 'Nurturing Resilience' headed by the Prime Minister and 'Human Capacity, Solidarity and Physical Infrastructure' headed by the Vice Prime Minister and Minister of Finance. After the additional stimulus package was announced, a Committee was set up, co-chaired by the Secretary to the Cabinet and the Joint Economic Council (JEC), the private sector coordinating institution.

Source: Ministry of Finance, Mauritius.

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12. Is the G-20 a temporary sticking plaster or a full organ transplant?

By Simon Maxwell

Great hopes have been vested in the London Summit of the G-20 leaders, which Gordon Brown will chair in London at the beginning of April. The Summit will bring together the Heads of Government of the world's largest economies, along with regional groupings like the European and African Unions, as well the heads of international institutions like the World Bank and the International Monetary Fund (IMF). The world's financial system will be saved. Growth will be re-established. Development needs will be met. A green agenda will be pursued. And, along the way, the governance of international institutions will be reformed.

Of course, this agenda is the right one, and the proposed actions are necessary. But the fact that the G-20 has taken on the mantle of leadership raises questions about the future configuration of global governance.

Optimists see the G-20 as providing a template for a more democratic future. They note that the group of G-20 was established in 1999 as a meeting of Finance Ministers, specifically to tackle problems in the global economy. It was seized upon last year as a vehicle for leaders to tackle the global crisis. Like the G-8, it is high-level, strategic, and light in terms of administration. Unlike the G-8, it is not simply a club of rich, industrialised countries, but also recognises the growing economic weight and power of the so-called emerging economies, like China, India, Brazil and South Africa. The official presentation of the G-20 makes the case:

'*Together, member countries represent about 90 per cent of global gross national product, 80 per cent of world trade ..., as well as two-thirds of the world's population. The G-20's economic weight and broad membership gives it a high degree of legitimacy and influence over the management of the global economy and financial system*.'

Real enthusiasts go further. They would like to see the G-20 replacing the G-8. They have further ambitions with regard to the agenda. They suggest that a permanent secretariat is needed. And they would like to see all of this cemented at the London Summit.

Sceptics take a different view. Leaders turned to the G-20 opportunistically at a time of crisis, and were right to do so. Tackling the financial crisis is within its remit. It does, indeed, have wider participation than the G-8. And, no doubt, there will be work to do after London, which will need careful management. But, in the end, they say, the G-20 suffers from the same lack of democratic legitimacy as the G-8, and the same limitations. South Africa is in, but Switzerland, Swaziland and Singapore are not. Furthermore, the G-20 runs the risk of encroaching on other fora. The G-20 can opine on trade, but cannot replace the World Trade Organization. It can issue warnings on climate change, but cannot rewrite the UN Framework Convention on Climate Change.

'The G-20 is the right short-term solution. The UN is the right long-term solution'

There is another institution that does allow for the participation of smaller countries, and whose writ does extend to the wider agenda, and that is the Economic and Social Council of the United Nations. ECOSOC was established under the UN Charter in 1945, specifically to lead global economic and financial discussion. It is a representative body, accountable to the General Assembly of the UN. It has authority over the specialised agencies of the UN, including, in theory, the IMF and the World Bank.

However, there is a problem. ECOSOC is widely derided. It may be representative, but critics say it has no authority and does not lead. It has played no part yet in solving the current financial crisis. It is true that the President of the General Assembly has established a commission of experts on reforms of the international monetary and financial system, led by Professor Joseph Stiglitz. The President of the GA will also convene a Conference on the Global Financial and Economic Crisis and its Impact on Development, to be held in New York in May this year. These are good initiatives, but the financial crisis has been with us for a year. Lehmann Brothers collapsed six months ago. The G-20 will have met twice at Heads of Government level before the UN Conference convenes – and, on present evidence, has a wider mandate.

This is not good enough. ECOSOC, its critics say, is the victim of UN politics, hobbled by the tension between the big powers in the G-8 and the develop-

ing countries in the G-77; by disagreement between those with votes and those with the money needed to implement decisions.

So, ECOSOC has the broad mandate and the legitimacy, but finds it hard to deliver. The G-20 has neither the full mandate nor the accountability, but can deliver. This is the dilemma of global governance. An ideal solution would be universal in membership, democratic in its structures, accountable to a wider public, and efficient, effective and speedy in its work. Is this too much to ask for? Apparently so, at least for now.

Leaders then have two options in April. Either, they give up on the UN and opt for further strengthening of the G-20, with a wider mandate and with a permanent secretariat. We could see G-20 Summits running in parallel with and eventually superseding the G-8. Or they could turn their backs on élitist bodies like the G-20, insist on reform of ECOSOC, and demand better performance from the UN.

Or – an attractive compromise – they could do both. The G-20 is the right short-term solution. The UN is the right long-term solution. That suggests that the G-20 should have UN issues on its agenda in April and also avoid taking actions that will make UN reform more difficult. The G-20 should channel some of the extra money it will raise through the UN, especially in the form of grants rather than loans for the poorest countries. It should look to changes to financial regulation that are accountable through the UN. It should certainly agree to reform the governance of the World Bank and the IMF, including open competition for leadership positions. The G-20 should support UN bodies active in other fields of development, like the UNFCCC. And, as a high-profile and urgent outcome, the G-20 should declare its commitment to a reformed and more effective UN. In the 1940s, the Bretton Woods Conference, which led to the establishment of the World Bank and the IMF, ran in parallel with Conferences at Dumbarton Oaks and in San Francisco, which led to the creation of the United Nations. If the G-20 is the forum for a new Bretton Woods, can it also give impetus to a new San Francisco? Can the G-20 put democratic accountability at the heart of its proposals for a new world?

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